CABLE HUSTON LLP

Think Charitably When Selling a Business

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Each year clients contact us to evaluate their charitable giving options. Most of these conversations take place at the beginning or end of the year. When owners are evaluating whether to sell their business, we encourage them to think charitably when planning for the transition. Charitable gifts are beneficial to both the business owner and the recipient.

Outright gifts to charities

Assets gifted to a charity outright do not cause any gift taxes to accrue. Additionally, gifts to a charity result in an income tax deduction. To use the income tax deduction, gifts of items other than cash require substantiation. If the value of the gift exceeds $5,000, a qualified appraisal in compliance with IRS rules is needed to substantiate the gift.

The most efficient asset to give to a charitable trust is one that has appreciated. For example, if the business owner wants to give $1,000 to his or her favorite Section 501(c)(3) organization and he or she has stock worth $1,000 that was purchased for $100, the business owner will recognize $900 of capital gains income if the business owner sells the stock and gives cash to the charity. If the business owner transfers the stock to the charity, neither the business owner nor the charity recognizes the taxable gain upon the sale.

Gifts to charitable trusts

Many business owners use gifts to charitable trusts to leverage the income tax impacts when selling an appreciated business. There are a few types of charitable trusts. Generally, charitable lead trusts make a distribution to a charity for a term of years with the remainder to noncharitable beneficiaries. Charitable remainder trusts provide an income stream to noncharitable beneficiaries for a term of years with the remaining assets passing to the charity at the end of the term.

Charitable remainder trusts
A charitable remainder trust can be used to create an income stream if the business owner has assets that are not income producing and a sale of the assets would cause the business owner to pay a substantial capital gains tax. When planning ahead, the business owner can transfer ownership interests in the business to the trust and the trust can sell the asset without incurring a tax.

The charitable remainder trust can then be structured to pay an annual or monthly stipend, as agreed, to individuals, including the business owner, for their lifetimes or for a period of years. Alternatively, the charitable remainder trust could be structured as a "unitrust" that pays an annual percentage based upon the value of the trust for that year. At the end of the term, the remaining assets then pass to a charity of the business owner's choice.

Charitable remainder trusts are useful to: 1, defer/avoid recognition of income on the sale of appreciated assets; 2, create an income stream for the business owner or the owner's spouse; or 3, create a fixed income stream for another individual such as a child or grandchild. Keep in mind that the trustee of a charitable trust should not be the individual who established the trust. In an example, a business owner owns stock worth $500,000 that was purchased for $50,000. A sale would cost $90,000 (at a 20 percent capital gains rate) in federal income taxes. (Additional state income taxes may accrue if the business owner's state taxes capital gains.) After payment of the $90,000 in taxes, the business owner would have $410,000 to invest.

If the business owner were to acquire double exempt bonds at 5 percent, the annual return would be $20,500. This stipend would be tax free.

If the business owner instead transferred the stock to a charitable remainder trust, the trust would realize no tax when it sold the stock. It would have $500,000 to invest in double exempt bonds, producing an income of $25,000. If the business owner actually needed an annual return of $45,000, the trust could stipulate that the business owner is to get a 9 percent return. The stipend from the trust would be taxed at capital gains rates until the business owner recognizes the $450,000 of realized gain.

There are some very technical rules regarding the amount of the stipend, but generally, it must be no less than 5 percent and rarely can exceed 9 percent in today's economy unless the business owner is an octogenarian.

In addition, the business owner can deduct the value of the remainder interest passing to charity upon the business owner's death. This value, like the other numbers, is calculated based on IRS tables that change monthly. In this example, if the trust were to grow at 6 percent and pay out at 9 percent for a period of 10 years, the charitable deduction would be $104,122.

Charitable lead trusts

A charitable lead trust is beneficial if the business owner or his or her family members do not need an income stream at the time the trust is created. Upon creation, the charity would receive the income stream and, at the end of the term, the remaining assets would pass to noncharitable beneficiaries. The value of the income stream going to charity for a term of years may create a charitable deduction at the time the trust is created or each year during the term, depending on the structure of the lead trust.

Using the same assumptions in the example above, if the charity were to receive payments of 9 percent for 10 years, the charitable deduction would be $404,217. The larger charitable deduction is based upon the larger payout to the charity.

Gifts to charities, whether outright or to a charitable trust, are extremely helpful tax-saving tools. The key is to plan ahead. These gifts must occur prior to the sale of a business. By strategizing early, the business owner can preserve more of the sale proceeds, save taxes, and support philanthropic objectives.

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