PHILANTHROPY ADVISOR

A TECHNICAL RESOURCE FOR PROFESSIONAL ADVISORS

ISSUE 26: FALL 2021

UNIVERSITY OF ILLINOIS FOUNDATION

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Being Confident: The Basics of Giving Closely Held Stock to Charity

A confident professional opinion can bring tremendous success and build a sterling reputation—unless you're wrong. Erik Sandberg-Diment, a *New York Times* columnist on software and technology, found this out the hard way when, in a 1985 article, he offered this prediction:

> ... the real future of the laptop computer will remain in the specialized niche markets. Because no matter how inexpensive the machines become, and no matter how sophisticated their software, I still can't imagine the average user taking one along when going fishing.[1]

Obviously, Sandberg-Diment's confident prediction did not hold true—people bring laptops (and their smaller technological descendants) fishing and just about everywhere else. Unfortunately, investors who made decisions based on his predictions missed extraordinary opportunities.

Like investors who rely on experts to make decisions, donors contemplating complex gift transactions rely on solid professional advice. The exiting owner of a closely held business, for example, may find great value in donating the company stock to a charitable organization. However, to achieve the desired result—one that is beneficial for both donor and charity—they must first find the right charity, then overcome obstacles, avoid pitfalls, and meet requirements.

In this issue of *Philanthropy Advisor* we focus on fundamental information that can serve as a starting point for discussions about charitable gifts of closely held stock, including the typical benefits and pitfalls, the possible business entities involved, the valuation process, and the impact of unrelated business taxable income (UBTI). There is also a discussion of various approaches to such a donation depending on the needs and circumstances of the donor.

Giving an Appreciated Business Interest: Benefits and Potential Pitfalls

In most instances, donors recognize the added benefits of making a gift of appreciated property over a gift of cash. They pay no tax on the appreciation, and (assuming they itemize) they can deduct the full amount of the gift. When most of a business owner's wealth is in the business itself, the owner may think that a gift of cash is the only option. In many cases, an owner decides to sell the business to a third party and make a charitable donation from the sale proceeds. Then, of course, the owner would have to pay tax on the appreciated value of the business interest.

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A business owner, however, may find a charitable gift of closely held stock is particularly attractive. An owner's basis is often very low or zero, so avoiding capital gains tax can be highly beneficial on its own, even before the charitable deduction.

Typically, a gift of closely held stock is made with the understanding that the company will redeem the stock from the charity for its current fair market value (FMV) after the gift is completed. The end result, then, is that the charity has needed cash while the business owner enjoys an increased basis without paying capital gains tax. Even when this is the intention of all involved, to ensure no tax is due on the transaction, there cannot be any pre-existing obligations—the charity cannot be obligated to sell the stock and the company cannot be obligated to redeem it.

Entities

A closely held business, of course, is an entity that is not traded on a public stock exchange. These businesses can be found in every city and town across the United States and they may be organized as:

- corporations (C or S)
- limited liability companies (LLCs)
- partnerships (limited partnership interest)

Many closely held businesses are operated as S corporations or LLCs to avoid the double taxation of C corporations. For owners of a C corp, donating closely held stock is complicated and requires care. For owners of S corps, LLCs, and certain limited partnership interests, donating a business interest is even more complex.

While a donation of any closely held business interest requires significant legal and tax planning, for the purposes of this discussion, we'll focus on a standard charitable gift of shares of a closely held C corporation.

Transaction Considerations

The threshold issue for any donation of a business interest is finding a charity that is able to manage a gift of closely held stock. Many charities are reluctant to accept these gifts or may even be prohibited from doing so. When closely held stock is transferred, the charity not only agrees to hold an illiquid asset but assumes ownership of the company for a period of time, which involves financial risk along with other potential liability.

If the charity agrees to accept the donation but intends to sell the stock, for tax purposes, it is important that the gift is made before any formal decision to sell or merge the company.

Assuming the owner identifies a willing charity, the next question is whether there are any obstacles to making the gift.

