

SELLING A MAJOR BUSINESS ASSET

And achieving philanthropic objectives at the same time

The sale of a major business asset often represents the culmination of many years of work. The asset might be a family business, an investment in real estate, intellectual property, or significant holdings in a publicly traded company where there will be significant income or capital tax gains taxes resulting from a sale. By creating a private foundation, a seller of any of these assets may avoid or reduce taxes while retaining control over all or a portion of the sale proceeds to be used for future charitable grants or activities.

The following six case studies illustrate the potential opportunities to both sell a major business asset and achieve philanthropic objectives.

CASE STUDY #1: ENTREPRENEUR WITH A CASH BUYOUT OFFER

Craig was a serial entrepreneur who, in recent years, had developed and operated for-profit career colleges through a privately held corporation. After several years of operating the colleges successfully, Craig received an all-cash offer to sell the colleges to another company in a similar line of business. This opportunity presented Craig with a dilemma: should he contribute stock of the corporation to his family foundation prior to executing an agreement to sell the stock to the buyer, or should he sell the stock and make a cash contribution to his foundation?

After consulting with his tax advisor, Craig concluded that selling the stock and making a cash contribution to his foundation was the optimal choice for two reasons. First, had he contributed the privately held stock, he would only have been allowed to claim a charitable contribution deduction for his adjusted basis in the stock, and not its fair market value of the stock as reflected in the sale price. Second, from his foundation's standpoint,



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although gifts of stock are not treated as excess business holdings for 60 months from the date of the gift, the foundation eventually would have to sell most of the stock to fall within the excess business holdings limits and avoid a violation, even if the anticipated sale did not close.

Had the privately held corporation been structured as an S corporation, another important consideration would be that any distributive share of net income from the S corporation received by the foundation would be treated as income from an unrelated trade or business, which is taxed at the for-profit rates, and a subsequent sale of the stock likewise would be treated as a taxable gain under the unrelated business income tax rules.

CASE STUDY #2: PROFESSIONAL WITH A STOCK BUYOUT OFFER

Rachel was a successful architect who, after many years of association with other firms, established her own architectural firm that she operated through an S corporation of which she was the sole stockholder. After several years of successful operations and expansion of the business, Rachel was presented with a once-in-a-lifetime opportunity to sell her company to a publicly traded real estate investment trust (REIT). The transaction was structured to qualify as a tax-free reorganization because Rachel received the stock of the REIT in exchange for 100% of the stock of her S corporation. After a short lock up period of six months, she was free to dispose of the stock by sale or gift.

After consulting with her tax advisor, Rachel decided to make a contribution of the REIT stock to her newly-formed family foundation. The stock she received from the REIT qualified as long term capital gain property because her holding period for the S corporation stock was tacked onto the

holding period for the REIT stock. Equally important from Rachel's standpoint was the fact that the S corporation stock was converted, tax-free, into publicly traded stock and, therefore, when she contributed the stock to her family foundation, she obtained a charitable contribution deduction for an amount equal to the fair market value of the stock rather than one that was limited to the stock's adjusted basis.

CASE STUDY #3: REAL ESTATE INVESTOR WITH NO IMMEDIATE BUYER

George, now deceased, was a co-founder and 50% owner of a limited partnership that constructed and purchased commercial office buildings for investment purposes. George's partner, who is unrelated to George, owns the other 50%. As part of his estate planning, George made a bequest of a 30% profits interest in the partnership to his family foundation and the balance to his children and grandchildren. Because his estate received a step-up in basis upon his death, his estate obtained an estate tax deduction for the fair market value of the partnership interest. And because more than 95% of the partnership's revenue was in the form of rents from real property, the foundation was permitted to retain ownership of the partnership interest under the excess business holdings rules generally applicable to private foundations. Although the foundation couldn't sell its partnership interest to George's family members because of IRS rules prohibiting certain transactions with insiders, the foundation could always sell its interest to an unrelated third party or have its interest redeemed by the partnership.

CASE STUDY #4 LANDOWNER WITH CASH BUYOUT

Emily retired from a successful career as an attorney and purchased, debt-free, a house and barn on 200 acres of land not far from a city on which to run an organic produce farm. After 20 years, having saved enough from her previous career and from the farming business to retire comfortably even without the proceeds from the sale of the farm, Emily decided to give up farming and move closer to her children. Since Emily purchased the farm, the rural area surrounding it had become more suburban, so she had received a number of attractive offers to sell the farm for residential development for much more than her original purchase price. Although Emily and her children believed strongly in educating the public about organic farming, they did not have the time or resources to turn the farm into a charitable farm education center. Instead, Emily supported a

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number of such organizations that already existed. She hoped to increase her donations to those and other organizations promoting organic farming and to engage her children in her philanthropic efforts.

