Steve Leimberg's Charitable Planning Email Newsletter - Archive Message #329

Date:	**05-Jul-23**
From:	**Steve Leimberg's Charitable Planning Newsletter**
Subject:	**Richard L. Fox On Estate of Hoensheid v. Commissioner: Cautionary Tale to Donors Making Charitable Contributions of Stock Prior to Sale of Company**

"Where shareholders of a closely held company plan to sell their company, the prospect of contributing shares of stock of the company to charity prior to closing is often considered which, when properly structured, can result in very favorable income tax consequences. And, if the shares are contributed to a donor advised fund ("DAF"), the shareholder can continue to utilize the sale proceeds to make charitable contributions to a variety of charities over time, similar to a private foundation.

In the recent case of Estate of Hoensheid v. Comm'r, T.C. Memo. 2023-34, a shareholder of a closely held company sought to take advantage of this type of planning by donating shares of stock to a DAF at Fidelity Charitable prior to the closing of the sale of the entire company. Unfortunately, the tax consequences of the donation were far different from what the donor had anticipated. Instead of avoiding the recognition of gain and related income tax liability on the sale of the stock contributed to the charity and obtaining a charitable income tax deduction for its fair market value, the usual favorable tax consequences associated with a charitable contribution of appreciated property, the donor had to recognize taxable gain under the assignment of income doctrine and was also precluded from claiming any charitable income tax deduction because of the failure to properly substantiate the donation. In the end, therefore, the donor was subject to income tax attributable to the contributed stock and could not claim any offsetting charitable income tax deduction, an extremely harsh result.

Interestingly, upon its receipt, Fidelity Charitable did not have any legal obligation to sell the contributed shares of stock, the bright-line test applied by the IRS and the courts in determining whether the assignment of income doctrine applies with respect to a charitable contribution of stock that is redeemed by the charity shortly after the contribution. Notwithstanding, because, at the time of the contribution, it was clear that the sale of the

shares of stock contributed to Fidelity Charitable was virtually certain to occur in connection with the sale of the entire company, the court held that the assignment of income doctrine applied.

In the end, the court determined that the transaction involving the sale of the entire company had proceeded too far down the road to enable the taxpayer to escape taxation on the gain attributable to the donated shares. To add insult to injury, no charitable income tax deduction was allowed because the appraisal obtained by the taxpayer for the donated shares did not meet the requirements of a qualified appraisal for income tax purposes."

Richard Fox provides members with commentary that examines *Estate of Hoensheid v. Commissioner*.

Richard L. Fox is an attorney and founding partner of the **Law Offices of Richard L. Fox, LLC** (www.richardfoxlaw.com). Richard is the author of the treatise, "Charitable Giving: Taxation, Planning and Strategies," a Thomson Reuters/Warren, Gorham and Lamont publication, and the Bloomberg Tax Management Portfolio "Tax-Exempt Organizations: Reporting, Disclosure and Other Procedural Aspects" (Portfolio 452), writes a national quarterly bulletin on charitable giving, and writes and speaks frequently on issues pertaining to philanthropy, charitable giving vehicles, estate and gift planning and nonprofit organizations. Richard is also member of the editorial board of the Estate Planning Journal and a Fellow of the American College of Trust and Estate Counsel (ACTEC).

Here is his commentary:

EXECUTIVE SUMMARY:

Where shareholders of a closely held company plan to sell their company, the prospect of contributing shares of stock of the company to charity prior to closing is often considered which, when properly structured, can result in very favorable income tax consequences. And, if the shares are contributed to a donor advised fund ("DAF"), the shareholder can continue to utilize the sale proceeds to make charitable contributions to a variety of charities over time, similar to a private foundation.

