Donating Your Company Stock To Charities And Private Foundations (Part 2)

Joshua Husbands

Led by the celebrated philanthropy of Warren Buffet, much interest has been expressed about contributing stock to charitable entities. Many factors are at play here, and you should consider them carefully. Part 1 discusses the timing and choices of donating company stock to charities, the use of company stock to fund a private foundation, and the specifics of donations involving stock options and restricted stock. This article discusses the related issues of taxation and securities law.

The main points impacting the tax and securities regulation that you need to know when contemplating a contribution of stock to charity are (1) whether the stock is publicly traded or closely held and (2) whether the charitable donee is a public charity or a private foundation. Each of these will be considered separately. The contribution of either marketable securities or closely held stock, either to a public charity or to a private foundation, will not be subject to gift tax. The tax implications discussed here are specific to your personal income tax.

Know whether the stock is publicly traded or closely held, and whether the charitable donee is a public charity or a private foundation.

Tax Issues

Although the tax treatment of stock donations to public charities and the tax treatment of donations to private foundations both result in a tax deduction, there are some important differences.

Marketable Securities: Public Charity

The contribution of marketable securities to a charity may be very advantageous to you for tax purposes. You are allowed a deduction of the full fair market value of appreciated marketable securities (held for more than one year) transferred to a public charity or donor-advised fund, in an amount up to 30% of your adjusted gross income, with a five-year carry-forward for any excess not deductible in the year of contribution. An additional benefit of donating stock, rather than donating net proceeds from selling stock, is that you will recognize no taxable gain on the appreciation in the stock. Thus the most tax-efficient stock donation is one with a low ratio of tax basis to current stock price.

> **Example:** You donate $100,000 of company stock held at least one year (1,000 shares trading at $100 per share that you received at $1 per share) to a favorite charity. You have a $100,000 tax deduction, which results in $40,000 of tax savings (assuming a 40% combined federal and state tax rate). If instead you sold the 1,000 shares to donate the cash, you would realize approximately $79,500 in net proceeds (after paying 15% federal capital gains tax and an assumed 5.5% state tax) and get a tax deduction for only this net amount. Your tax savings here would be around only $31,800.

If you donate stock you have held for less than one year, you are entitled to deduct from income only your cost basis or the fair market value of that stock, whichever is lower. The deduction is limited to 50% of your adjusted gross income, with a five-year carry-forward. For shares from stock option exercises, ESPP purchases, and restricted stock vesting, the holding period begins on the day after this event. The fair market value of the contributed marketable securities is determined as the mean between the high and low or the bid and ask price on the date of the contribution, based either on published figures or on quotes from securities dealers.

Marketable Securities: Private Foundation

The tax benefits of contributing marketable securities to a private foundation are more limited than those of contributions to a public charity. You are still entitled to deduct the current fair market value of your appreciated securities that are held for more than a year. However, you have a ceiling of 20% of adjusted gross income for contributions to private foundations, and the same five-year carry-forward is available, as with contributions to a public charity. Should you contribute stock valued at over 10% of all your corporation's outstanding shares, the deduction becomes your cost basis for the additional amount. Also, your cost basis deduction allowable for contributions of stock held less than one year is limited to 30% of your adjusted gross income, with a five-year carry-forward.

Closely Held Securities

If you contribute closely held stock to a public charity or a donor-advised fund, you are entitled to a deduction of the fair market value of the stock, with the same 30% of adjusted gross income limitation and five-year carry-forward allowance, just as in the case of a contribution of marketable securities. However, you are allowed only a deduction equal to your cost basis or fair market value, whichever is lower, for transfers of closely held stock to a private foundation, subject to a cap of 20% of adjusted gross income with the five-year carry-forward. All closely held securities contributed to any type of entity are limited to cost basis or fair market value, whichever is lower, if they have been held for less than one year.

