Five Essential Tips for Donating Your Business Interest Before You Exit

For business owners, the idea of retiring and selling a business can be an overwhelming and daunting process. The company that you have spent much of your working career building may have multiplied in value, and the complexities related to selling your interests can be difficult to navigate. Add to the mix that this is perhaps your most important wealth trigger event—holistic wealth management and legacy planning conversations must be undertaken all at the same time. Donation of privately held business interests can be an effective and tax-efficient way to achieve tax savings and charitable giving and legacy planning goals of the business owner; therefore, charitable planning must be factored in to the entire process.

For many founders, the original cost to start the business may have been low or even zero. Upon the sale of this interest, large capital gains tax may be triggered for the owner. A donation of some of the ownership interest provides a charitable tax deduction for the fair market value of the donated interest and minimizes capital gains exposure for the portion donated and sold by the charity rather than the business owner.

Fidelity Charitable® has accepted contributions of over $3 billion in complex, non-publicly traded assets and has irrevocably committed the proceeds for charitable purposes, namely grant making.[1] Leveraging this experience, we have compiled five important tips for you, as the business owner with charitable intent, and your advisor to consider when contemplating privately held business succession planning.

What's Inside

[1] *As of December 31, 2016*

FIDELITY Charitable℠

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White Paper

1. Prepare to Donate Early

Timing is essential. When donating privately held, non-publicly traded assets to charity, pre-planning conversations must start early—with clients, all advisors, and potential charitable recipients. Business exit opportunities can come together very quickly and, therefore, charitable planning conversations also may need to be fast-tracked. By working with experienced experts, the legal transfer of business interests to charity can occur without delaying the sale process and all the while maximizing the tax efficiency and philanthropic impact of the transfer.

Fidelity Charitable's Complex Asset Group had an opportunity to share this guidance when an advisor inquired about the possibility of donating privately held shares in an advertising agency. The agency and its owner had already entered into a legally binding agreement to sell the business. Consequently, it was too late for the owner to donate the shares in the most tax-efficient manner. Since the owner had already agreed to sell the company, the owner was no longer able to minimize the capital gains tax exposure.

A month later, the same advisor contacted Fidelity Charitable again. As the M&A market demonstrates, some sale transactions fall apart for various reasons. The advisor noted that the agreement to sell the advertising agency had fallen through because the buyer failed to get financing to purchase the company. The agency was now back on the market and the client wanted to revisit the possibility of making a charitable contribution of some of the shares of his business. Working with Fidelity Charitable, the donor was able to legally transfer the shares while the agency was being marketed for sale. Ultimately, the agency, with Fidelity Charitable as a minority shareholder, was sold and the proceeds funded the exiting business owner's donor-advised fund (DAF) at Fidelity Charitable. Through the DAF, the donor has been able to provide ongoing support to his favorite charities.

2. Ensure Company Documentation Is in Order Ahead of Time

Company governing documents (e.g., shareholders' agreement, membership agreements (LLCs), limited partnership agreements) should be reviewed to see whether shareholders, partners, or members and the transferees (i.e., the recipient charity) are subject to transfer restrictions. If transfer restrictions exist, the donor will need to investigate what amendments, approvals, or waivers are required to complete the charitable donation of the target interest. Companies commonly require approval from all or a majority of shareholders, members and/or board or managing member, and general partners to allow for the transfer, including charitable transfer, of ownership interests. Additionally, there may be rights of first refusal in favor of the company or other owners that may need to be waived before the shares can be donated to charity. Still, these restrictions are rarely burdensome enough to be a significant deterrent. Due to the donor's philanthropic intent, these barriers to transfer are typically handled with a simple waiver or consent by the other interest holders. Often the entity's management is delighted to facilitate the donation so long as the charitable recipient can comply with the governance structure. Many times, other interest holders become interested in donating some of their interest to charity as well, once they learn of the charitable giving strategy.