In the recent case of *Estate of Hoensheid v. Comm'r*, T.C. Memo. 2023-34, a shareholder of a closely held company sought to take advantage of this

type of planning by donating shares of stock to a DAF at Fidelity Charitable prior to the closing of the sale of the entire company. Unfortunately, the tax consequences of the donation were far different from what the donor had anticipated. Instead of avoiding the recognition of gain and related income tax liability on the sale of the stock contributed to the charity and obtaining a charitable income tax deduction for its fair market value, the usual favorable tax consequences associated with a charitable contribution of appreciated property, the donor had to recognize taxable gain under the assignment of income doctrine and was also precluded from claiming any charitable income tax deduction because of the failure to properly substantiate the donation. In the end, therefore, the donor was subject to income tax attributable to the contributed stock and could not claim any offsetting charitable income tax deduction, an extremely harsh result.

Interestingly, upon its receipt, Fidelity Charitable did not have any legal obligation to sell the contributed shares of stock, the bright-line test applied by the IRS and the courts in determining whether the assignment of income doctrine applies with respect to a charitable contribution of stock that is redeemed by the charity shortly after the contribution. Notwithstanding, because, at the time of the contribution, it was clear that the sale of the shares of stock contributed to Fidelity Charitable was virtually certain to occur in connection with the sale of the entire company, the court held that the assignment of income doctrine applied.

In the end, the court determined that the transaction involving the sale of the entire company had proceeded too far down the road to enable the taxpayer to escape taxation on the gain attributable to the donated shares. To add insult to injury, no charitable income tax deduction was allowed because the appraisal obtained by the taxpayer for the donated shares did not meet the requirements of a qualified appraisal for income tax purposes.

FACTS:

In the recent case of *Estate of Hoensheid v. Comm'r*, T.C. Memo. 2023-34, the taxpayer and his two brothers each owned one-third of the shares of stock of Commercial Steel Treating Corp. ("CSTC"), a closely held company historically engaged in the business of manufacturing heat-treating metal fasteners for use in automobiles and other commercial

vehicles. In the fall of 2014, the brothers decided to pursue a potential sale of the company. Thereafter, in early 2015, the company began to solicit bids and received several letters of intent to purchase the stock of CSTC from interested private equity firms. HCI Equity Partners ("HCI"), a Washington, D.C. based private equity firm which focuses in part on acquiring companies in the automotive industry, was one of the interested parties and on April 1, 2015, it submitted a letter of intent to acquire the stock of CSTC for total consideration of $92 million and, ultimately, a sale of CSTC to HCI was consummated.

Meanwhile, on April 20, 2015, the taxpayer began considering the prospect of establishing a DAF at Fidelity Charitable in order to make a presale charitable contribution of some of his CSTC stock. The taxpayer made it clear, however, that he only intended to make the contribution if the sale of the company went through. In an email to his estate planning attorney, for example, he stated that he "would rather wait as long as possible to pull the trigger" because if he makes the contribution "and the sale does not go through, I guess my brothers could own more stock than I and I am not sure it can be reversed." In a later email to the attorney, the taxpayer confirmed his intention to defer the contribution as long as possible, stating that "I do not want to transfer the stock until we are 99% sure we are closing."

Although there was an issue raised as to when the contribution actually took place, it was ultimately determined by the court that the taxpayer made a contribution of 1,380 shares of CSTC stock to Fidelity Charitable on July 13, 2015, which had an appraised value of $3,282,511. The closing of the sale of the entire company to HCI, including the 1,380 shares that were contributed to Fidelity Charitable, took place two days later on July 15, 2015. At closing, Fidelity Charitable received actual sale proceeds of $2,941,966 that were deposited into the taxpayer's DAF, $340,545 less than the appraised value.

On his 2015 tax return, the taxpayer did not report any capital gain associated with the sale of the 1,380 shares of CSTC stock and claimed a charitable income tax deduction for the contribution of such shares in an amount equal to $3,282,511. Although the taxpayer received a quote from a national accounting firm to prepare an appraisal, the taxpayer ultimately decided to utilize the financial advisory firm it engaged in connection with the sale of CSTC to prepare the appraisal.

Following an audit of the tax return, the IRS determined that under the assignment of income doctrine, the taxpayer was subject to tax on the sale of the 1,380 shares by Fidelity Charitable. The IRS also disallowed the charitable income tax deduction in full on the basis of (1) the appraisal not qualifying as a "qualified appraisal" for federal income tax purposes and (2) the required contemporaneous donee acknowledgment describing the contribution as cash, rather than shares of stock.

