Leaving a Legacy: Philanthropic Planning for Business Owners

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Philanthropically minded business owners often have goals relating to their philanthropic legacy as well as their business and family. Regarding philanthropic objectives, business owners often seek to maximize charitable impact over a period of time – sometimes forever. In order to do so, they will want to consider both the timing and structure of the charitable gift.

Timing

The timing of the gift may affect both capital gains tax liability and current charitable income tax deduction. Generally, upon the sale of a business, owners owe capital gains tax on the built-in appreciation in the company. By making a charitable gift of the interest in the business prior to selling it, owners may reduce or eliminate capital gains tax due upon the sale.

EXAMPLE 1

Sally owns a medical device company worth $30 million. Her basis in the company is $2 million. Sally intends to sell her company and use the proceeds for charitable purposes.

If Sally sells the company, she will owe capital gains tax on $28 million (the value of the company over basis). Assuming a capital gains tax rate of 23.8%, she will owe tax of $6.7 million, leaving her with $23.3 million after tax. If she contributes the after-tax proceeds to charity, Sally may be entitled to a charitable income tax deduction of $23.3 million, subject to certain limitations.

EXAMPLE 2

Assume, instead of selling the company, Sally transfers her business to charity. Because a tax-exempt organization holds the interest, neither she nor the charity would owe capital gains tax on the sale of the company. In addition, Sally would be entitled to a charitable income tax deduction. Depending on the charity's structure (as discussed next in this commentary), the value of her income tax deduction could be the full fair market value of her charitable contribution, or $30 million, subject to certain limitations.

In both examples, the business is sold, and all proceeds go to charity. However, because in the second example Sally gave her interest in the business to charity prior to the sale, the results are far more favorable – both for Sally personally and for the charity. In the second example, capital gains tax is avoided, Sally may be able to take a larger income tax deduction, and the charity ends up with $7 million more in assets.

Structure of Charitable Recipient

In addition to considerations relating to timing, business owners should consider the charitable recipient's structure. This will have tax implications, as well as an impact on the family's involvement in carrying out the philanthropic legacy. Three possible ways to structure a charitable gift include: a direct gift to charity, a gift to a private foundation and a gift to a donor advised fund. The following discussion of these structures assumes the business interest was given to the charity prior to the sale.

Direct Gift to Charity

A business owner may consider making a direct gift of business interests to a public charity. By doing so, he or she will receive an immediate tax deduction for the interest's fair market value. In addition, capital gains tax may be avoided upon the sale of the business.

EXAMPLE 3

Consider the previous example. Instead of selling her medical device business, Sally transfers her interest in the company to St. Jude Children's Research Hospital, a public charity. The value of Sally's current income tax deduction will be the fair market value of her interest in the company ($30 million). In addition, when St. Jude subsequently sells the business, capital gains tax is avoided.

There are, however, a few downsides to giving an interest in a business directly to a public charity. First, the charity may be required to participate in the negotiation and sale of the company, and an owner could be reluctant to have another party involved in a potential sale. In addition, some public charities may lack the sophistication to handle a gift of a business interest. Second, as noted earlier, to obtain the maximum tax benefits, business owners should consider transferring the interest in the business prior to a sale. As such, the amount of the sale – and hence, the amount ultimately flowing to the charity – will be uncertain. An owner may be reluctant to give away an interest in the company without knowing the amount ultimately going to charity. If the business sells for less than was anticipated, the owner may wish he or she had retained more of the interest for personal use. On the other hand, if the business sells for more than was expected, the owner may wish that the excess flowed to different charities. Finally, a direct gift to a public charity may not provide meaningful opportunities for business owners and their families to remain involved in carrying out the philanthropic legacy.

Gift to Private Foundation

In contrast to a direct gift to a public charity, a business owner may consider creating and funding a private foundation. Private foundations often provide an effective structure for family philanthropists wishing to create a lasting legacy. Owners can fund their foundation and receive certain tax benefits, and they and their family can continue to control the foundation and direct its annual grant-making to charitable organizations of their choice.

However, it is important to note that the income tax benefits for lifetime gifts of business interests to private foundations are more limited than those to public charities. Appreciated assets other than marketable securities are deductible at cost basis rather than fair market value.

EXAMPLE 4

Consider example No. 2. Instead of selling the company, Sally transfers her interest in the business to a private foundation, the Sally Family Foundation. She intends to make annual grants from the Sally Family Foundation to public charities. Because the charity is a private foundation rather than a public charity, the value of her current-year income tax deduction will be the basis in her company, or $2 million – compared with a $30 million deduction for a gift to a public charity.

So, lifetime gifts of highly appreciated business interests to a private foundation rather than a public charity may result in a diminished current-year income tax deduction.

In addition, private foundations are subject to certain restrictions on excess business holdings, the premise of which is that they should not be overly involved in a company's ownership. Generally, the restrictions provide that the foundation and its disqualified persons cannot hold more than 20% total of any business enterprise or, if control of the company is held outside the family, over 35%. There is a special rule whereby a foundation has a five-year period to reduce its ownership in the business enterprise down to permissible levels if the

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excess holdings were created by gift or bequest; this initial period may be extended if the holdings resulted from an unusually large gift or bequest. In order to reduce these holdings, the foundation will need to identify an unrelated buyer, as a purchase by a disqualified person will be prohibited due to the self-dealing rules, another set of restrictions applicable to private foundations.

Given the restrictions and tax implications, a lifetime gift of business interests to a private foundation often is not the best solution.

Gift to Donor Advised Fund

A business owner wishing to contribute business interests for charitable purposes may find the solution in a donor advised fund. A donor advised fund provides both the favorable income tax benefits associated with a gift to a public charity and the opportunity to remain involved with the grant-making associated with a private foundation.

A donor advised fund is a component fund of a public charity. As such, contributions are not subject to the more limited income tax benefits applicable to gifts of business interests to a private foundation. Thus, the business owner will avoid capital gains tax and receive an immediate tax deduction for the interest's fair market value.

Like a private foundation, a donor advised fund may provide an opportunity for philanthropists wishing to create a lasting philanthropic legacy. Donor advised funds can operate from a grant-making perspective in the same way as a private foundation, allowing owners and their family the opportunity to select which charitable organizations will receive a grant from the donor advised fund. While certain grants that are possible through a private foundation may not be possible through a donor advised fund, such as international grants or grants to individuals, most grants to domestic charities are permissible.

Though a donor advised fund may provide favorable tax benefits and the opportunity for family members to be involved, there are other considerations. For example, while many donor advised fund providers have sophisticated staff members that could handle the sale of a business, the owner may be hesitant to have the donor advised fund provider participate.

Other Considerations

Choosing to give a business interest to charity is a complex decision. Careful planning regarding the timing and structure of the gift can go a long way toward maximizing charitable impact. There are many other issues to consider as well, such as the business's structure; for example, there are specific rules associated with gifts of S corporation stock. Your BBH wealth planner would be pleased to discuss the ways in which you may accomplish your philanthropic goals or other objectives relating to your business succession.

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