

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

March 2010

## 1 Charitable Gifts Using Illiquid Securities

If you think a colleague would like to receive complimentary copies of *Professional Notes*, or if you wish to obtain past issues, please call our receptionist at (212) 686-0010, Ext. 0. For more information, call Jane L. Wilton, general counsel, at (212) 686-2563.

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The economic climate over the past couple of years—with fewer individuals owning highly appreciated stock—has encouraged donors to consider contributing assets other than publicly traded securities and cash to their favorite charities. For professional advisors with clients who have these unusual assets, determining the most tax efficient and advantageous way to make these contributions can be challenging. This article discusses income tax considerations in donating illiquid securities to a charity. It is the first issue of a three-part series discussing charitable gifts using unusual assets.

### Gifts of Illiquid Securities

Some of the more common gifts of illiquid securities include stock of closely held corporations and S corporations, restricted stock, and certain stock options.

### General Considerations

A donor's tax treatment for gifts of illiquid securities depends on the type of security that is contributed and the type of charity to which the security is contributed. Code Section 170(e)<sup>1</sup> provides that the deductible amount for a contribution of property is the value of the property, reduced by (i) the amount of gain that would not have been long-term capital gain if the property had been sold at its fair market value and (ii) in the case of a contribution to or for the use of a private foundation, the amount of gain that would have been long-term capital gain if the property had been sold at its fair market value.

Accordingly, when a donor contributes capital gain property, property that may or may not be illiquid and has been held for over a

<sup>1</sup> All references to the Code are to the Internal Revenue Code of 1986, as amended, and all Regulation Section references are to the regulations promulgated thereunder.

year, to a public charity, the donor can take a charitable income tax deduction for the donation based on its fair market value, which includes any appreciation of the asset, and can avoid tax on the capital gain.

By contrast, only gifts of “qualified appreciated stock” qualify for a full fair market value deduction when contributed to a private foundation. Code Section 170(e)(5) defines qualified appreciated stock as stock of a corporation for which market quotations are readily available on an established securities market, and which is a long-term capital asset. Consequently, gifts to a private foundation of illiquid stock, such as restricted or closely held stock, are not treated as gifts of qualified appreciated stock, and the deduction is limited to the donor’s cost basis. Even if the stock donated is qualified appreciated stock, if the total amount of stock contributed, including all past contributions, exceeds ten percent of all of the outstanding stock of the corporation, the donated stock in excess of ten percent of the value of the outstanding stock will not be considered qualified appreciated stock.

The Code generally permits a charitable deduction of up to 30 percent of a donor’s adjusted gross income for gifts of capital gain property, such as stock, held for over a year, to a public charity. A gift of such stock to a private foundation is deductible only up to 20 percent of a donor’s adjusted gross income. If the amount of a charitable contribution exceeds the allowed percentage of the donor’s adjusted gross income, the donor will be entitled to a carry forward of the deduction for the next five taxable years. Securities held for less than one year may also be donated, but the deduction is limited to the lesser of cost basis and fair market value.

### ***Stock of a Closely Held Corporation***

Individuals who own interests in closely held corporations, i.e., corporations with a small number of shareholders who generally are actively involved in managing the business, can realize substantial tax savings if they contribute their appreciated stock to a public charity.

Giving stock of a closely held corporation requires careful planning. A key concern for the donor who gives stock of a family-owned or other closely held corporation to a charity may be having an outsider who is not related to the other owners as a stockholder. In addition, the charity generally has no desire to be saddled with illiquid securities. To address these concerns, the company may redeem the charity’s stock at fair market value after the gift is completed.

In this type of transaction, the donor can take a deduction equal to the fair market value of the contributed stock. Assuming the stock has appreciated in value, the donor will not have to recognize the appreciation as gain.<sup>2</sup> The redeemed shares are carried at cost on the corporation’s books, so if the corporation had an accumulated earnings tax issue requiring it to pay a dividend before the redemption, its excess earnings may be reduced or eliminated depending on the share of the earnings that were attributed to the redeemed stock.