As an illustration, a consulting company in New York was in the early stages of vetting private equity opportunities with third-party investors. The co-founder was a longtime Fidelity Charitable donor and was familiar with the Complex Asset Group through a previous donation of privately held shares. The governing documents of the company required both board approval and a waiver of a right of first refusal in favor of the company before the shares could be donated. In the process of obtaining approvals from the board and the company, the donor educated his fellow co-founders, management team, and board of directors on his charitable giving strategy. After an introduction from our donor, Fidelity Charitable was able to work with company counsel to obtain all necessary approvals within 24 hours. One prospective contribution turned into five as the four other shareholders established donor-advised funds. Eventually, a sale agreement was reached with a private equity firm, which purchased all the donated shares from Fidelity Charitable. This strategic donation prior to a sale event empowered this group of donors to give 20% to 25% more to their favorite charities. In one instance, that savings efficiency allowed a donor to support not just seed money for an Alzheimer's research project at her alma mater, but also a scholarship endowment named in memory of her deceased father who suffered from the disease.

3. Don't Ignore the Appraisal Requirement and Don't Procrastinate

While much is made of timing the gift appropriately, neither matters much without a qualified appraisal of the donated asset to substantiate the donor's charitable tax deduction. Generally, for contributions of non-publicly traded securities, donors must obtain a qualified appraisal (an independent, third-party valuation) from a qualified appraiser to support the amount of the charitable tax deduction that the donor is claiming on their tax return. Appraisals can be obtained no earlier than 60 days before the date of the donation, and no later than the date that the donor's annual tax return (with extensions) is due for the year the charitable gift is given.

Therefore, while the appraisal does not need to be completed prior to the donation, the donor and his or her advisors should engage with a valuation firm early on in the planning process to confirm both the qualifications and availability of the appraiser, as well as to set expectations for the overall process. Engaging early also allows the appraiser to learn about the company as soon as possible and to share early opinions on estimated value, including potential discounts for lack of marketability and minority interests, as well as price and workload of the appraisal. Taking the first step with the valuation firm before the sale also keeps donors and advisors from scrambling at tax time to reconstruct the history of a company, which is likely in the hands of a new owner.

4. Choose your Charitable Giving Strategy Carefully

Donors have a variety of choices to consider when choosing what type of charitable vehicle to use, including giving directly to an operating charity, a private foundation or a public charity sponsoring a donor-advised fund (DAF) program. However, many donors and their advisors are unaware of the differences among these charities when considering donation of privately held business interests.

Donating directly to an operating charity

Contributions directly to an operating charity are generally deductible at fair market value (as determined by a qualified appraisal) up to 30% of the business owner's adjusted gross income (AGI). Yet it is important to note that because many charitable organizations are primarily mission and program focused, they may not be well equipped to handle the contribution of non-cash assets quickly and efficiently, and require both board education on the matter and approval prior to the acceptance of the assets. Because some charitable organizations might have limited experience in handling contributions of privately held business interests, the cost to the charity to outsource the compliance and liquidation work can be considerable. Although the business owners may still be eligible to claim a fair market value deduction, the net proceeds committed to charitable purposes could be significantly reduced when compared to the potential donation if given to an experienced DAF sponsor.

Donating to a private foundation

Private foundations generally have the expertise to accept business interests. However, the tax benefits are likely lower than those associated with donating directly to a public charity. A contribution to a private foundation is generally deductible to a maximum of 20% of the business owner's AGI at the lower of the original cost basis or fair market value; whereas contributions of most non-publicly traded assets, including privately held business interests, to a DAF sponsor or other public charity are generally deductible up to 30% of the business owner's AGI at the fair market value (as determined by an independent qualified appraisal). Also, when giving to a private foundation, it is important to note that the donor cannot give anonymously—something that is important to many donors.

Donating to a public charity with a DAF program

Donating to a charity with a DAF program can be an optimal method for donating business interests when measured by cost, flexibility, simplicity, expertise, and tax benefits to the donor. In addition, donating to a DAF sponsor, such as Fidelity Charitable, generally maximizes the net proceeds committed to charitable use. Similar to an operating charity, contributions of most complex assets, including privately held business interests, to a DAF sponsor are generally deductible up to 30% of the business owner's AGI at the fair market value (as determined by an independent qualified appraisal). In addition, donating to a DAF sponsor, gives you the potential to grow your gift tax-free, thereby maximizing the net proceeds ultimately made available for grants. DAF providers like Fidelity Charitable often have in-house expertise in facilitating the donation of business interests, making this transaction an easy process for the donor, and it can often be more financially and administratively advantageous for the receiving charities. Lastly, a DAF also allows you to recommend grants anonymously to many qualified charities over time.

