STRATEGICALLY FUNDING PHILANTHROPY WITH NON-CASH ASSETS

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This article examines the opportunity and considerations for donating non-cash (including non-publicly traded) assets to charity.

Charitable giving has steadily been on the rise for decades, and an overwhelming majority of the giving is done by individuals.[1] Notably, this facet of American culture remains strong even during market downturns and economic uncertainty. The key — especially during times of tighter wallets — is to make smarter decisions around the charitable gift, including what assets to donate, the timing of the donation, and the vehicle for giving.

Many donors choose to fund their philanthropy with cash for the obvious reasons of ease and accessibility. However, some of the more effective assets to donate are non-cash assets, including long-term appreciated stocks and complex assets such as privately held C-corporation and S-corporation stocks and limited partnership interests. These are often the most highly appreciated assets in a donor's portfolio and contributing them to charity can potentially minimize capital gains exposure.

The Opportunity

Long-term appreciated capital assets could vary from marketable securities traded on a public exchange to non-publicly traded assets (i.e., closely held shares in a private company). By contributing highly appreciated assets directly to charity, donors can maximize their charitable gift and contribute significantly more than if they had donated the post-sale proceeds. Indeed, if donors were to sell long-term appreciated stock and donate the net cash, they may become subject to capital gains tax. If they instead donate the stock directly to a public charity, the capital gains tax

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can be avoided and 100 percent of the stock's value can go to charity. The donor might also have the secondary benefit of qualifying for an immediate income tax deduction for the fair market value (FMV) of the asset up to 30 percent of his or her adjusted gross income.

Most practitioners are familiar with the benefits of contributing appreciated public company stock, but they may not be familiar with the process of contributing appreciated private company stock. While these assets may have appreciated in value similarly to public marketable securities, they will not generally benefit the recipient charity until a subsequent liquidity event, which provides cash proceeds for the charitable organization. The lack of marketability and the lack of control of the donated asset will lead to the IRS appraisal requirement for determining the FMV of the contributed asset on the date of the gift. The donor will need to evaluate the cost of obtaining an independent qualified appraisal to establish the FMV for the asset at the time of the contribution.

Considerations

While non-cash donations have become more popular and sophisticated over time, fundamental considerations remain. These considerations apply to donations of both appreciated public company stock as well as private company stock.

Both the donor and recipient charity must consider the timing and the impact of a proposed donation of appreciated stock to avoid potential negative tax implications. For a completed gift to occur, the donor will need to contribute an undivided interest in the asset to the recipient charity, thus relinquishing dominion and control. The charity, in turn, will have legal ownership of the contributed asset and discretion over its disposition. While there can be no express or implied agreement relating to the disposition of the asset at the time of the gift, the charity will generally seek to find liquidity in the near term to fund its charitable mission.

From the donor's perspective, the timing of a donation is important as it may affect the deduction value of the contributed asset. For donors that contribute private company stock and substantiate the donation value through a qualified appraisal, the customary discounts for lack of marketability and lack of control can play a key role in the timing of the donation. The donor should also be concerned with the timing of the donation as it relates to a potential assignment of income. The assignment of income doctrine, in effect, disqualifies the charitable gift if the recognition of gain is required by the taxpayer. When it comes to the assignment of income doctrine, the facts and circumstances relating to an individual donation may vary and will need to be reviewed on a case-by-case basis.

The recipient charity may take a conservative approach to accepting the gift before there is a legally binding obligation to sell the contributed asset. The charitable organization will need to perform its due diligence prior to accepting the asset. The due diligence primarily focuses on the risk associated with owning and disposing of an asset in addition to satisfying the desire for liquidity in the near term. Generally, the timing considerations for both the donor and the charitable organization align as gifts of non-publicly traded assets are contributed in advance of an express or implied agreement but with the prospect of a liquidity event on the horizon.

