GIVING A BUSINESS TO CHARITY

Pre-transaction Planning Considerations

As business owners contemplate retirement they begin to think “What should I do with the family business?”

• Should I sell it?
• Should I pass it down to the next generation?”

Once a decision is made, it would seem that the options are pretty clear either-

• Find a buyer to purchase the business, or
• Find a next generation family member to run the business

Right? Well, yes and no. There are many issues to consider when thinking about the final disposition of a family business. If selling the business is the route the business owner decides to pursue, two of the high priority issues (but not the only issues) to address typically are-

• How to minimize the impact of the taxes triggered by the sale, and
• How to replace the compensation previously provided by the business over the business owner’s lifetime, giving the former owner sufficient cash-flow to maintain his or her lifestyle, including anticipated capital purchases, gifts to children, and gifts to support charitable causes he or she cares about.

Starting the planning process early is critical to thoughtful gift and estate planning, as well as income tax planning, resulting in tax deferral and potentially greater cash flows.

Charitable Planning Considerations

Charitable vehicles can allow the philanthropic business owner to:

• Mitigate the tax consequences on the sale of a business by deferring the receipt of taxable income,
• Create an ongoing income stream over his or her lifetime or for a term of years, and
• Ultimately provide a significant gift to the business owner’s charity of choice.

What kind of charitable vehicle can potentially do all of this? A Charitable Remainder Trust (CRT). A CRT is an irrevocable trust that when properly drafted and operated allows individuals to obtain multiple benefits:

• Transfer assets to the trust and retain an income stream from the trust for a term of years or for the business owner(s)’ lifetime,
• Defer taxes on the recognized gains until the proceeds are received by the business owner, thereby potentially reducing total tax paid,
• Reinvest the sales proceeds – reduced only by the annual required distribution to the business owner, but not reduced by any taxes from the sale of the asset—to maximize the income stream to the trust beneficiary,
• Provide an income tax charitable deduction to the business owner equal to the actuarial value of the charitable remainder beneficiary’s interest in the trust, and
• Benefit charity at the end of the trust term, when the assets not distributed to the trust
beneficiaries passes to the charity designated in the trust agreement.

**Charitable Trust Design**

Once the goals of the business owners are identified, in order to maximize those goals, care must be exercised in the design of the trust, including the payout percentage, how long the trust should last, identity of the trustee, and the investment/portfolio composition. Let’s look at a case study to see how this works.

- Margaret (age 65) and Benny (age 68) Jones have owned a chain of business products stores (Fine Business Products for Less) for 30 years.
- They have worked side-by-side to grow the business to 10 thriving stores.
- They have several children—none of whom have expressed a desire to work in the business.
- Margaret and Benny, who now want to retire, realize some of their long cherished dreams are to travel and also to make a leadership gift to a charity.
- Margaret and Benny have identified a possible buyer for the business and are exploring with their legal advisors some ideas that will allow them to meet two objectives:
  - Sell the business in a tax-effective way, and
  - Make a gift to their charity of choice.

One option presented to the Jones’ is the transfer of all or a portion of the stock1 to a 6% Charitable Remainder Unitrust (CRUT) for the joint lives of Margaret and Benny. A CRUT makes variable distributions to Margaret and Benny based on revaluing the trust assets on the same date each year and multiplying the new value by the fixed 6% unitrust percentage to determine the amount of the distribution for such year.

<table>
<thead>
<tr>
<th>CRT</th>
<th>Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of the business:</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Basis in the stock of the company:</td>
<td>100,000</td>
</tr>
<tr>
<td>Immediately Taxable Capital Gains</td>
<td>-0-</td>
</tr>
<tr>
<td>Two lives charitable remainder unitrust</td>
<td>6%</td>
</tr>
<tr>
<td>Ages: 65 and 68</td>
<td>65 and 68</td>
</tr>
<tr>
<td>Gift date assumption:</td>
<td>07-24-2015</td>
</tr>
<tr>
<td>Annuity payment frequency:</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Taxes on stock sale (CA blended capital gains rate of 33%)</td>
<td>$0 to the trust; fraction of unitrust distribution to individual beneficiary</td>
</tr>
<tr>
<td>Net proceeds of sale</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Charitable Deduction:</td>
<td>2,938,600*</td>
</tr>
</tbody>
</table>

*Assumes IRS discount rate of 2.2% (July 2015 rate)

Once the trust owns the stock of Fine Business Products for Less, it can:
• Sell the stock to a third party purchaser without the imposition of any taxes at the trust level on the sale of the stock.
• Then reinvests the proceeds of the sale into a diversified portfolio—unreduced for taxes—and in an environment that is tax-free for the duration of the trust.

If the trust investment performance is in excess of the 6% unitrust amount, the trust value will grow and the following year, the payments will grow as well.

Although the sales proceeds are not taxable at the trust level, the taxable income of the trust will flow out to the Joneses with their unitrust distributions. For example, if the trust’s net ordinary income during the first year was $150,000, then the Joneses will receive $150,000 of ordinary income from the trust, and the rest of their distribution will be taxable as capital gains. Any taxable income of the trust that’s not distributed in a given year, will be “saved” and passed out to the Joneses in future years. In this way, income tax from the sale of the business is deferred until the proceeds are received by the business owners.

Selecting a relatively modest unitrust percentage is generally prudent in order to increase the likelihood of the trust investment performance generating a return in excess of the payout percentage (i.e., 6% in this example) because the amount in excess of the required distribution amount increases the value of the trust and therefore the future payments from the trust.

Note that the value of the income stream depends on the value of the trust’s assets each year. If the trust suffers losses due to poor investments or weak economic conditions, the business owner’s income stream will be reduced.

There are many types of charitable remainder trusts and tailoring the trust to each person’s goals is important to obtaining the desired result. In this example:

• The charitable income tax deduction is almost $3M, which Margaret and Benny can use to offset other income in the year of the gift.
• If not fully utilized in the year of the gift, the unused charitable income tax deduction can be used for up to 5 additional years to mitigate the income taxes on the trust distributions, which can mean a higher overall effective rate of return.

Note that, by transferring all of the family business to a CRT², the business owner has retained an income stream from the proceeds, but has made a gift to charity of some of the principal of this asset. At the end of the trust term, none of the remainder can be distributed to family members. Instead, the business owners’ legacy to family will come from non-business assets, and/or investments made with the unitrust payments received during the term of the trust.

This is just one example of how a business owner can take care of family and favorite causes at the same time. Although using a charitable vehicle as part of the sale of a business adds a layer of intricacy to an already complicated transaction, the potential rewards can justify the increased complexity.

Finally, note that the type of entity in which owners holds their business interests can affect their ability to take advantage of charitable giving vehicles like CRTs. Likewise, the timing of ownership transfers (to the trust and between the buyer and seller of the business)
can greatly impact the ability to take advantage of income tax deferral. Therefore, we suggest that you plan ahead and discuss your charitable options well in advance of the sale to reap the maximum benefit of taking care of family AND your favorite charity!

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1 This example assumes the business is operated as a C corporation. If a business is operated as a limited liability company, S corporation, partnership or sole proprietorship, other considerations must be explored. You should consult with your own personal tax advisor regarding your specific situation.

2 Of course the Jones’s do not have to transfer all of the company stock to the CRT—they could retain some of the stock and use the proceeds from any sale for their own purposes—including gifts to the next generation. Such decisions should be made with the help of their financial and legal advisors.