Benefits of Donating Private Equity Interests to Charity

A tax-smart approach to maximize your philanthropic impact

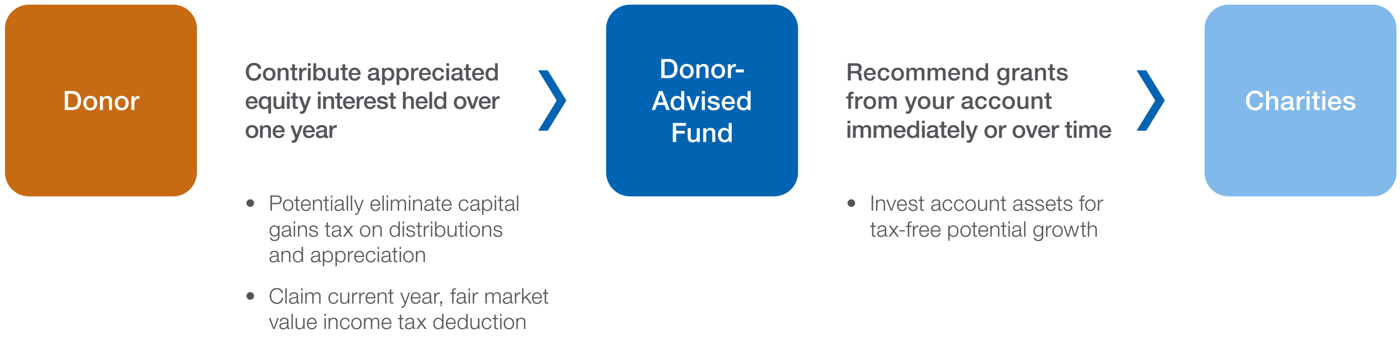
by the Charitable Strategies Group at Schwab Charitable

Donations of private equity interests may provide a unique opportunity to leverage one of your most valuable investments to achieve maximum impact with your charitable giving.

Private equity firms are organized in different ways, so principals and investors may own various assets such as a limited partnership (LP) fund interest, portfolio company stock, co-investment vehicles, special purpose vehicles (SPVs), and carried interest vehicles. Each of these assets offer a potential pathway to be charitable. These interests may accrue significantly in value over time, which can generate large capital gains taxes when liquidity events occur – making them ripe for charitable giving consideration.

Donating non-cash assets held more than one year can unlock additional funds for charity in two ways. First, you potentially eliminate the capital gains tax you would incur if you sold the interest yourself and donated the proceeds, which may increase the amount available for charity by up to 20%. Second, you may claim a fair market value charitable deduction for the tax year in which the gift is made and may choose to pass on that savings in the form of more giving.

Donor-advised funds, which are 501(c)(3) public charities, provide an excellent gifting option for donations of private equity fund interests, as the funds typically have the resources and expertise for evaluating, receiving, processing, and liquidating this type of gift. How does gifting these interests to a donor-advised fund work?



Please be aware that gifts of appreciated non-cash assets can involve complicated tax analysis and advanced planning. This article is only intended to be a general overview of some donation considerations and is not intended to provide tax or legal guidance. In addition, all gifts to donor-advised funds are irrevocable. Please consult with your tax or legal advisor.

SCHWAB CHARITABLE®

Multiple pathways to give

LP Fund Interest

A typical private equity fund is formed as a limited partnership with an expected term of years. Donors who make a charitable contribution of a percentage ownership interest in an LP fund may claim a charitable deduction at fair market value and potentially eliminate capital gains tax. LPs may not have liquidity for many years, so a gift of an LP interest may make the most sense in the later stages of the term.

If an LP interest is to be held as an investment, the fund is subject to a due diligence review and approval by the receiving charity. For LP interests held as an investment, distributions that flow to the donor-advised fund or other public charity over time enhance the overall charitable impact.

