January 31, 2020

Sagemark Consulting
A division of Lincoln Financial Advisors®

Business Transfer Newsletter

Charitable Gifting in Exit Transactions

Many business owners consider the wealth that they have accumulated in their businesses not only the product of years of hard work, but also the result of blessings and good fortune that others have bestowed upon that owner to help on his / her path to success. And, when it is time to harvest that wealth, many owners have thoughts of 'paying it forward' by donating a portion of their liquidity event to charitable causes.

This article is written to make business owners aware that there are benefits, beyond the charitable intent being satisfied, that can be served with privately-held company stock. The article draws from points made in Chris Mellen's June, 2018 article, Charitable Gift Valuations Prior to Business Sale, and points to a few resources and tips that can help owners and their advisors better plan for charitable bequests that accompany their business exits.

Do I Give Because I Am Wealthy, Or Am I Wealthy Because I Give?

There is a correlation between individuals [including business owners] who donate to charities, and those who go on to achieve high levels of wealth. So, it begs the questions as to 'whether you give because you can afford to?', or 'can you afford to give because you are charitable in nature?' However you choose to ask and answer these questions you are not alone amongst the charitably inclined. According to the National Philanthropic Trust, contributions to [the] 284,965 Donor Advised Funds in the US totaled $23.37 billion in 2016.

By using privately-held stock to fulfill your charitable desires, you can also gain in a few other ways.

How to Donate: Checkbook, Securities, or Privately-Held Stock

Individuals and business owners who are considering donating to charities and / or causes to which they care, have a number of options. The most obvious is to write a personal (or company) check for the donation. However, some folks have also been advised to consider low-basis [publicly-traded] stocks as an asset that can also be contributed. By contributing the low-basis [liquid, publicly-traded] stock, the individual can both hold onto their cash as well as avoid certain capital gains on the future sale of that stock. This is possible because the vehicle that holds the charitable bequest is most commonly a non-taxable entity so no capital gains tax is paid when the low-basis stock is sold after being donated to the charitable vehicle, such as a Donor Advised Fund.

Beyond writing checks and donating liquid stock, there is a 3rd alternative - *donating a percentage of your privately-held business*. When a business owner considers that the privately-held stock is illiquid in nature, it adds to the benefits listed above because, unlike cash and publicly-traded stock, there is no 'market' for illiquid stock until someone appears and is willing to purchase it.

Tax Benefits of Using Illiquid Stock

So we have now seen that there are practical benefits of using privately-held stock for charitable bequests because the liquid assets (cash and low-basis stock) can be retained and used for other purposes. We also see that illiquid stock can serve the purpose of gaining an immediate tax advantage. However, there is yet another benefit to bestowing stock for your charitable intent – it is to receive a current tax deduction for the value of the donation.

The example below helps to illustrate this point. The hypothetical situation below is drawn from Chris Mellen's June, 2018 article titled Charitable Gift Valuations Prior to Business Sale:

Ten years ago, you helped start a company and were granted 20,000 shares of stock at $1 per share, representing a one-third equity interest. That company has now retained an investment banker to market the company for sale, targeting a transaction price of $60 million. Being charitably-inclined, you have decided to tithe (donate 10 percent of) the proceeds. Based on a one-third interest in a $60 million company, this works out to donating 2,000 shares at an implied value of $2 million.

After consulting with your accountant and your wealth advisor, you are considering two options. The first option is to make a $2 million donation to charity[1] after the company is sold and you receive your $20 million proceeds. Based on the calculations outlined in the table below, including the fact that you will pay capital gains tax on this transaction, this results in a tax benefit of $344,000 given that you are in the highest personal income tax bracket.

The second option is to contribute 10 percent of your shares to charity shortly before the scheduled close.[2] This will require obtaining a valuation from an independent qualified appraiser. The appraiser concludes on a fair market value of $1.94 million, equivalent to a 3 percent discount to reflect the uncertainty of closing, by completing a scenario and probability analysis of various possible outcomes. This results in a tax benefit of $717,800, $373,800 more than by donating the cash after the sale of the company.

