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Valuable Lessons in Charitable Deductions

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A recent Tax Court case provides important guidance for donors and charities making and negotiating gifts of appreciated property. While generally donors who donate appreciated property to a public charity do not recognize capital gain — resulting in significant tax savings — the case explores an important exception. If it is "virtually certain" at the time of the donor's gift that the appreciated property will be sold, then the donor must recognize capital gain as if the donor had sold the property before donating it to charity. The court then turned its analysis to other requirements for property gifts of more than $5,000, including the exacting requirements for a "qualified appraisal" by a "qualified appraiser." Read on for more details.

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In the *Estate of Scott M. Hoensheid, et al. v. Commissioner*, T.C. Memo 2023-34, available here, the donor donated a portion of the donor's stock in his family business (the Company) to a donor advised fund (DAF) at Fidelity Charitable (Fidelity). Shortly after the donation, an unrelated third party purchased the shares in the Company, including Fidelity's shares. The donor claimed a charitable deduction for the appraised value of the stock on his income tax return and did not report any capital gains on the sale of the stock. The Tax Court upheld the IRS' denial of the claimed deduction of the stock and held that the donor must include the capital gain from the sale of the stock in his taxable income notwithstanding the fact that the sale occurred after the date of the gift. The court addressed several important concepts relating to charitable deductions, which are worth reviewing.

The factual history of the *Hoensheid* case is complex, particularly regarding the timing of various actions in the process of selling the Company and the timing of the documentation necessary to complete the gift to the DAF. The IRS obtained, and the court reviewed, various documentation, including dividend payments and tax returns and, perhaps most critically, communications of the donor, the Company, the purchaser of the Company, the donor's counsel, the appraiser, and Fidelity, which made clear that the Company would be sold to a specific buyer shortly after the donation.

In the end, the court made several determinations that are of interest.

<u>Prearranged Sale (Anticipatory Assignment of Income)</u>. The court held that the sale of the Company had progressed to the point that the sale was already a "practical certainty" by the date of the gift. Thus, it

concluded, the donor must recognize the capital gain on the sale after the date of the gift as if the donor had sold the shares before donating the shares to Fidelity. In reaching its conclusion, the court applied a two-part test that requires (1) an absolute gift of the property and divestment of title; and (2) that such a gift occur before the "property gives rise to income by way of a sale."[1]

The first defect in the donor's position was the timing of the gift. The court found that the gift occurred a month later than the donor claimed, bringing it closer to the date of the Company sale. To make this conclusion, the court reviewed the requirements of a completed gift under the Michigan law (the donor's state of residence): (1) donative intent; (2) delivery; and (3) acceptance. In arriving at its conclusion that the gift date was a month later than the date claimed by the donor, the court noted that the donor's communications and actions show that he waited until the sale was nearly final before deciding on the number of shares to transfer and the time of delivery of those shares to Fidelity. It therefore found that the requisite donative intent did not exist until the date the donor released the physical stock certificate to Fidelity. On the delivery requirement, the court reviewed the documentation surrounding the delivery of the stock assignment and certificate to the donor's counsel and then to Fidelity. The court cited extensive common law authority in past Tax Court cases regarding when delivery of stock gifts is complete for tax purposes and found that the delivery also occurred a month after the donor claimed he made the gift. Finally, the court reviewed the timing and content of communications about Fidelity's confirmation of the gift and held that Fidelity's acceptance was also a month later than the gift date claimed by the donor.

The second defect was the practical certainty of the Company sale on the date the gift was completed. In ruling that the sale was a practical certainty, the court determined that the appropriate test is to consider all the facts and circumstances, not just the binding legal documents. The court reviewed the long history of cases on the subject of anticipatory assignment of income, which is well-established doctrine that "recognizes that income is taxed ‘to those who earn or otherwise create the right to receive it.'"[2] The court held that "a donor's right to income from shares of stock is fixed if a transaction involving those shares has become ‘practically certain to occur' by the time of the gift, ‘despite the remote and hypothetical possibility of abandonment.'"[3] In so holding, the court rejected the application of Revenue Ruling 78-197 as the test for determining anticipatory assignment of income where the facts are not "substantially the same" as the facts in that ruling.[4] Revenue Ruling 78-197, and the many cases applying it, hold that an anticipatory assignment of income will be found only where the donee is legally obligated to sell the gifted property at the date of the gift. In *Hoensheid*, the court instead held that a donee's legal obligation to sell the gifted property is "only one factor to be considered in ascertaining the realities and substance of the transaction."[5] The court stated that the prearranged sale analysis must look to the following several factors to determine whether the sale of gifted property is "virtually certain" at the date of the gift:

(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.

