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"INSECURE ABOUT SECURITIES?" EFFECTIVELY HANDLING GIFTS OF STOCK

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This outline will focus on the issues which charities, donors and advisors must consider when contemplating gifts of securities. The information provided in this outline will equip all parties involved in stock gift transactions with the information needed to capitalize on the potential benefits associated with gifts of stock while also helping them avoid the potential risks involved with gifting this type of asset.

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Probably the most common non-cash gifts involve securities, either publicly traded or closely-held. Publicly traded stocks are easy to handle from the charities perspective and easy for the donor to transfer. The valuation of these stocks is well established and, therefore, makes them attractive gift options. However, the gift planner should be aware of all the various forms of stock and issues associated with each in order to advise potential donors of the consequences of their gift.

I. Taxation Issues

As the taxation issues for a gift of stock are examined, several pieces of information will be helpful as the gift planner outlines the gift for the donor. The length of time the donor has held the security will determine whether the security has been held long-term and thereby qualifies for long-term capital gain treatment.

How the donor acquired the stock determines the donor's basis in the security. If the stock is acquired by reason of a testamentary gift, the stock receives a step-up in basis. The step-up in basis equates to the fair market value of the stock on the date of the testator's death (or, if elected, the alternate valuation date). IRC § 2032. Obviously, if the stock was purchased by the donor, the basis will be what the donor paid for the stock at the time of acquisition. However, when the donor transfers stock or mutual funds with a dividend reinvestment program, this becomes less certain. If the stock is acquired by any other means, then a carry-over basis is attached, and the donor's basis is the same as that of the person from whom the gift was received.

The stock's basis determines whether the stock has a gain or loss. This knowledge helps the gift planner counsel the donor regarding the tax consequences of the gift and the advisability of using the stock as a gift asset.

A. Long-Term vs. Short-Term Capital Gain

If the gifted stock has been held by the donor for more than the required holding period of one year, the gift qualifies for long-term capital gain treatment, and the donor does not incur any tax on the long-term capital gains. IRC § 170(e). The required holding period of one year begins on the day after the trade date that the stock was acquired by the donor and ends on and includes the date of gift. Rev. Rul. 70-598, 1970-2 CB 168.

The charitable income tax deduction for an appreciated stock gift held for more than the required holding period is equal to the fair market value of the stock on the date of the gift and may be used to offset up to 30% of the donor's adjusted gross income in the year of the gift with a carryover for any excess deduction for up to five years. IRC § 170(e); IRC § 170(b)(1)(C)(i); Reg. § 1.170A-8(d)(1); and IRC § 170(b)(1)(C)(ii). For gifts to private non-operating foundations, the deduction is generally the lower of cost basis or fair market value and is limited to 20% of the donor's adjusted gross income. IRC § 170(e)(1)(B)(ii) and IRC § 170(b)(1)(D). If the donor is a corporation, the deduction is limited to 10% of the corporation's taxable income, with the same five-year carry over. IRC § 170(b)(2) and IRC § 170(d)(2). A donor may choose to take a 50% deduction for a gift of stock, if an election to reduce the value of the gift by the amount of the capital gain is made by the donor. IRC § 170(b)(1)(C)(iii); IRC § 170(e)(1)(B); and Reg. § 1.170A-8(d)(2).

For appreciated securities that have been held by the donor for less than one year, different rules apply. Such securities, if sold by the donor at fair market value rather than contributing them to charity, would generate gain that is not long-term capital gain. Reg. § 1.170A-4(b)(1). The charitable deduction for such short-term capital gain property must be reduced by the amount of gain which would have been recognized as gain which is not long-term capital gain if the securities had been sold by the donor at fair market value rather than contributed. IRC § 170(e)(1)(A); and Reg. § 1.170A-4(a)(1). In other words, the donor's deduction for a contribution of short-term capital gain property will be limited to the donor's basis. However, the deduction may be claimed up to 50% of the donor's adjusted gross income in the year of the gift. IRC § 170(b)(1)(A). And, as mentioned above, the donor is allowed five years after the year of the gift to carry over any unused portion of the deduction, subject to the same 50% limitation. IRC § 170(d)(1); and Reg. § 1.170A-10.

B. IRC § 306 Stock

Generally, as Conrad Teitell has said, "it's a dividend masquerading as a preferred stock." § 306 stock is stock distributed to the individual as a tax-free dividend, stock that is not common stock received in a non-taxable reorganization plan where gain or loss is not recognized, or is stock either received in exchange for other § 306 stock or was equivalent to a stock dividend.

The purpose of § 306 stock is to prevent a corporation from distributing earnings to stock holders by means of a second class of stock that the holder could then sell as a capital asset.

A § 306 stock, when sold, produces ordinary income rather than long-term capital gain.

The gift value of § 306 stock is reduced for deduction purposes by any amount that would be taxed as ordinary income once sold or redeemed. IRC § 1366(a)(1). This equates to the difference between the value of the stock on the date of contribution and its value when issued.

C. Unrelated Business Taxable Income from Controlled Corporations

Unrelated business taxable income ("UBTI") includes "the gross income derived by any organization from any unrelated trade or business ….regularly carried on by it…." IRC § 512(a)(1). Tax-exempt organizations are subject to tax on their UBTI at the regular corporate tax rates. IRC § 511. Excessive UBTI for a tax-exempt organization can ultimately jeopardize its tax-exempt status.

Generally, income from closely-held securities in the form of dividends or capital gain is considered "passive income" and not subject to the unrelated income tax. IRC §§ 512(b)(1), (2), (3), and (5). However, income derived from a controlled corporation may be taxable. IRC § 512(b)(13). For this reason, it is important to be mindful of the percentage ownership that is being acquired by the charity and the potential for earned income being realized during the length of time which the charity is likely to hold the controlling interest in the company.

II. Valuation Issues

A. Publicly Traded Securities

The valuation of publicly traded securities is very clear. The gift amount is the fair market value ("FMV") of the security on the date of the gift – the date on which the charity takes possession of the stock. FMV is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Reg. § 1.170A-(c)(2). The IRS has further asserted that the most probative evidence of FMV is the price at which similar quantities of property are sold in arm's length transactions. Rev. Rul. 80-69, 1980-1 CB 55. Therefore, FMV is to be determined in the market in which the item is most commonly sold to the public. Id. For publicly traded stock, the stock market provides the forum for determining the value. The value is determined by the mean between the highest and lowest quoted selling prices on the valuation date. Reg. §§ 25.2031-2(b)(1), 20.2031-2(b)(1).

