Exempt Organizations and S Corp Stock: Resolving Complex Tax Challenges
Leveraging Entity Structure, Navigating the IRS Supporting Organization and Excess Business Holdings Rules

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Exempt Organizations and S Corp Stock: Resolving Complex Tax Challenges

November 19, 2014

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Overview

• This seminar is primarily concerned with the tax consequences of donations of S corporation stock to tax-exempt organizations.

• We examine the results from the perspective of the shareholder/donor, the charity, and the S corporation itself.
Background

• Taxation of Corporations
• Taxation of S Corporations
• S Corporation Qualification
• Operating Issues
• Donation of Stock
Taxation of Corporations

- Generally, a corporation is subject to double taxation.
- Income is taxed at the corporate level.
- If a cash or property dividend is paid to shareholders, that distribution is generally taxable again at the shareholder level.
## Taxation of Corporations

### Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate taxes (40%)</td>
<td>-$40</td>
</tr>
<tr>
<td>Cashflow available for dividend</td>
<td>$60</td>
</tr>
<tr>
<td>Dividend to shareholders</td>
<td>$60</td>
</tr>
<tr>
<td>Tax rate to shareholders on dividend income (25%)</td>
<td>-$15</td>
</tr>
<tr>
<td>Net after-tax cash flow</td>
<td>$45</td>
</tr>
<tr>
<td>All taxes ($40 + $15)</td>
<td>$55</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>55%</td>
</tr>
</tbody>
</table>
Taxation of S Corps

• In contrast to a regular corporation, an S corp is subject to only one level of taxation.

• Income is earned at the corporate level, but is taxed directly to the shareholders.

• If the earnings of an S corp are distributed to shareholders, that distribution is generally not taxed again.

• But – if other cash/assets of an S corp are distributed to shareholders, result may differ.
### Taxation of S Corps

#### Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate taxes (0%)</td>
<td>-$0</td>
</tr>
<tr>
<td>Cashflow available for dividend</td>
<td>$100</td>
</tr>
<tr>
<td>Operating income directly taxed to shareholders</td>
<td>$100</td>
</tr>
<tr>
<td>Tax rate to shareholders on S corp income (45%)</td>
<td>-$45</td>
</tr>
<tr>
<td>Net after-tax cash flow</td>
<td>$55</td>
</tr>
<tr>
<td>All taxes ($45)</td>
<td>$45</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>45%</td>
</tr>
</tbody>
</table>
Taxation of S Corps

• Generally, the operating income of an S corp is subject to a single level of tax while the operating income of a regular corporation is subject to double taxation.

• This appears to be an advantage but consider:
  • Are significant amounts of earnings of the business regularly distributed to shareholders?
  • Are shareholders also employees and do they take out large amounts of compensation?
Shareholder Employees

• A regular corporation in which shareholders are also employees may not have a double taxation problem.

• Effectively, the earnings of the corporation are paid out in salaries. Provided the salaries are reasonable, they are deducted by the corporation and are taxed to the employee.
Qualification Issues

- Corporations eligible
- How many shareholders
- Who can be a shareholder
- Type of stock
- How to make the election
Eligible Corporations

• must be a “domestic” corporation
• can’t be an insurance company – i.e., taxed under subchapter L
• no:
  • foreign corps
  • possessions corps
  • DISCs, former DISCs, foreign sales corps
Eligible Corporations

• an LLC, LP, or other type of partnership entity can elect to be taxed as a corporation.
• such an entity can then elect to be an S corp
• but still have to follow the eligible corp rules
Eligible Corporations

• a corporation that is a member of a consolidated tax group is not eligible

• but – a parent/subsidiary group can qualify:
  • if parent is an eligible corp, it can elect to be an S corp, and can elect to treat its wholly-owned subsidiaries as “Qsubs” (qualified subchapter S subsidiaries)
  • a Qsub is treated as a disregarded entity – in effect a division of the parent S corp
Who Can Be A Shareholder

• One of the most difficult aspects of managing an S corp is ensuring that the shareholder qualification rules are satisfied.