The contribution and redemption must occur without any sort of prearrangement between the donor and the charity. In other words, the transaction must be accomplished without any preexisting binding obligation either on the charity’s part to tender the stock or on the corporation’s part to offer to redeem the stock. Failure to structure the gift properly will convert the transaction into a sale of the stock by the donor (with a corresponding tax on the gain), followed by a gift to charity of the proceeds.

In addition, donors who are shareholders of corporations that are contemplating termination, liquidation, or merger should consider contributing all or part of their shares prior to any formal decision. This timing avoids income tax on the gains allocable to the contributed shares, effectively providing for charity out of pre-tax dollars.

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<sup>2</sup> On the other hand, if the stock has depreciated, it would be better for the donor to sell the stock and then donate the proceeds to charity, taking both a loss deduction and a charitable deduction. Donating the depreciated stock would not allow the donor to take a deduction for the loss; instead, the donor could only take a charitable deduction for the value of the stock.

Philanthropic opportunities are also available for owners of so-called S corporations. These small businesses operate as corporations, but are treated as partnerships for tax purposes.

Notably, although a donor can also contribute stock of a closely held corporation to a private foundation, this contribution may trigger the excess business holdings excise tax rules because donors commonly own a substantial percentage of the corporation's stock (i.e., more than 20 percent). Donors may instead consider donating to a public charity, such as a community foundation, which is not subject to the private foundation excise taxes.<sup>3</sup>

If a redemption or sale of the stock is impractical, a donor can effectively control contributed stock through the use of a Charitable Remainder Trust (CRT), a trust in which the income first goes to beneficiaries for a term and the principal then goes to charity. CRTs allow a deduction upfront calculated by reference to the present value of capital gain property donated to a public charity with the same five year excess deduction carry forward. When the assets can be sold, the donor can avoid capital gain taxes. Donors using CRTs should be aware that the various federal tax rules that apply to private foundations also apply to CRTs.

A Charitable Lead Trust (CLT), a trust from which the income is first donated to a charity, and then, after a specified period of time, the principal is distributed to individual beneficiaries, may not be as appealing as a CRT, but it may provide some planning opportunities for certain donors. In the grantor form of the CLT, in which income, deductions, gains, and losses are all contributed to the donor, he can take an upfront charitable deduction. In the more common non-grantor form of the CLT, the trust is taxable on its income and takes a deduction for amounts distributed to charity. In both forms, the income or gains are fully taxable to the donor or the trust itself. The CLT lets the donor maintain greater control over the contributed stock and, in the non-grantor form, may be useful for a donor trying to reduce or eliminate

transfer or estate taxes in transferring the remaining amount of the trust to his heirs. As with CRTs, donors using CLTs should be aware that the private foundation rules generally apply to CLTs, with certain exceptions.

### ***Stock of an S Corporation***

Philanthropic opportunities are also available for owners of so-called S corporations. These small businesses operate as corporations, but are treated as partnerships for tax purposes. They have a maximum of 100 shareholders and only certain people are eligible to become shareholders. Generally, S corporation stock is treated much like closely held stock, with a few significant differences.

When evaluating a gift to charity, a donor of S corporation stock should be aware of the types of assets held by the corporation, especially appreciated inventory or unrealized receivables. A charitable deduction for a gift of appreciated property must be reduced by the amount of "ordinary income" that the donor would have had if the donor had sold the property. Code Section 170(e)(1) governs these kinds of contributions and provides that "rules similar to the rules of [Code] section 751 shall apply in determining whether gain on [S corporation] stock would have been long-term capital gain if such stock were sold by the taxpayer." Consequently, the donor's deduction for a contribution of S corporation stock, in most instances, will not be the full value of the stock, but will be reduced to the extent of the donor's share of the S corporation's appreciated inventory and unrealized receivables, including depreciation recapture.

All items of income and gain passed through to the charity during the period that it holds the S corporation stock will constitute unrelated business taxable income. In addition, any gain upon the charity's sale of the stock will be subject to tax. As a result, the value of the S corporation stock to the charity can be effectively diminished by the amount of tax liability that the

<sup>3</sup> Effective 2006, the excess business holdings excise tax rules also apply to donor-advised funds at particular charities. Accordingly, donors who set up these types of funds at community foundations should also be mindful of these rules.

charity must bear. This potential liability may affect the charity's willingness to accept S corporation stock.

