Tax-Forward and Philanthropic Ways to Exit a Business

A significant number of business owners – and perhaps even you – will retire in the next few years or move on to a "second or third" act. If you are planning for a potential business sale and are concerned about a large tax event and your legacy, looking at options that could involve a charitable component now, prior to a sale, may be an excellent way to save taxes and create a charitable legacy.

Many of you by now have read the recent headlines about the founder and CEO of Patagonia, Yvon Chouinard, who recently transferred ownership of his entire company (valued at $3 billion) to a special trust and a nonprofit organization. Rather than sell the company or take it public, Chouinard created a never-before used process to commit the company in perpetuity to his mission to combat climate change and protect undeveloped land throughout the world. **Most unique about the structure of this transfer is neither he nor his family received any tax benefits from it.**

How is that possible? First, Chouinard transferred the company's voting stock (about 2% of the company) to a special purpose trust controlled by his family and advisors to ensure the company remains true to its socially conscious mission. As a private trust, there is no tax benefit for this irrevocable transfer. Second, Chouinard donated the remainder and bulk of his Patagonia shares to a newly established nonprofit with a mission to combat climate change. This nonprofit, however, is not a 501(c)(3) that would have provided him with an enormous tax benefit. Rather, the nonprofit Holdfast Collective, was established as a 501(c)(4) that will allow it to play a much larger role in electoral politics, such as contribute to campaigns, endorse candidates, and lobby politicians. It also means, however, that the donation is not tax deductible.

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Interestingly, if Chouinard had wanted to sell Patagonia to an outsider rather than have the business continue to operate and use its profits for social change, the transfer would have been quite beneficial to him. **A sale of the business after the transfer to this nonprofit would have allowed him to avoid a substantial capital gains tax upon the sale.** Take for example, the recent case of Barre Seid, a Republican donor, who donated 100% of the shares of his private electronics company (Tripp Lite) to a nonprofit focused on conservative causes. Less than a year later, Seid (as remaining CEO) sold Tripp Lite to an Irish conglomerate for $1.65 billion and the nonprofit owner of such shares received a windfall of cash, and most importantly, Seid gave up his ability to profit from the sale of his company, but also avoided a huge capital gains tax.[i]

While many folks want to be philanthropic and want to avoid a large tax event, not everyone can afford to give away all of their company or business sale proceeds. **But, owners of closely-held businesses have many options and tools to transfer all or part of a business for philanthropic causes and also receive tax benefits that might encourage such a transaction when a large capital event is expected in the future.** In addition to transferring shares directly to a traditional nonprofit charity, other beneficial options include transferring shares to a donor advised fund (also a public charity) or to a charitable trust.

The sale of a small business while utilizing a charitable tool such as a charitable remainder trust (even if one transfers only a portion of their company shares) is not as straightforward as the contribution of publicly traded stock. There are a number of factors that must be considered, but once done, can be quite beneficial to an owner who wishes to be both philanthropic and tax-sensitive when a sale is under consideration.[ii] And it is certainly feasible. **The two biggest issues to be aware of are the (1) timing of the transactions, and (2) structure of your company.**

Timing is key: Charitable planning conversations need to happen <u>before</u> you have an offer or agreement to sell your company. At the initial thought of a business exit situation, you should consider your philanthropic options. Oftentimes, people think about this issue too late in the process and the IRS will disallow any tax deductions when the transfers to charity occur after an agreed-upon sale (whether formalized in writing or not). This is known as the “prearranged sale” doctrine and you want to avoid any appearance of walking too close to the line. If you are too far along in identifying the purchaser of your business, you may be viewed as compelling the trustee of the charitable trust to sell to a particular buyer and the IRS may tax the sale of the business, negating the tax benefits.[iii]

Before you move farther along with creation of a plan to transfer all or part of your company to charity, you must also ensure that the company form and legal structure will allow such a transfer. For example, a charitable remainder trust cannot hold S corporate stock and such a transfer will void the corporation’s S status and all the capital gains on the sale of the S stock will be taxed at regular tax rates.

You don’t need to have a business valued as much as Patagonia or Tripp Lite to get great benefits from these types of transactions. In fact, small businesses (those defined as firms with fewer than 500 employees) make up the overwhelming majority of American businesses. When you have spent the bulk of your life building your business, how to exit can seem like an overwhelming task. If you also consider that this is likely your most important wealth triggering event, it is easy to only follow the advice of your tax or legal counsel, without considering how this event fits into your legacy planning or your next act.

Even though these transactions must be carefully designed and thought through, a small business owner should not be scared off from exploring their options. It is simply a matter of having the right voices at the table early on in the process and taking a more holistic approach to planning. In addition to involving your accountant and lawyer, you should also have your financial advisor and philanthropic adviser to help you consider and work through various options and scenarios with you and your team. A philanthropic advisor, especially one who works closely with your other advisors from the beginning, can help you think through what might work best for your particular circumstances and help determine how best to meet your philanthropic goals.

BLB&B Advisors' Philanthropic Advisory Services can help. BLBB Advisors has a distinctive perspective on philanthropy because we oversee BLBB Charitable, our private foundation focused on supporting education and leadership opportunities in our community. We have a unique insight into choosing the right charitable instrument for your needs, as well as experience in helping create a philanthropic strategy. Knowing how to develop and execute upon a personal or family giving strategy and mission as part of your financial planning is critical to ensuring your philanthropic efforts have a maximum and lasting impact. If you are contemplating a business ownership transition and would like to learn more about incorporating philanthropy into this transaction, please contact Nicole Tell, Executive Director of BLBB Charitable, at 215-634-9001.

[i] In donating the company shares to a 501(c)(4) rather than a 501(c)(3) public charity, Seid did forgo the opportunity for a large charitable deduction. If he had donated to a 501(c)(3) organization, he would have avoided the large capital gains tax and received a significant charitable deduction for the transfer.

[ii] Transferring a portion of your company shares to a Charitable Remainder Trust, in particular, may not only provide a way to lessen capital gains exposure upon a future sale, but also may provide you or a family member with an ongoing stream of income from the trust.

[iii] One wonders, in fact, if the IRS will take a closer look at Tripp Lite's sale of the business just months after the transfer of the shares to the nonprofit.