• Permitted shareholders
  • US citizens or residents
  • certain types of trusts
  • certain types of estates
  • certain tax-exempt entities
How Many Shareholders

• An S corporation cannot have more than 100 shareholders.

• limit does not apply cumulatively – if the identity of the shareholders changes over the year, but does not exceed 100 at any given time, no violation

• counting rules:
  • spouses treated as a single shareholder
  • family members are treated as a single shareholder
How Many Shareholders

• Look only at the entity/person who includes the S corp earnings in income.

• Example:
  • Smith owns a single member LLC that is treated as a disregarded entity. The LLC owns stock in an S corp.
  • Smith also owns stock in the S corp directly.
  • Smith and his LLC are counted as only a single shareholder.
How Many Shareholders

• Approved workaround on 100 shareholder limit:
  • 200 investors are interested in funding a new business.
  • Organizers form S Corp A and S Corp B, each with 100 shareholders.
  • Corp A and Corp B form an LLC that owns and operates the new business.
• Rev. Rul. 94-43
Who Can Be A Shareholder

• US citizens or residents
  • A non-resident alien is not a permitted shareholder.
  • To qualify as a resident alien, need to meet residency tests.
  • Trap – resident alien status may change. If a shareholder no longer qualifies, may be a violation.
Who Can Be A Shareholder

Trusts

• grantor trusts – generally ok
• testamentary trusts – ok for 2 years after receipt of stock
• voting trust – generally ok
• Qualified Subchapter S Trust (QSST)
  • single income/corpus beneficiary
• Electing Small Business Trust (ESBT)
  • some complex trusts
Who Can Be A Shareholder

• Estates
  • The estate of an otherwise qualified shareholder is also a permitted shareholder
  • Applies only for a reasonable amount of time.
  • Upon transfer of the S corp stock to the estate’s beneficiaries, the beneficiaries must qualify on their own terms.
  • A bankruptcy estate is a permitted shareholder if the bankrupt shareholder was a qualified shareholder.
Who Can Be A Shareholder

Partnerships, LLC, LPs, LLPs, etc.

- Generally, any entity that is treated as a partnership for tax purposes cannot be an S corp shareholder.

- However, if the entity is treated as a disregarded entity for tax purposes, and the owner is a permitted shareholder, then not a violation.

Corporations

- Cannot be a qualified shareholder (unless meet exempt org exception).
Who Can Be A Shareholder

- Exempt Organizations
  - Permitted, but all income treated as UBIT and thus currently taxable.
  - However, this does not apply to an S corp ESOP.
Exempt Organizations

• Tax-exempt organizations not permitted shareholders until Small Business Job Protection Act of 1996 (which made a number of changes to the S corporation rules).

• Why was this changed?

• Committee report states:
  • qualified retirement plans added to encourage employee ownership
  • charitable organizations added to help with estate planning and encourage charitable giving.
Permitted Stock

• An S corp can only have one class of stock.
  • Look at all economic rights of the stock – are there different dividend, liquidation, or security rights?
  • Differences in voting rights generally ignored.
• Have to be careful if have debt with equity-like features.
• Incentive compensation arrangements are permitted, but must be careful.
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Making The Election

- An S corp election can be made at any time, subject to the following limitations:
  - All the shareholders must consent.
  - An election generally is effective for the next full tax year.
  - However, if make an election within 2½ months after the start of a tax year, election can be retroactive to the start of that year.
  - Relief available for late elections.
Terminating The Election

- Voluntary
  - majority of shareholders can revoke S corp election
- Involuntary
  - violate any of the S corp qualification rules
    - impermissible shareholder
    - number of shareholders
    - single class of stock
  - Passive Income Rule – applies only to a regular corporation that elected to be an S corp
Re-Election

• If terminate an S election (voluntarily or involuntarily), generally have to wait 5 years before can elect again.
Operating Issues

• Tax Distributions
• Shareholder Agreements
Tax Distributions

• S corp earnings are taxed to shareholders

• Often shareholders will agree to make S corp make cash distributions sufficient to pay tax on those income inclusion.