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Gifting Strategies and Timing

It is very common to see charitable gifts of private company stock in advance of a business sale. And for good reason: This strategy can be compelling for anyone with a high concentration of private company stock (generally a founder or a key employee) as they prepare for a sale of their business. Not only is the stock highly appreciated with little to no tax basis, but the donor likely owns a large position and is therefore facing a significant tax recognition event in the year of the sale.

It is critical that the charitable donation occurs prior to the execution of a legally binding agreement. Because of this, it is never too early to begin the donation process; it is common to engage an investment banker as soon as there are indications of interest and a non-legally binding letter of intent. The donor and his or her tax advisor will need to evaluate the timing of the contribution as it may lead to assignment of income im-

[1] "Giving USA 2022 Study", Indiana University Lilly Family School of Philanthropy(2022). Available at: https://benefactorgroup.com/givingusa2022/.

plications as previously discussed. A few recent income tax cases in a long line of precedent provide important guidance. In the Tax Court case Dickinson v. Comm'r of Internal Revenue, the taxpayer was the CFO and a shareholder of Geosyntec Consultants, Inc., ("GCI"), a privately held company.[2] Over several years, the taxpayer donated GCI stock to a donor-advised fund (DAF) sponsored by Fidelity Investments® Charitable Gift Fund ("Fidelity Charitable®") in the following manner. First, by written consent, the

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GCI board of directors authorized transfer of the shares to Fidelity Charitable. The written consents included an acknowledgement that it was Fidelity Charitable's DAF program's policy requirement to "immediately liquidate the donated stock."[3] The taxpayer then donated appreciated GCI stock to Fidelity Charitable. Following the donation, GCI sent a written confirmation to Fidelity Charitable that the company's books and records reflected Fidelity Charitable as the new owner of the shares, and the taxpayer signed letters of understanding indicating that the stock was "exclusively owned and controlled by Fidelity [Charitable]" and that Fidelity Charitable "maintains full discretion over all conditions of any subsequent sale" of the stock and that Fidelity Charitable "is not and will not be under any obligation to redeem, sell, or otherwise transfer" the stock.[4] Next, Fidelity Charitable sent letters confirming that Fidelity Charitable has "exclusive legal control over the contributed asset."[5] As the last step, GCI redeemed the shares for cash.

The Tax Court explained, per Humacid Co. v. Commissioner, that the form of the transaction is respected if the donor (1) gives the property away absolutely and parts with the title thereto and (2) does so before the property gives rise to income by way of sale.[6] With regard to the first prong, the Tax Court determined that the GCI letters confirming ownership, the letters of understanding, and Fidelity's confirmation letters all supported and confirmed the taxpayer's claim that he had given away all rights in the GCI shares.[7] With regard to the second prong, the redemption occurred after the donation. Accordingly, the Tax Court respected this form of the transaction.

More recently, in the U.S. District Court case Keefer v. United States, a motion for reconsideration was denied by Judge Jana J. Boyle.[8] In this case, the taxpayer Kevin was a limited partner in Burbank HHG Hotel, LP ("Burbank"), which owned and operated a hotel. On April 23, 2015, Burbank exchanged a non-binding letter of intent with a third party, Apple Hospitality REIT ("Apple"), to sell the hotel. Burbank did not sign the letter of intent and continued to negotiate for the sale of the hotel. Burbank was also considering other offers for the hotel. As of June 18, 2015, a tentative price had been agreed to by Burbank and Apple, a contract was drafted but not signed, and Apple had not conducted the review of the hotel and its records. On June 18, 2015, Kevin donated a 4 percent limited partnership interest in Burbank to establish a DAF sponsored by the Pi Foundation ("Pi"). On July 2, 2015, Burbank and Apple signed a contract for Apple to purchase the hotel. The contract gave Apple a 30-day period to evaluate the property. The sale closed on August 11, 2015. On or around September 9, 2015, Kevin received a letter from the DAF acknowledging the donation. Kevin had previously signed a DAF packet on June 8, 2015.

