

THE Good Advisor

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 prediction 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 *The Good 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, and the valuation process.

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.

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.

- **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
- 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)(i) 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

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.

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."¹¹ 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

- 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 <https://www.washingtonpost.com/history/2019/02/02/joe-namath-predicted-hed-win-super-bowl-then-he-did-it-redefining-football-fame/>

Access more information now!

An electronic copy of our companion booklet with more information about charitable organizations, including a discussion of supporting organizations, donor-advised funds, community foundations and private foundations is available in the Professional Advisor section of our website at www.catholicfoundation.com.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services.

Each professional must evaluate the tax and financial consequences of each individual situation.

Although The Catholic Foundation has been diligent in attempting to provide accurate information, the accuracy of the information in this newsletter cannot be guaranteed. Laws and regulations change frequently and are subject to differing legal interpretations. Accordingly, The Catholic Foundation shall not be liable for any loss or damage caused or alleged to have been caused by the use or reliance upon the information in this newsletter.

T H E
CATHOLIC
F O U N D A T I O N

12222 Merit Drive, Suite 850 • Dallas, TX 75251 • Phone 972-661-9792 • Fax 972-661-0140

www.catholicfoundation.com