Introduction to the Problems of Acquiring Properties from Partnerships, Corporations, Estates, and Trusts

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Introduction to the Problems of Acquiring Properties from Partnerships, Corporations, Estates, and Trusts

by William T. Hutton

Negotiating the acquisition of entity-owned properties (i.e., property owned by a legal entity other than one or more individuals) generally raises a number of legal and strategic concerns not confronted in dealing with an individual landowner. In order confidently to grapple with the complexity that such a transaction usually entails, the land trust negotiator would have to possess a fair working knowledge of the tax rules applicable to the entity involved, as well as a strategic appreciation for the objectives of the beneficial owners. Such knowledge and experience are hardly to be presumed, nor can they be gained in any relatively painless way. Our objective in this introductory excursion is not full-functional competence, therefore, but rather to gain a fundamental understanding of the system of taxation applicable to each type of entity apt to be encountered in a land trust’s acquisition forays, so that the negotiator will have some sense of the obstacles likely to be encountered and the questions that need to be asked.

Some Fundamental Precepts and Common Concerns

The “entities” with which we are concerned here are recognized, for federal income tax purposes, as separate legal persons. They may be taxpaying persons, as in the case of certain corporations, estates, and trusts, or they may be nontaxable entities, such as “S” corporations and partnerships, which are nonetheless important players because the tax consequences to their beneficial owners (shareholders or partners) will be determined with reference to those entities’ transactions. As a general rule, land trust acquisitions are substantially easier to effect when dealing with a nontaxable entity, but that is not to say that the

absence of a tax threat at the entity level will make a proposed acquisition as easy to accomplish as one in which the land trust deals discretely with several cotenants.

Determining Legal and Beneficial Ownership

In any case where there is the slightest indication that a person other than one or more individuals may be the legal owner of property, the land trust representative must determine where legal title and beneficial ownership reside. In every case of entity ownership, legal ownership of the property and the ultimate economic benefits or detriments of that ownership will be divided; e.g., a corporation is the legal owner of its timberland, with the power to sell, lease, harvest, etc., but the benefits of that ownership inure to its shareholders.

Problem (1). Sturdley Valley Land Trust has recently learned that a crucial parcel of an assemblage it intends to preserve as agricultural open space through the acquisition of conservation easements is owned by “The Old Boys’ Four-square Trust.” The land trust’s executive direc-

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ror is, accordingly, preparing a preliminary letter
of introduction, and she intends to include a hypothoetical case study illustrating the potential
benefit of an easement contribution to trust ben-
eficiaries, making various assumptions about in-
come levels and tax benefits. Is this approach
strategically sound?

Before presuming to illustrate tax benefits (an
enterprise that is inherently risky even where most
facts are known), it is essential to know that you are
playing in the right ballpark. The designation "Trust"
is hardly definitive; in many states corporations may
be so named, and even if a true trust, Old Boys’ may
not have those attributes generally associated with
trusts; for example, it may be a tax-exempt social
club or a charitable remainder unitrust. And as we
shall see, even where the nature of the entity is fully
known and understood, it is generally fruitless to
attempt to illustrate tax consequences without the
same assurance about the nature of that entity’s ben-
eficial ownership.

Basis and Holding Period

As in any conservation acquisition, the land trust’s
ability to provide a tax-beneficial deal is apt to turn
upon the tax consequences of alternative potential
transactions. In order to make a plausibly accurate
representation of those consequences, it is necessary
to have the same information, with respect to the
entity’s basis and holding period, as in the case of
properties owned by individuals. It may also be
necessary, in order fully to represent the consequences
of transactions with an entity, to have the same infor-
mation with respect to the basis and holding period of
shareholders’ or partners’ interests in a corporation or
a partnership.

Establishing Lines of Communication

Although it may appear that a dominant share-
holder or managing partner has the authority to nego-
tiate a transaction for a corporation or a partnership,
or that a trustee’s management powers would appear
to permit a bargain sale, the requirements of fiduciary
duty applicable to one in such a position make such
an assumption hazardous. Where the transaction
sought by the land trust involves a charitable con-
tribution, as it most often will, the land trust must
generally be assured that all beneficial owners are
aware of the full implications of the transaction and
are not to object. In many cases, the requirements
of contract or law may necessitate the agreement of
all, or a high percentage, of the beneficial owners.

For example, a partnership which seeks to dispose of
a principal asset by way of a bargain sale may well
need the acquiescence of a majority (or a higher
percentage) of its limited partners, although those
persons would normally have no control over day-to-
day business affairs of the partnership. Similarly, a
trustee who seeks to dispose of the trust property for
less than appraised value may need court approval,
which is apt to be conditioned upon the understand-
ing and approval of all affected beneficiaries.