Assignment of Income Doctrine

The court characterized the assignment of income doctrine as a longstanding "first principle of income taxation" that recognizes that income is taxed "to those who earn or otherwise create the right to receive it" and that tax cannot be avoided "by anticipatory arrangements and contracts however skillfully devised." Therefore, a person with a fixed right to receive income from property cannot avoid taxation by arranging for another to gratuitously take title before the income is received.

The court stated that this "same principle is often applicable where a taxpayer gratuitously transfers shares of stock that are subject to a pending, pre-negotiated transaction and thus carry a fixed right to proceeds of the transaction." In this context, the court noted, "[t]o avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of contribution that the sale will not close."

In determining whether an anticipatory assignment of income has occurred, the court cited case law holding that the "realities and substance of the underlying transaction" control. Thus, as opposed to a bright-line test, "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 court stated that in order to determine whether, as of date of the contribution of the CSTC shares to Fidelity Charitable, the taxpayer had a fixed right to the income from the sale of the shares upon the subsequent closing, the relevant factors to be considered include the following:

(1) any legal obligation to sell by the donee;

(2) the actions already taken by the parties to effect the transaction;

(3) the remaining unresolved transactional contingencies; and

(4) the status of the corporate formalities required to finalize the transaction.

Fidelity's Legal Obligation to Sells Contributed Shares. Contrary to the position of the IRS, the court determined that Fidelity Charitable was under no legal obligation to sell the contributed shares. In this regard, the court noted that the terms and conditions of Fidelity Charitable' s Letter of Understanding expressly disclaimed any such obligation. In addition, the court concluded that the IRS did not sufficiently establish the existence of any informal, prearranged understanding between the taxpayer and Fidelity Charitable that might otherwise constitute a legal obligation. Notwithstanding the absence of such a legal obligation being a factor that "weighs against an anticipatory assignment of income," the court stated that this factor alone was not dispositive and, indeed, other factors discussed below weighed in favor of its application.

Actions Already Taken by Parties to Effect the Transaction. As of the date of the contribution of the shares to Fidelity Charitable, "a number of acts had already taken place to suggest that the transaction was a virtual certainty" to occur:

- One week before the contribution, HCI had caused the incorporation of a new holding company subsidiary to acquire the CSTC shares.

- Three days before the contribution, CSTC had amended its Articles of Incorporation to allow for written shareholder consent, an action requested by HCI.

- During the week before the contribution, CSTC paid out \$6.1 million in employee bonuses and authorized a distribution of \$4.7 million to the taxpayer and his two brothers, thus resulting in CSTC distributing or determining to distribute its working capital in an amount over \$10 million.

With respect to the distribution of funds, the court found it highly improbable that the taxpayer and his two brothers "would have emptied CSTC of its working capital if the transaction had even a small risk of not consummating." Absent its working capital, the court noted, CSTC was no longer a going concern until the sale transaction was finalized.

Unresolved Sales Contingencies. The court then looked to what unresolved sale contingencies remained between the parties on the date of the contribution that would subject the sale to the risk of not closing. Here, the taxpayer argued that the transaction with HCI was still being negotiated up until the closing date of July 15, 2015. At trial, he identified several issues still being negotiated as of the date of the contribution, including an environmental liability, employee compensation arrangements, and excess real estate, and testified that he and HCI "basically negotiated right up until the day before we closed" - i.e., July 14, 2015.

The court, however, found that the record did not bear out the substance of the taxpayer's characterization, stating as follows:

> The identified employee compensation and excess real estate issues appear to have been resolved in drafts of the agreement prepared before July 13, 2015. At trial, a representative of HCI characterized the environmental liability issue as "the one probably biggest item of negotiation" resolved before closing. On July 10, 2015, HCI's counsel prepared a draft with a new seller indemnity provision addressing the environmental liability issue. By 4:38 a.m. on the morning of July 13, when HCI's counsel next ran a redline comparison of a new draft, the environmental liability provision had already been accepted into the draft agreement.