• Format

  • fixed tax rate times amount allocated
  • take into account prior losses
  • Cannot violate single class of stock rule, so need to make same per share distributions.
Shareholder Agreement

- Changes in shareholders can cause a termination.
- S corp shareholder agreements can
  - limit transfers of stock
  - limit quasi transfers (pledges, escrows, etc.)
  - grant rights of first refusal to S corp or other shareholders
  - require notice of events likely to end qualified shareholder status
Donating Stock

- Donating Stock vs. Donating Cash
- Special Rules on Donating S Corp Stock
- Valuation
Donating Stock

• The tax code incentivizes donations of appreciated stock.

• Generally, stock held for more than one year and donated to an exempt organization will generate a charitable deduction equal to the FMV of that stock.

• Note that the deduction is subject to the 30% AGI limitation (20% if the donation is to a private foundation), but the unused balance can be carried forward.

• This is a substantially better result than selling the stock and contributing the proceeds to charity.
Donating Stock vs. Cash

Example 1

• Jane Doe owns 1 share of Acme Corp., which she has held for 20 years. Tax basis is $0 and FMV is $1mm.

• She sells the stock, receiving $1mm in proceeds, and then contributes the proceeds to the Red Cross.

• She receives a $1mm charitable deduction, assuming the 30% of AGI limitation does not apply.

• Key – by selling the stock before donating it, Jane also has a $1mm capital gain.
Donating Stock vs. Cash

Example 1

• If Jane is subject to a 30% tax rate on capital gains and a 45% tax rate on ordinary income, the two transactions could yield a net tax benefit of about $150,000.

• However, if Jane’s capital gain from the stock sale is offset against her charitable deduction, then she could have a considerably smaller tax benefit.
Donating Stock vs. Cash

Example 2

• Same facts, but Jane donates the stock directly to the Red Cross.

• Jane receives a $1mm charitable deduction, assuming the 30% limitation does not apply.

• Key – the donation does not cause Jane to be taxed on the appreciation in the stock.

• If Jane is subject to a 45% tax rate on ordinary income, the direct donation could result in a $450,000 tax benefit.
Donating S Corp Stock

• While the rules favor direct donation of LT stock positions, a different rule applies in the case of S corporation stock.

• The amount of the deduction is reduced to the extent a sale of the S corp’s assets would produce certain types of ordinary income.

• The “hot asset” rules of §751 are incorporated to determine the ordinary income element of the deemed asset sale. Accordingly, an S corp with depreciation recapture, unrealized receivables, and inventory will be implicated.
Donating S Corp Stock

Example 3

• John owns all the stock of ServCo, which provides services to the public. ServCo’s most valuable assets are its accounts receivable. ServCo is on the cash method and has not included these accounts in income.

• John retires and donates all of stock in ServCo to his church. Assume the FMV of the stock is $1mm and that the FMV of the A/R is $900,000, while the rest of the assets have a FMV of $100,000. Assume John has a basis of $0 in the stock and the assets.
Donating S Corp Stock

Example 3

• If ServCo had sold its assets, it would recognize $900,000 of ordinary income under §751 principles, and $100,000 of capital gain.

• This $900,000 of ordinary income reduces John’s allowable charitable deduction from $1mm to $100,000.

• John will have to carefully model whether he is better off making a stock donation or selling the stock to a third party and then donating the proceeds.
Donating S Corp Stock

Example 4

• Same facts, but John terminates his S election upon his retirement. Because ServCo is no longer an S corporation, the look-through rule of §170(e)(1) no longer applies.

• John donates his stock and gets a $1mm charitable deduction.
  • NB – a termination pre-contribution may also be beneficial to the donee charity as discussed below.

• KEY – will the termination be respected for tax purposes?
Donating S Corp Stock

• Another complicating factor that applies if S corporation stock is donated is the valuation issue.

• While the value of publicly-traded stock can be easily determined, it is much more difficult to value private company shares.

• Absent unusual facts, a qualified appraisal will generally be required. Note that an appraiser is likely to include a discount for lack of marketability. If less than 50% of the stock is donated, a minority discount is may also be appropriate.
Corporate-Level Issues

• Short-Year
• Distributions/Single Class of Stock
Corporate-Level Issues

• What issues are raised from the perspective of the S corporation of a donation of some or all of its stock to a charity?

