Congress Delivers a Gift for Charitable Business Owners

BY ALEXIS KIM

What do you get when a philanthropic actor creates a salad dressing business and gives 100% of the profits to charity? No surprise, the answer is the Newman's Own brand of foods and Newman's Own Foundation, a tax-exempt private foundation. And what do you get when Paul Newman, the founder, gives the business away to the private foundation at his death, with the goal that all profits continue to go to charity? Until recently, it was a fat 200% excise tax assessment for violating the private foundation rules. Luckily, Congress stepped in and added an exception in the tax code that allows Newman's Own Foundation to continue to own Newman's Own, Inc. and use all the profits to further its charitable endeavors. While the exception was narrowly fashioned, it still provides an additional planning opportunity for other charitably-minded business owners.

Many wealthy families desire to help the community through philanthropic endeavors, and take advantage of the income, gift, and estate tax deductions available for charitable giving. But families whose wealth was created in the family business, and is often still tied up in it, may find significant charitable giving to be daunting if not impossible. These entrepreneurs have the desire to make impactful charitable gifts, but most publicly-supported operating charities are not willing to hold stock or membership interests in a closely-held, unmarketable company. There has also been increased interest in creating business models that incorporate charitable giving into corporate culture.

One tax-exempt vehicle that provides some flexibility in the types of investment assets it accepts as contributions is a private foundation. A private foundation under Internal Revenue Code (IRC) Section 509 does not have to meet a broad public support test, can accept gifts from a single person and qualify for tax exemption under IRC Section 501(c)(3). Gifts can be made to a private foundation during life, and funds can then be given to multiple operating charities. Private foundations are attractive because their funding provides an immediate income tax deduction, but the structure permits continued control and supervision of the investment and use of the assets after the contribution.

Private foundations are, however, subject to many restrictions under the Internal Revenue Code in addition to the basic organizational and operational tests required to qualify as an IRC Section 501(c)(3) charitable tax exempt organization. These private foundation rules (set forth in IRC Sections 4940 et. seq.) can be prohibitive and require a skilled and knowledgeable group of advisors to help with initial organization and structure of a foundation as well as ongoing compliance concerns. Even with advance planning, unforeseen circumstances can place a private foundation into violation of one of these rules.

To summarize some of the rules, a private foundation must make minimum annual distributions to publicly-supported operating charities, is subject to strict self-dealing prohibitions, and may not hold assets that jeopardize its charitable purpose. Additionally, ownership of greater than a 20% interest in any active business will automatically subject the private foundation to a 200% excise tax on the value of the excess over 20% if not corrected. These excise taxes are so severe that they would effectively require the complete shut-down of any private foundation required to pay them. The only relief granted by the rules is that private foundations are allowed a period of five years to divest themselves of the excess business holdings, and the treasury secretary may grant an additional five-year extension. Until recently, any continued business holdings over 20% after the period for divestment would subject the private foundation to the crippling excess business tax.

Paul Newman created Newman's Own, Inc. in 1982 as a salad dressing business that later expanded to sell a variety of food products made with organic and natural ingredients. During Paul Newman's life, he owned the majority interest in the operating business and voluntarily paid over all profits from the business to the foundation. He formed Newman's Own Foundation in 2005 to carry on his philanthropic legacy. When Paul Newman died in 2008, he gave the ownership of Newman's Own, Inc. to the Foundation, making the Foundation the 100% owner of the operating business. The Foundation was now in violation of the excess business holdings rule, and the Foundation had until 2013 to divest itself of at least 80% of the ownership interest in the business. The IRS granted the Foundation a five-year extension in 2013, which was set to expire in November of 2018. Newman's Own, Inc. and Newman's Own Foundation faced a serious dilemma: Paul Newman had built the charitable mission into the core of the operating business, but how could they continue to follow that charitable mission if they were forced to sell off 80% of the ownership to potentially unrelated shareholders who may not have the same charitable goals and would be looking for profit from their ownership in the company?

The Bipartisan Budget Act of 2018, signed into law on February 8, 2018, added new IRC Section 4943(g) providing an exception to the excess business holding rules for certain philanthropic businesses. Any private foundation that meets all the requirements of this exception will not be subject to the excess business holdings tax even after the five-year period for divestment (plus extensions) has expired. This is an extremely narrow exception that was tailored to Newman's Own Foundation but could possibly apply to other foundations under the right circumstances. The requirements to meet the exception are summarized here:

1. The foundation must be given or bequeathed 100% of the voting stock.
   a. No portion of the business can be sold to the foundation.
   b. If multiple owners hold the operating business, then they all must gratuitously give their voting stock to the foundation, either during life or at death.
2. The business must pay ALL of its net operating income to the foundation every year.
   a. Gross income is reduced by allowable deductions and taxes paid.
   b. The business may retain a "reasonable reserve" for working capital and business needs.
   c. All other profits must be paid to the foundation.
   d. Once the income is in the foundation, the foundation still must follow the minimum distribution requirements just like any other private foundation.
3. The foundation and business must be operated independently from each other.
   a. No family members may work for the business (including as director, officer, trustee, manager, employee or contractor).
   b. The majority of the members of the foundation's board of directors must not be family members (but family members may comprise a minority of the board).
   c. There may not be any loans between the family members and the business.

This exception should sound strict. The statute was narrowly tailored to fit the structure of Newman's Own, Inc. and Newman's Own Foundation. With careful planning, however, a charitable business owner could use this exception to allow the business to continue operations and thereby create ongoing income to be used solely for charitable purposes. While the structure does bear some similarities to a supporting organization, the private foundation differs in that it allows grant-making to any organization that carries out the private foundation's charitable purpose rather than a single or few supported organizations. Additionally, most supporting organizations are also subject to the excess business holdings tax under IRC Section 4943(f). A full description of the use of a supporting organization in this context is beyond the scope of this article.

This exception may be a good option for a business owner who has no close family or who has already provided for his or her family through other planning techniques and wishes to give the rest to charity. Because family members cannot be employed by the operating business, it is a better option for a person whose family is not active in the business and may prefer to sit on the board of the private foundation than for someone whose family wants to continue to work in the business. This structure may become more attractive since the reduction of corporate tax rates by the Tax Cuts and Jobs Act of 2017 (P.L. 115 – 97, Dec. 22, 2017), allowing even more after-tax income to pass to the foundation and be available for charitable use.

Perhaps the biggest hurdle to this technique is the requirement that 100% of the business be owned by the private foundation, and that the ownership is established through gift or bequest and not through a sale. If a business owner truly wants to leave a legacy in the form of an operating business that gives all profits to charity, then ownership should be preserved during life rather than spread out to other family members. This will be counterintuitive to most estate planning but will make it easier to ensure that the private foundation receives all of the business ownership by gift or bequest.

This new exception to the excess business holdings rule presents a creative alternative option for those who have already provided for family and wish to leave a legacy with a larger impact. Paul Newman's legacy started with a few bottles of salad dressing back in 1982, reached $450 million in charitable gifts through 2015, and continues to grow.

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