The chart below summarizes aspects of the charitable contribution process and impact that should be considered when donating these types of non-publicly traded assets to charity.

	Operating Charity	Private Foundation	Donor-Advised Fund* (DAF)
Tax deduction	Fair market value	Cost basis	Fair market value
Expertise handling complex assets	May need to outsource and could reduce net amount	Generally outsource	Internal expertise (some may outsource)
Income tax deduction**	30%	20%	30%
Ability to diversify giving with one asset	100% of asset to one charity	Multiple grants to many charities with one asset	Multiple grants to many charities with one asset
Confidentiality	May generate additional fundraising	Annual tax filings of IRS Form 990-PF is a public record of assets, contributors, and grants	Option to give anonymously
Efficiency	Multiple charities require multiple contacts	One point of contact for transaction	One point of contact for transaction

** Specifically, donor-advised funds at a public charity*

***Percentage of adjusted gross income (AGI)*

Questions to Ask When Choosing a Charitable Recipient

1. What types of assets is the charity capable of accepting and managing in an efficient way?
2. How experienced is the charity in accepting a non-publicly traded asset?
3. Who is the main point of contact at the charity for the proposed donation?
4. How long will it take for the charity to conduct diligence on the asset?
5. Does the charity outsource the work?
6. For this diligence, what costs will the donor incur as a result of donating the asset?
7. Who at the charity needs to approve acceptance, and how long does that take?

5. Utilize Experts to Help You Navigate the Process

It is important to leverage the expertise of those familiar with the donation of business interests in order to successfully and efficiently make charitable donations during a business exit.

External Advisors

If you have a relationship with an advisor, such as a trusted attorney, accountant or financial advisor, enlist their support as you move through this process. These advisors have a holistic view of your financial situation and likely understand your future goals. They can help you consider the portfolio implications surrounding the donation of some of your business shares and can help you explore what the tax consequences of the charitable gift might be.

Expertise at the Charity

In addition to bringing in trusted advisors to provide the bulk of the planning strategy, a business owner should leverage resources at the recipient charity to fuel his or her philanthropic goals. Until recently, non-publicly traded assets were a largely untapped source of philanthropic funding. Often donors and their advisors were not aware of this charitable giving option or considered the strategy too complex. To compound the issue, generally, public charities continue to ask donors to donate cash or publicly traded stock, instead of non-publicly assets.

Fidelity Charitable has the requisite expertise, dedicated professional resources specifically devoted to converting non-publicly traded assets into charitable dollars, and has seen substantial growth in these types of contributions in recent years. Over the last two years, Fidelity Charitable accepted over $1 billion in charitable contributions of non-publicly traded assets.[2] The Complex Asset Group at Fidelity Charitable is a complimentary team of in-house subject matter experts who work with donors and their advisors quickly and directly to maximize the giving power of these assets. Due to the group's experience and comfort with these types of charitable contributions and subsequent monetization of the donated assets, acceptance decisions can be made as soon as the necessary information is received, so that a business owner can be strategically philanthropic without hindering any larger transaction within the company.

[2] Includes charitable contributions from 2015-2016

About the Author

Karla Valas is managing director of the Complex Asset Group at Fidelity Charitable®, an independent public charity that has helped donors support more than 220,000 nonprofit organizations with over $25 billion in grants since its inception in 1991. Ms. Valas brings deep knowledge and technical expertise to donors who wish to contribute sophisticated assets, such as privately held C-corp or S-corp shares, to charity. She and her team work directly with donors, their advisors, and corporate and business lawyers to facilitate the charitable transfer of these assets to achieve the most favorable tax treatment with the greatest charitable impact.

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