Tax Strategy for Family Business Philanthropy

Family-Owned Business (FOB) constitutes a significant part of the United States economy and an even greater part of many other countries' economies. In the United States, FOBs have a history of giving back to the community through philanthropic gifts.

A Family Business Institute released an Executive Summary on the state of FOB in West Michigan. The summary is based on a survey conducted in 2013. Several questions in the survey were devoted to philanthropy giving by the FOB. The questions were directed to how FOBs give (through the business, through a foundation, or through individual owners), how they decide what to give (percentage of income, fixed amount, etc.), and to whom they give. There was a fairly even distribution between giving as a business, giving as a foundation, or giving as an individual. Some gave using two or more of the possible vehicles. There has been minimal research done on FOB giving in general. The survey indicated that 90% of the FOB engaged in philanthropic giving, so study in this area is certainly relevant.

What little research has been done addresses motivation for giving (enhanced Public Relations, a sense of giving back to the community, etc.) or how FOB decide on recipients of philanthropy (local causes, personal interest of owners, etc.). No significant work has been done on the vehicle for giving (FOB, foundation, or individual owners). The choice of vehicle can have a significant economic impact. Here is a very simplistic example:

Suppose a FOB has $1,000,000 in pre-tax dollars that they would like to contribute to the local food bank. The FOB is located in the United States in Los Angeles, California. The business is owned by a husband and wife who file a joint tax return. The business itself is highly profitable

(level of income is relevant because there are limitations on corporate giving that is tax-deductible) and pays the highest rates for federal and state taxes. The husband and wife have high income and also pay the highest rates. If the FOB contributes the $1,000,000 as a business, the 1,000,000 will not be taxed at federal and state levels. There will be no impact on the owners' individual tax return. The gift will be $1,000,000 and it will cost them $1,000,000. If they take the $1,000,000 and want to give the net proceeds as individuals, the following will happen: First, the $1,000,000 will be taxable income for the business. The FOB will pay the U.S. Treasury $390,000 and the State of California $7,000. They will have a net distribution to the owners of $603,000. The $603,000 will not be taxed by the U.S. treasury if it is donated (subject to limitations on charitable giving) and will be taxed by California at the rate of 13.3% or $80,199 which will leave them with $522,801 to give to charity. Each case takes $1,000,000 pre-tax dollars from the business with one giving $1,000,000 to philanthropic causes (assuming they meet the criteria for charitable giving) and one gives $522,801 to philanthropic causes and $487,188 to taxing authorities. On the surface, it looks easy: FOB should give as the FOB rather than as an owner. Here is where the complications arise:

1. There are limits on philanthropic giving that is deductible under U.S. tax code for corporations.
2. Whether philanthropic giving is deductible for state and local taxes for corporations varies.
3. There are limits on philanthropic giving for individuals under the U.S. tax code.
4. Whether philanthropic giving is deductible state and local tax returns for individuals varies.
5. Some states and local governments do not tax income for corporations and/or individuals.

6. Some FOB are not subject to corporate tax rates because they are organized as an S-corporation, partnership or sole proprietorship,
7. FOB owners have personal motivations for giving via the three vehicles (business, foundation, or individual).

Because of all these variables, it is not a simple case to say giving as a FOB has the greatest economic impact in all cases. In fact, depending on the state and local government tax rules, it might be that the optimal structure is to give part as the FOB, part as a foundation and part as an individual. The optimal formula will vary depending on how the business is structured (corporation, LLC, S-Corp, partnership or sole proprietorship) and what the state and local tax rules are. Because of the attraction of limited legal liability, most FOBs will organize as a corporation or S-Corp.

This paper creates a model for each form of business (given levels of taxable income) for two states in the United States so that a FOB can evaluate the after-tax impact of their giving for each giving vehicle so that they can include it in their decision making when balancing it with personal preferences as to the mode of giving. It also looks at two other countries with different tax structures that the United States to see how the model might change. For example, the Cayman Islands have no corporate tax rate and an individual tax rate of 15%. Most Western European countries have lower corporate rates but significantly higher individual tax rates.