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The Business of Giving: Considerations for Donors and Charities When Giving Business Interests

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*The Gift of a Business – Deductibility Rules and Considerations

- Deductibility Rules
  - Special rule: 60% limitation available for cash contributions if solely cash gifts (and no appreciated property gifts) are given to public charities
  - However: a donor's deduction may be reduced based on various factors (*e.g.*, how long the donor held the asset, whether an underlying partnership owns ordinary assets).
  - Contributions in excess of a donor's AGI may be carried forward and deducted over the five-year period following the year of contribution.
  - For contributions of $250 or more, a donor will need a contemporaneous written acknowledgement from the donee that describes a) the gift and b) any goods or services provided by the donee to the donor in exchange for the contribution.
- Deductibility Considerations
  - Unfavorable deduction rules for contributions to private foundations mean donors often seek to contribute these assets to a DAF.
  - Deductions are tied to valuation and appraisal concerns
    - ➢May be difficult to value a closely-held interest correctly
    - ➢Appraisal requirements can be onerous for donors.

* This presentation is adapted from one presented by Mr. Shevlin, Reynolds Cafferata and Rose Chan Loui

The Gift of a Business – Deductibility Rules and Considerations

	Private Non-Operating Foundation	Public Charity	Supporting Organization
Gifts of cash	Deductible up to 30% of AGI.	Deductible up to 50%/60% of AGI.	Same as other public charities.
Gifts of property such as partnership interests with holding period of more than one year	Deductible at cost basis up to 20% of AGI. Must obtain appraisal and complete IRS Form 8283, Section B.	Deductible at FMV up to 30% of AGI. Must obtain appraisal and complete IRS Form 8283, Section B.	Same as other public charities.
Gifts of publicly traded stock with holding period of more than one year	If qualified appreciated stock, deductible at FMV up to 20% of AGI. If not, deductible at cost basis up to 20% of AGI. Must complete IRS Form 8283, Section A(I).	Deductible at FMV up to 30% of AGI. Must complete IRS Form 8283, Section A(I).	Same as other public charities.
Gifts of tangible personal property (*e.g.*, works of art)	Deductible at cost basis up to 20% of AGI. Must obtain appraisal and complete IRS Form 8283, Section B.	Deductible at FMV up to 30% of AGI if put to related use; if not, deductible at cost basis up to 30% of AGI. Must obtain appraisal and complete IRS Form 8283, Section B.	Typically cannot be put to a related use, resulting in deductible at cost basis up to 30% of AGI. Must obtain appraisal and complete IRS Form 8283, Section B.
Will transfer restrictions reduce value?	Yes, and likely disqualify otherwise qualified appreciated stock.	Yes.	Yes.
Acknowledgement required from donee?	Yes.	Yes.	Yes.

The Gift of a Business – Appraisal Rules and Considerations

- Appraisal Rules
  - For non-cash contributions of $5,000 or more (other than publicly traded securities), a donor must acquire a qualified appraisal and file Form 8283.
    - *For contributions greater than $500,000, the donor must attach the qualified appraisal to their return.*
    - NB: a qualified appraisal may be required for a contribution of certain listed securities if those securities are subject to material restrictions.
  - Qualified appraisals must:
    - be completed and signed by a qualified appraiser;
    - be dated no earlier than 60 days before the date of contribution and no later than the due date (including extensions) of the return on which the related deduction is claimed; and
    - include certain information about the property and the qualified appraiser.
      - Will need to disclose the terms of any agreement entered into by the donor that relates to the use, sale, or disposition of the donated property (*e.g.*, temporary or permanent restrictions on the donee's use of the property, earmarks for particular use, rights to receive income, etc.).
  - Qualified appraisers must also meet certain requirements.
    - The following parties cannot be qualified appraisers: the donor, the donee, their employees and other related parties, and appraisers who appraise regularly for the preceding parties, but not for other unrelated parties.

The Gift of a Business – Appraisal Rules and Considerations (cont.)