The land trust representative must appreciate,
therefore, that it may be necessary to countenance
and endure the participation in negotiations of a con-
siderably greater number of players than might be
necessary in a normal “business” transaction. Not
infrequently, for example, where a substantial bar-
A cquisitions of Partnership Properties

The potential partnership acquisition is far and away the least forbidding of the various possibilities discussed in this article. A partnership is an aggregate of persons (which may include other entities — even other partnerships — as well as individuals) who agree to share the risks and reap the rewards of a business or investment venture. In respect of certain tax consequences of partnership operations, the “aggregate” nature of the legal entity dictates the result; most obviously, partnership income is attributed to its partners — the partnership itself never pays tax — and partnership losses are similarly allocated for (possible) use by the partners on their own returns. But for other purposes, the “entity” aspect of the partnership prevails; thus, if partnership property is taken by condemnation, in order to protect the realized gain from recognition under §1033, the partnership itself must make a qualifying reinvestment — reinvestment by each partner of his or her aliquot share of the sale proceeds will not suffice.

Outright Sales

We begin with the following problem in order to gain an appreciation for the way in which tax liabilities are determined with respect to the disposition of a significantly appreciated partnership asset.

Problem (2). Ike, Mike, and Petra formed the IMP Partnership in 1984, each contributing $100,000 cash. Their intent, as stated in the written IMP Partnership Agreement, was to “acquire, hold, and manage developed and undeveloped real estate for current income and capital appreciation.” Among the properties they acquired, for $60,000, was a 120-acre woodland which they believed would be ripe for subdivision within ten years. Time has proved the IMP partners’ original assumptions correct, if a bit conservative. A developer has recently made an offer of $480,000. What will be the effect of a sale by the partnership at that price?

IMP’s gain will be characterized and measured at the partnership level. Its basis is its “cost”; i.e., $60,000. Its amount realized, ignoring transaction costs, is $480,000. Thus the IMP gain is $420,000, and, since the asset has been held as investment property, in the expectation of appreciation in value, the gain would be characterized at the partnership level as long-term capital gain.

Each partner will then take his or her agreed-upon share of the IMP gain as a long-term capital gain on their individual returns. For the sake of simplicity, we shall assume that Ike, Mike, and Petra have agreed to share all items of partnership income, gain, and loss equally (although, as we shall soon see, that need not be the case). Thus each would have a $140,000 gain to report, taxed at a maximum federal rate of 28%.

Note that the tax effects just described will obtain whether or not the partnership distributes the sale proceeds. Inclusion of the $140,000 gain by each shareholder will create a corresponding increase in the basis of his or her partnership interest (i.e., by $140,000), if the proceeds of sale are distributed, the basis will be reduced by that distribution (i.e., by $160,000). The partners’ “capital accounts” will be similarly adjusted, as described below.

Thus, in this simple and quite common example, the results of the sale at the partnership level are predictably filtered into the partners’ own individual tax returns — one-third of the partnership-level gain is allocated to each, and the income tax liability of each is determined, in part, with reference to that gain.

Bargain Sales

Problem (3). Suppose, in the alternative, that Sturdley Valley Land Trust seeks to avert a conversion of IMP’s woodland to subdivision, and, accordingly, proposes a bargain sale at a price of $360,000 (i.e., 75% of appraised value). The partners confer and agree to accept this proposal.

Now the partnership has made a bargain sale, and the $315,000 gain at the partnership level ($360,000 less allocated basis of $45,000) will be attributed to the partners in equal $105,000 shares. The partnership will also have made a contribution of appreciated capital gain property in the amount of $120,000, and that too will flow to the partners equally « each will have a $40,000 contribution of capital gain property subject to the 30%-of-adjusted-gross-income (AGI) limitation. (Note that each partner’s AGI will be increased by $105,000 by the gain from the IMP bargain sale.) In this simple case, the results to the partners are identical to those which would have obtained had they merely owned the property as covenants, and agreed to sell their undivided interests for $120,000 each.
**Special Allocations of Gain and Contribution**

Not infrequently, the willingness to consider a charitable disposition will vary from partner to partner.

**Problem (4).** Ike is a member of the board of Sturdley Valley Land Trust, and has in fact encouraged the bargain purchase offer to IMP. Petra is mildly supportive of the proposal, but Mike, whose recent financial reversals have severely limited his ability to make use of charitable deductions, is unlikely to accede to a bargain disposition, unless he is not "made to suffer." Can a deal still be made without raising the land trust's offer?

