Liquid Capital Partners

The Family Investment Company and a Donor-Advised Fund

Reducing Income Tax by 50% and Eliminating Capital Gains Tax While Maintaining Control

Overview

The Family Investment Company LLC integrated with a Donor Advised Fund is a simple but elegant solution that allows for tax deductions for business owners and high income W-2 employees and/ or elimination of capital gains tax while addressing the traditional problems of charitable gifts – (1) Loss of control over the money (2) Loss of control over the disposition of the money (3) Loss of investment control (4) Loss of access to use of the funds for financial planning purposes. This strategy is able to overcome these problems in a conservative manner from a tax perspective.

Benefits

(1) Income tax deduction up to 50 percent of AGI.
(2) Carryover of excess deductions for an additional five tax years.
(3) The majority of the LLC income (99%) is tax-free.
(4) The majority of the LLC assets (99%) are outside of the taxpayer's taxable estate.
(5) Taxpayer retains management control over the LLC and LLC assets.
(6) The taxpayer as manager continues to manage the LLC assets.
(7) The taxpayer as manager is able to retain full discretion over the distribution of income to the public charity.
(8) The taxpayer as manager is able to earn a management fee. The taxpayer may defer the management fee on a tax deferred basis.
(9) The LLC assets are protected (99%) from the claims of the the taxpayer's personal creditors.
(10) The charity is entitled to annual distributions at the discretion of the Manager. When the decision is made to liquidate the LLC, the charity will receive 99% of the LLC's assets. The taxpayer may replace this wealth through the purchase of life insurance in an irrevocable life insurance trust (ILIT), which may include lost cost / non-commissioned coverage through private placement life insurance.

Conceptually, a primary benefit of a family investment company integrated with a donor-advised fund (DAF) is that it allows someone to donate assets for charity today – and receive a tax deduction now – even though the actual funds may not be granted to the final charity until some point in the future. In other words, the donor-advised fund essentially functions as a conduit, where the donor receives a tax deduction when the money goes into the DAF, but has discretion about when the assets will finally leave the DAF and actually go to the charity… and in the meantime, assets inside a donor-advised fund may grow tax-free.

Given the potential of a donor-advised fund to separate the timing of the contribution and tax deduction, the donor can maximize the value of the tax deduction in a high-income year, but retain the flexibility to decide in the future the final disposition to charity.

Set up

The strategy entails the formation of an LLC capitalized by cash and/ or appreciated assets and donating up to 99% of the LLC's interest to a charity. The taxpayer retains a 1% interest as a Managing Member, which permits the taxpayer to retain an income interest.

The compensation should be arms-length in amount and structure. Investment partnerships (private equity and hedge funds) frequently provide an investment structure that has a management fee of 2-3 percent as well as a performance fee equal to 20-30 percent of investment income within the LLC. A similar arrangement could be established in this situation. This management fee could also be deferred on an indefinite basis.

The operating agreement of the LLC has typical powers for the managing member. The operating agreement allows the managing member to make loans using LLC assets to third parties, or to himself or other members of the LLC, or to secure a loan on behalf of the LLC. The terms of the loan should be arms-length equal to the Applicable Federal Rate (AFR).LLC funds could be accessed through the LLC using tax-free secured or unsecured demand loans.

The public charities that receive benefits under the taxpayer's DAF, will receive a large endowment equal to its LLC interest, once the LLC is liquidated which may be multiple generations. The LLC operating agreement may provide for a finite period of existence, i.e. 40 years or perpetual existence subject to the decision of the managing member. The managing member interest may be gifted directly or in trust for future generations in order to perpetuate the structure. Life insurance in an irrevocable life insurance trust insuring family members may be used to replace wealth that passes to the donor advised fund.

The legal viability of the Family Investment Company from a tax standpoint with respect to charitable deductions is dependent upon treating the charities fairly. The taxpayer should establish a regular pattern of distributions as managing member for the benefit of the Donor Advised Fund. No legal standard exists to establish how much is too little or too much. As a result, it is recommended annual distributions to the Donor Advised Fund of at least 2-5 percent of the LLC's net asset value.

Examples

W-2 Income
Bob forms Smith Investment Holdings, LLC, a Delaware single member LLC. He contributes $500,000 of cash and marketable securities to the LLC. Bob retains a one percent managing

member interest and donates a 99 percent interest in the LLC to the Army Powerlifting Team at the United States Military Academy. The valuation of the LLC interest on Form 8283 reflects a ten percent discount for lack of marketability and control. The gift for tax purposes is valued at $450,000. the deduction is taken on Schedule A of Form 1040. The tax benefit is $211, 500.

