

## Client Alert



### Be the Next Paul Newman - Give 100% of Your Business to Your Private Foundation, Newman's Own Style

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The "Bipartisan Budget Act of 2018" added the "Newman's Own" exception to the private foundation excess business holdings rule, allowing business owners to make a charitable contribution of 100% of a business to their private foundation, and keep it there in one piece. The business must then give all of its profits "upstream" to the private foundation, and meet certain other requirements. The new law creates a significant planning opportunity for business owners seeking to convert their company into a social enterprise 100% owned and controlled by their private foundation.

Notwithstanding the 100% private foundation ownership, equity-based incentive compensation can still be utilized by the business, including through the use of phantom stock options. Non-voting stock or options can also be utilized, which could prove highly valuable in the case of a sale of the business by the foundation or an initial public offering (IPO) of 80% or more of the foundation's stock in the business enterprise. In other words, the business can continue to operate and provide incentive compensation as a for-profit company — a wholly-owned taxable subsidiary that dividends its profits to its parent private foundation.

Also, notwithstanding the independent ownership rules, it appears that the business owner making the contribution can retain ultimate control of the private foundation by retaining the right to appoint and remove a majority or more of the private foundation's board of directors.

In the absence of this exception to the excess business holdings rules, the Newman's Own Foundation would have been forced to sell most of its now nearly ten years old 100% ownership interest in the ubiquitous "Newman's Own" salad dressing and pasta sauce company.

Note that the parameters of the Newman's Own exception do not need to be met during the 5 or 10 year period during which excess business holdings acquired other than by purchase, such as by gift or bequest, are not yet subject to tax.

#### Parameters of the "Newman's Own" Exception

The tax on excess business holdings no longer applies to a private foundation's holdings in any business enterprise that meets certain ownership rules, distributes all profits to the parent private foundation, and operates independently of the foundation.

### **100% Voting Stock Ownership**

The ownership requirements are satisfied if:

- (1) 100% of the voting stock in the business enterprise is held by the private foundation at all times during the taxable year; and
- (2) 100% of the private foundation's ownership interests in the business enterprise were acquired other than by purchase (i.e., by gift or bequest).

### **"All Profits to Charity"**

No later than 120 days after the close of the taxable year, the business enterprise must distribute an amount equal to its "net operating income" for such taxable year to the private foundation.

For this purpose, "net operating income" is the gross income of the business enterprise for the taxable year, reduced by:

1. the deductions for the taxable year directly connected with the production of the income,
2. the federal income tax imposed on the business enterprise for the taxable year, and
3. an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

The foundation's receipt of these required dividend distributions is exempt from federal income tax, but the income will be subject to the 2% (or 1%, in certain cases) private foundation excise tax on net investment income.

### **Independent Operation**

The following three independent operation requirements must be met at all times during the taxable year:

- (1) No substantial contributor to the private foundation, or family member of such a contributor, is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing).

In other words, the private foundation's contributing family cannot be on the business enterprise side in any capacity.

- (2) At least a majority of the board of directors of the private foundation are not also (i) directors or officers of the business enterprise or (ii) family members of a substantial contributor to the private foundation.

So, a minority of the private foundation board can be made up of family members of a substantial contributor, and a minority of the foundation's board (the non-substantial contributor/family directors) can also serve as directors and officers of the business enterprise.

While the law is silent as to control of the private foundation itself, presumably the foundation, as a nonprofit corporation, could have substantial contributors or their family members serve as statutory members of the private foundation. Those statutory members could have the right to appoint and remove all of the foundation's directors, such that the contributing family maintains ultimate control although constituting only a minority of the foundation's board. Alternatively, the substantial contributor and/or his or her family could hold designation rights with respect to the foundation's board of directors. Of course, regardless of the source of their election, appointment or designation to the board, the directors owe their fiduciary duties to the private foundation and its charitable purposes.

- (3) There is no loan outstanding from the business enterprise to a substantial contributor to the private foundation or a family member of such a contributor.

Note that the Newman's Own exception does not apply to donor advised funds and certain supporting organizations that are subject to the excess business holdings rules, charitable trusts, or split-interest trusts.

## Excess Business Holdings (Generally)

The excess business holdings rules applicable to private foundations and certain deemed private foundations (e.g., donor advised funds and certain supporting organizations) are designed to limit an individual's ability to retain control of a business enterprise by establishing a private foundation and transferring substantial ownership of the business to such private foundation.

Section 4943 of the Internal Revenue Code limits the percentage interest that a private foundation and its disqualified persons can together own in a business enterprise to 20%, though the limit is increased to 35% if the foundation can demonstrate that an unrelated person or persons have effective control over the business enterprise. A foundation generally has a 5-year period to dispose of excess business holdings acquired other than by purchase, such as by gift or bequest, without being subject to tax on such excess business holdings. This 5-year period may be extended an additional 5 years in limited circumstances, such as an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures.

The initial tax is equal to 10% of the value of the excess business holdings held during the foundation's applicable taxable year. After the initial tax has been imposed, an excise tax of 200% of the excess holdings is imposed on the foundation if it has not disposed of the remaining excess business holdings by the end of the applicable taxable period. This 200% confiscatory tax ensures that private foundations seek to immediately dispose of any excess business holdings.

## Conclusion

The new exception appears best suited to situations where an individual is seeking to transfer ownership of a wholly-owned business to a private foundation by gift or bequest, and for the business to pay dividends of all of its profits to the foundation.

Notwithstanding the independent operation requirements, the contributor and his or her family can still maintain ultimate control of the private foundation (through statutory membership interests or director designation rights) while the private foundation retains 100% of the voting interest in the business enterprise.

Also, as a for-profit, the business enterprise can utilize "phantom" stock or similar equity-based incentive compensation plans for senior executives and other key employees as an alternative to stock options or an employee stock ownership plan (ESOP). Non-voting stock or options can also be utilized and eventually monetized upon a sale of the business by the foundation or an initial public offering (IPO) of 80% or more of the foundation's stock in the business enterprise.

If you have a question about the "Newman's Own" exception to the excess business holdings rule or would like further information, please contact Ofer Lion at [olion@seyfarth.com](mailto:olion@seyfarth.com) or Douglas Mancino at [dmancino@seyfarth.com](mailto:dmancino@seyfarth.com).

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