How Late Is Too Late? When Is It Too Late to Implement Pre-Sale Tax-Saving Strategies?

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Timing is everything!

You know the mantra all too well. Whether you deliver the punch line of a joke or engage in financial transactions, *when* you do something can make all the difference to the outcome. Many individuals who make gifts of appreciated stock to charity or children are partially motivated by an expectation that certain tax advantages accompany those gifts. For them, timing is, indeed, everything! Particularly concerning gifts of family business stock, significant tax savings may ensue if the gift is made before selling the business to an outside party.

However, if a gift is made too close to the sale's closing date, those tax savings may disappear in the blink of an eye. Whether evaluating the ramifications of a gift to a charity or a gift to family members, transfer of donated shares must take place long enough in advance of the liquidity event for the transaction to be deemed a pre-sale gift of company stock rather than a gift of the liquid sales proceeds. Wait even a day too long or until the sale is a *fait accompli*, and business owners can lose the expected tax and financial benefits.

But, how long can you wait? At what point – in the course of events leading up to a sale – does it become too late to make a gift and still benefit from the favorable tax treatment?

This article will focus primarily on charitable gifts and the timing requirements for an income tax deduction.

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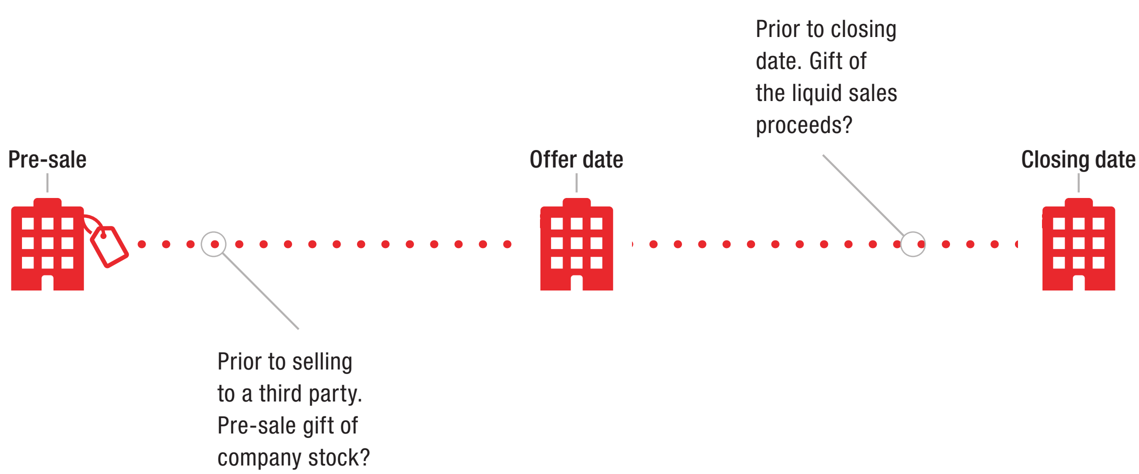


Charitable gifts and the income tax deduction

Several tax advantages arise when appreciated securities are gifted to charity:

1. The donor is entitled to an income tax deduction tied to the "fair market value" of the donated stock when the donee is a public charity or when marketable securities are donated.
2. The donor never has to pay tax on their "gain," the difference between the sales price and his cost basis when the charity ultimately sells the stock.
3. The charity itself can sell an appreciated security at its full value without paying any tax on that which would otherwise be classified as capital gains.

The second advantage – the donor avoiding tax on capital gains – receives the most scrutiny from the Internal Revenue Service (IRS), particularly in instances where there is a tight sequence of events between the donor's gift and the sale by the charitable entity. The IRS is likely to try to invoke the **step transaction** and **assignment of income** principles in making its case that the gain should be taxable to the donor.

The **step transaction** argument claims that the donor's gift, when followed closely by the sale of shares, is, in reality, a single, unitary, or indivisible transaction. In the IRS's view, what appears to be two logically independent steps is equivalent to the donor selling the shares and contributing the liquid proceeds to charity. According to IRS reasoning, the donor bears the tax liability when shares sell at a profit.

In advancing the **assignment of income** doctrine, the IRS will cite the Supreme Court's ruling that the taxpayer cannot insulate himself from taxation merely by assigning or transferring the right to income to another party.