Given that the written drafts memorialized the negotiations between the parties, the court found that the parties had resolved the environmental liability issue before the contribution to Fidelity Charitable. Moreover, the court noted, the only substantive change made to the drafts after the contribution to Fidelity Charitable was a minor revision to the provision for ongoing compensation for health insurance. Thus, the court found that none of the unresolved contingencies remaining on July 13, 2015 "were substantial enough to have posed even a small risk of the overall

transaction's failing to close” and that, consistent with his “99% sure” statement, that taxpayer had waited “until all material details had been agreed to with HCI before he transferred the shares to Fidelity Charitable.”

Corporation Formalities. Finally, the court looked to the status of the corporate formalities necessary for effecting the transaction at the time of the contribution. In this regard, the court noted that although the taxpayer and his brothers unanimously approved pursuant a sale of all outstanding stock of CSTC to HCI on June 11, 2015, they did not provide final unanimous consent to the sale until July 15, 2015, two days after the date of the contribution. The court stated, however, that while such approval has often proven to be sufficient to demonstrate that a right to income from shares was fixed before a subsequent sale, the approval is not necessary for a right to income to be fixed when other actions taken establish that a transaction was virtually certain to occur on the date of the contribution.

The record showed that the final written consent was a foregone conclusion, particularly because the taxpayer, along with his two brothers, were involved in negotiating the transaction, “making their approval all but assured as of July 13, 2015.” On this basis, the court concluded that formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale was, as of July 13, “remote and hypothetical.” In the end, the court stated that:

> To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of contribution that the sale will not close. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing eliminated any such risk and made the sale a virtual certainty. Petitioners' right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the 1,380 appreciated shares of CSTC stock.

Of note in this case is that the court rejected the taxpayer’s reliance on another case, *Dickinson v. Comm'r, T.C. Memo. 2020-128*, also involving the contribution of shares of stock in a closely held company to Fidelity

Charitable where the shares were redeemed by the company shortly after the contribution. There, the court stated where a donee redeems shares shortly after a donation, the assignment of income doctrine applies “only if the redemption was practically certain to occur at the time of the gift, and would have occurred whether the shareholder made the gift or not.” The court noted that “practically certain to occur” standard does not include the “mere anticipation or expectation” of a sale.

In *Dickinson*, court held that the redemption was not “practically certain to occur at the time of the gift” because but for taxpayer making a charitable contribution of the shares, the redemption would not have occurred at all. Therefore, the redemption in *Dickinson* was not a fait accompli until after the contribution of the shares was made. In contrast, in the *Hoensheid* case, a charitable contribution of the shares would not have been made but for the impending sale to HCI. Therefore, the *Dickinson* rationale did not apply to the taxpayer in *Hoensheid.*

The court in *Hoensheid* also did not follow the bright-line “legally bound” standard applied in Rev. Rul. 78-197, 1978-1 C.B. 83, under which the assignment of income doctrine will only apply where a charity receiving shares of stock is legally bound, or can be compelled by the corporation, to surrender the shares for redemption at the time of the contribution. The sale of the donated shares in the *Hoensheid* case was not pursuant to an isolated redemption of shares following the donation, as was the case in Rev. Rul. 78-197, and, in any event as the court pointed out, unlike the IRS, “revenue rulings are not binding on this Court, or other Federal courts.”

Disallowance of Charitable Income Tax Deduction

The IRS disallowed the taxpayer’s claimed charitable income tax deduction for the contribution of the CSTC shares to Fidelity Charitable based on the failure of the taxpayer to obtain (1) a contemporaneous written acknowledgment that met the requirements under Section 170(f)(8) and (2) an appraisal meeting the requirements of a “qualified appraisal” for federal income tax purposes.

Contemporaneous Written Acknowledgment. Section 170(f)(8)(A) provides that no charitable income tax deduction shall be allowed for any contribution of $250 or more unless the donor substantiates the

contribution by a contemporaneous written acknowledgment ("CWA"), which under Section 170(f)(8)(B) must include, among other things, "the amount of cash and a description (but not value) of any property other than cash contributed."

