

# CHARITABLE STRATEGY

Concept Overview & Illustrations

# BEFORE WE GET STARTED...

Charitable planning has historically involved the use of either a charitable trust or private foundation. Although these strategies do, indeed, provide some tax and philanthropic benefits, both strategies come with significant limitations.

In the case of most charitable trusts, the donor's charitable deduction is substantially discounted because the charitable gift is of future interest, rather than a current interest.

In the case of the private foundation, the deductibility limit as a percentage of AGI is substantially reduced, and the IRS has established strict rules governing these foundations.

Additionally, in both situations, the donor loses significant control of the asset. In recent years, the use of a Limited Liability Company (LLC) as the vehicle for charitable planning has become more popular and is being used by many high-profile wealthy individuals.

At the most basic level, the donor does not create a tax-exempt organization or trust. Rather, the donor donates ownership units of his/her privately held LLC to a reputable charitable organization and receives an itemized tax deduction in an amount equal to the fair market value of the donated LLC units.

Mechanically, the client funds a single member LLC with certain amounts of cash, securities, real estate, or other assets. The entity is a for profit LLC with the business purpose of holding assets, making loans, and/or any number of other legitimate business purposes. The transfer of the assets to the LLC triggers no tax consequences because the single member LLC is disregarded for federal tax purposes.

After funding the LLC, membership units of the LLC (which is distinguishable from the assets inside the LLC), are donated to a qualified charitable organization usually using a Donor Advised Fund (DAF).