• If there is a valid pre-donation termination, then the corporation may have a bifurcated tax year.
Corporate-Level Issues

Example 5:

• Assume ServCo has a calendar tax year.

• John terminates the S election of ServCo on 7/1/2014.

• ServCo will have a short “S” tax year from 1/1/2014 to 6/30/2014, and a short “C” tax year from 7/1/2014 to 12/31/2014.

• With certain exceptions or if a closing-of-the-books election is made, items of income and loss will be allocated pro rata between the two short tax years.
Corporate-Level Issues

• As explained below, all S corp income will be subject to UBIT. A charitable donee will be concerned about cash flow – it will need the S corporation to make cash distributions that at least cover the tax liability.

• Recall, that an S corporation can only have a single class of stock.

• If a charitable donee is given all the stock of the S corporation, it should be able to obtain sufficient control to require the S corporation to pay tax distributions.

• What if the charity does not have majority control?
Corporate-Level Issues

Example 6:

• Eve owns all the stock of Newco, an S corporation. She donates 40% of the stock to Charity on 1/1/2014.

• Newco earns $1mm in 2014. Eve also works for Newco and receives a large salary. Eve’s business plan is to reinvest as much of Newco’s earnings as possible in order to fund future growth. Accordingly, she traditionally do not make any distributions and uses her own salary to pay the tax on the flow-through income.
Corporate-Level Issues

Example 6:

• In early 2015, Charity receives an estimate of Newco’s earnings and determines that it will have $400,000 of UBTI for 2014. It further estimates that it will have a tax liability of $160,000 on this income.

• Charity requests that Jane cause Newco to make a distribution to it of $160,000.

• Jane is told that if Newco makes a distribution to Charity, it will also have to distribute $240,000 to Jane.

• Jane refuses.
Corporate-Level Issues

Example 7:

- Same facts, but Charity conditions accepting the stock on a requirement that Newco make tax distributions each year.

Example 8:

- Same facts, but Charity conditions accepting the stock on a termination of the S election.

Example 9:

- Same facts, but Charity refuses the gift.
Corporate-Level Issues

• If a charitable donee is given all the stock of an S corporation, it may desire to impose governing rules that are consistent with its own mission statement.
  • religious restrictions
  • profit maximization
  • charitable donations by the S corp
• Not a tax issue.
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Sales Instead of Donation
Sales to Charities

- Instead of donating S corporation stock to a tax-exempt organizations, can a shareholder sell the stock for cash to such an entity?
- Most charities will not be interested in such a transaction.
- Among other things, it may implicate a number of fiduciary and valuation concerns, as well as the operational tax rules discuss herein.
If an public charity is unwilling to buy the stock of an S corporation, can the shareholder form a private foundation to do the same?

Technically, this could be done, but it is not clear how using a private foundation would ameliorate any of the issues raised elsewhere.

Where would the PF get the funds?

What valuation would be used?
Sales to Private Foundation

- in addition to all the issues raised elsewhere, this would likely trigger the excess benefit transaction ("EBT") rules.
- Those rules would put great focus on the valuation and would also feed back into the purpose for forming the PF.
- The EBT rules could require that the sale be undone, that the consideration be returned, and may assess significant penalties against the PF founder.
Sales to Private Foundation

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Alternatives

- ESOP
- Charitable Giving Program
ESOPs

• An ESOP is an eligible shareholder.
• An ESOP is not subject to UBIT on S corporation income.
• ESOPs can purchase stock of the S corporation from existing owners.
• Numerous details and compliance issues, but can eliminate tax on S corp earnings if done correctly.
Charitable Giving

• An S corporation can make charitable contributions.
• These gifts do not get netted out of taxable income, but flow through as separate items to shareholders.
• Thus, the utilization of an S corporation’s charitable donations is determined at the shareholder level.
• Assuming reasonable assumptions are made, it should be possible to develop a charitable giving program at the S corporation level that will generally benefit the shareholders.
Charitable Giving

Example 10

• Newco is owned 100% by Adam. Newco adopts a charitable program starting in 2014 in which 20% of its estimated taxable income will be donated to Adam’s church (a valid public charity).