The IRS asserted that the acknowledgment provided by Fidelity Charitable failed to satisfy Section 170(f)(8)(B) because it described the taxpayer's contribution as shares of stock rather than as cash. The position of the IRS in this regard was that because the assignment of income doctrine applied, the donation for federal income tax purposes was the cash proceeds from the sale of the donated stock, not the stock itself.

As a matter of state law, the court held that the taxpayer made a valid gift of CSTC shares to Fidelity Charitable. However, for federal income tax purposes, the court held that the donated shares were treated as carrying a fixed right to the cash proceeds of the sale of the shares. That second holding, according to the court, does not disturb the conclusion that the taxpayer made a valid gift of stock.

Accordingly, the court did not interpret Section 170(f)(8)(B) to require a donee to ascertain and correctly describe a contributed property interest in accordance with how that interest should be classified for federal income tax purposes. "It is sufficient here that the CWA provided by Fidelity Charitable described the contributed property as shares of stock. We conclude that the CWA issued by Fidelity Charitable satisfied the requirements of section 170(f)(8)(B)." Thus, the IRS disallowance of the charitable income tax deduction for the failure to obtain a CWA was not sustained.

Qualified Appraisal for Income Tax Purposes. The IRS fared better on the disallowance of the charitable income tax deduction on the basis of the appraisal obtained by the taxpayer not meeting the requirements of a "qualified appraisal" for income tax purposes.

The IRS contended that the taxpayer's appraisal was not a qualified appraisal because it (1) did not include the statement that it was prepared for federal income tax purposes; (2) included the incorrect date of the contribution; (3) included a premature date of appraisal; (4) did not sufficiently describe the method for the valuation; (5) was not signed by the individual who had prepared it; (6) did not include such individual's

qualifications as an appraiser; (7) did not describe the property in sufficient detail; and (8) did not include an explanation of the specific basis for the valuation.

The taxpayer did not argue that he strictly complied with the qualified appraisal requirements but sought to rely on the doctrine of substantial compliance and reasonable cause. The court held, however, that the taxpayer's "failure to satisfy multiple substantive requirements of the regulations, paired with the appraisal's other more minor defects, precludes them from establishing substantial compliance" and, further, that the taxpayer did not have reasonable cause for his failure to provide a qualified appraisal. Accordingly, the court sustained the determination by the IRS to disallow the claimed charitable income tax deduction in its entirely.

COMMENT:

Estate of Hoensheid v. Comm'r is a cautionary tale of the income tax risks of making a charitable contribution of shares of stock of a closely held company that is in the process of being sold to a third party. Where the contribution of stock is made at a time when it is a virtual certainty that the sale will take place such that the donor essentially bears little or no risk of the sale not occurring, the donor will recognize taxable gain on the sale of stock by the charity under the assignment of income doctrine. In this case, the transaction involving the sale of the entire company had proceeded too far down the road to enable the taxpayer to escape taxation on the gain attributable to the donated shares.

This case also highlights the absolute need to ensure that an appraisal obtained for the contribution of property to charity strictly complies with the requirements for a "qualified appraisal" for income tax purposes. Here, in an apparent attempt to save money in connection with a $3 million charitable contribution, rather than engaging a firm specializing in appraising property for income tax purposes, the taxpayer utilized the services of an individual working for his financial advisor firm who was not a "qualified appraiser" and clearly failed to comply with the requirements for a "qualified appraisal" for income tax purposes. The result was a complete denial of the claimed charitable income tax deduction.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Richard Fox

CITE AS:

LISI Charitable Planning Newsletter #329 (July 5, 2023) at http://www.leimbergservices.com. Copyright © 2023 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited - Without Express Permission. This newsletter is designed to provide accurate and authoritative information regarding the subject matter covered. It is provided with the understanding that **LISI** is not engaged in rendering legal, accounting, or other professional advice or services. If such advice is required, the services of a competent professional should be sought. Statements of fact or opinion are the responsibility of the authors and do not represent an opinion on the part of the officers or staff of **LISI**.

CITES:

Estate of Hoensheid v. Comm'r, T.C. Memo. 2023-34; IRC Section 170(f)(8)((B); Rev. Rul. 78-197, 1978-1 C.B. 83.