After consulting with her tax advisor, Emily decided to create a private foundation with herself and her children as directors and donate the farm property to it, rather than selling the farm and donating the after-tax sale proceeds. Because the property was donated and not sold, no capital gains tax was due on the significant appreciation in the value of the farm property. Thus, Emily was able to direct the farm's full fair market value to her charitable endeavors and receive a charitable contribution deduction in the amount of her cost basis in the farm property. Despite being limited to her original cost, the charitable deduction was as large as Emily could have used given her other income. Due to its tax-exempt status, when the foundation subsequently sold the land, it was subject to minimal tax on the sale proceeds and was able to devote the net proceeds to its charitable mission.

CASE STUDY #5: ARTIST WITH NEED TO SELL OVER TIME

Steve had a long career as a commercially successful contemporary artist. He received significant income from the sale of his original works and royalties on licensed reproductions. Over the years, he had retained a large collection of his own works worth over \$20 million with a tax basis of close to zero. Steve was terminally ill and wanted to use the value of his art for two purposes: to support his one child, Bill, and to provide financial awards to young artists. Steve was justifiably concerned that the value of his art might decline after his death as it ceased to be as contemporary and he was no longer around to promote it. Steve also knew that the value his art would be greater if individual pieces were sold gradually over time rather than all at once.

Steve considered simply leaving the art and royalties to his son, but that would have resulted in a very large estate tax liability, which could have only been paid by quickly selling a substantial part of the collection, likely at a discount. Instead, Steve's advisors worked with him to set up an estate plan under which he would leave \$10 million of his art and \$1 million of royalties (the estate tax exemption amount) to Bill. He quickly set up a private foundation that would receive the rest of his estate, \$10 million of art and \$1 million of bonds. The foundation obtained approval from the IRS for a program of making financial awards to young artists.

Thanks to this proactive planning, after Steve's death, no estate taxes were due. Son Bill received a stream of taxable royalties, but he was able to reduce the taxes by selling some of his father's art tax-free (because of the basis step-up caused by the art's having passed through Steve's estate) and giving the proceeds to the foundation. If Bill needed more income, he could have kept the proceeds of art sales for himself or, if he was managing the foundation, it could have paid him a reasonable salary for doing so. The foundation could strategically promote Steve's art (incidentally helping to maintain the value of Steve's art in Bill's hands) by making gifts or loans to museums for exhibit and making essentially tax-free sales of Steve's work to raise funds to make awards to young artists. If Steve's work increased significantly in value over Bill's remaining life such that Bill could not pass all of it on to his children without an estate tax, Bill could repeat the same strategy using the same foundation in his own estate plan.

CASE STUDY #6: EXECUTIVE WITH SUDDENLY VALUABLE STOCK OPTIONS

Patricia was a long-time executive at a public company. Over the years, she had been granted non-qualified stock options (NSOs) to purchase 100,000 shares of her company's stock at \$20 per share. Although the stock had never traded at more than \$20 per share, the stock suddenly increased in value to \$50 per share, due to the profitability of a new product line. Patricia wanted to capture the run-up in the stock's value and—since she didn't need it for retirement—decided to donate it to her private foundation.

With her tax advisor, Patricia considered several alternatives:

- Contributing the NSOs themselves to the private foundation
- Exercising the NSOs, immediately selling the stock acquired upon exercise, and donating the after-tax cash proceeds from the sale to the foundation in the same tax year
- Exercising the NSOs, selling only as much stock as needed to cover taxes on the exercise, holding the remaining stock for at least a year to obtain long-term capital gains treatment, and then donating it to the foundation
- Exercising the NSOs and donating other appreciated property of a similar value to the foundation in the same year as the exercise in order to offset the tax triggered by the exercise

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Although some types of stock options cannot be transferred by law, and many stock option plans do not allow transfers or only permit them to family members, Patricia's company's NSO plan permitted transfers to charity. However, Patricia ruled out donating the NSOs to the foundation after her tax advisor pointed out that when the foundation exercised them, she—and not the foundation—would owe ordinary income tax on the exercise. For this reason, it was preferable for Patricia to exercise the NSOs herself under one of the other three alternatives. (Patricia's tax advisor explained that under each of the alternatives, she would owe ordinary income tax on the difference between the exercise price and the value of the stock received upon exercise.)

Patricia ultimately decided to immediately donate to her foundation \$3 million of publicly traded stock that she had obtained in a divorce settlement 15 years before and in which she had a low basis. She received a charitable contribution deduction for the fair market value of the stock (thus avoiding tax on the significant gains built up in the stock), which offset the taxes she owed on her NSO exercise and resulted in a larger donation to her foundation than would have been the case under the other alternatives.

As these case studies illustrate, thoughtful tax planning can help philanthropic-minded individuals achieve their charitable objectives when they are looking to monetize a major business asset.

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