With closely held stocks (or a particularly volatile publicly traded stock), a charity has a definite economic interest in selling that stock within a reasonable period to deploy the proceeds for its charitable operations or diversify its investments. Whom might the charity expect to purchase the shares of a closely held business it has come to own? Potential purchasers usually can be found within the corporation, other shareholders, or a third-party buyer waiting in the wings to buy the entire corporation.

Analyzing the Case Law

The sequence and timing of events surrounding any gift to charity and sale of stock are critical in answering the question: "How late is too late?" Fortunately, a series of court cases help articulate and illuminate the legal standards that apply to these situations.

Palmer v. Commissioner[1]

A 1974 Tax Court case, the taxpayer contributed voting shares of a corporation that he controlled to a private charitable foundation that he also controlled.

The court ruled that "the presence of an actual gift…and the absence of an obligation to have the stock redeemed have been sufficient to give such gifts independent significance."

While the Service tried to argue that this redemption was anticipated, the Tax Court ruled that "expectation is not enough." Further, "the redemption had not proceeded far enough along…to conclude that the foundation was powerless to reverse the plans of the [taxpayer]." The presence of an actual and valid gift, combined with the fact that the foundation was not a sham, led the court to rule that the gift of stock was not in substance a gift of the liquid proceeds of a redemption.

The *Palmer* case presented some potentially adverse facts for the taxpayer, namely, the gifting of stock to the charitable foundation one day before redemption and the taxpayer possessing effective control over both the foundation and the corporation executing the redemption. The corporation and the foundation were even located next door to each other. Nevertheless, in a 1978 Revenue Ruling, the IRS conceded that the Tax Court's ruling in Palmer was correct, stating that it will treat the proceeds of a redemption in stock as income to the donor ***only*** *"if the charitable organization is legally bound, or can be compelled by the corporation to surrender the shares for redemption."*

After *Palmer* and Revenue Ruling 78-197, the law on timing seemed reasonably straightforward.

Although a shareholder might effectively control whether a corporation will redeem stock, he or she will not be taxed on a charitable donation of appreciated stock prior to a sale provided that the charity is not under a binding, legal obligation to sell the stock at the time it receives the donation. However, subsequent case law adds some additional complexity to the analysis as to whether the absence of a charity's legally binding obligation alone is sufficient for a taxpayer to avoid assignment of income and step-transaction arguments.

Blake v. Commissioner

The *Blake v. Commissioner* case from 1981[2] illustrates one situation where the donor can be taxed, even though the charity may not technically find itself under a legal obligation to redeem the stock.

As background to this ruling, S. Prestley Blake, the co-founder and majority stockholder of the Friendly Ice Cream Corporation, owned a yacht named *America*.

After purchasing the yacht for $2,500,000 in 1972, he soon found it worth far less.

Blake proposed the following transaction to a charity, the U.S. Merchant Marine Academy. He would donate $700,000 of Friendly stock to the Academy, which would sell those shares on the open market and use $675,000 to purchase *America* from Blake. Blake expected to receive a $700,000 charitable deduction and a $1,800,000 long-term capital loss on the sale of the yacht.

As a poet might say, "the best-laid plans of mice and men oft' go awry," and such went the plans for Mr. S. Prestley Blake. He testified at trial that he would not have made such a substantial donation of Friendly stock to the charity if it were not "for the boat thing." Consequently, the Tax Court ruled that Blake had sold his Friendly stock for $700,000 and made a charitable gift to the Academy for the yacht's actual value, about $200,000 (Incidentally, the Academy nearly lost its tax-exempt status due to self-inurement issues uncovered in an audit of its Form 990).

While the charity may not have been legally bound to sell the Friendly shares at the time of the gift, the court ruled that the doctrine of promissory estoppel could have compelled the charity to surrender the shares. It is the presence of a "quid pro quo" that distinguishes *Blake* from *Palmer*. The charity in *Blake* was never in a position to decide with equanimity whether it should sell the stock or not. Instead, the court found that Blake had an enforceable promissory estoppel action against the charity if it didn't go along with the yacht purchase. In return for a larger-than-otherwise donation, the charity was expected to purchase the yacht from Blake at an inflated value. *Blake* places the mutual understanding or a legally enforceable promise on a par with the legally binding commitment language of *Palmer* and Rev. Rul. 78-197. If *Blake* had not involved a quid pro quo, or were it not a veiled attempt to obtain an inflated tax deduction, the result would likely have been much different.