- Substantiation Requirements
  - Charities must provide contemporaneous written disclosure statements to donors reciting either that:
    - (i) no goods or services were provided to the donor by the charity <u>or</u>
    - (ii) the deductible portion of the contribution is limited to the value of the donor's contribution less the value of the goods or services provided by the charity, as well as a good faith estimate of the value of such goods or services.
- Appraisal Considerations
  - IRS and tax courts strictly enforce the qualified appraisal requirement.
    - A donor may be denied any deduction because of a technical misstep, even if the value of the property exceeds the amount of the claimed deduction.
  - While donees can help to ensure the appraisal is incorporated into the gift planning process, appraisal is ultimately the responsibility of the donor.
  - Confidentiality concerns.

The Gift of a Business – Assignment of Income Doctrine

- Overview
  - **Background**: Founders and investors often seek to make contributions when a sale or other realization event is on the horizon for purposes of avoiding capital gains tax on their appreciated shares.
  - **Assignment of income doctrine**: Those who actually earn or create the right to receive income may not assign such right in order to avoid taxation of the income.
  - Depending on the certainty of the pending transaction, the donor may be deemed to have realized income from the sale and then contributed the proceeds.
    - Q: Is there a "fixed right to income" or only a "mere expectancy of profit"?
  - Facts and circumstances inquiry and an area of active IRS enforcement.
    - The absence of an executed sale agreement and/or binding letter of intent is strong evidence against an assignment, though does not guarantee that the IRS will not assert that there has been an assignment.
    - Conversely, the presence of a definitive agreement strongly suggests that there has been an assignment, unless the conditions to closing give rise to significant uncertainty.
    - Case law is ultimately not settled on this point (see next slide).
- Considerations
  - When accepting strategic contributions of appreciated securities, charities should be aware of this doctrine and the implications for donor deductions.

The Gift of a Business – Assignment of Income Doctrine (cont.)

- **Relevant Authorities**:
  - Treas. Reg. 1.170A-1(b)
  - *Grove* (2nd Cir. 1973) – TP won
  - *Carrington* (5th Cir. 1973) – TP won
  - *Palmer* (Tax Court 1974) – TP won
  - Rev. Rul. 78-197 – TP lost
  - *Ferguson* (9th Cir. 1999) – TP lost
  - *Rauenhorst* (Tax Court 2002) – TP won
  - *Dickinson* (Tax Court 2020) – TP won
- **Latest case: *Estate of Scott M. Hoensheid*, T.C. Memo. 2023-34**
  - Facts:
    - ➢ Petitioner and his two brothers, Craig and Kurt, held equal interests in Commercial Steel Treating Corp. ("CSTC"). In 2014, Kurt decided to retire. In lieu of acquiring debt to finance a redemption of Kurt's interest, Petitioner and Craig decided to sell CSTC.
    - ➢ On April 1, 2015, PE firm HCI Equity Partners ("HCI") submitted a letter of intent to acquire CSTC for $92 million. Petitioner concurrently began to consider funding a Fidelity Charitable DAF with his CSTC stock for purposes of avoiding capital gains.
    - ➢ Petitioner was concerned that his brothers would own more stock than he did if sale fell through and so delayed the donation. On April 23, parties executed a *nonbinding* letter of intent for HCI to acquire CSTC for $107 million.

The Gift of a Business – Assignment of Income Doctrine (cont.)

– Facts (cont.):
  - On June 1, Petitioner sent Fidelity a letter of understanding outlining plan to donate stock but did not specify number of shares. At a board meeting two weeks later, CSTC approved Petitioner's request to transfer a yet-undetermined quantity of shares of CSTC to DAF.
  - On July 10, CSTC paid out $6 million in officer bonuses in preparation for sale.
  - Number of shares finally determined on July 13 and PDF of stock certificate provided to Fidelity.
  - The sale closed on July 15. On November 18, Fidelity sent contribution confirmation letter acknowledging charitable contribution and noting that shares had been received on June 11.
  - Petitioner claimed a charitable deduction and the IRS disallowed, in part citing the assignment of income doctrine.

The Gift of a Business – Assignment of Income Doctrine (cont.)

- Holding:
  - The elements of a valid gift were not present until the title to the shares was transferred on July 13, which was too late to avoid the recognition of gain.
  - Petitioner's right to the proceeds of the sale became fixed before the contribution to charity occurred, because all terms of the sale had been worked out prior to the gift date and material steps taken, even though the sale agreement had not yet been signed and the letter of intent was nonbinding.
  - In order to avoid an anticipatory assignment of income, a donor must bear at least some risk at the time of the contribution that the subsequent sale would not close. By delaying his contribution, Petitioner eliminated any such risk.