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- **Are there any restrictions on the stock?** Restrictions that prohibit the transfer or sale of an interest in the company may be imposed through an existing shareholders agreement, a buy-sell agreement with other owners, a loan agreement, or some other creditor agreement.
- **Do any of the assets of the corporation present special issues or require additional review?** In some cases, a Phase I or Phase II environmental report needs to be completed on real property owned by the corporation. Assets, both real and tangible, should be free of non-financing liens and there should be no clouds on the title to real property. There should not be pending litigation (or known potential claims) against the corporation.
- **Are there any statutory or regulatory issues to consider?** State statutes and regulations must be researched to confirm that there are no obstacles to any such transfer. In addition, any laws dealing with the particular industry in which the business operates need to be reviewed.

Valuation

A gift of a business interest requires the donor to value the business. In this regard, it is essential to understand the valuation rules of the Internal Revenue Code (IRC). Generally, a business interest owned by the donor for longer than one year is valued at its fair market value—the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[2]

Qualified Appraisals

Because closely held stock is not publicly traded and does not have a ready market, proper valuation is very important. A donation of closely held stock would exceed the $5,000 threshold beyond which the IRS requires a qualified appraisal. Failure to meet appraisal requirements may result in the charitable deduction being disallowed.

The appraisal must be conducted by a qualified appraiser no earlier than 60 days before the transfer in accordance with generally accepted appraisal standards and should assess the value as of the proposed date of the gift.[3] It must include the required appraisal information and may not involve a prohibited appraisal fee.[4] The required appraisal information includes:[5]

- A sufficiently detailed description of the property
- The physical condition of any tangible property
- The contribution date (or expected date)
- The terms of any agreement or understanding that restricts or reserves rights to or use of the property

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- The name, address, and other identifying information and/or the identifying number of the qualified appraiser
- The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership (if any) in professional appraisal associations
- A statement that the appraisal was prepared for income tax purposes
- The date (or dates) on which the property was appraised
- The appraised fair market value (see Treas. Reg. §1.170A-1(c)(2)) of the property on the date (or expected date) of contribution
- The method of valuation used to determine the fair market value
- The specific basis for the valuation

IRS Notice 2006-96 provides additional information on qualified appraisers and qualified appraisals, including comment on substantial and gross valuation misstatements attributable to incorrect appraisals.[6]

Qualified Appraisers

IRC §170(f)(11)(E)(ii) defines a qualified appraiser as someone who:

- has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,
- regularly performs appraisals for which the individual receives compensation, and
- meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.[7]

The Code further requires that a qualified appraiser "demonstrates verifiable education and experience in valuing the type of property subject to the appraisal" and "has not been prohibited from practicing before the Internal Revenue Service by the Secretary at any time during the three-year period ending on the date of the appraisal."

Those specifically excluded from the definition of qualified appraiser include:

- The donor or taxpayer who wants to claim the income tax deduction, as well as any relative or employee of the donor.[8]
- Any person who is party to the transaction in which the taxpayer acquired the property, unless the property is donated within two months of acquisition for an amount not to exceed the acquisition price.[9]
- Anyone who regularly performs appraisals for one of the other excluded parties to a transaction and who does not perform a majority of their appraisals for other people.[10]

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The IRS will require that the donor submit an appraisal summary or the actual appraisal with their taxes in the year of the gift. Treasury regulations detail exactly what information must be included in an appraisal summary. The appraised value itself will be reported on IRS Form 8283.

Unrelated Business Taxable Income (UBTI)

Before accepting a charitable contribution of a business interest, a charity must consider the unrelated business taxable income that may result from the gift. While income generated by a charity is usually tax exempt, under IRC §511, income from activities that are not in line with the organization's charitable purpose are likely taxable.[11] Unrelated business income is income from a trade or business regularly carried on by the exempt organization where the business activities do not substantially relate to the purpose for which the organization was granted tax-exempt status.

The UBTI issue will impact any organization that is exempt from taxation under IRC §501(a), as well as some others, including:[12]

- charitable, religious, and scientific organizations, as well as other organizations described in §501(c)
- employees' trusts forming part of pension, profit-sharing, and stock bonus plans under §401(a)
- individual retirement arrangements (IRAs), including traditional IRAs, Roth IRAs, simplified employee pensions (SEP-IRAs), and savings incentive match plans for employees (SIMPLE IRAs)
- state and municipal colleges and universities
- qualified state tuition programs described in §529
- qualified ABLE programs described in §529A
- medical savings accounts (MSAs) described in §220(d)
- Coverdell savings accounts described in §530

Organizations *not* subject to the unrelated business income requirements include:

- corporations that are instrumentalities of the U.S.
- colleges or universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government, and
- certain title holding corporations under IRC §501(c)(2).