It might be suggested that Mike be allocated a share of the sale proceeds equal to one-third of the fair market value of the property ($160,000). This will require that Ike and Petra take no more than $200,000 of those proceeds, and that the full amount of the charitable contribution be allocated to those two partners. Assuming that Ike agrees to bear the full cost of Mike's insistence on receiving full fair market value, the allocation of gain, charitable contribution, and cash distributed would be as follows (in thousands of dollars):

<table>
<thead>
<tr>
<th></th>
<th>Gain</th>
<th>Charitable Contribution</th>
<th>Cash Distributed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ike</td>
<td>70</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Mike</td>
<td>140</td>
<td>-0-</td>
<td>160</td>
</tr>
<tr>
<td>Petra</td>
<td>105</td>
<td>40</td>
<td>120</td>
</tr>
</tbody>
</table>

Ignoring tax consequences, Mike would appear to be advantaged by this special arrangement to the extent of $40,000 — the increase in the amount of cash he receives over that he would have received had the gain, charitable contribution, and sale proceeds been allocated equally. Similarly, Ike would appear to be disadvantaged by $40,000, and the disparity between the two appears to be $80,000. But Mike will pay $19,600 more federal income tax than Ike on the gain (28% of $70,000), and Ike will enjoy a $24,800 tax benefit attributable to his specially allocated share of the charitable contribution (31% of $80,000). So the real gap between the bottom-line consequences to Ike and Mike will be $35,600. That amount might properly be described as the measure of Ike's "disproportionate, disinterested generosity."

Will the special allocation of the partners in such a situation be respected by the IRS? Testing the validity of partners' special allocations is one of the most complicated and vexing areas of tax practice. The statute requires that, to be respected, a special allocation must have "substantial economic effect." IRC §704(b). Well over 100 pages of dense Treasury Regulations elaborate on that standard, in ways so wondrous strange as best to be described here as simply "beyond our ken." For our purposes it will do to understand that the partners' allocation must either bear or deny economic fruit.

To illustrate, in the example above, Ike’s disproportionately allocation of charitable contribution was matched by a corresponding reduction in the amount of sale proceeds distributed to him; correspondingly, Mike’s disproportionately greater allocation of sale proceeds was matched by a correspondingly greater reportable gain. Conformity of the arrangement with economic reality is readily perceived. If no distribution of the sale proceeds had been made, the partners’ “capital accounts” (an ongoing measure of each partner's economic interest in the partnership) would have to have been adjusted so that future distributions would take account of the disproportionate bargain sale/charitable contribution allocation (i.e., after increasing capital accounts for the gains and decreasing them for the charitable deductions, Mike’s capital account would have been $150,000 greater than Ike’s at the end of the day.) The concept of “capital account” is the touchstone of the regulations’ approach to the determination of substantial economic effect.

**Conservation Easements**

Transfers of conservation easements by partnerships produces little additional complexity. Provided that the transfer meets the requirements of §170(h), a bargain sale or outright donation of a conservation easement affords the same opportunities and challenges in a partnership context as does any other type of donation.

**Problem (5).** Ike has persuaded Mike and Petra that the IMP donation of a conservation easement, limiting future uses of the woodland to recreational pursuits, will be an appropriate civic-minded thing for them to do, producing intangible satisfactions as well as measurable tax benefits (the easement will reduce the value of the property from $480,000 to $120,000). Mike and Petra have agreed to allocate 50% of the resulting charitable contribution to Ike. Immediately before the contribution is made, each partner’s capital account stands at $100,000.

This problem raises the question of whether the partners' allocation can meet the "substantial economic effect" test under these circumstances. A
partner's capital account is, in effect, a constantly adjusting measure of his or her economic interest in the partnership. Here, where allocating $180,000 of the contribution to Ike would drive his capital account negative by $80,000, the transaction will lack substantial economic effect, and the allocation will therefore not be respected for tax purposes, unless Ike is unconditionally required to restore the deficit balance in his capital account upon liquidation of the partnership. Thus, in order to make the intended disproportionate allocation of charitable contribution “real” for tax purposes, the economics of the partners’ arrangement must mirror the tax treatment. Since Ike intends to enjoy a substantially greater charitable contribution deduction than either of his partners, that current benefit requires that his future claim to partnership assets be correspondingly diminished, and, in the event that partnership assets upon dissolution are insufficient to satisfy the disproportionately greater claims of his partners, that he make a capital contribution to the partnership at that time (in the amount of any deficit in his capital account) to make up the shortfall.

[This may well take you somewhat further than you need to go. The essential question, where any disproportionate allocation of charitable contribution is suggested, is “Will the special allocation meet the requirements of the regulations as to “substantial economic effect”?]

