STRATEGIC WEALTH ADVISORY GROUP

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Creating a lasting philanthropic impact as you exit your business

Philanthropic strategies to consider when you sell your company

Frequently, business owners are so focused on the operations of the business, they lack the time to consider how a sale will impact them and their loved ones. Even those who have put in place a wealth transfer plan to benefit themselves and their family overlook the philanthropic causes that are important to them.

When preparing the sale of your business, you may also want to take advantage of this opportunity to consider your philanthropic goals, including faith-based giving. If giving of this nature is an important facet of your overall financial goals, there are several strategies you may want to consider that would allow you to be more efficient with your philanthropic giving plan.

A successful long-term charitable giving plan that addresses your specific needs may include several charitable giving vehicles. While the charitable income tax deduction is generally not a primary driver for those who choose to give back, it is an important consideration in the structuring of your charitable gifts.

The importance of the timing of your philanthropic gift

When it comes to any wealth transfer planning with the goal of minimizing gift, estate, or generation-skipping transfer taxes, earlier is often better.

However, when it comes to philanthropic planning, business owners generally don't want to give an interest in their company to a charity in advance of a sale for one primary reason: if the sale of the business does not come to fruition, the charity becomes a co-owner of the business, which can complicate future sales and may limit the business's ability to operate freely. Under IRS regulations, a charitable deduction is determined in part by the value of the asset(s) at the time of contribution. This means timing a gift requires a delicate balance.

In general, donors want to wait until they are close to the sale's transaction because the company being sold is worth the most at that time. However, waiting too long may result in the IRS asserting the position, under the *assignment of income* doctrine, that the donor should be taxed on the gain and the contribution treated as a cash contribution after the transaction has closed.

It is generally accepted that contributions made prior to the execution of a binding letter-of-intent is sufficiently in advance of a sale to avoid this issue. However, each situation is unique, so even this does not necessarily mean that the opportunity is lost. One way to help ascertain whether this approach remains a viable option is to consider whether there is a party outside of your control that retains the ability to keep the transaction from going forward. For example, is the purchaser still conducting due diligence or does the transaction have yet to receive regulatory approval? An experienced tax advisor who is familiar with these issues is in the best position to determine whether a donor should move forward with a philanthropic strategy designed to defer or avoid capital gain. Otherwise, the business owner may end up having the structure denied by the IRS, resulting in having to not only pay capital gains on the donated assets, but also being denied the charitable deduction (and, therefore, owe tax, interest and potentially penalties).

How late is too late?

Is it "practically certain" that the transaction will occur?

Ferguson v. Commissioner

Weak IRS Position **Strong**

Prior to signing of binding letter of intent (LOI)*	Prior to signing of definitive sales agreement†	After most or all material closing conditions have been satisfied‡
• The more time that passes between the gift and the signing of a definitive sales agreement, the weaker the IRS' position	• Certain elements of an LOI may be partially binding • LOI may require a definitive sales agreement to be totally binding	• Has the voting ownership approved the sale?

* In *Gerald A. Rauenhorst v. Commissioner*, 119 T.C. 157 (2002), the Tax Court found in favor of the Donor because the donees were not legally bound, and could not be compelled, to sell their stock warrants.

† In Rev. Rul. 78-197, the IRS stated that it would treat the proceeds of a redemption of stock as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.

‡ In *Ferguson v. Commissioner*, 108 T.C. 244 (1997), the Tax Court found that the transferred property had sufficiently "ripened" for tax purposes and that the taxpayers would be taxed on any gain realized from stock that was transferred to a charitable organization.

A range of choices on structuring the gift of business interests

If you are thinking about donating an interest in your business to fund your charitable goals, you have a range of ways you may want to structure the gift. Depending on your specific goals, you may want to employ a Donor Advised Fund, a private foundation, or a type of charitable trust — or some combination that helps you best fulfill your goals and maximize your tax benefits.