• In December, 2014, Newco estimates that its taxable income will be $1mm. It makes a donation of $200,000 to the church by 12/31/2014.
Charitable Giving

Example 10

• Adam receives a K-1 for 2014 showing $1mm of taxable income and a separately stated $200,000 charitable deduction.

• Adam’s other income and losses are such that he can fully deduct the contribution, so that his net income from Newco is $800,000.
Charitable Giving

Example 11

• Same facts, but Newco votes to make the charitable deduction by the end of each year and fund the gift within 2½ months after the end of each year, relying on §170(a)(2).

• IRS takes the position that §170(a)(2) does not apply to S corporation.
Charitable Giving

Example 12

- Same facts, but instead of a charitable giving program, Adam donates 20% of Newco’s stock to his church.
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Definition of Exempt Organization

• Who are EOs
  – For purposes of our discussion: tax-exempt organizations described in Section 501(c)(3) of the Code
  – or, unless otherwise noted, pension trusts described in Section 401(a) of the Code
How EOs are subject to income tax

- EOs’ income is generally exempt from income tax
  - Code Section 501(a)

- However, income from trade or business not substantially related to exempt purposes (“UBI”) is taxed
  - Code Section 501(b)

- UBI is addressed in Code Sections 511-514 and includes income from a business, as well as investment income under some circumstances

- An EO’s taxable UBI is the net income from trades or businesses regularly carried on that are not substantially related to exempt purposes
  - But a Section 401(a) trust’s taxable UBI is income from any trade or business
How EOs are subject to income tax

• For purposes of determining tax on UBI, all provisions of Code apply unless otherwise provided in Subchapter F

• EO organized as corporation or trust pays tax at corporate or trust respective rates with usual deductions
How EOs are subject to income tax

• Generally, passive investment-type income is not subject to tax, and excluded from UBI, when earned by an EO. This includes:
  – Dividends
  – Interest
  – Royalties
  – Rents
  – Gains and losses from the sale or other disposition of property (other than stock in trade or property held primarily for sale to customers in the ordinary course of trade or business)
    – This has important consequences with respect to S corp stock!
How EOs are subject to income tax

• Generally, an EO’s income from a passthrough entity follows regular tax rules
  – It passes through to the EO retaining its character
  – Code Section 512(c) provides that: “If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall... include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.”
Special S Corp Treatment

- Section 512(e) provides that all EO income from S corp stock, including gain on sale, is UBI
  - Only exception: ESOPs

- This breaks off the flow-through nature of the S corp income; even if it engages entirely in passive activities, all income is UBI to the EO shareholder
Special S Corp Treatment

• EO’s share of S corp income is taxed at EO level whether distributed or not
  − phantom tax issue

• Taxation of gain on disposition may be the greater disadvantage
  − Sale of assets by partnership or LLC, or sale of partnership or LLC interest, would usually pass through as non-taxable for the most part
Additional Private Foundation Restrictions

- All 501(c)(3) organizations are either public charities or private foundations
  - Private foundation by default
  - Can qualify as public charity based on
    - Nature of activity
    - Financial support profile
    - “Supporting organization” relationship to a public charity qualifying based on nature of activity or financial support profile

- Why do we care?
Additional Private Foundation Restrictions – Excess Business Holdings

- Private foundations, and certain “supporting organizations,” are subject to restrictions on business holdings
  - A private foundation and its disqualified persons cannot own more than 20% of a “business enterprise”
  - Corporate stock is ownership in a business enterprise unless the corporation’s income is 95% passive or is functionally related to exempt purposes
  - S corp stock is neither, so it is subject to excess business holdings limitations
Additional Private Foundation Restrictions – Disposing of Excess Business Holdings

• Note that a private foundation’s disposition of stock to donors or their related parties, or other disqualified persons, can create a prohibited self-dealing transaction.

• If S corp stock is received by a private foundation as gift or bequest, the private foundation has at least 5 years to dispose of before excess business holdings penalties apply.
Additional Private Foundation Restrictions – One Bright Spot

- UBI tax paid by a private foundation reduces its required annual 5% payout
- This includes UBI tax paid on S corp holdings
Thank You

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