In *Hoensheid*, the court found that at the date of the gift, Fidelity did not have a legal obligation to sell the gifted shares. However, the court said the actions of the parties in causing the Company to pay significant dividends and bonuses before the gift indicated that they knew the sale would be completed, that the few minor contingencies in the drafts of the sale documents showed the transaction was not very contingent, and that the integral involvement of all the Company shareholders in negotiation of the sale made formal approval by the shareholders a foregone conclusion. Thus, the court held that, contrary to a "bright-line rule, " the factors evident in the *Hoensheid* situation compelled the inclusion in the donor's taxable income of the capital gains realized on the ultimate sale of the gifted stock.

Charitable Deduction Issues. The Tax Court went on to review various aspects of the substantiation of the charitable gift of the Company stock. Notably, the court examined the history and requirements for a qualified appraisal by a qualified appraiser and whether those requirements were met by the donor. The requirements of a qualified appraisal are set forth in Treas. Reg. § 1.170A-13 and are very detailed. In *Hoensheid*, several of the requirements were missing from the appraisal. Noting that the doctrine of "substantial compliance" may be applied to excuse the failure to comply with the strict requirements of the appraisal regulations, the court stated that if an appraisal does not meet the substantive requirements or "omits entire categories of required information," substantial compliance will not save it. Here, the court found that: (1) the appraiser was not a qualified appraiser as defined in the regulations; (2) the appraiser's qualifications were not sufficiently described in the appraisal; and (3) the appraisal failed to state the correct date of the contribution. The court noted that the one month difference between the date used in the appraisal (the donor's stated date), and the date the court found the gift was made was significant because between those two dates, the Company made large distributions which would affect the value of the shares and the sale of the Company's stock became virtually certain. In addition to finding a lack of substantial compliance, the court declined to apply a "reasonable cause" exception for the insufficient substantiation and denied the deduction.

Takeaways. Donors and nonprofits can learn important lessons from the court's opinion in this case. First, the legal documentation completing the gift must be in place in a timely fashion. Each type of property has a method for transferring title, and the actual gift date depends on the completion of the proper documentation and action items. Communications and other materials surrounding the gift should be consistent with the desired legal and tax consequences of the transactions and events. Second, the prearranged sale

(assignment of income) doctrine cautions against making gifts where a sale of the gifted interest is sufficiently imminent and practically certain. The circumstances and timing of a sale transaction can be examined on audit, and if, like in *Hoensheid*, the gift is completed at a time when the donor's right to income has already become practically certain, the donor can incur capital gains tax on the sale. Third, donors and their advisors must ensure compliance with the requirements for qualified appraisals and qualified appraisers. Despite the ability of a court to find substantial compliance or reasonable cause to excuse non-compliance in narrow circumstances, donors and their advisors must carefully consider and document the qualifications of the appraiser and ensure that the contents of the appraisal reflect every requirement in the regulations. Failure to carefully complete charitable gifts can easily raise the specter of adverse tax consequences.

[1] *Hoensheid v. Commissioner*, T.C. Memo 2023-34, *16 (quoting *Jones v. United States*, 531 F.2d 1343, 1345, 1346 (6th Cir. 1976)).

[2] *Id.* at *26 (quoting *Helvering v. Horst*, 311 U.S. 112, 119 (1940)).

[3] *Id.* at *27.

[4] *Id.* at *28 (citing Rev. Rul. 78-197, 1978-1 C.B. 83). In the *Hoensheid* court's words, Revenue Ruling 78-197, and the case to which the ruling was responding, involved "a taxpayer's contribution of shares of stock in his controlled corporation to a charitable foundation of which he was a trustee, followed by a redemption of the shares by the corporation." *Id.* The court did not elaborate on why the current facts were distinguishable from the Revenue Ruling.

[5] *Id.* at *28 (internal quotation marks omitted).