Donor Advised Fund

If philanthropy plays an important role in your financial goals, but you aren't ready to give a significant sum of money to any specific organization at this time, a Donor Advised Fund (DAF) might be the right vehicle for you. A DAF is a charitable giving account administered by a public charity that enables you to pursue your charitable goals. Because the DAF is sponsored by another organization that has already qualified for non-profit status, opening the account is a straightforward, quick, and cost-effective option for philanthropic giving.[1]

Because the DAF is a charitable, tax-exempt entity, assets sold by a DAF are not subject to income or capital gains tax.[2] This gives you and your loved ones a greater pool of assets that can be used to support the causes that are important to you.[3] Additionally, if privacy is important to you, this is a great option because it also allows you to give anonymously through the sponsoring organization.[4]

Since the charitable deduction is an important consideration for many business owners, it's important to note that contributions of an interest in a private company to a DAF are entitled to a charitable income tax deduction based on the fair market value[5] of the interest at the time of contribution, subject to certain AGI limitations.

Private Foundation

If you like the flexibility that a Donor Advised Fund provides, but you want more control over the charitable entity, you may want to consider a private foundation instead.[6] The private foundation is your own charitable entity, so it allows you to retain the greatest level of control of any charitable vehicle, such as maximum control over grant-making and investment management.

Like a DAF, the private foundation is able to sell assets and not be subject to income or capital gains tax.[7] There is, however, one very important distinction: while you receive a charitable income tax deduction for the contribution of an interest in your business to the private foundation, your deduction is limited to your basis in the company, which is usually low for most business owners, and subject to certain AGI limitations.

There are also some additional requirements associated with a private foundation that you don't often find with other charitable vehicles. These include a required annual 5% distribution on the value of assets in the private foundation to qualified charities and annual IRS reporting requirements. And unlike a DAF, grants are a matter of public record.[8]

One benefit of private foundations is the ability to employ family members as part of the board or as a trustee of the private foundation, but note that certain states limit the ability to pay related parties compensation for the services rendered. Also, because of the costs associated with establishing a private foundation, such as the initial legal fees, ongoing annual reporting requirements, and excise taxes, they are generally more cost effective for gifts in excess of $10 million.

Charitable Remainder Trust

If philanthropy is important to you, but you are also concerned about ensuring that you will have sufficient income to maintain your lifestyle, a Charitable Remainder Trust (CRT) may be the right structure for you. The CRT is a tax-advantaged philanthropic strategy that allows you to direct your wealth in ways that reflect your charitable values and beliefs, while also providing you with a payment stream during your lifetime.[9]

This trust can provide distinct income tax advantages when you are selling your company[10] because the trustee is able to sell the assets of the CRT without an immediate recognition of capital gains, thus reinvesting the proceeds, net of sales costs, into a diversified portfolio.

CRTs work in a way that is distinct from a direct donation to a DAF or a private foundation. When establishing a CRT:

1. You would make an irrevocable gift of an interest in your company to the CRT, in which you or your loved ones[11] retain the right to receive a regular payment stream. The length of the trust can be a set term of up to 20 years or one based on life expectancy — even if this actuarially extends beyond 20 years.
2. After property is contributed to the CRT, it can be sold by the trustee without recognition of the associated capital gains taxes at the time of the sale. The sales proceeds can then be reinvested in a diversified portfolio for growth, income, or total return.[12]
3. The charities that you designate at the time you establish the CRT, which may include your own Donor Advised Fund or private foundation, will receive the remaining trust assets at the end of the trust term.

One caveat of this strategy is that to qualify as a CRT, the present value of the charity's interest when you establish and contribute assets to the CRT must be at least 10% of the total value transferred to the trust. The discounted value of the assets that eventually pass to charity at the end of the CRT's term can then be used to offset your income taxes as a charitable deduction in the year of contribution.