The Keefers' tax advisor commissioned an appraisal of the 4 percent limited partnership interest as of June 18, 2015, which Kevin had donated to the DAF. The appraiser estimated the fair market value at $1.257 million and gave only a 5 percent probability that a sale would not occur. The taxpayers did not report the allocated share of the gain recognized on the sale of the hotel that was attributable to the 4 percent limited partnership interest in Burbank held by the DAF; instead, they reported a charitable donation of $1.257 million on their joint 2015 federal income tax return (Form 1040), both of which were successfully challenged by the IRS.

The IRS successfully asserted that the donation of the 4 percent limited partnership interest was an anticipatory assignment of income, and the gain allocated to it was taxable to the taxpayers and not the DAF.[9] Under the anticipatory assignment of income doctrine, once a right to receive income has "ripened" for tax purposes, the taxpayer who earned or otherwise created that right will be taxed on any gain realized from it even if the taxpayer transfers the right before receiving the income.[10] In other words, a taxpayer who has earned income cannot avoid paying tax on that income by assigning it to another tax-

payer. The doctrine requires a donor to give the property away absolutely and to do so before the property gives rise to income by way of sale or other disposition.

The Court in Keefer focused on the two-prong test enumerated by the court in Humacid Co. v. Commissioner, which sets forth that donations of appreciated property to a charity will be respected if the taxpayer gives the property away (1) absolutely and parts with the title thereto and (2) does so before the property gives rise to income by way of sale.[11] The Court first focused on the second prong of the Humacid analysis and determined that Burbank's right to income from the sale of the hotel to Apple had not vested when Kevin assigned his 4 percent limited partnership to his DAF. The Court supported this holding based on the uncontroverted facts that at the time Kevin assigned his 4 percent limited partnership interest to his DAF, the contract of sale had not been signed by Burbank, and, furthermore, the contract gave Apple a 30-day review period. The Court determined that Apple had no binding obligation to close and the deal was not "practically certain" to close until that review period expired.[12] The Court also noted that the non-binding letter of intent that was sent by Apple to Burbank was never signed by Burbank.

The Court then turned to the first prong of the Humacid analysis and found that Kevin did not contribute his entire 4 percent limited partnership interest on June 18, 2015; instead, he retained a portion of his interest. The Court noted in Kevin's testimony that "equipment reserves" and "working capital reserves" were reflected on Burbank's balance sheet, and that these had been "reserved from the distributions that [the partnership had] been making from the partners."[13] Kevin further testified that he had an oral agreement with Pi, the sponsor of his DAF, that he would retain the right to receive his allocable share of the reserve funds from the closing proceeds, and Pi would receive the remaining proceeds attributable to his 4 percent limited partnership interest. Kevin retained the right to receive cash from Burbank's reserve accounts, which established that he did not transfer his entire interest in the property. Hence, the Court found that the anticipatory assignment of income doctrine applied to Kevin's contribution.

The Court also denied the taxpayers' charitable deduction. Section 170 of the Internal Revenue Code[14] provides, in a pertinent part, that a taxpayer can claim a deduction if the charity provides the taxpayer with a contemporaneous written acknowledgement (CWA) of the amount of a single charitable contribution worth $250 or greater. In Keefer, Kevin received a DAF packet along with an acknowledgement letter, which he claimed together constituted a CWA. The Court determined that while the DAF packet outlined the full legal control the charity would have over any contributions made to the DAF account, it failed to acknowledge a completed contribution or one that was legally obligated to cover. The DAF packet was provided prior to the date Kevin contributed his 4 percent limited partnership interest in Burbank and contemplated that the contribution may or may not occur. The Court determined that the taxpayers did not obtain a CWA that satisfies the strict compliance requirements of Sections 170(f)(8) and (18). Therefore, it could not have been an acknowledgment of a completed contribution.

Potentially Underutilized Gifting Strategies

While gifting in advance of a business sale is a common strategy, some charitable business owners have become more creative when it comes to fueling their philanthropy. "Giving while growing" approaches have gained momentum, and some of the more prevalent examples are highlighted in the following sections.