Acquisitions of Corporate Properties
Perhaps the most revolutionary aspect of the Tax Reform Act of 1986 was the repeal of the so-called “General Utilities rule.” Under that rule, of judicial origin but long reflected in statutory provisions governing corporate distributions and liquidations, a corporation was permitted to distribute appreciated property without recognizing the lurking gain (with certain limited exceptions). Under the regime which persisted until the 1986 Act change, therefore, conservation organizations had several promising avenues towards the acquisition of highly appreciated corporate lands — a threshold distribution of property to shareholders via distribution or liquidation; an acquisition of stock by bargain purchase or gift, followed by redemption or liquidation; a spin-off of the target property into a new corporation, followed by acquisition of the stock of that company from the parent or its shareholders; etc. Virtually all of those possibilities are now foreclosed; the land trust contemplating an acquisition of corporate real estate will most likely hear a dismal litany of prospective tax consequences. There are, however, two happy exceptions to that gloomy forecast, and, to accentuate the positive, we begin with the one most likely to be encountered where the land trust deals with a closely held company.

S Corporation Properties
The S corporation enjoys immunity from tax and is treated, in most respects, like a partnership. While it is chartered as a corporation under state law and thus affords its shareholders the usual immunity from liability for corporate obligations, it is not, generally, a taxpaying entity; its income, gains, and losses are computed at the corporate level, as are the various components thereof which may have differing effects upon the tax situations of its shareholders. Those items are reported by the shareholders according to their proportional stock ownership. Thus an S corporation’s transactions generally produce only one level of tax consequence—to the shareholders.

Definition. The fundamental requirements for qualification to elect and maintain S corporation status are the following:

(a) not more than 35 shareholders (husband and wife are treated as one shareholder);
(b) each shareholder is an individual, an estate, or one of four types of qualified trusts;
(c) no shareholder is a nonresident alien; and
(d) there is no more than one class of stock.

Further, a corporation will not qualify for S status if it is a member of an affiliated group of corporations, or is one of several types of corporations specifically described in the statute.

Effects of S corporation donations or bargain sales. The consequences of an S corporation donation of land, or a bargain sale, are similar to those described above as to partnerships. There are, however, two salient distinctions. First, S corporations have no license to make special allocations of gain or charitable contribution among their shareholders; the gain and/or contribution amounts are allocated according to stock ownership. Second, an S corporation shareholder’s charitable deduction is limited by his basis in stock and debt (if any).

Problem (6). Land Baron Properties, Inc. elected S corporation status upon its incorporation in 1977. Among its several properties is an ecologically important slough of about 300 acres, which is proposed to be sold to the Birdwatchers Anonymous Land Trust at a bargain-sale price of $50,000 (appraised value is $150,000), adjusted basis $75,000). Land Baron has five equal shareholders, four of whom favor the transaction; the dissenter is adamantly opposed. If the corpora-
tion makes the proposed bargain sale, what tax consequences will obtain?

The relevant statute requires that each shareholder report one-fifth of the total charitable contribution and a similar fraction of the realized gain. An attempt to take account of the dissenter’s objection by adjusting the economic consequences will be hazardous. For example, were the corporation to approve a special distribution of cash or property to the dissident, in order to take account of his inability to make use of his share of the contribution, that authorization might well lead to the conclusion that the corporation maintained more than one class of stock. (The more-than-one-class-of-stock rule has been the subject of rather intense scrutiny and debate over the past couple of years, and Land Baron’s advisors are apt to be extremely sensitive to potential breaches of that rule’s requirements.)

S corporations with prior histories. In order to take comfort in S corporation status, it will be necessary to determine (i) that the corporation has always maintained S status, (ii) that the corporation has been an S corporation for more than ten years, or (iii) that the corporation converted to S status under special provisions of the 1986 Act which required an election to be made prior to January 1, 1987. A corporation not described in the preceding sentence with a prior history under the provisions applicable to regular business corporations (Subchapter C of the Internal Revenue Code) may be subject to corporate-level tax on the amount of appreciation in its assets as of the date of conversion to S status (so-called “built-in gain”).

**Problem (7).** Suppose that Onyx Properties, Inc., after several years of operation as a regular business corporation, converted to S status for its taxable year beginning January 1, 1990. At that time, one of its orchard properties, Flaming Arrow Farms, had a basis of $120,000 and a fair market value of $500,000. It is now worth $750,000, and Onyx proposes to make a bargain sale of the property to the Sidewinder Land Trust for $500,000. What result?