For publicly traded securities with no sales on the valuation date but sales within a reasonable period before and after the valuation date, the value is the weighted average of the means between the highest and lowest sales on the nearest dates before and after the valuation date. Reg. §§ 25.2512-2 (b)(1), 20.2031-2(b)(1).

If the securities are listed on more than one exchange, the records of the exchange where the securities are principally traded are those used to determine FMV on the valuation date. Reg. §§ 25.2512-2 (b)(1), 20.2031-2(b)(1).

For publicly traded securities, the tax rules are clear as to valuation, but charities must provide the correct substantiation to the donor. Most charities have a policy to sell gifted securities immediately. Typically, the security will be sold the day the gift is made or shortly thereafter. The charity must be diligent in its record keeping. The gift of stock must be recorded and not credited to the account as cash from the sale of the security. Charities must pay attention to the written substantiation and clearly define the gift as one of stock. If the charity is going to credit the donor with a dollar amount for gift recognition purposes that amount should be reported separately.

B. Closely-Held Securities

Closely-held securities generally provide difficult issues with the valuation. The Service has detailed approaches, methods and factors that should be considered in these valuations.

- Reg. §§ 25.2512-3(a)- Valuation of interests in business
- Rev. Rul. 59-60, 1959-1 CB 237 – "In valuing the stock of closely-held corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes."
- Rev. Rul. 65-193, 1965-2 CB 370 – Separate appraisals needed to value the tangible and intangible assets of a business
- Rev. Rul. 77-287, 1977-2 CB 319 – Deals with securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws
- Rev. Rul. 80-213, 1980-2 CB 101 – Valuation of stock of a subsidiary corporation that may only be sold with shares of the parent organization (i.e., "paired" stock)
- Rev. Rul. 83-120, 1983-2 CB 170 – Factors to consider in valuing common and preferred stock of a closely-held corporation

C. Restricted Securities

In some instances, transferring shares of publicly traded corporations may be restricted. Stocks are restricted if they are acquired, directly or indirectly, in a transaction not involving a public offering. SEC Rule 144 provides a safe harbor for the sale of these securities. Charities should know how to recognize a restricted stock. In Rev. Rul. 77-287, 1977-2 CB 319, the Service has provided information and guidance concerning the valuation of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws.

D. Timing of Gift

There is a formal system for transfer of title to stock. Stocks can be held in certificate form or in street name at a broker. To transfer a stock held in certificate form, the donor can endorse the back of the certificate or execute a stock power to accompany the certificate. In either case, the transfer is then handled by a broker and transfer agent. A charitable gift is made when the properly endorsed and transferable stock is delivered to the institution or agent for the institution.

A donor can hand deliver the certificate and stock power to the charity. The date of the gift is the date on which the charity takes possession of the certificates. If the donor mails the stock to the charity, the date of the gift is the date on which the envelope containing the certificate is postmarked. If the donor wants to mail the certificate, the gift planner should advise the donor to mail the certificate (without endorsement) and the executed stock power in separate envelopes to prevent any unintended person from coming into possession of the certificate in a negotiable form.

The donor can deliver the certificate to the corporation that issued the stock or to his broker for purposes of transferring title to the charity. In such case, the gift date is the date on which the transfer of the security is recorded on the corporate books. If the certificate is delivered to a broker representing the charity, then the gift date is the date of delivery.

In the case of securities held in street name, generally, the donor will provide a letter of instruction to the corporation or broker holding the shares requesting that a transfer be made to the charity. An example of such a letter is attached hereto as Appendix A. The donor's signature on the letter must be "Medallion" guaranteed. Particular attention should be paid to ensure that the shares are transferred into the charity's name before being sold to avoid any recognition of gain on the part of the donor.

The transfer process can be slowed in the case of some mutual fund companies that require the charity to create an account into which the shares are transferred. In order for the gift to be completed, the charity must complete an application and all paper work to open an account. This takes time!

Typically, the date of a gift of stock does not raise any issue unless you are dealing with a year end gift and the donor wants to ensure the gift will be counted in that year or there is an event that sets the price of the stock. In these cases, timing of the gift is therefore crucial.

What happens when a donor calls and says, “I want to transfer stock to you today, because the company is being sold!” One of the first questions the gift planner should ask is whether or not the donor is legally bound to sell the securities to a purchaser with the price having already been negotiated and set. If so, the Service takes the position that the sale of the property was by the donor, and the gift was one of the proceeds to the charity. The Service calls this a step-transaction. The doctrine says that two or more seemingly independent transactions are consolidated and treated as a single transaction for federal tax purposes. The charity must not be legally bound at the time of the gift to sell the property to the prospective purchaser. Further discussion of the history and application of the step-transaction doctrine can be found in Section V.B.1 of this outline.

E. Donor’s Percentage of Ownership or Control in Closely-Held Securities

If a donor holds less than a full ownership interest in a closely-held corporation, the appraised value of his stock may be discounted. Typically, an ownership interest in a business that represents less than full ownership will be discounted from 30% to 40%. This is important to remember because the charitable deduction that the donor will be entitled to upon establishing the trust will be calculated using this appraised value.

III. Qualified Appraisal Rules for Closely-Held Securities

A. What securities must be appraised?

When a donor makes a gift of closely-held securities and the amount claimed as a charitable deduction exceeds $5,000, a qualified appraisal must be obtained in order to substantiate the claimed value. Reg. § 1.170A-13(c)(1)(i). A fully completed appraisal summary must be attached to the return on which the deduction is first claimed. Reg. § 1.170A-13(c)(2)(i)(a)-(c).

B. Qualified Appraisal Requirements

A comprehensive overview of the requirements for completing a qualified appraisal is attached hereto as Appendix B.

