Charitable Remainder Trusts to Sell Assets?

By Robert W. Wood • Wood & Porter • San Francisco

Many M&A TAX REPORT readers encounter clients holding closely held C corporation stock, where the corporation in turn holds substantially appreciated assets. There is rarely an easy solution to this problem, particularly when the shareholder clients are advancing in years, when the appreciation is enormous, and when they belatedly face the proposition of selling the business. I want to focus here on only one possibility, which clearly is not the right one for many.

Still, since it is a little unusual, it is worth adding to the panoply of discussion items one should pull out in this kind of client circumstance. The topic is charitable remainder trusts.

Facing a fact pattern such as that described above, suppose that you:

- have the C corporation contribute its assets to a charitable remainder trust;
- have the corporation retain a unitrust interest;
- have the trust sell the asset or assets tax free;
- elect S corporation status; and
- have the corporation receive and pay out the unitrust payout, (hopefully) achieving only a single level of tax.

Hit List

Readers will quickly identify several potential problems with this idea. Certainly one of them is the possibility that the C corporation would recognize gain on all of the assets it transfers to the exempt organization. Apparently, this should hinge on whether the transfer is of substantially all of the assets. [*See* Reg. §1.337(d)-1(a)(1).] As long as the asset transfer is *not* of substantially all of the assets, then at least this leg of the transaction should probably be okay.

Another potential problem with this idea relates to our old friend Code Sec. 1374. M&A TAX REPORT readers will recall that under current law, when a C corporation converts to S status, it must pay a built-in gain tax on any C corporation gain it recognizes over the ensuing 10 years. The question here would presumably be whether the unitrust interest is a built-in gain item.

The assets transferred from the C corporation to the tax-exempt entity presumably did have built-in C corporation gain, so that much is clear. So far, Code Sec. 1374 is generally interpreted broadly, another nail in the coffin of *General Utilities* repeal. Whether that makes the unitrust annual payout in essence a representation of that historic C corporation gain is unclear. Perhaps one might argue that the unitrust amount represents subsequently earned interest on the investment income of the trust, but how will that argument fare?

Early Termination

Unitrusts generally must last for 20 years, so that may suggest that this strategy (even apart from the items identified above) may not be ideal for many clients. Nevertheless, in some circumstances, such trusts can be terminated early. In that case, a payout of the actuarial value of the interest to the beneficiaries can be made. This kind of possibility may get a client's juices flowing. Indeed, perhaps one latent

question here is whether this strategy would be useful apart from charitable motivations.

Charitable remainder trusts are optimally used by those who are charitably motivated, and who want the security and certainty of an annuity payout, along with some nice benefits. In the case of a closely held corporation whose owners are not charitably motivated, this kind of strategy presumably would make no sense.

However, suppose the shareholders are assuming that the actuarial value of the corporation's interest in the trust will be high. Also suppose that the shareholders think they may be able to strip out the annuity payment, shortcutting the 20 years to something drastically shorter than that. Of course, any such machinations would inevitably make Code Sec. 1374 far more troublesome. Indeed, there may well be other serious tax problems associated with this end run too.

Authority?

Take a look at LTR 200644013 (June 21, 2006). This ruling supports this kind of a transaction, although it does not deal with a couple of the issues I consider significant. For one, LTR 200644013 does not address the "substantially all" question. That's a tough issue, since this kind of technique would be far more attractive if one could sell the assets wholesale.

Presumably under the facts of the ruling, there were some assets sold, but not a sufficient quantity of assets to constitute "substantially all." That meant there was no reason to discuss the regulations under Code Sec. 337, which require C corporations to recognize gain on assets sold to a tax-exempt organization, at least where the items sold constitute "substantially all" of the assets.

The other latent problem with reliance on this private letter ruling concerns the built-in gain issue. Once again, that is a tough one. LTR 200644013 suggests that the corporation will have Code Sec. 1374 gain to the extent the amount it receives (in unitrust payments) is characterized as capital gain under Code Sec. 664(b). Thus, the ruling doesn't resolve that point.

Last Thoughts

Perhaps the biggest message here is simply that it is worth considering this or related techniques in appropriate cases. There may be few appropriate cases, and certainly, the idea of collapsing the unitrust amount is quite dangerous. But, if the clients are charitably minded, can avoid the "substantially all" problem and are prepared to run what may be a big built-in gain tax risk, perhaps this could be considered.