Onyx’s built-in gain on the Flaming Arrow properties is $375,000. Thus an outright sale of the property for $750,000 would result in $375,000 of corporate-level gain recognition, and Onyx would pay tax on that gain. The proposed bargain sale would, therefore, force the recognition of substantial gain at the corporate level — presumably two-thirds of the total built-in gain (on account of the relativity to contribution to sale price, although neither the statute nor regulations provides assurance that the IRS would apply such a pro-rata approach in a case involving built-in gain).

In the case of an outright donation or a conservation easement gift, however, the fact that the subject property represents the potential for recognition of built-in gain should have no untoward effects, since there is no recognized gain. The deduction attributable to the conservation easement would pass through to the shareholders, and the consequences would be identical to those applicable to an S corporation not subject to the built-in gain rules.

C Corporation Properties

Potential acquisitions of C corporation properties (so labeled because their owners, taxable business corporations, determine the tax consequences of their transactions under Subchapter C of the Internal Revenue Code) raise significantly different planning problems. A C corporation is a fully taxable entity; its taxable income produces a corporate-level federal income tax at rates that graduate to 34% for taxable income in excess of $75,000 (that rate applies to both ordinary income and long-term capital gains). Thus, for a corporation which contemplates the sale of a highly appreciated tract of land and the distribution of sale proceeds to its shareholders, the so-called “double tax effect” may seem positively confiscatory.

**Problem (8).** Orca Equities, Inc., a C corporation, acquired a Lake Michigan island property for $100,000 in 1967. It has recently received a solid, all-cash offer to dispose of that property for $1,100,000. If it does so, and distributes the proceeds of sale, net of corporate tax, as a dividend to its shareholders, each of whom is in the maximum (31%) federal income tax bracket, what will be the after-tax results?

The federal income tax imposed on Orca will be $340,000 (34% of its $1 million gain). That leaves $750,000 for distribution to the shareholders, which, after a 31% tax of $235,600, reduces their net to just $524,400.

As this simple but painful example so vividly illustrates, the combined rate of tax on the corporation’s $1,000,000 gain is 54.46%. Faced with such discouraging arithmetic, it is little wonder that advisors to shareholders who find themselves in such circumstances are inclined to explore highly “creative” alternative possibilities. The land trust must be vigilant to ensure that any suggested disposition plan is not simply an attempt to shift some part of the aggregate tax liability to the land trust.
When a corporate donation or bargain sale makes sense. When a corporation has substantial income, a donation of property producing current tax benefits to the corporation may be attractive. In order to be fully deductible, the amount of the charitable contribution may not exceed ten percent of the corporation's taxable income for the year of the gift. Should the donation exceed that amount, the excess carries forward for up to five years.

Problem (9). Murgatroyd Electronics, Inc., a public company, expects to have taxable income of not less than $15 million this year. Surplus suburban real estate, with a basis of $200,000 and a fair market value of $1.2 million, is sought as a gift by the Purgatory Hollow Land Trust, which seeks to preserve that property as part of a greenbelt. What tax benefits will Murgatroyd enjoy in respect of an outright donation?

The $1.2 million donation, fully deductible this year, will produce $408,000 in federal income tax benefits (34% of the fair market value of that property). A sale at fair market value, assuming a 10% offset for transaction costs, would leave the company with $780,800 after tax. It may fairly be represented then, that an outright donation of $1.2 million costs Murgatroyd only $372,800.

Bargain sales at the corporate level may also produce relatively salutary results, assuming that the proceeds of sale may be put to work in the business and not distributed to the shareholders.

Problem (10). Assume, in the Murgatroyd situation, that the company is not in a position to make an outright donation, but agrees to sell the property to Purgatory Hollow at 50% of its appraised value ($600,000).

The charitable contribution aspect of this transaction produces a tax benefit of $204,000 (34% of $600,000). The bargain sale leaves $430,000 after tax ($600,000 proceeds less $100,000 allocated basis times 34% = $170,000 tax). The company thus realizes $634,000, just $145,800 short of the return on an outright sale (again assuming 10% transaction costs on a market transaction). Note, however, from Purgatory Hollow's perspective, this transaction is notoriously inefficient; it costs the land trust $600,000 to amplify Murgatroyd's after-tax return by $226,000.

Distributions of property and contemplation of shareholder donations. In the good old days, under the General Utilities rule it was frequently possible to make distributions of highly appreciated target property to one or more shareholders, either as a dividend distribution or, more likely, in redemption of stock or pursuant to a liquidation of the corporation. Such a distribution could be effected with only shareholder-level tax, and, in the redemption or liquidation scenario, the shareholder tax was nearly always computed at capital gain rates. That set the stage for the shareholders to make a donation or bargain sale. Under the post-1986 regime, the distribution of appreciated property by the corporation will be a taxable event. Thus double-tax consequences are inescapable — gain at the corporation level and dividend or capital gain to the shareholder(s).