## Steps in the transaction:

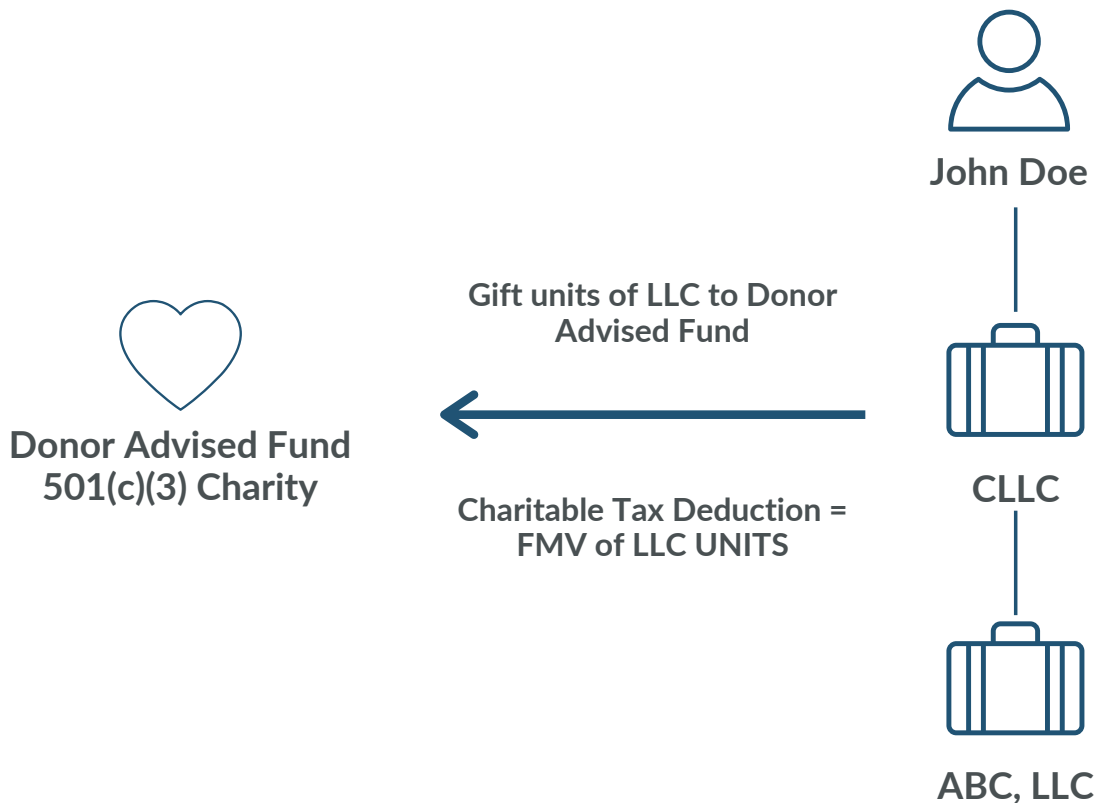
Step #1: Funding the Single-Member LLC

Step #2: Donation of the LLC Units to a Qualified Charity

# SCHEMATIC

Note on managerial control: you will appoint the managers of the CLLC when the CLLC is formed. There are no restrictions on who may serve as the manager of the CLLC provided you (the sole member at the time of formation) vote to approve the manager. Accordingly, you may serve as the sole manager, your spouse may act as a co-Manager, a third party may serve, or a combination of multiple managers may serve. Although the manager will have the exclusive right to manage the day to day operations of the CLLC, the manager must adhere to a fiduciary standard with respect to his or her managerial decisions.

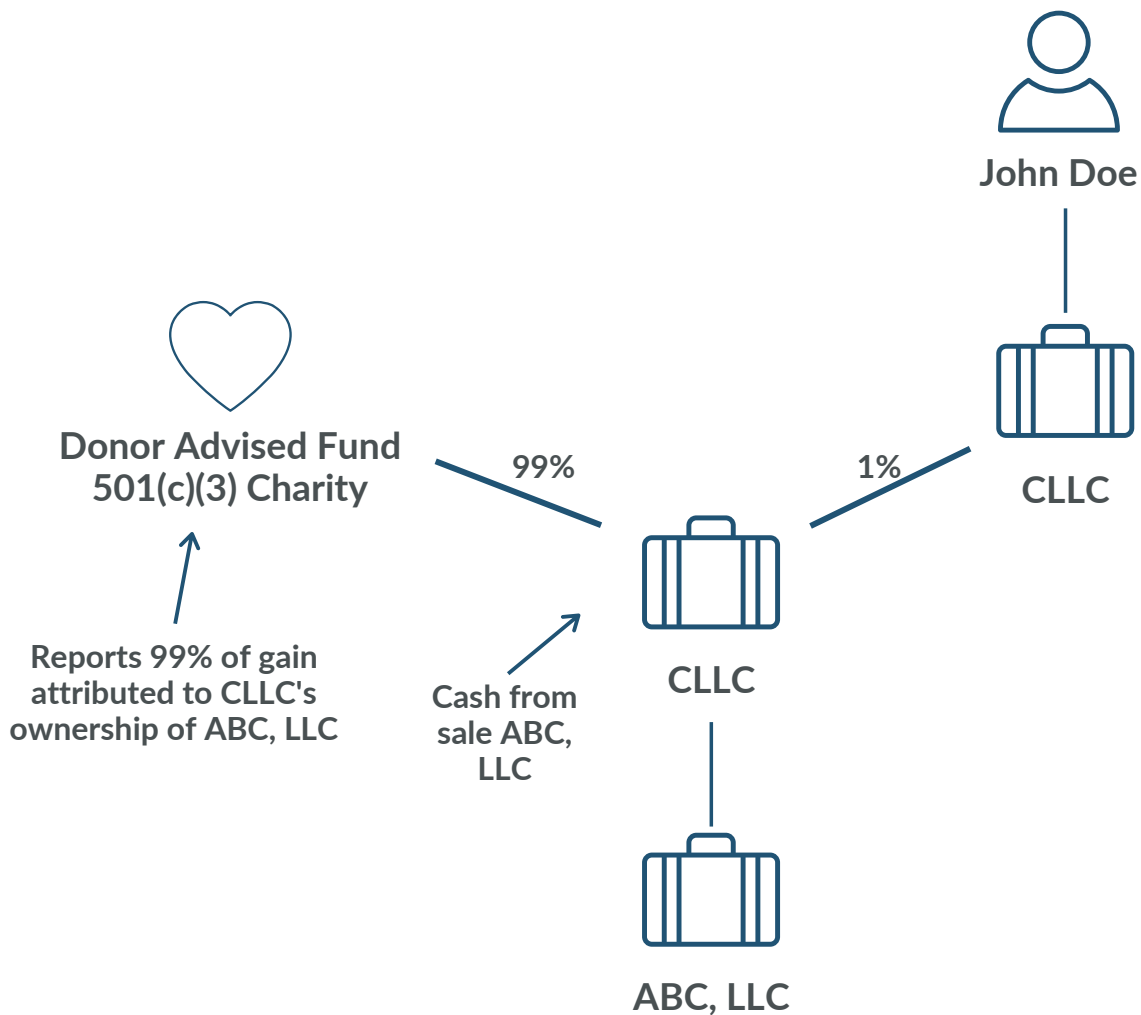
Figure 1.