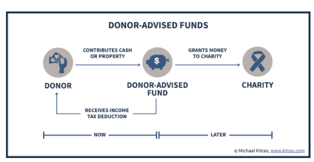
As managing member, Bob will manage the LLC's investments in a balanced investment portfolio. He plans to make annual distributions of $15,000 to the Army Powerlifting Team to fund the team's participation in the NCAA Championship meet each year. Bob retains a management fee of $15,000 per year but elects to defer recognition.

All of the LLC's income (99%) is earned on a tax-free basis. The LLC assets are beyond the control of Bob's personal creditors. Bob submits a new W4 to his HR to reduce his tax withholding- instead, he will fund the LLC with additional capital contributions and elect to issue and donate additional LLC interests to Army Rugby.

Capital Gains Tax
Bob owns a gym that he wants to sell to a third party for $5 million. He contributes the gym ownership to a family investment company as described herein which sells the gym. At the time of the contribution, Bob is eligible for a charitable deduction equal to the fair market value of the gym. At the time of the sale, no capital gains taxes are due as it is owned by the charity.

Technical Details

Generally, a donor advised fund is a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization. Each account is composed of contributions made by individual donors. **Once the donor makes the contribution, the organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account.**



The IRS is aware of a number of organizations that appeared to have abused the basic concepts underlying donor-advised funds. These organizations, promoted as donor-advised funds, appear to be established for the purpose of generating questionable charitable deductions, and providing impermissible economic benefits to donors and their families (including tax-sheltered investment income for the donors) and management fees for promoters.

Examinations of these arrangements may result in the following Service actions in appropriate cases: (a) disallow deductions for charitable contributions under Internal Revenue Code section 170 for payments to the fund; (b) impose section 4966 excise taxes on sponsoring organizations and managers of donor-advised funds; (c) impose section 4958 excise taxes on donors or managers of donor advised funds; and/or (d) deny or revoke the charity's 501(c)(3) exemption.

Additional information
New Requirements for Donor-Advised Funds
Donor-advised funds are subject to new requirements under the Pension Protection Act of 2006.
The IRS has issued guidance and new procedures implementing the legislation.
New excise taxes may apply to sponsoring organizations and managers of donor-advised funds.

Thus, transactions between sponsoring organizations and fund managers may be subject to intermediate sanctions excise taxes and donor-advised funds may be subject to taxes on excess business holdings.

Donors are provided guidance on how to determine whether a grantee that is a donor-advised fund is a public charity under section 509(a)(1), (2), or (3), in IRS Business Master File information.

Notice 2006-109 provides interim guidance on issues affecting supporting organizations and sponsoring organizations of donor advised funds.
Responding to Congressional direction, Treasury Department reported the results of a study of donor-advised funds and supporting organizations in December 2011.

Taxes on Excess Business Holdings
Generally, under section 4943 of the Internal Revenue Code, the combined holdings of **a private foundation** and all of its disqualified persons are limited to 20 percent of the voting stock in a business enterprise that is a corporation. The 20 percent limitation also applies to holdings in business enterprises that are partnerships, joint ventures, or other unincorporated enterprises. For a partnership or joint venture, profits interest is substituted for voting stock, and for any other unincorporated enterprise, beneficial interest is substituted for voting stock. A private foundation that has excess business holdings in a business enterprise may become liable for an excise tax based on the amount of the excess holdings.
Initial tax. An excise tax of ten percent of the value of the excess holdings is imposed on the foundation. The tax is imposed on the last day of each tax year that ends during the taxable period
The amount of the excess holdings is determined as of the day during the tax year when the foundation's excess holdings in the business were the greatest.

The initial tax may be abated if the foundation can show that the excess holdings were due to reasonable cause and not to willful neglect, and that the excess holdings were disposed of within the correction period.

For purposes of the taxes under section 4943, certain donor-advised funds and supporting organizations are treated as private foundations.

Additional tax. After the initial tax has been imposed, an excise tax of 200 percent of the excess holdings is imposed on the foundation if it has not disposed of the remaining excess business holdings by the end of the taxable period. The additional tax will not be assessed, or if assessed will be abated, if the excess business holdings are reduced to zero during the correction period.

Sources

IRS website https://www.irs.gov/charities-non-profits/charitable-organizations/new-requirements-for-donor-advised-funds