Problem (11). With reference again to Murgatroyd's greenbelt property, suppose it makes a pro rata dividend distribution of the target property to its shareholders, who in turn make contributions of their undivided interests to the land trust. What are the after-tax results to a 10% shareholder?

Before the transaction a 10% shareholder in Murgatroyd had an equitable interest in the target property worth $120,000 (this ignores, of course, the lurking corporate tax liability.) After the distribution, his interest in the corporation has been diminished by $154,000 ($120,000 land plus $34,000 corporate tax liability on account of the distribution.) He has land worth $120,000, but its distribution costs him a tax on the dividend of $37,200 (31% of $120,000). Upon donation of that property, he realizes a tax benefit of identical magnitude (31% of $120,000). The end result demonstrates that this is a virtually inconceivable transaction. It has cost our shareholder $154,000 of corporate value to convey a benefit of $120,000. Compare this result to the corporate-level outright donation described above. There, even if the corporation can make no use of the tax benefits, the "cost" of making the donation is limited to the value of the property.

Were the distribution and donation described in Problem (11) to have taken place in the context of a liquidation plan, the results would be marginally better. The shareholder-level tax would be computed on the shareholder's gain on the liquidation; i.e., the full distribution would not be taxable, but only the excess of the value of the properties received over the shareholder's stock basis. And that gain would be taxed at 28%, rather than 31%. These slight improvements are not likely to add up to a heart-pounding inducement.

Stock transactions. The double-tax discouragements just described are most frequently encountered by closely-held and family companies, usually in connection with proposed dispositions of major properties where corporate-level income is entirely inad-
equate to accommodate the intended charitable contribution. In those circumstances, a stock donation or bargain sale is apt to seem, to the affected shareholder(s), an exceedingly good idea.

Problem (12). Boggy Wallow Land Trust has recently acquired an option to purchase a 565-acre woodland, the only significant asset of Boxwood, Inc., a C corporation. Boxwood’s basis is $175,000, the property’s appraised value is $2,575,000, and the option price is $1,800,000. The transaction was negotiated by Boxwood’s regular attorney, Kitty Maroon, who has no particular expertise in tax matters. Subsequent to execution of the option contract, Kitty consulted with the corporation’s accountants, and their review of the tax consequences has stimulated consideration of an alternative plan. Kitty has now proposed to Boggy Wallow that the land trust acquire 100% of the stock of the corporation for $1.8 million, subject to appropriate indemnities to protect the land trust against known and unknown corporate liabilities. Should the land trust accede to Kitty’s request to change the structure of the deal?

Unless the proposed indemnities include reimbursement for corporate-level tax on the ultimate liquidation (highly unlikely), the suggested reformulation must emphatically be rejected. Once Boggy Wallow becomes the owner of the corporation, it will assume, as a “transferee,” the liability for corporate taxes subsequently accruing. When the land trust causes the corporation to be liquidated and its only significant asset distributed, the corporation will realize a gain of $2.4 million and a federal income tax liability of $816,000. Although that liability belongs to the liquidating corporation, the IRS will exact satisfaction from the distributee of the corporate assets, Boggy Wallow. Were Kitty to succeed in this attempt, the apparent bargain sale of stock becomes a sale at a premium.

As is apparent from this example, the value of the Boxwood stock may not properly be determined with reference only to the value of its properties; one must consider, as well, the lurking corporate-level tax liability. Thus, in order to effect a true bargain sale of stock in these circumstances, the shareholders would have to agree to sell their stock at a price significantly less than $1,759,000 — the value of the Boxwood properties less the $816,000 potential income tax liability.

If Kitty’s alternative proposal is rejected, she may well attempt to rescind the contract — an understandable strategy, but one which the land trust must energetically resist. Under contract principles, agreements may sometimes be voided for a “material mistake of fact.” Here, however, Kitty’s mistake was one of law, not fact, and her chances of achieving rescission of the deal would appear to be negligible.

A glimmer of hope. Given the proper factual circumstances — a high-priority potential acquisition, the opportunity for a significant bargain purchase, and the feasibility of maintaining the corporate existence of the target corporation — a stock acquisition may be feasible. It may be possible to avoid corporate tax entirely by maintaining the corporate identity of the target corporation as a for-profit subsidiary company. It may also be advisable, in some circumstances, to consider a conversion of the target corporation from for-profit to non-profit status; for example, to a §501(c)(2) title-holding company or a §509(a)(3) support organization. Although one might expect the IRS to take a dim view of such a conversion plan, experience indicates that IRS approval of the shift to nonprofit status may indeed be obtainable in proper circumstances.

