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Maximizing Contributions to your Private Foundation – A Conduit Foundation

Private foundations have long been used to drive wealthy individuals' and their family's philanthropic goals.

The benefits of these foundations include an upfront tax deduction for the donor, income tax free return on contributed assets (subject to an excise tax of 1% or 2%) and control of the foundations assets, along with the various non-tax benefits of creating a family legacy that can last multiple generations. However, one main disadvantage of a private foundation is the AGI limitations imposed on contributions to foundations as compared to a public charity or donor advised fund (30% vs 50% for cash contributions, 20% vs 30% for noncash contributions). If any portion of the contribution is not deductible due to these limitations in the current year, that portion will carry over for five years, and is then lost if not used. However, there is a little known exception to these rules that allows an individual to receive the benefit of increased AGI limitations for contributions to private foundations called a conduit foundation.

Conduit Foundation

Under Sec. 170(b)(1)(F)(ii), a private non-operating foundation will qualify as a conduit foundation if by the fifteenth day of the third month after the end of the tax year (March 15th for calendar year end returns) the foundation makes qualifying distributions out of corpus equal in value to 100% of the value of the contributions received in such year. To be qualifying distributions, the distributions must be made to an organized charity that is not controlled directly or indirectly by the foundation or another private foundation. For the contributions to qualify as *out of corpus*, the foundation must distribute the annual required amount of *minimum investment return* under Sec. 4942 and 100% of the contributions received in the current tax year. Minimum investment return is defined as 5% of the fair market value of all foundation assets other than those used in carrying out the foundation's exempt purpose. A private foundation is eligible for this status on a year-to-year basis and does not require any prior approval by IRS.

To ensure the foundation qualifies a statement should be attached to the foundation's tax return to include the calculation for status as a conduit foundation. The foundation may use any portion of the excess distributions (distributions over the minimum investment return amount) from prior years to satisfy the distribution requirements stated above. In addition, an election must be made on the foundation's current year tax return and signed by the foundation manager. The taxpayer claiming the charitable deduction will receive the increased AGI limitation amount, but must also obtain documentation from the foundation that the conduit status was achieved.

A separate election must also be made to include any portion of distributions made during the 2 ½ month period after the end of the year as if it were made out of corpus of the prior year. To qualify, these distributions cannot be treated as made out of undistributed income of the immediately preceding taxable year. This election must also be attached to the foundation's return and signed by the foundation manager.

Example:

X is a private foundation on a calendar year basis. As of January 1, 2015, X had no undistributed income for 2014. X's distributable amount for 2015 was $600,000. In July 2015, A, an individual, contributed $500,000 (fair market value determined at the time of the contribution) of appreciated property to X (which, if sold, would give rise to long-term capital gain). X did not receive any other contribution in either 2014 or 2015. During 2015, X made qualifying distributions of $700,000, which were treated as made out of the undistributed income for 2015 and $100,000 out of corpus. X will meet the conduit foundation requirements 2015 if it makes additional qualifying distributions of $400,000 out of corpus by March 15, 2016.

The increased AGI limitations for donors to a conduit foundation requires the foundation to retain complete and accurate records. Donors also must receive sufficient evidence from the foundation showing the foundation made the required qualified distributions within the time prescribed to attach to their income tax return. In general, a copy of the foundation's tax return will meet this requirement.

In addition to the increased AGI limitation for contributions made to private foundations, there is another potential benefit for donations to a conduit foundation. Generally speaking, a donor can only get a deduction equal to the basis of property contributed to a private foundation, rather than its fair market value (FMV), unless that property is *qualified appreciated stock* (stocks traded on the open market). A contribution to a conduit foundation however, allows a donor to get a deduction equal to FMV even if the contributed property is not qualified appreciated stock. When receiving long-term capital gain property, the foundation must use the FMV of the contribution on the date it is received in its calculation to satisfy the conduit foundation requirements.

While there are many non-tax reasons a taxpayer may want to donate to their foundation, maximizing tax efficiencies at the same time is never a bad idea. Under the right circumstances, a conduit foundation can increase a donor's deduction for making the exact same contribution. When executed properly, a conduit foundation can be extremely beneficial.

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The Clock Strikes Midnight: IRS Issues Proposed Regulations Limiting Discounts on Transfers of Closely-held Interests

On August 2, 2016, IRS issued long-awaited proposed regulations pertaining to valuation discounts on transfers of closely-held family entities. Such interests include closely-held interests in corporations, partnerships, and other entities.

The proposed regulations would affect the value for federal tax purposes of transfers of interests to family members. In general, they aim to limit the amount of discounts that can be factored into the value of the transferred interests.