# SCHEMATIC

After you donate LLC units, the CLLC will be owned primarily by the DAF, making the CLLC a multi-member LLC classified as a partnership for federal and state income tax purposes. Partnerships require the partners to report their allocable share of the partnership's income, regardless of whether the partnership's income is distributed to the members. Accordingly, if the CLLC sells ABC, LLC a majority of the resulting gain will be reported by the DAF (a tax-exempt organization); however, the resulting cash from the ABC, LLC liquidation will remain in the CLLC.

Figure 2.

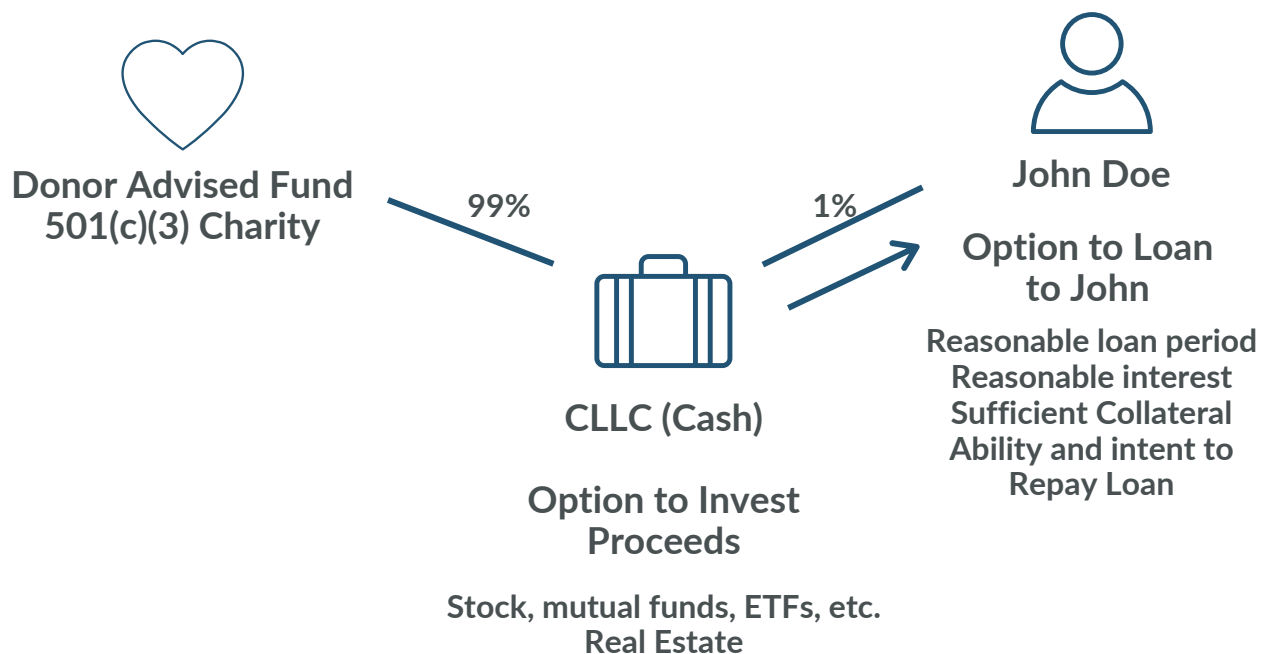


# SCHEMATIC

Upon liquidation of ABC, LLC by the CLLC, the proceeds from the sale will belong to the CLLC and the manager may elect to invest the resulting assets as the manager, in the manager's sole and absolute discretion, believes is prudent for the CLLC. The manager therefore has the option to: (1) invest the proceeds in any manner the manager deems appropriate, including real estate, equities, bonds, and the like; (2) make interest-yielding loans in a prudent fashion subject to a proper business purpose; or (3) make distributions to the members in the proportion to the member's ownership.