The Gift of a Business – Assignment of Income Doctrine (cont.)

- Not really a departure from *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).
- In Rev. Rul. 78-197, the IRS announced that it would treat proceeds as income "under facts similar to those in the Palmer decision only if the donee is legally bound, or can be compelled by the [issuing] corporation, to surrender the shares for redemption."
- Although the T.C. in *Rauenhorst* held the IRS to its own bright line test from Rev. Rul. 78-197, it stated that donee control is only one factor, and "the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer."
  - The T.C. found that when the warrants were transferred to the charitable donees, there was no legally operative offer for the purchase of the shares of NMG.
  - The letter of intent did not bind the shareholders and warrantholders to sell their shares and warrants.
  - Note the potential significance of how much control the donor has.
- The TC had another opportunity to address Rev. Rul. 78-197 in *Dickinson* (2020).
  - "This Court has not adopted Rev. Rul. 78-197 as the test for resolving anticipatory assignment of income issues, see *Rauenhorst*… and does not do so today. The ultimate question, as noted in *Palmer*, is whether the redemption and the shareholder's corresponding right to income had already crystallized at the time of the gift."

The Gift of a Business – Fractional Interests

- Overview
  - A donor is entitled to claim a deduction only for completed gifts.
  - For a gift to be complete, all ownership rights associated with the relevant interest or percentage must be transferred.
  - If a donor retains substantial rights (*e.g.*, the right to vote stock) in the contributed property, no deduction is allowed.
    - The IRS has found that certain rights are so insubstantial that gift is, in substance, completed and the deduction is allowed.
- Considerations
  - Donors and donees should discuss what rights in the business or other interest, if any, the donor wishes to retain.
  - If a donor is not prepared to give up substantial rights in the business, an alternative arrangement, like a pledge agreement, may be appropriate.

The Gift of a Business – Gift Acceptance Policies

- Charities should pay attention to the nature of the businesses in which they are gifted interests, particularly where those businesses are closely-held and the interests not as easily disposable.
  - Gift acceptance policies should be reviewed for consistency with the charity's purpose (*e.g.*, a hospital should not accept interest in cigarette or vape company).
- Charities should also pay attention to the nature of the property that it accepts and the associated tax implications.
  - Cash and publicly-traded securities are generally liquid, though securities may be subject to securities law and contractual restrictions.
  - For securities of closely-held businesses, unless there is a potential buyer in sight, the expectation should be that the securities will be held over a longer term.
  - Active income and passive, debt-financed income earned from interests in closely-held, pass-through entities (*e.g.*, partnerships, LLCs) will generate UBTI.
  - Gift acceptance policies should be reviewed with an eye towards desired liquidity of assets and UBTI risk.

Structural Options

- Stock
  - Public but subject to trading restrictions
  - Non-Public
  - C-Corp or S-Corp
  - Other interests—warrants, options, appreciation rights
- Partnership
  - General
  - Limited
- Limited Liability Company
  - Member Managed or Manager Managed
  - Taxed as:
    - Disregarded Entity
    - Partnership
    - C-Corp
    - S-Corp

The Gift of a Business – Rule 144 Safe Harbor for the Sale of Restricted Securities

- Overview
  - Restricted stock, as opposed to publicly-traded stock, is not listed on a national securities exchange and may only be sold in discrete transactions (*e.g.*, "private placements") or pursuant to an exemption from registration with the Securities and Exchange Commission (the "SEC").
  - A charity that receives a gift of restricted stock will typically be subject to substantial restrictions on the sale or transfer of the stock.
- Rule 144 of the Securities Act of 1933
  - Rule 144 is a "safe harbor" that permits public resales of restricted stock, provided that the following conditions are met:
    - There is adequate public information about the company; and
    - A minimum of six months has elapsed between the later of the acquisition date from the company or from an affiliate and the resale for securities of issuers that are reporting companies. Otherwise, the applicable holding period is one year.
      - "Tacking" applies.
  - Additional conditions apply for sellers who are affiliates of the company at the time of the sale or within the three months preceding the sale:
    - The amount of securities sold, together with all sales during the preceding three months, may not exceed the greater of (i) 1% of outstanding shares and (ii) the average weekly trading volume during the preceding four weeks;
    - Sales must be made through a broker or market maker; and
    - If the amount of sales during any three-month period exceeds 5,000 shares or $50,000, a notice of sale must be filed on Form 144 with the SEC.

