Selling for the Greater Good

Why business owners should consider and discuss with their CPA the potential benefits of donating company ownership before a sale, not after.

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Often when an entrepreneur considers selling his/her business, there is an initial thought of wanting to do good for others with some portion of the proceeds. Because of the emotional nature of focusing on the transaction to maximize value for shareholders and family, opportunities can be missed. Despite their best intentions, charitably minded entrepreneurs frequently fail to maximize the amount of money going to their favorite charity/charities while potentially reducing the amount of money that would go to the federal government. A CPA can often times be the most trusted advisor for entrepreneurs; therefore, you have a unique opportunity to discuss the benefits and the challenges.

While there may be uncertainties that entrepreneurs have to address when selling their business, the uncertainty of having enough income in retirement is usually a priority. The thought of giving money away before a sale is not usually a topic that is of interest. As a CPA, this can help differentiate you and your practice by sharing the specifics of a charitable remainder trust (CRT).

A CRT is "a tax-exempt irrevocable trust designed to help reduce the taxable income of individuals by first dispersing the income to the beneficiaries of the trust for a specific period of time and then donating the remainder of the trust to the designated charity or charities."[1]

Donating stock prior to a sale can have several benefits. From a tax perspective, it can potentially reduce the value of your client's estate and it can reduce the amount of capital gain taxed owed. From a retirement perspective, it can help provide income to your client and their loved ones. From a philanthropic perspective, it can potentially maximize the money your client can give to the causes they love, as well as provide some level of certainty to the receiving charities that their programming goals will be funded.

Why Do So Many Business Owners Donate to Their Favorite Charities After a Sale Rather Than Before?

Oftentimes people who give to charity have more than one that they care about helping. They have a spirit of wanting to help them all and trying to decide which charities to give to, how much to give and how often can complicate the decision process. Not truly knowing how much income will actually be needed in retirement can be another issue. These factors all usually intersect at a point of no action until after a transaction has occurred.

There are three basic questions that a CPA can help clarify for clients, in an uncomplicated way, if it is better for them to give shares to a charity or charitable entity prior to a sale or after:

1. What causes are important to you currently?
2. Have you thought about making a direct gift to the charities you love?
3. Would you like to have an income stream generated by the assets that would be donated to charity?

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What causes are important to you currently?

Since people who are charitably inclined have a heart for more than one organization, it can be difficult to decide who to donate to. This feeling of being rushed to make a decision before a sale occurs makes it easy to wait to do something about it until after the transaction is completed. As a CPA, you can help lessen this feeling of being rushed by discussing some of the benefits of transferring ownership to a donor advised fund prior to the sale to the entity.

Have you thought about making direct gifts to the charities you love?

You often hear of entrepreneurs gifting some part of their company stock to a charity directly, but this could potentially create certain tax traps that were unintended for the charity. You have the ability to speak directly to these potential tax traps, unlike a wealth manager or some attorneys.

One tax trap that can be created is unrelated business taxable income (UBTI). This can occur when gifting an active business asset. Establishing a donor advised fund can potentially remove this issue.

Would you like to have an income stream generated by the assets that would be donated to charity?

Whether this applies to income for your client or for some other family members of the client, if this answer is yes, a CRT might be a good option for you to consider for your client.

Donation of business shares to a CRT can potentially provide an income tax deduction. Depending on the type of charity that will ultimately receive the donation, the deduction allowable will be based on either the fair market value of the donated shares or the cost basis. As a CPA, you should always confirm the potential tax treatment prior to selecting the charity or charities that will benefit from the remainder interest.

Once the client or any other non-charity beneficiary (this can be their children) begins receiving income, the income received would be subject to income tax in the year it was received.

There are a few different choices as to how long the income stream can last. If the client (grantor) is the beneficiary, they can choose it to last over their expected lifetime. If they are married, they can choose it to last until the second death. If they are providing income to a beneficiary other than themselves, they can choose a period of time not to exceed 20 years, with the remainder passing to charity[2]. Any one of these options could provide some comfort to your client that they are not giving away assets that are needed to generate income during the early years of retirement.

For the charitably minded entrepreneur, pre-transaction planning creates an opportunity to help the causes they love without jeopardizing their liquidity or cash flow needs in retirement. This, however, is not always immediately clear prior to the sale of a business. As a CPA, you are potentially one of your clients' most trusted advisors and they will likely look to you for sound strategies to help

Figure 1. The Impact of Donating a 20% Non-voting Interest in a 5MM C-Corp (Cost Basis 100K)

	Income tax liability of business owner	Value to charity	Income tax saved by business owner	Total tax benefit for owner
Scenario 1 Sell then donate	1,166,200 (2a)	766,760 (3a)	283,701 (4a)	283,701 (5a)
Scenario 2 Donate then sell	932,960 (6a)	370,000 (7a)	370,000 (8a)	603,240 (9a)

2a. Sale of the business triggers long-term capital gain tax and Net Investment Income Tax (NIIT) of $1,166,200. Calculation: tax bracket of 23.8% (20% federal + 3.8% NIIT) X 4.9MM ($5MM minus 100K basis) = $1,166,200.

3a. Only $766,760 goes to charity since you are giving from after-tax proceeds (5MM - $980,000 capital gains - $186,200 NIIT = $3,833,800 X 20% gifted portion) = $766,760.

4a. Assumes 37% tax (37% federal) X $766,760 deduction = $283,701.

5a. Total tax benefit = income taxes saved.

6a. Assumes the asset is owned by the non-profit at time of sale. No NIIT or long-term capital gain tax on donated portion. Calculation: 5MM asset - 1MM gift - 80K cost basis = personal gain of $3,920,000 X 23.8% (20% federal + 3.8% NIIT) = $932,960

7a. Assumes full 1MM is received by the charity since charity does not pay capital gains tax and is not subject to NIIT on the gift.

8a. Assumes 37% effective tax (37% federal) X 1MM deduction = $370,000 (assumes full deduction can be taken against ordinary income)

9a. Assumes $233,240 in long-term capital gain tax and NIIT are saved plus $370,000 income taxes saved = $603,240 total tax benefit for the owner.

them understand the key issues they might face.

You have the unique ability to help maximize the positive impact entrepreneurs can have for the causes they love and their family by explaining the potential tax benefits of a CRT and helping your clients understand their specific cash flow needs in retirement.

By demonstrating a meaningful solution, you can help reduce the emotional stress when making a decision. Don't let the stress of the transaction keep you from asking your clients the three simple questions. The causes they support are counting on it!

Sources

1. http://www.investopedia.com/terms/c/charitableremaindertrust.asp#ixzz4joekYBzK.

2. Preserve and protect your legacy; A resource from UBS Trust Solutions. February 2018, p.9.

National Christian Foundation, Maximize Your Sale to Multiply Your Giving, 08/29/2016.