Buffet's 'well lawyered' estate plan saves billions

By Andrew Osterland InvestmentNews
July 24, 2006

Warren E. Buffett's plan to give away $37 billion to charity not only made him one of the most generous philanthropists, it helped him avoid one of the biggest personal tax bills in U.S. history.

Mr. Buffett's gift of 12.05 million Berkshire Hathaway B shares - 10 million of which will go to the Bill and Melinda Gates Foundation of Seattle - will face neither the capital gains tax nor the estate tax, which is pegged at 46% of estate value.

As Mr. Buffett acquired much of his stake in Berkshire Hathaway Inc. of Omaha, Neb., in the 1960s, when it was a small textile manufacturer, the cost basis of his shares is likely a small fraction of its current market value.

"He was almost a founding shareholder at Berkshire," said Bob Willens, a managing director at Lehman Brothers Inc. of New York. "I would expect that at least 90% of the proceeds from selling the shares would have been taxable."

The 15% capital gains tax on the shares alone would likely have been more than $5 billion.

If Mr. Buffett had decided simply to bequeath his entire $44 billion in shareholdings to his heirs, the capital gains tax wouldn't apply, but the estate tax would have produced a windfall of up to $20 billion for the Department of the Treasury. That is just slightly less than the total estate taxes the government received in each of the last five years.

Both Mr. Gates and Mr. Buffett - the two wealthiest individuals in the world - oppose President Bush's drive to do away with the estate tax.

Close call

In early June, the tax narrowly avoided permanent repeal when Senate Republicans came up three votes short of forcing consideration of a bill already passed by the House. Senate Majority Leader Bill Frist, R-Tenn., has vowed that he will work for some kind of compromise and bring it to the Senate floor for a vote this year.

On June 26, when Mr. Buffett announced his plans, he took the opportunity to defend the estate tax - commonly referred to as the death tax in Republican circles.

"I would hate to see the estate tax gutted. It's in keeping with the idea of equality of opportunity in this country," Mr. Buffett said at a news conference in New York, at which he announced his donations.

He and other notably wealthy individuals such as George Soros, Agnes Gund, and David and Steven Rockefeller in the past have argued that repeal of the tax would be tantamount to encouraging an aristocracy of wealth.

They also have suggested that it would result in a major reduction in the kind of charitable giving on which Mr. Buffett has embarked.

Although he supports the estate tax, he also is a stickler for tax efficiency, and his estate planning is no exception.

"Compared to the option of giving the shares to Mr. Buffett's heirs, this will save an enormous amount of taxes," said Jon Bakija, an assistant professor of economics at Williams College in Williamstown, Mass., and an expert on estate taxes.

Even after Mr. Buffet's charity bonanza, he still will own about 75,000 Berkshire A shares - currently worth a little less than $7 billion. Unless he decides that those shares, too, will go to charity, his three children and other heirs potentially could split more than $3.5 billion after estate taxes.

Mr. Buffett apparently believes that the Bill and Melinda Gates Foundation, the Omaha-based Susan Thompson Buffett Foundation and the three other charities - run by his children - to which he is contributing will make better use of the money than the U.S. government. Also, he has stated frequently that he is not a believer in dynastic wealth, referring to heirs as "members of the lucky sperm club."

Mr. Buffett explicitly stated in letters to the five affected foundations that they "must continue to satisfy legal requirements qualifying my gifts as charitable and not subject to gift or other taxes."

That's no small task, particularly in the case of the Gates' foundation, whose assets will double to about $60 billion. The tax-free conveyance of $31 billion took some creativity, and the structuring of the scheme has impressed philanthropy experts.

"I've never seen anything like it," said Bruce Hopkins, a tax attorney with Polsinelli Shalton & Welte in Kansas City, Mo.

"The plan has been very well lawyered," added Harvey Dale, director of the National Center on Philanthropy and the Law at New York University.

The major challenge for Mr. Buffett's lawyers was to preserve the deductibility of the fair market value of the Berkshire stock.

He is entitled to deduct up to 20% of his adjusted gross income as a result of his gifts to private foundations.

If he had chosen to give the shares to a public institution such as the University of Nebraska in Lincoln, the contributions could have offset up to 50% of his income.

As the Berkshire shares are "qualified appreciated securities," their fair value is fully deductible. However, if the charities accumulated more than 10% of the value of the company's total outstanding stock, than the gift's tax deductibility would be reduced to the cost basis of the shares - again, a small percentage of their fair value.

The solution was to dole out Mr. Buffett's shares (he owns 31% of Berkshire stock) in 5% increments annually.

It would therefore be seven to eight years before the threshold were breached. The second way to preserve the full deductibility of the donations is by requiring the organizations to spend the entire annual gift within a year of receiving it.

In the case of the Gates Foundation, Mr. Buffett stipulated that beginning in 2009, the foundation would have to spend at least 5% of its net assets (required of charitable organizations) and the full value of his previous year's contribution. That means the foundation will have to spend a minimum of approximately $3 billion annually.

"The tax deductibility of the gifts is protected in the first few years by the qualified-appreciated-stock rule and then later by the flow-through spending requirement [mandating that the entire annual gift be spent]," Mr. Dale said.

Another factor that Mr. Buffett's lawyers had to consider was the excess-business-holdings rule (Section 4943 of the Internal Revenue Code), which states that private foundations cannot control more than 2% of the value of a public company and maintain more than 2% voting control.

The Gates Foundation, if it chooses to hold on to the Berkshire shares, will own more than 3% of the company after the second year of the plan. Berkshire's unusual dual-class share structure afforded a solution to this problem.

Mr. Buffett is converting his 475,000 Berkshire A shares at a 1-to-30 ratio into B shares, which he then will distribute to the foundations. The B shares, however, carry only 1/200th of a vote, so while the Gates Foundation becomes Berkshire's biggest shareholders, its voting interest will remain minimal.

CNS