C. Selecting a Qualified Appraiser for Gifts of Stock

The individual selected must hold himself or herself out to the public as an appraiser or perform appraisals on a regular basis and not be one of the persons described in Reg. § 170A-13(c)(5)(iv). Under this Regulation, the following persons cannot be a qualified appraiser: (1) the donor, (2) a party to the transaction whereby the donor acquired the property, (3) a representative of the donee charity, or (4) any person that is employed by or related to any of the foregoing persons.

D. Appraisal Fees

Appraisal fees for valuing closely held stock can be substantial. The gift planner should discuss this subject with the donor prior to the completion of a gift. The economics of the situation may or may not make sense. Donors often do not think about making a significant outlay of cash in order to substantiate their gift value.

E. IRS Forms 8283 and 8282

When the donor is required to obtain a qualified appraisal to substantiate the claimed deduction, an appraisal summary must be attached to the return on which the deduction is first claimed. Reg. § 1.170-13(c)(2)(i)(B). The summary is made on the IRS prescribed Form 8283 - Non-Cash Charitable Contributions.

A contribution of non-publicly traded stocks where the claimed deduction is greater than $5,000 but less than $10,000 requires a partially completed appraisal summary.

Form 8283 must be signed by the charity to acknowledge receipt of the gift and by the appraiser who prepared the qualified appraisal. By signing the form, the charity is not agreeing with nor endorsing the value placed on the stock by the appraiser. The charity is only acknowledging receipt of the gift on the date specified in the summary. Additionally, the charity's signature acknowledges that it has certain reporting requirements to which it is subject if the property is sold, exchanged, consumed or otherwise disposed of within two years after the date of the gift. Reg. § 1.170A- 13(c)(4)(iii).

The charity's signature must be made by the official authorized to sign the tax or information returns or a person specifically authorized to sign appraisal summaries by the official authorized to sign the charity's tax or information returns. Reg. § 1.170A-13(c)(4)(iii).

There are no sanctions imposed on the charity if it does not sign Form 8283, but it is good policy to do so. A file copy should be maintained. If the property is sold within two years of the date of the contribution, the charity is required to file Form 8282 - Donee Information Return and to provide a copy to the donor. IRC § 6050L(a), Reg. § 1.6050L1(a)(1), IRC § 6050L(c), Reg. § 1.6050L-1(d).

Substantial penalties are possible when a charity fails to file Form 8282, fails to include all required information, or includes incorrect information. For each occurrence, a penalty of $50 may be imposed, with a maximum penalty of $250,000 for all such failures within a calendar year. IRC § 6762(a).

The penalty may be less in some instances and can be mitigated if the charity can show reasonable cause and not willful neglect in not filing. IRC §§ 6721(b), 6721(c), 6721(d), and 6724(a).

IV. Redemption of Closely-Held Securities from Charitable Trusts or Private Foundations

For those donors who have either established their own business or who own a percentage interest in a family owned business, the asset which represents a majority of the value of their estate and has the highest appreciation in value is often closely-held shares in the business. When closely-held shares of stock are being considered as a contribution to a private foundation or to fund a charitable remainder trust, all parties to the gift arrangement should be mindful of the Code sections and regulations which prescribe the manner in which a subsequent redemption of the shares by the corporation must be accomplished.

A. Application of Self Dealing Rules

IRC § 4941 imposes sanctions on self dealing transactions that occur between certain "disqualified persons" described in the code section and private foundations. A charitable remainder trust which complies with IRC § 664 and for which a deduction is allowed under IRC § 170 is a "split interest trust" described in IRC § 4947(a)(2), thereby making it also subject to the self dealing sanctions imposed by IRC § 4941.

The term "disqualified person" includes substantial contributors, greater than 20 percent shareholders of substantial contributors, private foundation managers (or an individual having power or responsibility concerning the administration or operation of a charitable trust), family members of the foregoing, and partnerships or estates or trusts in which the foregoing have greater than 35 percent ownership interests. IRC § 4946(a)(1); IRC § 4946(b).

The transactions prohibited as self dealing include (1) sales, exchanges and leases of property; (2) loans; (3) supplying of goods, services or facilities; (4) excessive compensation or expense reimbursements to employees and other persons performing services for the foundation (or the charitable trust); and (5) transfers of income or assets to a disqualified person or for their use by or for the benefit of a disqualified person. IRC § 4941(d)(1).

In addition, IRC § 4941(d)(2)(F) imposes certain restrictions regarding redemptions of closely-held stock from closely related parties. The tax regulations which speak to this issue provide that a redemption of closely-held shares held by a private foundation or charitable remainder trust will not result in a self-dealing transaction so long as all the securities of the same class as that held by the foundation or trust are subject to the same terms of redemption and such terms provide for receipt by the foundation or trust of no less than fair market value. Treas. Reg. § 53.4941(d)-3(d). The regulations further state that all of the securities are not subject to the same terms unless the corporation makes a bona fide offer on a uniform basis to the foundation or trust and every other person who holds such securities. Id.

A disqualified person who participates in a self dealing transaction is subject to a tax of 5 percent of the amount involved in the transaction, while a foundation manager (or trust administrator) who knowingly participates in a self dealing transaction will be subject to a tax of 2½ percent of the amount involved. IRC § 4941(a). If the parties involved in the transaction fail to correct or rescind the self dealing transaction in a timely manner, an additional tax equal to 200 percent of the amount involved may be assessed against the disqualified person, while an additional tax equal to 50 percent of the amount involved may be assessed against the foundation manager (or trust administrator). IRC § 4941(b).

B. Appraised Value of Shares vs. Amount of Redemption Offer

As discussed previously in this outline, donors who gift closely-held shares of stock are required to obtain a qualified appraisal in order to determine the value of the gifted shares. The appraisal is necessary to substantiate the charitable deduction to which the donor is entitled by virtue of having made the gift. However, a discrepancy between the appraised value of the shares (and the resulting deduction) and the amount at which the shares are subsequently redeemed by the issuing corporation could lead the IRS to determine that a self-dealing transaction has occurred.

As explained above, the private foundation or charitable trust must receive no less than fair market value for the shares upon redemption in order to avoid a self-dealing transaction. Treas. Treas. Reg. § 53.4941(d)-3(d). Should the qualified appraisal show that the fair market value of the stock is greater than the amount at which the stock is redeemed by the issuing corporation, the IRS could establish that a self-dealing transaction has occurred, which could result in the imposition of sanctions under IRC § 4941.