Types of Charitable Remainder Trusts

- A **Charitable Remainder Annuity Trust (CRAT)** pays a fixed dollar amount that does not fluctuate throughout the term (for example, $500,000 per year for 20 years).
- A **Charitable Remainder Unitrust (CRUT)** pays a fixed percentage of the trust value, which is recalculated annually (for example, 5% of a trust's fair market value as of December 31st of each year for 20 years; if the trust's fair market value on December 31st is $10,000,000, 5% equals $500,000).

There are further options available within the CRUT that allow you flexibility regarding the timing of payments you receive, so make sure you select the one that best fits your financial goals.

- A **NICRUT (Net Income [only] Charitable Remainder Unitrust)** limits the payment to the lesser of the fixed percentage or trust accounting income (for example, if the CRUT annuity percentage is 5%, but income is 2%, you would receive only a 2% payment from the NICRUT).
- A **NIMCRUT (Net Income with Make-up Charitable Remainder Unitrust)**, like a NICRUT, limits the payment to the lesser of the fixed percentage or trust accounting income. However, distributions greater than the fixed percentage are allowed in future years to "make-up" for prior years when the trust accounting income was less than the fixed percentage (for example, expanding on the NICRUT example, if income is 7% in year 2, you would receive the 5% due + the additional 2% to "make-up" for the 3% you did not receive in year 1).
- A **"flip" CRUT** usually starts out as a NICRUT or a NIMCRUT, but "flips" to a traditional CRUT upon a triggering event. The "flip" must be triggered "on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons".[13] For NIMCRUTs, any remaining "make-up" amount is forfeited upon conversion on the flip date from a NIMCRUT to a traditional CRUT.
- A **"spigot" NIMCRUT** often uses a single-member limited liability company (LLC) to restrict trust accounting income. This creates more flexibility and control over the timing of when trust income is distributed because trust accounting income is generated when a distribution is made by the manager (who must not be related or subordinate to the grantor-beneficiary) from the LLC.[14]

Charitable Lead Trust

If none of the previous strategies resonate with you, you may want to consider a Charitable Lead Trust (CLT) to help you fulfill your philanthropic goals. The CLT may be particularly useful if you currently make recurring annual charitable contributions.

With the proper structuring, you may be able to take a dollar-for-dollar current year charitable income tax deduction for contributions to a CLT (the CLT must be a grantor trust, and the present value of the payment stream distributable to charities must equal the amount contributed). This can be particularly valuable in a year in which you have a significant amount of income or capital gains to offset. However, if you want to benefit from the charitable deduction, as an irrevocable grantor trust, future income that the CLT generates will be taxable to you, and you will not be entitled to any additional charitable deductions for the annual distributions to charities.[15]

When funding your CLT, you should consider contributing assets that you anticipate will increase in value. The CLT will make annual payments to the charity of your choice, which may include your own Donor Advised Fund or private foundation[16] for a term of years. The present value of the charitable payments offsets the gift tax value of the assets you transfer to the CLT, which allows the CLT to be "zeroed-out" in order to maximize the value of your charitable deduction, while minimizing the gift implications of the remainder interest passing to your loved ones.

Employing this strategy also provides you with the opportunity to transfer assets to your loved ones at a reduced value for gift tax purposes.[17] At the end of the initial CLT term, any assets remaining in the CLT can pass to your loved ones without triggering any additional federal gift or estate taxes. Alternatively, if you are concerned that you may need additional assets down the road, the CLT can be structured so what's left in the trust passes back to you.

Conclusion

Selling your business is an exciting time fraught with so many moving pieces that it is nearly impossible to properly manage them all. As you think about how you want to transfer the value of your business to yourself or loved ones, take time to consider your charitable goals as well. With some advanced planning and guidance from your Merrill advisor, you may be able to maximize the benefit of a sale and help mitigate income and transfer taxes, allowing you to support more of your wealth transfer and philanthropic goals.

For additional wealth transfer strategies to consider as you near the sale of your company, see our whitepaper, "**Is it too late?**".

Talk to your Merrill advisor to learn more about how wealth transfer planning can help you achieve your charitable goals.