Although a charity may hold S corporation stock, the tax law currently prohibits CRTs and some CLTs from holding S corporation stock (the grantor form of the CLT may hold S Corporation stock). The transfer of S corporation stock to a CRT or certain CLTs will automatically terminate the S corporation status of the corporation, and make it taxable as a C corporation.

Instead of an individual owner donating S corporation stock, the S corporation itself can donate assets to charity. The gift is treated as if made on a *pro rata* basis by the shareholders and is subject to their individual contribution limits. Generally, the shareholder's basis is reduced *pro rata* by the fair market value of the property contributed by the S corporation. The charitable deduction that a shareholder can take is limited to the basis in her shares. Deductions that are unused because of this basis limitation may be carried forward indefinitely.

### ***Restricted Stock***

Sometimes stock is subject to restrictions on sales imposed by the Securities and Exchange Commission (SEC), by agreement with an underwriter, by the corporate charter, or by a shareholders' or other agreement. These restricted securities usually trade at a discount in relation to freely traded securities because of the restrictions. Restricted stock can be donated to public charities in much the same manner and can often produce the same tax consequences as closely held stock discussed above.

But donating restricted stock raises additional issues in determining the amount that a donor can claim as a charitable deduction. The IRS has ruled privately that stock subject to Rule 144 (i.e., restricted stock of a type that is publicly traded, but which is not readily marketable under SEC rules), is not "qualified appreciated stock" under Code Section 170 for purposes of a contribution to a private foundation because market quotations were not

A donor should consult with a tax advisor to determine whether a full fair market value deduction is appropriate for a contribution of restricted stock to a public charity or a private foundation.

readily available on an established securities market. As a result, the donor's deduction was limited to his basis in the stock. The ruling also noted that the value of the stock was less than the value listed on the established securities market because it was subject to resale restrictions.

(Private Letter Ruling 9247018)

In a ruling involving a contribution of stock subject to Rule 144 volume restrictions to a private foundation, the donor agreed to restrict his own sales so the volume restriction would not apply to prevent a private foundation from selling the shares, and the IRS held the stock was qualified appreciated stock, deductible at fair market value. The IRS found that the restricted stock could be considered qualified appreciated stock because the shares that the foundation received would be freely transferable immediately upon receipt as a result of the agreement between the donor and the foundation. (Private Letter Ruling 9734034)

A donor should consult with a tax advisor to determine whether a full fair market value deduction is appropriate for a contribution of restricted stock to a public charity or a private foundation. To the extent that the restricted stock requires the charity to make certain representations as a new investor before the donor can contribute the stock, the donor should ensure that the charity can make such representations.

### ***Stock Options***

Instead of contributing stock itself, a donor can contribute stock options, rights to buy or sell shares of stock at a guaranteed price during the life of the option. Before donating options, a donor must first review the terms of the option plan to determine if an option transfer is even possible.

A living donor cannot donate incentive stock options (ISOs), which are a type of employee stock option granted only to employees and which confer a

significant tax benefit. If the option plan permits, the ISOs can be given as a bequest, which would generate a charitable deduction for the estate. Alternatively, a donor can exercise the ISOs and give the ISO shares as an *inter vivos* gift. If the donor has held the shares for the requisite holding period,<sup>4</sup> she can claim a fair market value deduction and avoid recognition of any capital gain. Importantly, donating ISO shares before the expiration of the required ISO holding period will completely erase the donor's favorable tax treatment and cause her to recognize income at the time of the gift. Notably, with this type of gift, Alternative Minimum Tax (AMT) concerns may arise and a donor should review her tax situation to determine whether the AMT will apply.

On the other hand, a donor can transfer nonqualified stock options (NSOs), which are options granted to employees or service providers to purchase shares of stock at a fixed price, during his lifetime. NSOs generally do not have a readily ascertainable value at the date of grant, and the employee or service provider will be subject to tax only at the time of exercise (even if donated to a charity). Donating NSOs can be problematic, however, because NSOs generally generate income to the donor upon exercise, and a possible timing difference exists between the recognition of income and the completion of the gift for purposes of the charitable contribution deduction. In other words, the charity's exercise of the option, although it results in income to the donor, does not necessarily occur at the same time as the event triggering the charitable deduction for the donor. Because the donor may not know exactly how much income he will recognize or the value of the charitable deduction, it may be better for the donor to first exercise the NSOs and then donate the proceeds to charity.