For this reason, the donor is well advised to obtain the qualified appraisal in advance of the date of gift or funding of the trust and to also make a prior determination of the value at which the corporation will subsequently redeem the shares of stock. In many situations, the shareholders of the corporation will be subject to the terms of a business continuation agreement or a buy-sell agreement (discussed below) that will contain provisions regarding the value at which shares will be redeemed. If no such agreement exists, the donor may have to consider the valuation method used by the corporation in prior redemptions or any stated corporate policy regarding the valuation of shares generally or for redemption purposes. In any event, all parties to the gift transaction should be mindful of the interplay between the appraised value of the gifted shares and the amount at which the shares will later be redeemed so as to avoid a self-dealing problem.

E. Documentation of the Redemption Process

Because the provisions of Treas. Reg. § 53.4941(d)-3(d) spell out clearly the elements of a redemption process that must be present so as to avoid a self-dealing transaction, it is important for the gift planner to be certain that all documentation surrounding the implementation of the gift reflect and affirm that these elements are included in the redemption process. Specifically, all correspondence and/or supporting documents need to reflect that (1) the redemption applies to all outstanding shares of the same class as that held by the foundation or charitable trust, (2) that all shares are subject to the same terms of redemption (i.e., that the corporation makes a bona fide offer on a uniform basis to the foundation or trust and every other person who holds such shares), and (3) that such terms provide for receipt by the foundation or charitable trust of no less than fair market value. Attached to this outline as

Appendix C are sample letters of the type which should be exchanged between the private foundation or trustee and the redeeming corporation to document that the requirements of Treas. Reg. § 53.4941(d)-3(d) have been met.

While the foregoing paragraph emphasizes the importance of documenting that certain elements or factors have been included in the redemption process, it is also important to be mindful that the documentation surrounding the redemption does not include certain elements that could be problematic. Specifically, care must be taken to assure that no documentation which affects the transfer of shares among the parties (the donor, the private foundation or charitable trust, and the redeeming corporation) is drafted so as to create an obligation on the part of the foundation or trust to sell the gifted shares back to the issuing corporation. Such an obligation would amount to a prearranged transaction. When this situation occurs, the IRS will view the transaction as a sale of the property by the donor to the corporation and a subsequent gift of the cash proceeds to charity, causing the donor to recognize the taxable gain from the sale of the gifted shares. *Martin v. Machiz,* 251 F. Supp. 381 (D. Md. 1966).

V. Buy-Sell Agreements / Business Continuation Agreements

For a donor or charity that is contemplating a gift of closely-held securities or a partnership interest in a business, more often than not the provisions of a buy-sell agreement or business continuation agreement will have to be dealt with. Such an agreement provides for the transfer of an ownership interest in the closely-held corporation or partnership upon the occurrence of certain contemplated events. Such events typically include the owner's death, disability, insolvency, retirement, or other withdrawal from the business at an earlier time than expected. Several common versions of the agreement are typically encountered, including:

1. A corporate stock redemption agreement or a partnership liquidation agreement entered into between the business itself and the individual owners whereby the business agrees to acquire each owner's interest upon the occurrence of certain stated events;

2. A cross-purchase agreement entered into among the individual owners whereby the remaining owners would acquire the withdrawing owner's interest upon the occurrence of certain stated events:

3. A "third party" business buyout agreement entered into between the individual owners and a specified individual (key person, family member, third party, etc.) whereby the withdrawing owner agrees to sell his interest to the specified individual; or

4. A combination of the foregoing.

A. Provisions Affecting Transfer of Shares to Charity

The primary reason that most buy-sell agreements and business continuation agreements are put in place is to prevent all or any part of the business from falling into the hands of outsiders. Accordingly, most of these agreements are drafted in a manner that provides the most protection possible for the business entity and its existing owners by limiting the possibility for an ownership interest to pass to any party not already associated with the business. It is rarely contemplated that a charitable gift of the closely-held business interest will occur, and as a result, you are unlikely to ever see a provision in one of these agreements that provides for a charitable contribution of an ownership interest in the business.

What you will see is a provision or multiple provisions that place restrictions on the manner in which the transfer of an existing ownership interest may be accomplished. For example, some agreements provide that an existing ownership interest may not be conveyed to any outside party without the prior approval of the board of directors or a majority of the remaining partners. In this type of situation, it is very possible to complete a gift transaction by following the procedural requirements of the buy-sell agreement or business continuation agreement to obtain the requisite approval. Typically, the members of the board of directors or the remaining partners will be closely connected to the prospective donor (family members, long-time business partners, etc.) and will understand the donor's objectives in funding a planned gift with the closely-held business interest. When open lines of communication exist between the donor and these key players within the business and these individuals have a clear understanding of the donor's intentions, it is much more probable that the donor's charitable plan will be supported and that the approval to transfer the donor's interest in the business to the donee charity will be approved. This clear communication and understanding will also benefit the charity after the gift is completed when the charity seeks to redeem or sell the gifted interest.

More commonly, a buy-sell agreement or business continuation agreement will grant the remaining individual owners or the business entity itself, or both, a right of first refusal to acquire the ownership interest of the withdrawing owner. Only after the parties who are granted the right of first refusal under the agreement have formally declined their right to purchase may the withdrawing owner transfer his ownership interest to an outside party, such as a charity. Again, this scenario does not preclude a charitable gift of the ownership interest. In such a case, the prospective donor must take the necessary steps to provide proper notice to the relevant parties of his intention to transfer his interest, allow any required time period for the exercise of the right of first refusal to pass, and adhere to any other particulars specified under the agreement. As mentioned in the previous paragraph, clear communication and understanding of the donor's objectives in gifting the shares to charity will preclude many concerns or hesitations among the remaining owners. After all procedural steps are followed, and assuming that no one exercised the right of first refusal, the donor would be able to complete the gift of his business interest.