Acquisitions from Estates and Trusts

Even the most intrepid land trust negotiator is apt to quiver when faced with the difficulty of acquiring estate- or trust-owned property. Not only are tax benefits likely to be of minimal consequence, but the executor’s or trustee’s fiduciary duties may virtually bar any transaction in which the entity does not receive fair market value. But on rare occasions, where all interested parties are able to put conservation ahead of financial interests, such transactions do happen. Our attempt here is simply to provide a brief introduction to the most frequently encountered acquisition scenarios and problems.

The Nature of Estates

An estate is a taxable legal entity which comes into existence upon the death of an individual, and lasts for such period as is necessary to satisfy the liabilities of the decedent and distribute his or her properties according to the dictates of a will (or, in the case of a decedent who dies intestate, according to the applicable laws of succession). Estate properties which are the subject of testamentary charitable dispositions will of course be distributed out of the estate to the named charitable beneficiaries, producing a charitable deduction for estate taxes purposes. We are not here concerned with those properties (it is too late to do anything about charitable testamentary planning), but rather with such land, or interests in land, as to which no specific devise obtains.
The problem for the land trust, in such a situation, is that the executor has a fiduciary duty to realize maximum value on each asset of the estate for the designated beneficiaries. In an exceedingly unusual case, the executor may be given some latitude to make discretionary charitable contributions, although the inefficiency of such a will provision should be patentely obvious (there is no charitable deduction for estate tax purposes unless the directive is ignored).

When confronted with the implacable demands of an executor’s fiduciary duties, often not the best strategy is to plan the conservation acquisition with the beneficiary or beneficiaries who stand to receive the target property on distribution out of the estate. If the property is the subject of a specific bequest, the ultimate destination of the property will be known, and the land trust may commence to negotiate with the named beneficiary. If the property is part of the residuary estate, it may be possible to work with the executor and beneficiaries to structure an equitable distribution that will place the target property in the hands of those most charitably inclined, or those best able to take advantage of charitable contribution tax benefits (not necessarily the same folks).

Trust Properties

Merely knowing the property is held in trust provides very little intelligence about the degree of difficulty apt to be encountered in pursuit of its acquisition. Trust ownership may be no barrier at all, or, at the other pole, it may effectively preclude any land trust attempt to acquire it, even by a full-price purchase.

“Living trusts.” So-called “living trusts” are often established as an element of an estate plan. These trusts are revocable; their principal objective is to streamline and simplify the probate process — property held in such a trust bypasses the probate estate and is applied directly according to the terms of the trust. For income tax purposes, however, such a trust has no independent tax significance; trust properties are treated as owned directly by the grantor. Thus there is no discouragement arising out of the trust’s legal title to a target parcel. The potential donor will be treated as owning the property directly, and the land trust negotiator will be free to represent the entire galaxy of charitable acquisition possibilities applicable to any individually owned property.

Family trusts. If the trust is irrevocable, and has been established to provide for the management of income-producing properties for the benefit of one or more family members (often members of one or more successor generations to the trust’s settlor), the same fiduciary duty barrier is apt to be confronted as in the case of property held by an estate. In some cases, a family trust may allow the trustee to make charitable distributions out of current income, often in favor of specifically named charitable beneficiaries. More commonly, income of such a family trust is entirely distributable to noncharitable persons; thus any charitable gift (of an easement, for example) or bargain sale would serve to derogate the interests of the current beneficiaries, the persons entitled to take the remainder upon termination of the trust, or both.

Problem (13). Laidlaw Walkup established by will a trust to provide income for life for his three children, Curlew, Dufus, and Jane, with a succeeding 21-year income interest in such grandchildren of Laidlaw as survive the death of the last child to die. After the termination of the grandchildren’s 21-year income interest, the corpus of the trust property is to be distributed to Laidlaw’s then-surviving grandchildren and/or great-grandchildren. Upon Laidlaw’s death in 1967, his children were in their 40s, and he had seven grandchildren. Today, Curlew, Dufus, and Jane are all in reasonably good health and their seven grandchildren have produced five great-grandchildren.

Most of the trust’s properties are blue-chip stocks and government bonds, but the trustee holds as well a 3,200-acre tract of Oregon timberland, which Laidlaw directed to be held for not less than 25 years, subject to sustained-yield timber harvesting. The Sasquatch Land Trust would like to acquire that property, which has recently been appraised at $2.5 million, and wonders about the possibility, and tax efficacy, of a bargain purchase from the trust at a price of $1.5 million.