The Gift of a Business – Rule 144 Safe Harbor for the Sale of Restricted Securities (cont.)

- Restricted Stock Considerations
  - To comply with the volume restrictions contained in Rule 144(e), donors, related parties, and donees must communicate regarding proposed sales and/or enter into formal agreements governing the timing and volume of sales.

The Gift of a Business – Rule 10b-5 and Rule 10b5-1

- **Overview**
  - Applies primarily to publicly-traded securities.
  - Rule 10b-5 is an SEC regulation that prohibits securities fraud and insider trading.
  - Rule 10b5-1 contains exceptions that allow individuals in possession of material nonpublic information ("MNPI") about a business to proceed with trading shares of that business.
    - For example, an affiliate in possession of MNPI may make predetermined trades pursuant to a Rule 10b5-1 plan, which is a written plan that specifies the price, amount, and dates of sales or purchases of shares.
- **Considerations**
  - If a donor has entered into a Rule 10b5-1 plan to personally sell shares in a business in the future, a charity that received shares in the business from the donor may want to obtain written assurance that the donor will not engage in personal sales that would impair the charity's ability to sell the gifted shares under Rule 144.

The Gift of a Business – Contractual Restrictions

- In addition to restrictions contained in securities laws, contractual restrictions contained in stockholders agreements may further limit sales and other dispositions of gifted shares.
- Common restrictions include:
  - **Right of first refusal**, which obligates the charity to notify the company of intended sales or transfers. Within a certain timeframe, the company (and sometimes other shareholders) has the option of purchasing the shares before the charity may sell to its intended buyer.
  - **"Tag-along" right**, which allows other shareholders to choose to participate in the charity's sale to its intended buyer, typically pro rata based on the relative number of shares owned. The exercise of a tag-along right occurs after that of any refusal right and may restrict the quantity of shares that the charity can sell.
  - **"Drag-along" right**, which allows majority shareholders to force minority shareholders to join in the sale of the company.
  - **Demand registration right**, which permits a certain percentage of shareholders to demand that the company use reasonable best efforts to sell their shares in a public offering.
  - **"Piggy-back" registration right**, which entitles to the charity to elect to sell a certain number of shares in a public offering once it has been determined that such offering will occur.
  - **"Lockup"** or **"market standoff,"** which prohibits the charity from selling its shares for a period of time after a public offering (usually no more than 180 days).
- Certain restrictions may reduce the value of the gifted shares, which has implications for donor deductions.

Legal Structure General Checklist for Closely-Held Securities

1. Legal structure of the entity.
2. Type of interest in the entity proposed to be gifted (the "gifted interest").
3. Management rights with respect to the gifted interest.
4. Any management or governance or fiduciary responsibilities resulting from holding the gifted interest?
5. Would the charity be subject to entity liabilities?
6. Would the charity be required to make additional capital contributions to entity?
7. Would the charity be subject to shareholder or other agreements (financing, etc.), etc. that could result in liability outside of their interests in the entity?
8. What is the ability of the entity to change its structure, dissolve or enter into merger or other significant transactions without the consent of the charity?

Legal Structure General Checklist for Closely-Held Securities (cont.)

9. Is the gifted interest subject to changes to its rights and preferences without the charity's consent?
10. How are distributions from the entity determined?
11. What happens on a liquidation or dissolution of the entity?
12. What is the ability of the charity to sell or otherwise convert the gifted interest to cash? Does any such restriction on sale materially impact the value of the gift to the charity? Is the interest marketable?
13. Are there buybacks, registration (tag along, drag along), or other rights/agreements that could affect the liquidity of the gifted interest?
14. Are there transfer restrictions (rights of first refusal/offer) that could impact the transfer of the gifted interests?
15. Will distributions from the entity be treated as UBTI?

Legal Structure General Checklist for Closely-Held Securities (cont.)