The valuation of a contribution of more than $5,000 worth of closely held securities is more demanding and is established by an independent appraisal applying IRS rules. The following is a summary of the appraisal

requirements:

- The appraisal must be prepared by a "qualified appraiser" who has earned a designation from a recognized professional organization.
- The appraisal must include a description of the property transferred, the date of contribution, any terms or conditions put on the property transferred, information on the qualified appraiser, the basis for making the valuation, the appraiser's signature, and the date of the appraisal.
- The appraisal cannot have been made more than 60 days prior to the date of the contributions.
- If the contribution value is over $500,000, the full appraisal must be attached to the return.
- An appraisal summary (IRS Form 8283) must be signed by the appraiser and the donee and attached to the tax return.

Private Foundations: Excess Business Holdings Excise Tax

Another issue to be aware of when contributing stock to a private foundation is the excess business holdings rule. A private foundation may not own more than 20% of the voting stock of a corporation (35% percent if voting control is held by completely unrelated parties), reduced by the amount of voting stock of the corporation owned by any "disqualified persons." An offending private foundation will be subject to an excise tax of initially 10%, and then 200% if it does not correct the excess holdings problem. A disqualified person is defined as a foundation manager (board member, officer, etc.) or a substantial contributor to the foundation, as well as a byzantine web of related parties.

The most common excess holdings issue arises when a foundation board member (often the founder or family member of the founder of the private foundation) contributes stock but has a material voting interest in the stock as well. If the foundation board member holds at least 20% of the voting shares of the corporation, the foundation will always be limited to a *de minimis* exception from the rule that allows it to hold up to 2% of the stock. If the foundation receives the stock by gift or bequest, it will have five years to correct the issue before the excise tax is imposed.

Problems can arise when a foundation board member contributes stock but has a material voting interest in the stock as well.

Securities Issues

The transfer of stock to a charity, though gratuitous in nature, must be closely analyzed under existing securities regulations. For publicly traded securities, there are rules governing insider trading and restricted securities.

Insider Trading

Rules 10b-5 and 10b5-1 of the federal securities laws, and the Securities Exchange Act of 1934 in particular (the "Exchange Act"), contain antifraud provisions for anyone buying and selling stock. Anyone who is aware of "material nonpublic information" about the company and trades stock on the basis of such information will have to disgorge any profit, may have to pay damages, and can face criminal charges (see this website's section on insider trading). These rules restrict the transfer of shares to a charity if you, as an insider, are aware of confidential information about your company that will affect its stock price. It does not matter that the transfer to the charity is gratuitous. Correspondingly, the charity or foundation is restricted from selling shares you have donated if you have revealed the material nonpublic information to its directors. Until that information is publicly disclosed, this restriction applies even if the information was communicated at the time of the original transfer and not when the shares are sold.

Though the case did not involve a donation of stock, in *SEC v. Zomax* (2005) the Securities and Exchange Commission successfully brought an insider-trading enforcement action against company executives who sold stock through a charitable remainder annuity trust (CRAT). In this case, the company announced lower-than-expected earnings only one day after the defendants liquidated their stock holdings through the CRAT. The stock price eventually sank 61%, and the early sale saved the executives millions, according to the SEC complaint.

Rule 144

Rule 144 under the Securities Act of 1933 applies to sales of unregistered stock and to sales by a public company's senior executives, directors, and large shareholders. Shares of stock that are not registered with the SEC through a public offering are referred to as "restricted securities." Restricted securities must be issued, fully paid for, and held for at least six months for stock in reporting companies and one year for stock in nonreporting companies before they can be resold under Rule 144 without any limitation. For restricted securities transferred to a charity, the charity will be considered to have owned the shares from the time you, as the donor, acquired the shares. The holding period of the charity will tack on to your holding period prior to the transfer.