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Related or Unrelated?

The "unrelated" part of "unrelated trade or business" goes to whether the activity producing the income is substantially related to the tax-exempt purpose of the organization. The IRS states:

> To determine if a business activity is *substantially related* requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related.[13]

For activities that are not substantially related, even though the production of funds directly impacts the charitable purpose, it will be necessary to review the facts and circumstances of the activities to determine whether the activity "contributes importantly."

The IRC has identified certain activities that are excluded from the definition of unrelated trade or business, including:

- **Volunteer labor.** Any trade or business is excluded in which substantially all the work is performed for the organization without compensation.
- **The convenience of members.** Any trade or business is excluded that is carried on by an organization described in §501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees.
- **Selling donated merchandise.** Any trade or business that sells merchandise that was received as gifts or contributions is excluded. Many thrift shop operations of exempt organizations would meet this exception.
- **Bingo.** Certain bingo games and other gaming activities are not considered an unrelated trade or business.[14]

Concerns for the Charity

UBTI is likely a non-issue for the donor of a business interest, but it can be a big issue for the charity. In fact, the UBTI provisions of the Internal Revenue Code may cause the charity to carefully consider the gift before accepting it, or in some cases even reject the gift outright.

1. The charity must understand any associated tax obligation (at the current corporate income tax rate of 21%, or higher if some of the proposed increases become law).

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2. The charity must be sure the gift of the business interest will not cause a loss of tax-exempt status, which is a risk if the organization engages in more than an insubstantial amount of unrelated business activity. Unfortunately, neither the IRC nor the IRS have clearly defined "more than an insubstantial amount" of UBTI.

Planning for a Donation of a Business Interest

A donor who wants to make a charitable donation of a business interest must plan carefully and consider a number of important areas. The rules are complex and a successful donation requires the guidance of legal and financial professionals.

The donor has several different options when it comes to arranging the donation of the business interest—some are straightforward and others require more planning.

Sale and Donation of the Proceeds

The easiest method to make a charitable donation is for the donor to sell the business interest to a third party and then donate the proceeds to the charity. However, this is not usually the most beneficial approach as it results in higher taxes for the donor (due to the payment of capital gains tax on the appreciated stock at the time of the sale). The donor would likely be able to take the federal income tax charitable deduction for the donation.

Donation and Corporate Redemption

A donor with an interest in a closely held corporation may donate the stock and then have the corporation repurchase the stock from the charity. With this strategy, the corporation maintains ownership control in the remaining stockholders while the donor gets a federal income tax deduction and, more importantly, avoids the imposition of capital gains tax on the transfer of the appreciated closely held stock. The charity receiving the donated stock is not required to pay capital gains tax on the donated shares, and when the corporation reacquires the shares from the charity at fair market value in an arm's-length transaction, the shares will take on a higher basis resulting from the transaction.

This technique for making a charitable donation can be particularly attractive to a client who holds an interest in a closely held corporation with significantly appreciated stock and wants to make a gift but does not want to diminish control in the corporation. By donating the shares and then redeeming them, the client can accomplish several goals at once.

Example: Louisa gives her favorite charity stock in her closely held corporation. Louisa obtains an appraisal valuing the stock at $500,000 ($450,000 of that is appreciation). She does not owe any capital gains

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tax on the gift (which she would have paid on a sale) and she receives a charitable income tax deduction for the appraised amount. The charity provides Louisa with a written agreement and acknowledgement clarifying that the charity has full ownership rights to the stock with no pre-arranged obligation to dispose of the stock.

Since the charity wants to sell the stock for cash, and most closely held businesses have little market for their stock, Louisa's corporation decides to redeem the stock from the charity. The corporation can either carry the shares as treasury stock or retire the shares. There was no plan in place before the gift that required the corporation to repurchase the shares or required the charity to sell the shares, so the transaction avoids any "assignment of income doctrine" issues. (The "assignment of income doctrine" provides that a gift linked to a prearranged redemption could be reclassified for tax purposes as a sale by the donor, with corresponding realization of the gain, followed by a gift to charity of the proceeds.)