If instead the donor donates the shares received from exercising an NSO, he will be allowed a charitable deduction that can be used to offset the income

recognized at exercise. The deduction will be equal to either the donor's basis in the shares (offset up to 50 percent of adjusted gross income) if the shares are transferred within 12 months of the exercise date, or fair market value (offset up to 30 percent of adjusted gross income), if the donor transfers the shares after 12 months.

Because of the complexities involved in contributing stock options, donors should consult with their tax advisors to determine the most tax-effective way to make such donations.

### Substantiating the Gift

In order to claim a deduction for contributing any of these illiquid securities, a donor must substantiate the contribution with a receipt from the charity showing (i) the name of the charity; (ii) the date of the contribution; and (iii) a reasonably detailed description of the property. In addition, if the donor claims a charitable deduction for more than \$500, she must receive and keep an acknowledgment of the contribution, and maintain written records that substantiate the manner and date of acquisition of the stock and the cost or other basis of the stock.

### Valuing the Gift

#### *Appraisals*

The IRS generally requires an appraisal made by a qualified appraiser of any contributed property, other than publicly traded stock, valued over \$5,000. A donor does not need an appraisal if the property is nonpublicly traded stock worth \$10,000 or less. Accordingly, only gifts of closely held stock and restricted stock for which the donor claims a deduction of more than \$10,000 require a qualified appraisal. A donor's failure to obtain an appraisal will disqualify a charitable deduction to the extent of the donor's basis.

A qualified appraisal must be made by a qualified appraiser in accordance with generally accepted appraisal standards, and must meet the relevant requirements of

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<sup>4</sup> To obtain favorable tax treatment, the shares received upon exercise must be held by the employee for at least (i) two years from the date that the option was granted and (ii) one year from the date the option was exercised. A three month employment requirement also has to be satisfied prior to exercise. See Code Section 422(a)(2).

Section 1.170A-13(c)(3) of the Regulations and Notice 2006-96. A qualified appraiser is an individual who has either earned an appraisal designation from a recognized professional appraiser organization or has met certain minimum education and experience requirements. For appraisers of property other than real property, the appraiser must have successfully completed college or professional-level coursework relevant to the property being valued, have at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and fully describe in the appraisal her qualifying education and experience. The individual must also regularly prepare appraisals for pay, and must not be prohibited from practicing before the IRS at any time during the three year period ending on the date of the appraisal. The donor, the donee, or the taxpayer who claims the deduction is not a qualified appraiser with respect to the contribution.

The appraisal may not be made earlier than 60 days before the date of contribution of the property, and no part of the fee arrangement can be based on a percentage of the appraised value of the property. A separate appraisal is needed for each item of property that is not included in a group of similar items of property.

If the claimed deduction for an item of donated property is more than \$5,000, the donor must attach Section B of IRS Form 8283 to her tax return. If a donor claims a deduction of more than \$500,000 for a contribution of property, the donor must not only attach Section B of Form 8283, but must also attach the qualified appraisal of the property itself. If the donor does not attach the appraisal, she cannot deduct her contribution, unless the failure to attach the appraisal is due to reasonable cause and not to willful neglect. Donors should also be mindful of the timing requirements that exist as to when the appraisal should be received and when it should be claimed on a return.

When the IRS reviews a return with a gift requiring an appraisal, it may accept or dispute the

appraisal. Donors may be liable for a penalty if they overstate the value of donated property.

A donor cannot take a charitable deduction for fees that she paid for appraisals of the donated property. Still, these fees may qualify as a miscellaneous deduction, subject to the two percent limit if they are paid to determine the amount allowable as a charitable contribution. The charity should not pay for the appraisal unless it can show the cost of the appraisal as consideration received for the gift. If the gift is to a donor-advised fund or a supporting organization, the charity may not pay the appraisal fee.

