

Gifts of Privately Held Business Interests ©

John Dobosz , CFA

Quite frequently, most of an entrepreneur's personal net worth is in the form of highly appreciated, closely held stock, which, if sold, would trigger a large capital gains tax. For philanthropically-inclined business owners, making gifts of closely held stock in their business to a community foundation presents an extremely attractive option for both maximizing the size of their charitable contribution and for reducing their own personal income and potential estate taxes.

Donating closely held stock to a community foundation rather than to a private foundation has significant advantages for the business owner, particularly a greater income tax deduction and avoiding taxation of the usually substantial capital gains on the appreciated stock. Giving stock to a private foundation limits the donor's charitable income tax deduction to his or her cost basis in the stock, which is usually much lower than market value. When a gift of closely held stock is made to a community foundation, however, the donor is permitted to claim the full fair market value of the stock as a deduction (up to 30% of adjusted gross income and able to be carried forward for five years, versus 20% of AGI in the case of a private foundation gift).

It's an excellent giving strategy for the business owner, and I think it would be much more common if people knew about it, says Aviva Shiff Boedecker, Director of Gift Planning at the Marin Community Foundation in Novato, California. Until 1998, charitable organizations were prohibited from owning stock in subchapter S corporations-which are the most prevalent form of incorporation for closely held businesses, since they combine tax advantages with limited liability for owners. *

How it Works

Because closely held stock is not publicly traded, arriving at a valuation is a key part of the process. The Internal Revenue Service requires all gifts of privately held stock greater than \$10,000 receive a written independent appraisal in order for the donor to claim a charitable deduction. The appraisal can be provided by either a CPA qualified to perform appraisals or by an independent appraisal firm. Once a valuation is established, the donor will transfer his or her stock to the community foundation, which will hold the stock for an indefinite period of time.

Since those shares are illiquid, the foundation will need to sell them in order to raise the cash needed to make grants on the gift. A typical scenario involves the foundation selling those shares back to the donor, who pays cash from the company's retained earnings. Alternately, the foundation may choose to hold the stock and sell them if the company is acquired.

A lot of times you'll see the community foundation turn around and sell the stock back to the donor, but especially around here you also saw people giving shares in the next great dot-com, which the charity would hang on to, notes Erik Dryburgh, a partner at the San Francisco law firm of Silk, Adler & Colvin.

Dryburgh cautions donors not to make gifts of shares after a "binding agreement" to sell the company has been reached. Such a donation would be characterized by the IRS as an "anticipatory assignment of income" and result in the gift being treated as a sale of stock by the donor, triggering a taxable capital gain on the appreciated shares. Similarly, he notes, a properly structured gift of closely held stock cannot include an obligation on the part of the foundation to sell the stock back to the donor.

Other Considerations

While giving appreciated stock in a closely held business may be the only way for business owners to make a substantial charitable gift, Prof. Christopher Hoyt at the University of Missouri-Kansas City School of Law notes that, in some cases, it can be preferable for the corporation itself to make gifts of appreciated property-particularly real estate.

"When the corporation makes a donation of appreciated property, the charitable income tax deduction is reported on the corporations income tax return and then flows through to the shareholder's individual return," says Hoyt, adding that the cost of the appraisal and the necessity of discounting minority interests can reduce both the charitable contribution and the donor's deduction. In addition, the community foundation is obligated to pay unrelated business income tax (UBIT) while it holds the shares, and also on the gain when they are sold.

Despite any potential obstacles, however, community foundations welcome the benefits of receiving gifts of closely held stock. "Business interest donations can work very effectively," says Lynn Andrews, director of development at the Community Foundation of Greater New Haven in New Haven, Connecticut. "We're able to work with our donors to help make the process as smooth as possible."

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