Finally, as a last resort, if certain provisions of the buy-sell or business continuation agreement preclude or do not allow for the transfer of an existing ownership interest to an outside party, then it may be necessary to amend the agreement before a charitable gift of the business interest may be considered. If this seems to be necessary, a thorough review of the document should be conducted to determine the possibility and manner in which an amendment may be made. As with other procedural aspects of the agreement, the process of amending the agreement to allow for a gift of the donor's interest to charity should be conducted carefully to ensure that the gift of the business interest to charity cannot be subsequently questioned. Once the amendment is properly made, the new provisions of the agreement should also be carefully followed to complete the gift transaction.

B. Provisions Affecting Post-Gift Redemption or Transfer by Charity

1. Avoiding Step-Transactions

After the closely-held business interest has been successfully conveyed to a charitable organization or qualified charitable trust, the charity or trustee must then consider issues which surround liquidation of the closely-held interest. As with the transfer of the interest from the donor to the charity or qualified trust, the provisions of the buy-sell or business continuation agreement can have significant consequences for the charity as a newly established owner of the business interest. Specifically, the provisions of the agreement should be closely reviewed prior to acceptance of the gifted interest in the business to ensure that a prearranged transaction (or "step-transaction") will not occur upon the subsequent disposition of the interest by the charity.

A prearranged transaction occurs when a series of separate and independent steps are treated as a single transaction when such steps are "in substance integrated, interdependent, and focused upon a particular result." *Esmark v. Commissioner*, 90 T.C. 171 (1988). When applied, the step-transaction doctrine dictates that two or more ostensibly independent transactions (usually the gift of an appreciated asset followed by a subsequent sale of the asset by charity) are consolidated for tax purposes. This can happen when, under the facts and circumstances surrounding the gift, the donee charity is obligated to sell the gifted property to a purchaser that was prearranged by the donor prior to the gift. Hopkins, The Tax Law of Charitable Giving § 6.8 (John Wiley & Sons 1993). When this situation occurs, the IRS will view the transaction as a sale of the property by the donor to the third-party purchaser and a subsequent gift of the sales proceeds to charity, causing the donor to recognize the taxable gain from the sale of the gifted property. *Martin v. Machiz*, 251 F. Supp. 381 (D. Md. 1966).

In *Palmer v. Commissioner*, 523 F.2d 1308 (8th Cir. 1975), a taxpayer with voting control of both a corporation and a tax-exempt private foundation donated shares of the corporation's stock to the foundation and subsequently caused the corporation to redeem the shares from the foundation, pursuant to a prearranged plan. The United States Tax Court treated the transaction according to its form because the foundation was a legitimate tax-exempt entity, the transfer of stock to the foundation was a legitimate gift, and the foundation was not obligated or required to redeem the shares at the time they were received. In a subsequent revenue ruling, the Service acquiesced to the *Palmer* ruling, stating that "[t]he Service will treat the proceeds of a redemption of stock under facts similar to those in

Palmer as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 CB 83.

Accordingly, great care must be taken to ensure that the documentation which governs the transfer of a business interest must not be drafted so as to create an obligation on the part of the donee charity to sell the gifted interest to a purchaser that is prearranged prior to the gift. It is, however, permissible for the business entity or the remaining business owners to hold a right of first refusal to purchase any outstanding business interest from a withdrawing owner. Such a right does not impose upon the donee charity an unavoidable obligation to transfer (by redemption or sale) the gifted interest to a specific party. A right of first refusal merely creates an opportunity for the holder of the right to acquire the interest should the donee charity elect to make it available.

2. Valuation Issues

It will also be important for the donee charity to understand the provisions of the buy-sell or business continuation agreement that will determine the value of the gifted business interest for the purpose of a subsequent redemption or sale to other owners. There are several methods which are typically used to arrive at the value of a business interest. One fairly common approach is for the agreement to set the exact redemption or purchase price in advance with a further provision that would allow the parties to amend the amount in the future, as needed. Another common approach is to base the purchase price upon the company's book value as determined by the most recent financial statements. A third valuation approach is to include a formula in the agreement that is to be applied at any point in time that a transfer of an interest is to be made. Formula approaches to valuation are often preferred because they allow factors such as net earnings, profitability and even goodwill to be taken into consideration. Regardless of the method of valuation that is to be employed, the donee charity should become familiar with the manner in which valuation will be handled and determine a reasonable expectancy of the benefit that will actually be received upon liquidation of the gifted interest.

Concerning the redemption of closely-held securities from qualified charitable trusts or private foundations in particular, Section VIII, B of this outline speaks to the interplay of the valuation of closely-held shares as part of the redemption process and the potential that exists to create a self-dealing transaction under Treas. Treas. Reg. § 53.4941(d)-3(d). In that situation, the donor should be advised to carefully consider the applicable regulations and Code sections (identified in Section VIII, B herein) to ensure that a self-dealing transaction does not occur upon redemption of the gifted shares by the qualified charitable trust or private foundation.

VI. Special Situations

A. S Corporation Stock Issues

Unlike corporations which are described in Subchapter C of the Internal Revenue Code, whose income is subject to taxation at both the corporate level and the individual level, Subchapter S of the Code provides an alternative manner of taxation for certain corporations with less than one-hundred shareholders that also meet other specified criteria. In most every respect, an S corporation functions in the same manner as a C corporation, except that the corporation's income is taxed directly to the shareholders, avoiding the double taxation that occurs with C corporations. Operating under the corporate form limits the shareholders' personal liability, while the income and deductions of S corporations are allowed to pass through to its shareholders. IRC §§ 1363 and 1366.

Prior to 1998, charitable organizations were not included as eligible shareholders of S corporations. If S corporation shares were transferred to a charity, the corporation would immediately lose its S corporation status and become taxed the same as a C corporation. However, the Small Business Job Protection Act of 1996 (P.L. 104-188) allowed charitable organizations to be included among the eligible shareholders of S corporations as of January 1, 1998. Other eligible shareholders include individuals, estates, and certain trusts (discussed below). Partnerships and for-profit corporations are not allowed as shareholders of S corporations. Nonetheless, the passage of the Small Business Job Protection Act created new opportunities for donors and charities by allowing gifts of stock in many closely-held companies that were previously not possible.