This gift and repurchase strategy benefits all involved:

- Louisa fulfills a philanthropic goal, avoids paying capital gains tax on the appreciation, and receives a charitable income tax deduction.
- The corporation does not experience any interruptions due to the sale and repurchase of the stock.
- The charity receives a useful and substantial gift.

Recent Tax Court Case: In a 2020 case on this concept, *Jon Dickinson and Helen Dickinson v. Commissioner*, the Tax Court ruled against the IRS in a challenge to a taxpayer's deduction for contributions of appreciated stock to a charitable donor-advised fund immediately before liquidation of the stock.[15] In this case, Jon Dickinson, CFO and shareholder of Geosyntec Consultants, Inc. (GCI), made donations of closely held stock to §501(c)(3) tax-exempt Fidelity Investments Charitable Gift Fund as part of a corporate program with Fidelity. Immediately after the donation, Fidelity's policy was to liquidate the stock by tendering back to the corporation for cash, and Fidelity did that with the GCI shares. Fidelity and Dickinson had a written agreement and letter of understanding that the transferred stock was exclusively owned and controlled by Fidelity; that Fidelity was under no obligation to redeem, sell, or otherwise transfer the stock; and that Fidelity had exclusive legal control over the contributed assets. The IRS claimed that the donations of GCI shares followed by Fidelity's exchange of the shares for cash should be treated as a redemption of the shares by the petitioner, followed by a donation of the cash proceeds to Fidelity by the petitioner. While the Tax Court ruled against the IRS and in favor of the taxpayer in this case, it is clear the IRS will continue to challenge taxpayers on these transactions, making detailed planning a necessity.

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Donation with Third-Party Purchase

A client may want to sell appreciated shares in a closely held corporation to an interested third party. To avoid the imposition of capital gains tax on the appreciation, it is possible for the business owner to donate the shares to charity, then let the interested buyer step in after the donation to purchase the shares from the charity. In this circumstance, the donor must take great care to follow the Internal Revenue Code and other regulations to avoid issues with the assignment of income doctrine.

The donor should obtain a written agreement that the charity will own and have exclusive legal control over the transferred stock without any pre-arranged obligation to sell or transfer the stock. Once the donation is complete, the charity would be free to arrange an arm's-length deal with the third party to purchase the closely held stock.

Being Confident and Being Right

On certain occasions, a confluence of circumstances gives rise to bold confidence that establishes legends. In the 1969 Super Bowl, the New York Jets were the overwhelming underdog to the powerful Baltimore Colts. Joe Namath, the starting quarterback for the Jets, was a young and talented player known almost as much for his love of nightlife as for football. When discussing the upcoming game, Namath's confidence came through loud and clear: "The Jets will win on Sunday. I guarantee it."[16] The Jets did indeed beat the Colts, and Namath's legend grew from that point. He is still celebrated today for his bold prediction and, more importantly, for being right.

When a donor wants to make a charitable donation of a closely held business interest (or any other asset, for that matter), having knowledgeable and confident advisors can make all the difference. Such a life-altering gift, when successfully completed, can be a victory every bit as great as a Super Bowl win.

ENDNOTES

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1 https://www.nytimes.com/1985/12/08/business/the-executive-computer.html
2 Treas. Reg. §20.2031-1(b); IRC §2701.
3 IRC §170(f)(11)(E) and Treas. Reg. §25.2512-3.
4 Treas. Reg. §1.170A-13(c)(3).
5 Treas. Reg. §1.170A-13(c)(3)(ii).
6 Notice 2006-96, I.R.B. 2006-46, October 19, 2006.
7 IRC §170(f)(11)(E)(ii).
8 Treas. Reg. §1.170A-13(c)(5)(iv).
9 Treas. Reg. §1.170A-13(c)(5)(iv)(B).
10 Treas. Reg. §1.170A-13(c)(5)(iv)(D).
11 IRC §511(a)(1).
12 IRC §512 and IRS Publication 598.
13 https://www.irs.gov/charities-non-profits/substantially-related
14 IRC §513(d).
15 *Jon Dickinson and Helen Dickinson v. Commissioner*, T.C. Memo. 2020-128 (Tax Ct. 2020).
16 https://www.washingtonpost.com/history/2019/02/02/joe-namath-predicted-hed-win-super-bowl-then-he-did-it-redefining-football-fame/