### ***Special Considerations in Valuing Stock of Closely Held Corporations (S Corporations) and Restricted Stock***

Gifts are valued as of their date of gift, usually indicated by recent arms-length sales. Unfortunately, this information is rarely available for these types of stock. Accordingly, valuing illiquid securities is often quite difficult and subjective, making the valuation process more art than science.

The IRS has articulated a number of factors that should be considered when determining the fair market value of closely held securities, including the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors, including the nature and history of the business, especially its recent history; the good will of the business; the economic outlook in the particular industry; the company's position in the industry, its competitors, and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business that are listed on a stock exchange. Appropriate discounts for lack of marketability, minority interests, and other factors are then applied to establish the fair market value of the stock.

In terms of valuing restricted stock, the process is typically more involved than valuing the underlying

publicly traded stock, and the qualified appraisal will likely take into account the nature and duration of the restrictions. To arrive at fair market value, the appraiser or the donor, if a qualified appraisal is not required, will consider certain factors, including the resale provisions found in the restriction agreements and the market experience of freely traded securities of the same class as the restricted stock.

The IRS recommends that donors keep complete financial and other information on which the valuation is based, including copies of reports on the company made by accountants, engineers, or any technical experts on or close to the valuation date.

## Conclusion

Donors and charities must consider a number of issues when making and accepting gifts of illiquid securities, including the timing and valuation of the gift, potential tax liabilities, and any restrictions on subsequent sale or disposition of the stock. The New York Community Trust, because of its flexible structure and knowledgeable staff, is well positioned to handle these gifts. If your client is thinking of donating illiquid securities because of a prospective sale or transfer of the business or generally, The Trust can provide opportunities for integrating long-term philanthropic goals into a donor's business planning while generating significant tax deductions for your client.

### **For further reference, see:**

IRC Section 170(b)(1)(A): General rule for percentage limitations for individuals.

IRC Section 170(e)(5): Special rule for contributions of stock for which market quotations are readily available.

IRC Section 422: Incentive Stock Options.

IRC Section 512(e): Special unrelated business income rules applicable to S corporations.

Donors and charities must consider a number of issues when making and accepting gifts of illiquid securities, including the timing and valuation of the gift, potential tax liabilities, and any restrictions on subsequent sale or disposition of the stock.

IRC Sections 1361-1379: Rules governing S corporations.

IRC Section 4943: Taxes on excess business holdings.

Treas. Reg. Sec. 1.83-1(c): Dispositions of nonvested property not at arm's length.

Treas. Reg. Sec. 1.83-7: Taxation of nonqualified stock options.

Treas. Reg. Sec. 1.170A-1(c): Value of a contribution in property.

Treas. Reg. Sec. 1.170A-13(b): Charitable contributions of property.

Treas. Reg. Sec. 1.170A-13(c): Deductions in excess of \$5,000 for certain charitable contributions of property.

Treas. Reg. Sec. 1.1366-2: Limitations on deduction of pass-through items of an S corporation.

Treas. Reg. Sec. 20-2031-2: Valuation of stocks and bonds.

IRC Section 312: Effect on earnings and profits.

Revenue Ruling 59-60, 1959-1 CB 237.

Revenue Ruling 78-197, 1978-1 C.B. 83.

Palmer v. Comm'r., 62 T.C. 684 (1974).

Blake v. Commissioner, 42 T.C.M. 1336 (1981), Aff'd, 697 F.2d 473 (2nd Cir. 1982).

Hewitt v. Commissioner, 166 F3d 332 (4th Cir. 1998).

Private Letter Ruling 9247018.

Private Letter Ruling 9441032.

Private Letter Ruling 9734034.

Private Letter Ruling 9825031.

IRS Publication 526: Charitable Contributions.

IRS Publication 561: Determining the Value of Donated Property.

Notice 2006-96, 2006-46 I.R.B. 902.

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## About The Trust

For 85 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds—which now number nearly 2,000—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2009, The Trust made grants of \$127 million from \$1.8 billion in assets (unaudited).

**For more information call Jane L. Wilton,  
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March 2010

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