As part of estate, gift and generation-skipping transfer tax (transfer tax) planning, taxpayers who hold interests in closely-held entities frequently transfer all or a portion of their interests during their lives, to younger family members. Such a transfer has two benefits: first, it removes the asset from the taxpayer's transfer tax base, and second, any increase in value of the transferred asset will not be subject to the transfer tax for the taxpayer who has transferred the interest.

The entity's governing documents and/or state law frequently impose certain restrictions that reduce the overall value of the interest for transfer tax purposes. Frequently, the restrictions limit the ability of a transferee to transfer or liquidate their interest which, in turn, results in various discounts that apply when the interest subject to those restrictions is valued for transfer tax purposes. After applying the discounts to the value of the property transferred, the transfer tax liability associated with the transfer can be significantly reduced. Examples of discounts include valuation discounts for lack of control (own a minority interest in the entity) or lack of marketability (no readily available market for selling the interest to unrelated third parties), voting rights restrictions, and restrictions on the ability to liquidate the interest. Although generally losing on the issue, IRS has long argued that for purposes of valuing family entities, families should be considered one unit with respect to control of these entities, thereby eliminating many of these discounts.

In 1990, Congress added Sec. 2704 to the Internal Revenue Code which was designed to limit valuation discounts for transfers of interests in closely-held family entities to other family members. However, due to certain exceptions in the statute and various changes to state laws, which impacted rights with respect to entity control, IRS has argued that Sec. 2704 and its regulations were rendered ineffective in limiting these discounts. As a result, the Treasury Department has proposed a new set of regulations that are intended to significantly affect the value of transfers of closely-held family entities to other family members.

If the proposed regulations are finalized in their current form, certain restrictions would no longer be considered in determining the value of the transferred interest. Without these restrictions, the value of the transfer would be greater for transfer tax purposes. This increased value would likely produce a significantly greater transfer tax liability than would occur if the interest were transferred under the current regulations.

The mechanism by which these proposed regulations would eliminate discounts is to force an assumption that each interest holder in a family-controlled entity has a put right that would enable the holder to force a redemption of their interest for cash or a very short-term note (six months) in an amount equal to a pro rata share of the entire value of the underlying assets of the entity. Essentially, IRS is doing by regulation what they could not do through litigation, namely treating the family entity as if it were controlled by each member of the family.

Additionally, the proposed regulations would apply to any transfers between family members, regardless of whether there was any donative intent. This application would have the effect of potentially imposing gift taxes on transactions that are negotiated at arms-length between owners of a family enterprise simply because they are related. For example, suppose an interest in a family business is left to two siblings, one of whom is involved in the business and one of whom is not. The non-participating sibling then sells the interest to an unrelated third party. In that case, discounts for lack of control and marketability would be taken into account in determining sale price. If the non-participating sibling sells that same interest to the participating sibling (a common fact pattern), those discounts would not be taken into account and either the selling sibling would have to charge more for the interest, or be charged with making a gift.

The proposed regulations are subject to a 90-day public comment period. The Treasury Department has scheduled a hearing on the regulations for December 1, 2016. With some exceptions, the regulations would apply to transfers of closely-held interests to other family members after the regulations are issued as final regulations. Therefore, taxpayers who are considering transferring interests in their family-owned entities should consider making those transfers as soon as possible.

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New Rules Allow Significant Opportunities to Expense Capital Expenditures

New legislation included in the Protecting Americans from Tax Hikes of 2015 Act (PATH Act) along with recently issued final tangible property regulations provide taxpayers with significant opportunities to expense or accelerate tax deductions for the cost of fixed assets.

However, taxpayers may need to put new processes in place to fully take advantage of these new rules.

Taxpayers should first consider whether expenditures can be immediately expensed under the *de minimis* safe harbor. A taxpayer can expense any item that does not exceed $2,500 ($5,000 for taxpayers with an audited financial statement), as long as it is also expensed for book purposes. This expensing rule covers routinely purchased items such as office furniture and equipment, laptops, appliances and smartphones. For example, if a taxpayer pays a $100,000 invoice for the purchase of 50 computers that cost $2,000 each, each computer falls under the $2,500 *de minimis* amount and the entire $100,000 invoice can be expensed for tax purposes so long as the taxpayer also expenses the computers in its books and records. To elect the *de minimis* safe harbor, a taxpayer must have a policy in place to expense items for book purposes as of the beginning of the year (the policy must be in writing for taxpayers with audited financial statements). Therefore, taxpayers should ensure a policy is in place by the end of 2016 in order to make the *de minimis* safe harbor election for 2017.

When incurring expenditures related to existing buildings, land improvements or other tangible property, a taxpayer should consider whether the expenditure must be capitalized for tax purposes or whether it could be currently deducted as repair and maintenance expense. Generally, such expenditure must be capitalized for tax purposes if it results in an improvement (a betterment, a restoration or an adaptation) to a building, building system or other unit of property. Expenditures that taxpayers routinely capitalize and depreciate for book purposes can be expensed for tax purposes under these rules. For example, a cosmetic refresh or remodel of a portion of a building where there is no impact to the building's structure or systems is generally not required to be capitalized. Costs that are deducted under the *de minimis* rule or as a repair and maintenance expense are not subject to depreciation recapture rules upon a future transaction.