Portfolio Company Stock

Some private equity firm structures allow for in-kind distribution of portfolio company stock to limited partners before potential liquidity events. Donating these shares can be an effective philanthropic strategy. Targeting low cost basis positions, held for more than one year, maximizes tax savings.

From a timing perspective, these gifts often are done in the later stages of the company's growth cycle, when valuations have grown and liquidity options are more apparent. Higher value means more money going to the donor's desired charitable causes. However, any transfer to a charity should occur prior to any binding commitment to sell the portfolio investment, so it is best to contact the charity well in advance of any potential sale.

Special Purpose Vehicles or Co-Investment Vehicles

Some private equity firms create SPVs and co-investment vehicles, allowing partners to increase their exposure to desirable portfolio company investments. The vehicles are generally formed as a limited liability company (LLC) or LP.

Contributing a percentage interest in the entity to charity can be an effective giving strategy. Not only may the contribution qualify for a fair market value deduction and capital gains tax elimination, but after the gift is made, similar to a gift of an LP fund interest, future distributions flow to the donor-advised fund or other public charity when each portfolio investment is sold.

Case study: donating an LP fund interest

To illustrate the benefits of donating long-term held and appreciated private equity fund interests, consider the case of Bob, an entrepreneur. He recently retired and now wants to dedicate his time and money to supporting his favorite charities. Bob meets with his advisor to identify portfolio holdings he can utilize to fund his philanthropic and legacy plans. In the meeting, Bob is surprised to learn he might be able to donate his limited partnership interests in two private equity funds, both of which have recently completed the investment stage and will soon realize and distribute gains.

Working with his advisor, Bob identifies an interest held more than one year with a fair market value of $3 million and adjusted cost basis of $250,000. Assuming a 20% federal capital gains tax rate based on Bob's retirement income level, if he sold his interest he would realize appreciation or capital gains of $2,750,000 and owe an estimated $550,000 in federal capital gains taxes ($2,750,000 x 20% = $550,000).

In this scenario, as shown in Option 1, after paying the federal capital gains taxes, Bob's estimated net cash available for charitable giving is $2,450,000.

In Option 2, Bob decides to donate the interest to a donor-advised fund that is willing to accept this type of asset and hold it until termination. With proper approvals from the private equity fund's general partners and from the donor-advised fund, Bob's advisor coordinates the transfer of ownership to the donor-advised fund. In this scenario, Bob may be able to eliminate capital gains taxes ($550,000) while potentially taking a current year income tax deduction based on the fair market value of his interest ($3,000,000), assuming he itemizes his deductions.

Original investment (cost basis) in interest: **$250,000**

Federal long-term capital gains tax rate: **20%**

Fair market value of interest:

$3,000,000

	Option 1: Sell the interest and then donate the after-tax proceeds	vs.	Option 2: Contribute the interest directly to Schwab Charitable	
Long-term capital gains taxes paid	$550,000		$0	
Charitable contribution and tax deduction	$2,450,000		$3,000,000	Additional amount available to grant to charities: **$550,000**
Tax savings	$356,500		$1,110,000	Additional amount saved on taxes: **$753,500**

This hypothetical example is only for illustrative purposes. The example does not take into account any state or local taxes or the Medicare net investment income surtax. The tax savings shown is the tax deduction, multiplied by the donor's income tax rate (37% in this example), minus the long-term capital gains taxes paid.

Additional considerations

In addition to the potential tax benefits described above, the following considerations may apply.

1. Equity fund transfers are complex and require proper approvals.

Private equity fund general partners typically oversee transferability of fund shares. Limited partners who wish to donate a portion of their investment(s) to charity should work with the general partner to achieve this goal.

In some cases, general partners have established charitable giving programs to enable their investors to achieve their philanthropic goals by permitting charitable transfers of partnership interests or distribution of portfolio company stock prior to a sale. Such programs require active involvement of the fund's general partner, may be complex, and can take time to establish. As such, initiating donation discussions well in advance of a liquidity event is critical.