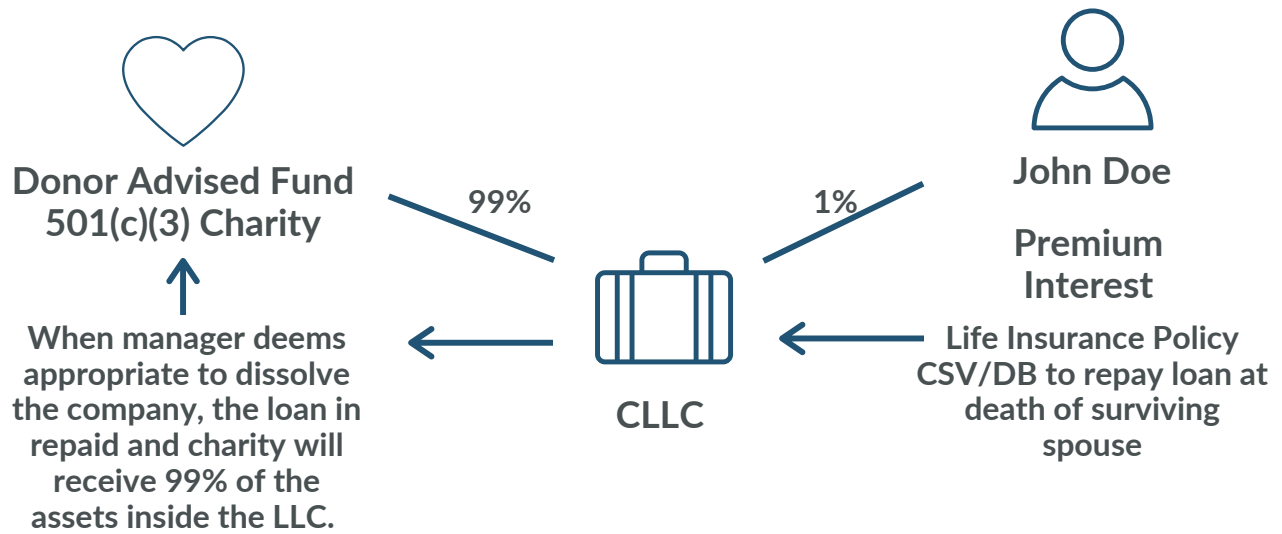
If a related party loan is made by the CLLC to a Member, the Manager, or a family member of either, careful precaution must be taken to ensure the loan is collateralized, interest is properly and timely paid, and the borrower has the ability and intent to repay the loan. For the portion of the assets loaned to a related part, a permanent life insurance policy can be placed on the life of the borrower, and placing a collateral agreement on the life insurance cash value and death benefit to ensure the loan will be repaid in the future. The Manager must ensure the death benefit of the life insurance policy is greater than the loan balance at all times. In the event the life insurance death benefit drops below the balance of the loan, the Manager should seek additional collateral.

Figure 3.



# SCHEMATIC

Figure 4.



# BENEFITS OF THE STRATEGY

Substantial income tax deduction - taxpayers are permitted to take a federal itemized deduction in an amount equal to the fair market value of assets gifted to a qualified charitable organization. Calculation of fair market value is one of the most critical components of this strategy and it is a well-established principle in tax law that the value of a privately-held company must be discounted when an owner has no readily available market to liquidate the units in the closely-held company (Lack of Marketability) and when the charity has no control over the day-to-day operations of the company (Lack of Control). The discount will vary depending upon the asset the LLC holds; greater for stock and other tangible assets and less for cash. Either way, a considerable tax deduction will arise that can be carried forward for up to 6 years.

Reduction/Elimination of Capital Gains Tax - Upon donation of the LLC units to the qualified charity, the LLC is no longer a single-member LLC, but rather a multi-member LLC. Once this transaction occurs, the assets in the LLC can be sold and the percentage owner by the charity will experience no capital gains tax (typically 99% of the LLC value).