While charities may now receive outright contributions of S corporation shares without jeopardizing the favorable tax treatment of the corporation, it is very important to note that charitable remainder trusts may not receive S stock without significant consequences. Specifically, a transfer of S corporation stock to a charitable remainder annuity trust or charitable remainder unitrust is prohibited under IRC § 1361(e)(1)(B)(iii) and will cause the corporation to immediately lose the S election for all shares, not just for those shares actually contributed to the trust. In most cases, the resulting negative tax consequence for all other shareholders will preclude a donor from gifting S stock into a charitable remainder trust. However, if all outstanding shares of the S corporation will soon be sold or gifted, this otherwise undesirable result may be of less consequence to the other shareholders. Nonetheless, all shareholders should be aware that, if the S corporation has operated as a C corporation at any time during the previous ten years, the corporation could have some retained earnings that would be taxed as ordinary income upon the conversion of the corporation by the loss of the S election.

It is possible to fund a charitable lead trust with S stock, but only in limited circumstances where the trust is structured in a manner that complies with the Code provisions that allow certain trusts to qualify as shareholders of S stock. Specifically, IRC § 1361(c)(2)(A) identifies the trust types which are allowed, including (1) qualified subchapter S trusts, (2) electing small business trusts, (3) grantor trusts, (4) former grantor trusts for the two year period following the grantor's death, and (5) any testamentary trust for a two year period following the funding of the trust. So, either a grantor lead trust or a testamentary lead trust (for two years after funding) may hold shares of S stock without jeopardizing the company's S election.

In any context in which a charitable organization (or charitable trust) contemplates holding S corporation shares, the charity should be mindful that it will be subject to unrelated business income tax ("UBIT") for its portion of the S corporation's accounting income for as long as it holds the shares. IRC § 512(e)(1). Further, even the gain that may be realized upon the sale of the S stock by charity will be subject to UBIT. IRC § 512(e)(1)(B)(ii). Accordingly, a charity should be sure that it will be able to satisfy this potential tax liability prior to accepting the gift of S stock.

B. Anticipatory Assignment of Income

On occasion, stockholders find themselves in a situation where they will be forced to realize income from the involuntary disposition of their stock because of a taxable takeover of the corporation or because the corporation is in the process of liquidation. If such events run their course, the stockholder will be forced to recognize any appreciation in the shares once they are sold. This type of situation often causes shareholders to consider making a charitable gift of the shares so that they may avoid realization of the taxable gain and also obtain the benefit of a charitable income tax deduction for the value of the shares contributed. However, under the anticipatory assignment of income doctrine, the gain from the post-gift sale of the stock may be taxable to the donor on the theory that the asset transferred to charity by the donor is, in practical effect, a right to receive cash rather than an asset that might or might not be converted to cash at some point in the future.

1. Corporate Stock Subject to a Taxable Takeover

In the case of a taxable takeover of the corporation, a shareholder will be able to avoid recognition of gain only by gifting the shares before the final outcome of the takeover attempt is certain. Any failure to complete the gift before the outcome of the takeover bid is known will cause the gain to be attributed to the shareholder/donor. In the case of a cash tender offer for the stock, ownership and control of the shares which are subject to the tender offer must be conveyed to the charitable donee before the tender offer is accepted, and the charitable donee must subsequently take the required procedural steps to accept the tender. *Richardson v. Commissioner*, T.C. Memo 1984-595.

Several key cases speak to the application of the assignment of income doctrine in a taxable takeover situation. In its *Ferguson* decision, the Ninth Circuit applied the assignment of income doctrine to a complicated tender offer fact situation. *Ferguson v. Commissioner,* 108 T.C. 244 (1997), aff'd, 174 F3d 997, 83 AFTR2d 99-1775 (9^{th} Cir. 1999). In its ruling, the Court determined that the donor's transfer of shares to charity occurred after the right to the takeover proceeds had "ripened" into a fixed right to receive cash because the merger that would result from the tender offer was substantially certain to occur. As a result, the donor was taxed on the gain that was represented in the gifted shares. While the donor was still entitled to claim a charitable deduction, the conveyance was treated as a gift of cash rather than stock.

Despite the seemingly negative consequence of the *Ferguson* case, a close examination of the facts still leaves room for comfort for donors and charitable gift planners. Specifically, the *Ferguson* decision is not inconsistent with the doctrine established in *Palmer v. Commissioner* that a gift will still be effective so long as the charitable donee can not be legally compelled to surrender the donated property. *Palmer v. Commissioner*, 523 F.2d 1308 (8th Cir. 1975).

After the *Palmer* decision was reached, the IRS acquiesced to the decision by issuing Rev. Rul. 78-197 which states that the IRS will treat stock proceeds as income to the donor only in situations where, as of the date the charitable donee receives the shares, the charitable donee is legally bound or may be compelled by the issuing corporation to surrender the shares. This position was further supported by the decision reached in the case of *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002), wherein the donor gifted stock-purchase warrants to four charities who subsequently converted them to stock and tendered them to the issuer for cash. The IRS asserted that, similar to the *Ferguson* fact pattern, the proceeds had "ripened to a practical certainty." However, the Tax Court ruled in favor of the donor, finding that the charitable donees were not legally bound to sell the warrants at the time they were received. Thus, a binding contract or legal obligation to act must exist before the IRS may successfully assert the assignment of income doctrine.

2. Corporate Stock Subject to Liquidation

For donors who hold shares in a corporation that is in the process of liquidation, the ability to avoid income recognition by gifting the stock may be less certain. Some lower courts have held that a donor may avoid the recognition of income so long as the stock is conveyed to charity prior to the final vote of the stockholders or board of directors to liquidate the corporation. However, higher courts have created more uncertainty by ruling that income will be attributed to the donor in situations where the liquidation plan cannot be practically withdrawn at the time the shares are conveyed to charity. *Jacobs v. United States*, 390 F2d 877 (6th Cir. 1968); Rushing *v. Commissioner*, 441 F2d 593 (5th Cir. 1971); Hudspeth *v. United States*, 471 F2d 275 (8th Cir. 1972); Kinsey *v. Commissioner*, 477 F2d 1061 (2nd Cir. 1973). The conclusion to be drawn from these decisions is that a donor must complete the gift transfer before the liquidation process reaches a point where it cannot be reversed, either legally or practically. Otherwise, the donor will be forced to recognize the proceeds from the liquidation of the shares as income.