Note also that the donor-advised fund or other public charity will generally not assume liabilities associated with these investments. If your private equity interest is contributed to a donor-advised fund, you should plan to contribute sufficient non-cash assets to cover your grant recommendations as well as the private equity fund's open commitments, unrelated business income tax, and other liabilities.

2. Appraisal requirement and annual deduction limits apply.

Overall deductions for donations to donor-advised funds are generally limited to 50% of your adjusted gross income (AGI). The limit increases to 60% of AGI for cash gifts, while the limit on donating appreciated non-cash assets held more than one year is 30% of AGI. The IRS permits a carryover for five tax years, should your charitable deduction exceed AGI limits in a given tax year.

Your fair market value tax deduction will be determined by a qualified appraisal of the contributed interest as of the date of transfer to the donor-advised fund or other public charity. In order to realize the full value of the investment, the charity must normally be able to hold the interest until the scheduled termination date or liquidity event. Sales of these interests in the secondary marketplace prior to this may be subject to steep discounts. In addition, if the private equity fund carries debt, you may be liable for taxes if the contribution is treated as a bargain sale.

3. Schwab Charitable generally requires liquidity within 120 days for any gift of a non-cash asset.

If the donor recommends holding the asset longer than 120 days, Schwab Charitable may require due diligence to be performed on it as if it were an investment.

4. Avoid prearranged sales.

If a sale of a portfolio company or other liquidity event is expected, the terms of the sale should still be under negotiation. The documentation must not have proceeded to the point at which the IRS would consider it a prearranged sale. In that unfortunate instance, the IRS may deem your gift an "anticipatory assignment of income" to the charity. As such, you may be required to pay capital gains taxes on the sale by the charity.

5. Private equity gifts require due diligence by the charity and careful planning by the donor.

Many charities will not accept gifts of private equity interests due to the complexity involved. Donor-advised funds and other public charities that do accept these gifts likely will do so only after performing substantial due diligence. For example, the company's governing documents – such as the shareholder agreements, operating agreement, and articles of incorporation – must be reviewed to understand whether there are any transfer restrictions or embedded liabilities, and additionally to assess the time and process to complete the charitable transfer.

There can be complexities on the donor side of the gift as well. For example, donations of indebted interests may trigger negative tax consequences for you and the receiving charity, including tax liability and a reduced charitable deduction, if you itemize. In addition, the deduction for gifts of S-Corp, LP, and LLC interests may be reduced by the amount of ordinary income that would have been realized if you had sold the interest at fair market value on the date contributed.

The above is one example of many possible considerations. Please consult with your tax advisor prior to donating private equity interests.

Interested in learning more?

The Charitable Strategies Group at Schwab Charitable is a team of professionals with specialized knowledge about non-cash asset contributions to charities. Our team stands ready to support you and your advisors, from initial consultation through asset evaluation, receipt, processing, and sale. We strive to provide unbiased guidance and frequent communication at every step of the process to help you and your advisors make informed decisions and stay aware of the time required for your transaction.

For more information about the advantages of contributing appreciated non-cash assets, you can review our infographic, read an overview article, or call us at 800-746-6216.

If you would like to learn more about Schwab Charitable donor-advised fund accounts, click here.

SCHWAB CHARITABLE®

Giving is good.
Giving wisely
is great.

For questions or assistance with philanthropic planning or charitable giving:

Visit www.schwabcharitable.org

Call Schwab Charitable at 800-746-6216

Contact your advisor

Follow Schwab Charitable

This information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. A donor's ability to claim itemized deductions is subject to a variety of limitations, depending on the donor's specific tax situation. Where specific advice is necessary or appropriate, Schwab Charitable recommends consultation with a qualified tax advisor, Certified Public Accountant, financial planner, or investment advisor.

Schwab Charitable is the name used for the combined programs and services of Schwab Charitable Fund™, an independent nonprofit organization. The Schwab Charitable Fund has entered into service agreements with certain subsidiaries of The Charles Schwab Corporation.