No/Limited Tax on Investment Earnings - since the charity does not pay income tax on whatever percentage of the LLC it now owns, only the percentage retained by the donor will experience tax on those earnings. Assuming that is only 1% of the assets, you have effectively eliminated tax on virtually all future earnings from the LLC.

There are no estate, gift or GST taxes on the asset.

The asset is creditor proof.

The donor retains complete, unrestricted control over the assets.

The donor can receive tax-free income from the LLC.

Ultimately, the asset must pass to the charity but in most cases, that is many years in the future i.e. 30 years. Assuring the charity is eventually made whole is usually secured by a life insurance policy whose cost is substantially less than the tax savings from the transaction. In many cases, that policy can also be financed which creates additional multi generational wealth since the donor will, in this case, experience no "out-of-pocket" cost for the premium.

# ONE FINAL WORD OF CAUTION

**As is the case with most sophisticated tax planning, proper execution is critical. Audit risks can be broken into three major categories but will never become a problem if these areas are properly addressed:**

**Incomplete Gift** - Transfer to a charity is not deductible unless it is a completed gift. To be considered completed, the donor must relinquish dominion and control over the asset without any retained rights, interest or control. The charity must ultimately receive the gift free of any encumbrances, and it must have the right to freely manage, dispose, and/or control the asset without restrictions placed on the asset by the donor. However, in the Charitable LLC context, the key issue is whether the donor has retained control over the gifted LLC units not whether the donor has managerial control over the LLC operations and as long as that tenant is not violated there will be no issue.

**Lack of Business Purpose** - Notwithstanding the term "Charitable LLC", there is nothing charitable about the underlying LLC other than one of the members is a tax exempt charitable organization. As such, the LLC must have a legitimate business purpose for existing. Formalities such as bank accounts, meetings of owners and managers, and proper financial reporting are necessary.

**Improper Valuation Discount** - It is critical to hire a fully independent business valuation firm with sufficient experience and expertise in performing valuations of closely held LLCs. The valuation firm will execute commonly understood and accepted valuation methods to determine the proper value of the donated units.

When all is said and done, this strategy remains a very powerful planning technique for the right individual and the proprietary specialist that we use in these cases has 25 years of experience executing these plans and on hundreds of plans has only had about a dozen audits and in no case were the deductions disallowed.

## **Case Study**

A 64 year-old physician making approximately \$500,000 per year sells his interest in an outside business. Based on the structure of the business agreement, a small portion of the proceeds for the sale are considered long-term capital gains and the majority will be recognized as income. Note the significant reduction in taxes attributed to the use of the Charitable LLC (CLLC).



# John Doe Summary Report

Base Scenario  
2019

CLLC  
2019

## Income:

Wages	499,624	499,624
Interest & Dividends	1,069	1,069
Self-employment income	18,361	18,361
Capital Gains & Losses	120,000	120,000
Other Income	1,246,481	1,246,481
<b>Total Income</b>	<b>1,885,535</b>	<b>1,885,535</b>

## Adjustments:

Self-employment Tax & Other Adjs	246	246
<b>Total Adjustments:</b>	<b>246</b>	<b>246</b>

Adjusted Gross Income 1,855,289 1,855,289

Personal Exemptions 0 0

## Itemized Deductions:

Charitable Contributions	2,500	942,500
Taxes	10,000	10,000
Interest Expense	32,396	32,396
<b>Total Itemized</b>	<b>44,896</b>	<b>984,896</b>
Standard Deduction	24,400	24,400

Total Deductions from AGI 44,896 984,896

Taxable Income 1,840,393 900,393

## Regular Tax:

Schedule or Table Tax 619,085 271,285

Appropriate Regular Tax 619,085 271,285

Self-employment Tax 492 492

High Income HI, Medicare & Other Tax 7,001 7,001

Total Federal Taxes 626,578 278,778

Net Federal Tax Due 626,578 278,778

Resident State Tax 131,682 131,682

Net Resident State Tax Due 131,682 131,682

Total Net Tax Due 758,260 410,460

Marginal Nominal Federal Rate 37 37

Marginal Federal Rate with Phaseouts 37 37

Marginal Resident State Rate 7 7



**Contact us to learn more and find out if this  
Charitable Strategy may be right for you.**

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