When there is a capitalizable improvement made to a building or other property, taxpayers can write-off the remaining tax basis of the replaced property by making a partial disposition election. Often times, taxpayers do not separately track the tax basis of a component of a building, such as a roof or elevator system. The regulations provide a simple technique for estimating the tax basis of the disposed property when a restoration is made. To use this technique, the taxpayer applies a formula based on the *producer price index* and tax depreciation tables to estimate the remaining tax basis of the disposed property [See prior article on partial dispositions].

Assume a taxpayer spends $750,000 in 2016 to replace all elevators in the building. The replacement of the elevators is required to be capitalized as a restoration to the building. The taxpayer purchased the entire building, including the elevators, for $10,000,000 in 2012. The building was depreciated using the straight-line method over a 39-year recovery period.

1. Compute Discount Factor		
Producer Price Index for Elevators - 2016	110	a
Producer Price Index for Elevators - 2012	11	b
Discount Factor	1.1	c = a / b
2. Discount Replacement Cost of Elevators to Placed-in-Service Date		
2016 Elevator Replacement Cost	$750,000	d
Discount Factor	1.10	e
Amount of Building Acquisition Allocable to Retired Elevators	681,818	e = d / c
3. Adjust for Accumulated Depreciation		
Accumulated Depreciation Factor (Tax Depreciation Table)	11.758%	f
Accumulated Depreciation Allowed or Allowable from 2012 to Retirement Date	80,168	g = c * f
Remaining Tax Basis in Retired Elevators	601,650	h = e - g

A partial disposition election is made by disposing of the $601,650 remaining tax basis of the retired elevators on the originally filed tax return for the year of disposition (2016).

The PATH Act also extended the availability of bonus depreciation through 2019 (2020 for certain longer-lived and transportation property) and made enhanced small business expensing levels under Sec. 179 permanent. The $500,000 dollar limitation for expensing Sec. 179 eligible property and the dollar-for-dollar reduction in the maximum for property placed in service over $2,000,000 are indexed to inflation. Beginning in 2016, there is no separate real property dollar limitation for expensing qualified real property under Sec. 179. As a result, taxpayers may elect to use their entire Sec. 179 dollar limitation to expense qualified real property expenditures, including qualified leasehold improvement, restaurant and retail property.

Beginning in 2016, The PATH Act also expanded the definition of building improvements that are bonus eligible. A new category called *qualified improvement property* includes any improvement to the interior portion of a nonresidential building that is not attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. The improvement must be placed in service after the date the building was originally placed in service, it must be original-use property and it must be placed in service during a year when bonus depreciation is in effect (currently through 2019).

No special recovery period was specified for qualified improvement property. Thus, a 39-year recovery period for a commercial building will continue to apply, unless the property fits the definition of qualified leasehold improvement, restaurant, or retail property, which has a 15-year recovery period. This new category is distinctly different from qualified leasehold improvement property, which was eligible for bonus depreciation prior to 2016. Qualified leasehold improvement property is made under or pursuant to a lease by the lessor or the lessee (restrictions apply to related party leases) to a building that is at least three years old. Under the expanded definition, bonus depreciation is available for owner-occupied, 39-year building improvements or improvements to common areas of leased buildings that otherwise fit the criteria for qualified improvement property. Taxpayers should either put a process in place to identify qualified improvement property and take the allowable bonus depreciation, or should affirmatively elect out of bonus depreciation for the 39-year property.

Putting it all together

Assume a taxpayer makes expenditures in 2016 related to the interior portion of an existing commercial building that it owns and uses in its business and the expenditure is not for qualified real property under Sec. 179. The taxpayer should identify separate property such as appliances and furniture and determine whether those items could be expensed under the *de minimis* safe harbor. If the items are above the dollar threshold, consider whether to expense under Sec. 179 (if applicable) or whether bonus depreciation should be taken instead. Next, the taxpayer should determine whether the remaining expenditure results in an improvement to the building or is deductible as a repair based on the standards described above. If the expenditure results in an improvement that fits the definition of qualified improvement property, 50 percent bonus depreciation will apply even though the recovery period is 39 years. If the improvement replaced an existing portion of the building, a partial disposition election could also be made to write-off the remaining tax basis in the replaced property.

Taxpayers have abundant opportunities to accelerate deductions related to fixed assets given the changes provided by the PATH Act as well as under the final tangible property regulations. Determining how these rules apply to your business and optimizing the available deductions and implementing the strategies will require careful planning and coordination of the different rules and elections that may apply.

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