Note: In all relevant cases on this point, the Service did not assert that the donation itself was defective or that the charitable deduction should be disallowed. The issue was always the recognition of income and capital gain arising from the proceeds of the donated asset.

C. Stock that is "Pregnant" with a Dividend

Frequently, donors will gift securities to charity that are soon to receive a dividend from the issuing corporation. To determine the tax treatment that applies in this situation, it is important to be familiar with the significant dates related to the pending dividend distribution. The "declaration date" is the date upon which the corporation makes known its intention to pay a future dividend of a given amount for each outstanding share of stock. On the stated "record date," those individuals who own outstanding shares become entitled to actually receive the dividend distribution. After the declaration date and before the record date, the value of a stock will typically increase to reflect the value of the upcoming dividend distribution. Once the record date has passed, the value of the stock will usually decline again.

The Fifth Circuit Court of Appeals considered a fact situation involving these factors in the case of *Caruth v. United States*, 865 F2d 644 (5th Cir. 1989). In this case, the donor conveyed preferred shares of stock to a charity soon after a dividend had been declared but a few days before the dividend record date. The donor subsequently claimed a charitable deduction for the enhanced market value of the shares, including the value of the pending dividend. The IRS did not challenge the legitimacy of this deduction amount, but rather argued that the amount of the dividend should be attributed to the donor as income. The IRS based this argument on the donor's control over the issuing corporation (and therefore the key dates surrounding the dividend) and the fact that the donor later reacquired the gifted shares eleven months later. The Court disagreed with the arguments made by the Service and concluded that the "pregnant" stock was an appreciated asset, and that because the donor had given away the appreciated value without first realizing it, the donor was not required to include the appreciation in his income stream.

D. Gifts of Stock Options

A stock option issued by a corporation allows the holder of the option to purchase shares of the corporation's stock at or before some future date at a price determined at the time the option is granted. It is not uncommon for corporations to grant stock options to qualified charitable organizations. By doing so, the corporation is able to realize an income tax charitable deduction without having to actually expend existing cash or other assets. However, the corporation is not entitled to any charitable deduction merely by transferring the option to a charitable organization. The charitable donee must first exercise the option before the deduction may be claimed. Rev. Rul. 82-197, 1982-2 C.B. 72; Rev. Rul. 78-181, 1978-1 C.B. 261. The amount of the charitable contribution deduction is measured by the excess of the stock's fair market value on the exercise date over its option price. Rev. Rul. 82-197, 1982-2 C.B. 72; Rev. Rul. 75-348, 1975-2 C.B. 75; Priv. Ltr. Ruls. 8340058, 8505012, 8714013, 8825069, and 8826008.

Extra caution must be exercised if an option is to be conveyed by a corporation to a private foundation. IRC § 4941 imposes sanctions on self dealing transactions that occur between certain "disqualified persons" and private foundations. If the corporation meets the definition of a disqualified person under IRC § 4946(a)(1), then the subsequent exercise of the option by the private foundation would constitute a self dealing transaction pursuant to IRC § 4941(d)(1) for which sanctions would be imposed under IRC § 4941(b). However, in a 1993 private letter ruling, the Service stipulated that a donor/corporation would be allowed a deduction when an option conveyed to a private foundation was subsequently sold to a public charity that then exercised the option. As mentioned in the preceding paragraph, the deduction amount was equal to the excess of the fair market value of the stock over the exercise price on the date that the unrelated public charity exercised the option. Priv. Ltr. Rul. 9335057.

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Baptist Foundation of Texas
1601 Elm Street, Suite 1700
Dallas, Texas 75201-7241

Appendix A

Sample Letter of Authorization from Donor to Donor's Broker

DONOR NAME
Donor's Address
City, State Zip Code

Mr. Broker's Name
Brokerage Firm
Address
City, State Zip Code

RE: Account No. XXXXXXXXXXX

Dear Mr. Broker:

I hereby authorize and direct you to transfer the following securities to Baptist Foundation of Texas, using the delivery instructions listed below:

List of Securities

Delivery instructions for Baptist Foundation of Texas' account are as follows:

BROKERAGE FIRM
DTC # __________
Acct. No. __________

Should you have any questions concerning this matter, please contact Larry Jones from Baptist Foundation of Texas at 214-123-4567. Thank you for your prompt attention to this matter.

Sincerely,

Donor's Name

[Medallion Signature Guarantee]

Appendix B

Qualified Appraisal Requirements

Qualified Appraisal Requirements

[These steps must be followed by a "qualified appraiser" to meet the criteria established by the Internal Revenue Service for non-cash charitable gifts.]

1. The appraisal must be prepared no earlier than 60 days prior to the date that the contribution is made, and must be prepared not later than the due date of the return on which the deduction is claimed or the date an amended return is filed if the amended return is the first return on which the deduction is claimed.

2. The appraisal must be prepared, signed and dated by a qualified appraiser as defined below.

3. The appraisal must include the following information:

    a. A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

    b. In the case of tangible property, the physical condition of the property;

    c. The date (or expected date) of contribution to the donee;

    d. The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor which relates to the use, sale or other disposition of the property contributed. This includes restrictions on the donee's right to use or dispose of the donated property, all provisions which confer on anyone, other than the donee charity, the right to income from the donated property or the right to possession of the property, including voting rights to securities, a right of purchase, or a right to designate the person to receive income, possession or right of purchase, or a provision which earmarks the donated property for a particular use. As an added precaution, all agreements between the donor and the donee charity relating to the gift should be attached to the appraisal and incorporated into it by reference;

e. The name, address, and taxpayer identification number of the qualified appraiser and, if the qualified appraiser is a partner in a partnership, an employee of any person (whether an individual, corporation, or partnership), or an independent contractor engaged by a person other than the donor, the name, address and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

f. The qualifications of the qualified appraiser;

g. A statement that the appraisal was prepared for income tax purposes;

h. The date or dates on which the property was valued;

i. The appraised fair market value of the property on the date (or expected date) of contribution;

j. The method of valuation used to determine the fair market value, such as the income approach, the market data approach, or the replacement-cost-less-depreciation approach;

k. The specific basis for the valuation, if any, such as any specific comparable sales transactions;

l. A description of the fee arrangement between the donor and the appraiser.