[1] Many charities are not set up to receive gifts of privately-held company stock. As such, these types of gifts are usually made to larger charities, donor-advised funds, or private foundations.

[2] You must work closely with your tax and legal counsel to avoid violating the IRS's Anticipatory Assignment of Income Doctrine.

Option 1 - Contribute cash after sale of securities:		
Immediate Cost of Donation	A	$2,000,000
Basis	B	$20,000
Taxable Amount	C = A - B	$1,980,000
Capital Gains Tax Paid @ 20%	D = C*20%	$396,000
Income Tax Savings @ 37%	E = (A*37%) - D	$344,000
Cost to Donor	F = A - E	$1,656,000
Donor's Tax Benefit	G = A - F	$344,000
Option 2 - Contribute appreciated securities shortly before sale:		
*FMV of Donation of 2,000 shares (less 3% for uncertainty)	H = A * (1-3%)	$1,940,000
Income Tax Savings @ 37%	I = H*37%	$717,800
Cost to Donor	J = A - I	$1,282,200
Donor's Tax Benefit	I, or A - J	$717,800
Tax Benefit of Donation of stock (vs. cash donation)	F - J	$373,800

*This is the result of a valuation involving a scenario analysis reflecting the uncertainty (as of the valuation date) that the transaction actually closes. For ease of illustration we are assuming this uncertainty results in a fair market value that is 3% less than the ultimate transaction price.

**These calculations do not consider other tax-related factors such as state tax, AMT (Alternative Minimum Tax), etc. Also note that charitable deductions are limited to certain percentages of adjusted gross income.

In essence, by going with Option 2, you: (i) would receive a tax deduction of $717,800 based on the fair market value of the securities donated; (ii) would avoid capital gains tax; and (iii) if donated to a DAF, would now be able to support several charities over time with the proceeds from this donation to that DAF.[3]

We see that by donating illiquid, privately-held stock to the charitable vehicle of their choosing, business owners can get superior tax results, hold onto their cash and low-basis, publicly-traded stock, as well as use an otherwise illiquid asset to satisfy charitable intent.

Concluding Thoughts

This newsletter is intended to raise awareness to business owners of the opportunity to use illiquid stock in your chartable bequests. However, there are many additional steps that need to be followed to execute these transactions effectively. It is recommended that owners get with their advisory teams to further pursue this value-add strategy. In doing so, you will be more prepared for a future exit transaction that truly meets more of your overall personal and business goals.

Private Wealth Advisor

Cathey Paine, CBEC, CEP, CLTC is a registered representative of Lincoln Financial Advisors Corp.

Securities offered through Lincoln Financial Advisors Corp., a broker/dealer (member SIPC). Investment advisory services offered through Sagemark Consulting, a division of Lincoln Financial Advisors Corp., a registered investment advisor. Insurance offered through Lincoln Marketing and Insurance Agency, LLC and Lincoln Associates Insurance Agency, Inc. and other fine companies.

Please do not send any trading or transaction instructions through this email. They will not be honored or executed. Should you need immediate assistance, please call the Lincoln Financial Advisors trade desk at 1-800-237-3815.

If you do not wish to receive future e-mails from me, please call me at 818-540-6945, fax me at 818-540-6991, or e-mail me at Cathey.Paine@lfg.com. We will comply with your request within 30 days.

Lincoln Financial Advisors Corp. and its representatives do not provide legal or tax advice. You may want to consult a legal or tax advisor regarding any legal or tax information as it relates to your personal circumstances.
CRN-2522883-043019

[3] Note that Option 2 relates to Scenario 1 – making a gift shortly before a transaction closes. A more conservative scenario discussed below is to make a gift several weeks or months before any potential transaction closes.