On the assumption that the terms of the trust cannot allow the trustee the discretion to make such a contribution (generally a reliable working assumption), in order to do so the trustee would presumably have to secure the approval of each trust beneficiary, including each contingent remainder beneficiary — grandchildren and great-grandchildren, and a guardian representing the interests of unborn contingent remainder beneficiaries. Court-appointed guardians are usually required to represent the interests of minors and unborn persons, and the entire acquisition plan will be subject to court review and approval. The prospect of running that procedural gauntlet is daunting indeed.

In some cases, it may be more promising to attempt to arrange for a disposition out of the trust to...
one or more beneficiaries who both favor the bargain conveyance and are personally willing to assume the cost of making the gift. In our problem, for example, if Dufus’ interest in the trust is actuarially worth $2.5 million or more, he might seek the approval of each other beneficiary to permit a distribution of the target property to him (such distribution would not cause recognition of gain to either Dufus or the trust, and he would inherit the trust’s basis in the property), so as to set the stage for Dufus to make the suggested bargain sale. Such a scenario is by no means bereft of technical problems, but is apt to have a considerably higher probability for success than would a bargain sale out of the trust itself.

Charitable trusts. Acquisitions of properties from trusts which have exclusive or substantial charitable purposes raise problems not radically different from those pertaining to family trusts. The trustee of an exclusively charitable trust, which may or may not be a tax-exempt organization, will be bound to apply the income of that trust to its stated charitable purposes. If, happily, the trustee’s charge is broad enough to permit distributions of income and/or assets for the benefit of a land trust which seeks to acquire one of that trust’s properties for conservation purposes, the acquisition may be as straightforward as seeking a major grant from a foundation. But if the trustee is bound to apply the resources of the trust to the promotion of animal welfare or research on the decline of civility in urban societies, a fair market value deal may be all that is available.

Charitable remainder trusts are apt to pose similar fiduciary problems. Even if the land trust which seeks to acquire a target property from a charitable remainder trust is the sole remainder beneficiary, sale by the trustee at a bargain price would likely affect the interests of the income beneficiaries, probably endangering the qualification of the trust as a tax-exempt entity. A sale at full fair market value would not be proscribed, however (note that the self-dealing rules would not prevent that transaction, since the land trust would not be a “disqualified person”), and it ought to be possible to effect such a sale under the installment method. Where the income beneficiaries’ interests are (actuarially) of short duration, the land trust might well expect to satisfy a substantial part of the installment obligation upon termination of the trust.

Charitable income trusts typically provide an income stream to one or more charities for a term of years, with the remainder paid over to noncharitable persons (generally younger-generation family members) at the termination of the trust. Where the land trust is also the income beneficiary, however, it may be possible to commute or diminish the land trust’s income interest in return for a distribution or bargain purchase of the target property. Such an approach would surely require the concurrence of the remainder beneficiaries and, very likely, court approval.

Tax Benefits for the Estate or Trust

As we have seen, executors and trustees will very rarely have the discretion to make charitable contributions not approved by the governing instrument, but, in those rare cases where an acceptable plan to have a contribution or bargain sale made by the entity is fashioned, tax benefits may be germane. Accordingly, we shall attempt here a very cursory description of the system of taxation applicable to both estates and trusts.

Estates and trusts are taxable entities subject to rates of tax identical to those applicable to individuals (although the top marginal bracket is reached very quickly). They are, however, permitted deductions for distributions of income properly made to their income beneficiaries. Thus, to take a simple case, an estate which received $5,000 in interest and dividends during one of its taxable years during the period of estate administration, could completely eliminate its tax liability by distributing at least $5,000 to its beneficiaries during that year (or within the first 65 days of the following year). The distribution deduction in effect makes the estate or trust a quasi-taxable entity; i.e., taxable only to the extent that it does not, or cannot, limit its liability through distributions.

As to charitable contributions, the operative requirements for estates and trusts differ. An estate may achieve a charitable contribution deduction with respect to such amount of its gross income, for a particular year, as is irrevocably set aside for charitable purposes, as well as for such amounts as are actually paid to accomplish charitable purposes (including, of course, distributions of cash or property to properly qualified charitable organizations.) The nonexempt trust, however, enjoys no “set-aside” deduction; only amounts actually paid to charity out of gross income will qualify.

Neither an estate nor a trust is subject to any percentage limitation. If the governing instrument and/or the affected noncharitable beneficiaries so permit, an estate or trust may eliminate its entire taxable income through charitable contributions (a frequent state of affairs with respect to distributions made by charitable income trusts).