4. The appraiser must sign the appraisal summary upon its presentation to the appraiser by the donor. In this regard, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property.

5. To be a "qualified appraiser," the appraiser must sign and complete Internal Revenue Service Form 8283, Section B, denoted "Appraisal Summary." The Appraisal Summary includes declarations by the appraiser that:

   a. The individual holds himself or herself out to the public as an appraiser;

   b. Because of the appraiser's qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued.

   c. The appraiser is not:

      (1) The donor or the taxpayer who claims or reports the deduction under Section 170 for the contribution of the property being appraised;

      (2) A party to the transaction in which the donor acquired the property being appraised (i.e., the person who sold, exchanged or gave the property to the donor, or any person who

acted as an agent for the transferor or for the donor with respect to such sale, exchange or gift), unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price;

(3) The donee of the property;

(4) Any person employed by any of the foregoing persons or related to any of the foregoing persons under Section 267(b) (e.g. if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting);

(5) Any person whose relationship with any of the persons listed in (1) through (4) above would cause a reasonable person to question the independence of such appraiser. For example, an appraiser who is regularly used by any person described in (1) through (3) above and who does not perform a substantial number of appraisals for other persons has a relationship with such person that is similar to that of an employee and cannot be a qualified appraiser with respect to the property contributed.

d. The appraiser understands that a false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under Section 6701 for aiding and abetting an understatement of tax liability, and consequently the appraiser may have appraisals disregarded pursuant to 31 U.S.C. Section 330(c).

Appendix C

Sample Letters Documenting Redemption of Closely-Held Securities from a Qualified Charitable Trust or Private Foundation

[CLOSELY-HELD CORPORATION, INC. STATIONARY]

_____

_____

[THIS IS A DRAFT OF AN OFFER LETTER TO SEND
TO ALL CLASS A STOCK SHAREHOLDERS]

_____, 2005

Mr. Jeff W. Smith
Vice President and General Counsel
Baptist Foundation of Texas
1601 Elm Street, Suite 1700
Dallas, Texas 75201-7241

Dear Mr. Smith:

As you are aware, Baptist Foundation of Texas currently owns 12, 400 shares of Closely-Held Corporation, Inc. Class A stock as Trustee of the ____________________ *Charitable Remainder Unitrust No. 1*.

This letter is to inform Baptist Foundation of Texas that a redemption of Closely-Held Corporation, Inc. Class A stock will be open from _____, 2005, until _____, 2005, during which time the corporation will purchase from the shareholders any or all Class A shares held by them for $_____ per share. All purchases will be made in cash. The valuation of the Closely-Held Corporation, Inc. Class A stock was made on _____, 2005, and it was this valuation which was used to determine the purchase price stated above.

You may redeem your Class A shares at fair market value until _____, 2005.

Sincerely,

____

President
Closely-Held Corporation, Inc.

[THIS IS A DRAFT LETTER THAT THE CHARITY MAY SEND TO THE CLOSELY-HELD CORPORATION IN RESPONSE TO THE REDEMPTION OFFER.]

_____, 2005

Mr. ___________________
President
Closely-Held Corporation, Inc.
____
____

Dear Mr. ____________________:

We have received your offer to redeem the 12,400 shares of the Class A stock of Closely-Held Corporation, Inc. held by a charitable remainder unitrust established by Mr. and Mrs. ____________________, of which Baptist Foundation of Texas is Trustee.

As you may know, charitable remainder trusts are subject to certain self-dealing rules under the Internal Revenue Code that impose restrictions regarding redemptions of stock from closely related parties. Those restrictions allow for a redemption of the trust's shares, so long as the offer price is at fair market value and so long as the same offering is made on the same basis to all other holders of the same class of stock which is the subject of the redemption.

Baptist Foundation of Texas, acting as Trustee of the referenced trust, is prepared to accept the offer of redemption of all of its 12,400 shares at $_____ per share, for a total price of $_____.

We request that you verify the accuracy of the information above to confirm that a self-dealing transaction does not occur. Upon verification of that information, we would request that you provide a check payable to Baptist Foundation of Texas in the amount of $_____. If there is any variance from the assumptions stated above that would cause this transaction to be treated as an act of self-dealing, please advise us of what assumptions are incorrect prior to mailing the check.

Thank you very much for your help with this matter. If I can provide anything further, please let me know.

Sincerely,

Joseph E. Hancock
Senior Trust Attorney
Direct Dial: 214-978-3394
Direct Fax: 214-978-3395

[CLOSELY-HELD CORPORATION, INC. STATIONARY]

_____

_____

[VERIFICATION LETTER TO BE SENT TO THE CHARITY FROM THE CLOSELY-HELD CORPORATION]

_____, 2005

Mr. Joseph E. Hancock
Senior Trust Attorney
Baptist Foundation of Texas
1601 Elm Street, Suite 1700
Dallas, Texas 75201-7241

Dear Joe:

On _____, 2005, a valuation of Closely-Held Corporation, Inc. Class A stock was made and, as of that date, the fair market value per share of Closely-Held Corporation, Inc. Class A stock was determined to be $_____. All Class A stockholders of Closely-Held Corporation, Inc. were informed in writing on _____, 2005, that a redemption of Closely-Held Corporation, Inc. Class A stock would be open from that date until _____, 2005, during which time the corporation would purchase from the shareholders any or all Class A shares held by them for $_____ per share. All purchases would be made in cash.

Accordingly, the offer to redeem shares held by the charitable remainder trust created by Mr. and Mrs. ____________________ on December _____, 2005, with Baptist Foundation of Texas, as Trustee, was made on the same terms as the offer made to all other Class A shareholders, and the offer was made at fair market value. The offer to Baptist Foundation of Texas, as Trustee of the ____________________ *Charitable Remainder Unitrust No 1, w*as made on _____, 2005, and the redemption occurred on _____ 2005, which was in the redemption period referenced above.

Sincerely,

____
President
Closely-Held Corporation, Inc.