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Jean has advised ultra-high-net-worth individuals and families on wealth transfer and philanthropic strategies for over twenty years. She also helps families define the purpose of their wealth and integrate strategies that help them to pursue their goals in a tax-efficient manner.

Jean joined Merrill in 2010 and is a Managing Director, Private Wealth Strategist in the Century City and Newport Beach offices of Merrill's Strategic Wealth Advisory Group. Jean's experience includes, in conjunction with their tax and legal professionals, helping clients plan for estate and gift taxes, wealth preservation, philanthropy, concentrated stock diversification, stock options, and other tax minimization strategies.

Jean first joined Bank of America through Bank of America Private Bank in 2005, where she was a Senior Vice President of Wealth Planning Solutions in Newport Beach. Prior to 2005, Jean was a founding member of the San Francisco site of the Wealth Planning Center of Wells Fargo Private Client Services. Jean served as West Region leader for Personal Financial Services Software Solutions for PricewaterhouseCoopers and also practiced law with a focus on estate planning.

Jean is a frequent speaker on topics relating to legacy planning and philanthropy. She enjoys volunteering through her church and within the public school system.

Education | Designations | Licenses | Memberships

- Bachelor of Arts in Psychology (Regents' Scholar) – University of California, San Diego
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- Is a CERTIFIED FINANCIAL PLANNER® certificant
- Member of the Bar in California
- Past President, Los Angeles Estate Counselors Forum

Members of the Strategic Wealth Advisory Group do not provide tax, legal or accounting advice.

Endnotes

[1] Each sponsoring organization will have its own due diligence process before accepting an interest in a privately held business.

[2] Some excise taxes may be applicable, such as on non-qualifying distributions, prohibited investments, and excess business holdings.

[3] Contributions of privately held S-corporation shares to a DAF are subject to an unrelated business income tax, which reduces the value of funds available for philanthropic giving.

[4] Grant recommendations are subject to approval of DAF sponsor.

[5] "Fair market value" is measured on the date of the transfer as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

[6] The type of "private foundation" discussed in this update is a private non-operating foundation (grant-making), different rules apply for a private operating foundation.

[7] Private foundations are subject to an excise tax of 1.39% of net investment income (beginning in December 2019). There are possible additional excise taxes, such as taxation on jeopardy investments, self-dealing, and excess business holdings.

[8] Many donors will opt to partner with a Donor Advised Fund when they desire a grant to be made anonymously.

[9] A charitable remainder trust can be constructed to provide a payment stream to the creator of the trust or other designated beneficiaries for life or a specific period.

[10] Due to the limitations on what type of entity can qualify as an S corporation shareholder, this strategy is generally not appropriate for shares of S corporation stock. However, the S corporation may consider establishing and contributing qualifying assets to a CRT.

[11] Consider the applicability of gift taxes when a non-charitable beneficiary other than a U.S. citizen spouse is named.

[12] CRTs should avoid owning leveraged assets or certain business interests that may generate unrelated business taxable income (UBTI) which is taxed at a rate of 100%.

[13] Examples of a single event not within the control of any other person include the sale of unmarketable assets or life events (such as marriage, divorce, death, or the birth of a child).

[14] Technical Advice Memorandum 9825001 states that the ability to defer an income interest the Donor would otherwise be entitled to does not constitute self-dealing. The income beneficiary (a disqualified person) cannot control the investment so unreasonably that it impacts the charitable organization's remainder interest.

[15] In Rev. Proc. 2007-45, the IRS states that the grantor will realize capital gain on appreciated assets distributed to a charitable organization to satisfy an annuity payment.

[16] To avoid incomplete gift treatment, if your private foundation is the lead recipient, the funds paid to it by the CLT should be segregated into a separate account in which you have no distribution authority.

[17] Consider the applicability of generation-skipping transfer taxes, which apply when a gift is made to or for the benefit of (1) a family member who is two or more generations younger, such as a grandchild, or (2) an unrelated individual who is greater than 37.5 years younger.

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