16. Will there be significant taxable income without corresponding distributions to pay tax?
17. Are there CFC or Prohibited Tax Shelter tax concerns from the activities of the entity?
18. What is the business of the legal entity? Does having an investment in that entity create any public relations or other non-financial issues?
19. Is there any conflict (board, officers, employees, insiders) with holding the interest?
20. What are the financial projections for the entity, the value of the interests, distributions from the entity and other relevant financial projections?
21. What are the anticipated outside costs in evaluating the gifted interest, transferring the gifted interest to the Charity, and in the future, maintaining and, eventually, disposing of the gifted interest.
22. Are there potential funding obligations (indemnities, increased capital calls, etc.) after the receipt of the interest in the entity.
23. Is the entity compliant with the new IRS partnership audit rules?

Case Study

Background

Cathy and Bob are husband and wife. Cathy was employee number five at a startup company that is now being acquired or is going public. Cathy's interest in the company is worth $40 million based on the acquisition valuation. Cathy and Bob have reached out to your organization, a public charity, as long-time supporters. They want to share some of the good fortune, but also want to plan for their future. Cathy has worked hard for several years and wants to scale back.

Cathy owns 25% of the capital stock of the company. They're considering a substantial gift to your organization, but have also heard about DAFs and are contemplating their own private foundation. They'd like an honest assessment from you as to these options (understanding you are not their tax adviser). In particular, Cathy is concerned that the company may want her to vote/control the disposition of the stock and want to know if that is possible.

After careful consideration: GOOD NEWS!! Cathy wants to donate a significant portion of her interest in the company to your organization!! Before popping the champagne cork, you receive an email with from the audit committee chair (who, unfortunately for you, is also a tax lawyer) asking the following questions:

1. Is Cathy's company being acquired or is it going public? She has heard conflicting stories.
2. If a merger, has the merger agreement been signed? If an IPO, has the underwriting agreement been signed? Why does this matter?
3. If an IPO, will the organization be subject to any securities law restrictions/filings?
4. The organization is thinking of asking Cathy to join the Board. How would that affect the analysis?
5. What agreements is the organization going to be subject to regarding its ownership in the company?

The Gift of a Business – Gifts of Carried or Other Interests in Hedge Fund or Private Equity Partnerships

- Donor Considerations
  - Donor may be entitled to a full FMV deduction and avoid tax on appreciated gain.
    - However, may give rise to income other than long-term capital gains when sold, which will reduce the deduction accordingly.
    - If donating to a private foundation, deduction limited to donor basis.
  - Risk that the gift may be deemed a partial interest in property and invalidate their deduction (see next slide).
- Donee Considerations
  - Private foundations will need to consider whether owning the interest runs afoul of any of the excess business holding rules.
  - If the interest leads the PF to own more than 20% (and possibly less) of the profits interest in a "business enterprise," may be subject to a 10% tax on the excess and even a 200% tax if the PF fails to dispose of the excess holdings promptly, which could be difficult.
  - Risk of future UBTI if the fund qualifies as an active enterprise or is debt-financed.
  - Involvement in an active business with unknown partners – additional due diligence and ongoing oversight may be required.
- Alternative Arrangement: donor and donee could enter into a formal pledge agreement whereby donor makes contributions to donee as and when they receive cash distributions from the fund.

Alternative Structures for Holding Business Interests

- 501(c)(4) Social Welfare Organization and the Purpose Trust
  - **Patagonia**: Founder Yvon Chouinard transferred 100% of the company's voting stock to the Patagonia Purpose Trust and 100% of nonvoting stock to the Holdfast Collective, which is a 501(c)(4) dedicated to environmental causes. The purpose trust holds the business with all profits invested into the 501(c)(4).
  - ➢ Chouinard and his heirs avoid potential capital gains and estate taxes of around $1 billion.
  - ➢ Chouinard did pay a gift tax of around $17.5 million on the transfer to the trust.
  - **Tripp Lite**: Executive Barre Seid donated his 100% stake in Tripp Lite to the Marble Freedom Trust, which is a 501(c)(4) dedicated to conservative political causes. The 501(c)(4) immediately sold Tripp Lite to a large publicly traded company.
    - ➢ No charitable deduction for the donation, but Seid avoided capital gains and gift taxes.
- Newman's Own Private Foundation
  - 100% charity owned
  - No family involvement
  - Independent boards