Business growth provides an opportunity for liquidity for founders, key employees, and early investors through a corporate redemption strategy. Many private companies with a broad ownership structure may offer cyclical liquidity opportunities for shareholders following the annual valuation of the company stock. This provides an opportunity for individuals to realize a return on their investments and an even greater opportunity for those individuals to maximize the impact of their charitable giving. Similar to other giving

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2 *Dickinson v. Comm'r of Internal Revenue,* 120 T.C.M. (CCH) 188 (T.C. 2020)

3 *Ibid.*

4 *Op. cit.* note 2.

5 *Ibid.*

6 *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964)

7 *Op. cit.* note 2.

8 *Keefer v. United States*, No. 3:20-CV-0836-B, 2022 WL 3227853 at *1 (N.D. Tex. Aug. 10, 2022).

9 *Ibid.*

10 *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

11 *Op. cit.* note 6.

12 *Ferguson v. Comm'r*, 174 F.3d at 1004, 1001-02 (9th Cir. 1999).

13 *Op. cit.* note 6.

strategies, the individual can contribute private shares to a charitable organization prior to the recurring liquidity opportunities. As with other charitable gifts, the donor must relinquish discretion and control over the shares at the completion of the gift. The charity will then become a shareholder of record on the books and can participate in the upcoming liquidity event. This is an effective strategy, as it can be a repeatable and efficient process for the donor, the charity, and the company.

Additional giving opportunities arise during periods of capital infusion. Private equity investments and capital infusion allow for continued liquidity opportunities for founders and early investors. A company may provide liquidity opportunities to existing shareholders during or following a financing round. For example, following a funding round, the company may have the additional capital to purchase stock from individual shareholders. Contributing a portion of the stock to charity prior to the sale could allow for a more significant tax deduction for donors in a high-income year. As these opportunities arise, consideration needs to be paid to the timing of the completion of a gift prior to a legally binding commitment to sell. This structure may provide for a repeatable gifting process over the life of the investment as private equity firms look for a return on investments through multiple financing rounds and expected subsequent liquidity events.

Note that at present, the redemption of private domestic company stock is not subject to a 1 percent excise tax under the Inflation Reduction Act of 2022, which, inter alia, added Section 4501 to a new Chapter 37 of the Code.[15]

Charitable giving strategies for private company stock are ever evolving and not limited to the opportunities discussed in this article. Gone are the days of contributing assets only in advance of a business sale or other forced liquidity event. With the appropriate planning, donors can harness the appreciation of their private company stock to further their philanthropic and tax-planning goals, and do so in a more effective, strategic, and repeatable manner. While there are many tax and legal considerations to contemplate when contributing appreciated assets to charity, the benefits generally will outweigh the efforts.

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Giving Vehicles

To implement tax-smart giving strategies and achieve longer-term goals, donors may choose a charitable vehicle. This may mean giving directly to a public charity, a private foundation, or a public charity sponsoring a DAF program.

While there are benefits to each approach, it is worth noting that contributions of privately held business interests to private foundations may only be deductible up to 20 percent of the donor's adjusted gross income, rather than the 30 percent limit when contributing directly to a public charity. This includes public charities with DAF programs.

Donating to a public charity with a DAF program can be a win-win for the donor and the charity. This is because public charities may lack expertise in receiving gifts of private business interests, and a donation could trigger additional administrative overhead and outside costs for processing it. On the other hand, a public charity with a DAF program should have a complex assets team that specializes in facilitating a wide range of private asset donations. The DAF vehicle also provides donors with time; the donors can recommend investments in the account while they decide which causes to support. In addition, donors can recommend grants to multiple charities from their single complex asset gift if they so choose.

As generous Americans and their advisors think through charitable plans year-round, they should remember the traditionally untapped sources of funding. By harnessing the unique power of assets like long-term appreciated stock and complex assets such as private business interests, they can make more impactful gifts while achieving their financial and legacy-planning goals. ■

[14] Internal Revenue Code Section 170(f)(8) and (18).

[15] Inflation Reduction Act of 2022, Public Law 117-169, 136 Stat. 1818 (August 16, 2022); see also IRS Notice 2023-2, Section 2.01.