Even when the stock you intend to donate to the charity is already registered, if the charity is deemed to have a control relationship with the company due to significant ownership of the company's stock, the charity may be still restricted by, and must be aware of, Rule 144, even though the holding period requirement will not apply. Shares of stock acquired by a person or entity that has a control relationship with the issuing company are known as "control securities." Rule 144 is concerned with the sale of control securities, not their gratuitous transfer, so the subsequent sale of the stock by the charity, not your gift of the shares to the charity, would be subject to the

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restrictions of Rule 144, if it is applicable. The charity must follow Rule 144 if it has a control relationship with the issuing company.

Section 16

Section 16 of the Exchange Act requires senior officers, directors, and shareholders who own more than 10% of the company's stock to promptly report a change to their company stock holdings by filing Form 4 with the SEC within two business days of the change. Upon filing, Forms 4 are immediately made public. Furthermore, Section 16(b) requires that any insider's "short-swing" profit (the difference between purchase and sale prices for any two transactions within any six-month period) must be forfeited to the company. However, *bona fide* gifts to a charity are exempt from Section 16(b) matching. Any charity that owns at least 10% of a publicly traded company's stock will be subject to Section 16.

If you are required to report under Section 16 and you transfer shares to a charity, including a private foundation you have created and for which you serve as a director, the transfer of your stock to the charity must be reported in the annual filing of Form 5, or voluntarily reported earlier on Form 4. Ordinarily, assuming the shares cannot be used for your benefit, you will no longer have beneficial ownership in the stock once the charity owns the shares. The charity will be the Section 16 reporting party as long as it owns at least 10% of the shares. You will no longer have any Section 16 reporting responsibility, with respect to the transferred shares.

Beneficial Ownership Reporting

Section 13(d) of the Exchange Act requires a person (or persons acting together) who beneficially owns more than 5% of a public company to publicly report that person's (or group's) stock holdings in the company, within 10 days after an acquisition that increased the stock ownership to greater than 5%. This reporting would be required of any charity that owns at least 5% of the outstanding shares of a publicly traded company. The directors of the charity are responsible for meeting these filing requirements. Beneficial ownership of the shares is essentially based on the power to vote or control the disposition of the shares. You and the charity must be aware of these rules to determine your beneficial ownership after the transfer of stock to the charity. Depending on your ability to control the voting and disposition of the shares once they are transferred to the charity, you may have an ongoing Section 13 reporting obligation even though you transferred the shares to the charity.

Stock Transfer Restriction Agreements

In addition to federal and state securities law restrictions, stock in closely held companies (and in some instances public companies) can be further restricted by agreements between shareholders or between a shareholder and the company. These agreements can include buy-sell agreements, first-purchase option agreements, and variations of these. Agreements in closely held companies are all specific to the company, founders, and other participating shareholders, making it hard to generalize about their terms.

However, certain common issues arise in these agreements. First, does the agreement flat-out prohibit transfers of the stock, or does it grant the company or other shareholders a right of first refusal to purchase the shares? If the latter, then shareholders often can agree to allow transfers to charitable organizations without triggering the right of purchase. Second, many agreements specifically exempt transfers to charity from the transfer restrictions in the agreement.

Be especially careful when you transfer, to a charity, shares of closely held stock subject to a shareholder buy-sell agreement.

You have to be careful when you transfer, to a charity, shares of closely held stock subject to a shareholder buy-sell agreement. A right to reacquire the shares can cause you to be treated as the beneficial owner of the shares for Section 13 and 16 purposes (if the shares were issued by a public company), and may also run afoul of the prohibited transaction rules, if the donee is a private foundation.

Conclusion

This article series has been intended as a primer to educate you on the basic choices involved in donations of company stock and on the issues of tax and securities law surrounding the contribution of your company stock and stock options to a charity or foundation entity. These issues can be very complex, and in all instances you should seek the advice of competent counsel when considering a charitable contribution of stock. The tax benefits can be considerable, but your net worth will still be less than it was prior to the charitable donation, and legal hurdles clutter the landscape. However, keep in mind the intangibles mentioned earlier. You may find that the rewards you receive by seeing your philanthropy in action provide a return that can't be quantified in dollars.

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