It is the presence of a "quid pro quo" that distinguishes Blake *from* Palmer.

As mentioned previously, it is often in the charity's best economic interest to sell donated stock expeditiously, particularly in the case of closely held stock for which no ready-made market exists. Such practices help the charity realize the value of often volatile securities and put the proceeds to work for its charitable proceeds. The *Greene v. U.S.*[3] case in 1994 helps illustrate that standard operating procedures or even 'standing orders' for a charity to sell a donated stock is not enough to convert a gift of stock into an anticipatory assignment of income, and is not conclusive evidence of a prearrangement between donor and charity.

Instead of a stock redemption like that found in *Palmer*, what about those cases involving outside sales and ongoing negotiations to sell an entire corporation to a third party?

We know from *Palmer* and *Blake* that unless the charity is legally bound or compelled by some arrangement to surrender the shares at the time of the gift, there is no anticipatory income assignment, and the donating shareholder will not be taxed on the gain.

How does the law view a situation where there are still significant contingencies or controversies that could prevent the sale from being consummated? As we all know, many deals fall through at the last minute. If the proverbial "dotted line" remains unsigned before a charitable donation, can the donor still avoid being taxed on the gain?

Ferguson v. Commissioner

The *Ferguson v. Commissioner*[4] case tries to answer questions as to how “contingent” these pre-sale contingencies can be to avoid the assignment of income arguments. The taxpayers, in this case, wanted to tithe by donating their combined 19% interest in American Health Companies Inc. (AHC) to their church. Most of the relevant facts in this 1997 decision occurred in 1988. In July, AHC entered into a merger agreement with “CDI” and “DC Acquisition,” who would acquire shares pursuant to a tender offer for $22.50 a share. The tender offer was conditioned on DC Acquisition’s owning and receiving at least 85% of the AHC stock, but DC Acquisition could waive that condition at its sole discretion.

The timing and sequence of events are critical to the court’s ruling in *Ferguson*.

1 **Between August 15 and August 21**, taxpayers executed “donation-in-kind” records, stating their intention to donate a total of 61,111 AHC shares to their church and their broker, facilitating the opening of separate brokerage accounts for their respective stock holdings.

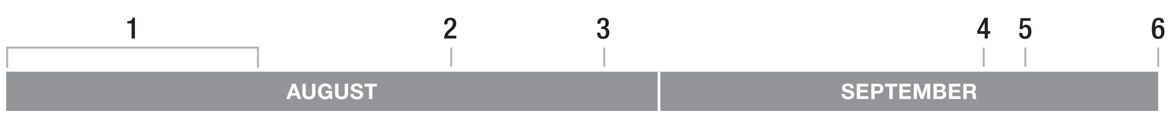
2 **On August 26**, two family charitable foundations were formed.

3 **By August 30**, more than 50% of outstanding shares had been tendered or guaranteed.

4 **On September 8**, the broker transferred the shares to the newly created charities.

5 **On September 9**, one day later, the merger took place, and the charities tendered their shares of AHC.

6 **On September 13**, DC Acquisition purchased all tendered or guaranteed shares for $22.50 a share.



Notably, Judge Halpern held that the broker was not an agent of the charities but the taxpayers’ agent instead. Since the charitable foundations were not even formed until August 26, the court rejected the plaintiffs’ arguments that the gifts occurred on August 15 and August 21. By the court’s determination, the taxpayers effectuated their gifts by relinquishing dominion and control over the shares on September 8. Then, 95% of the outstanding shares had already been tendered, and even the notional contingency had been removed.

Since the acquiring company could waive the minimum 85% condition, it was not a contingency preventing DC Acquisition from proceeding unilaterally and consummating the merger. According to *Ferguson*, the crossing of the Rubicon occurred on the date when the shareholders lost the ability to say “no” to the deal, and that was when 50% of the outstanding shares had been tendered or guaranteed.

"By the close of business on August 31, 1988, more than 50% of the outstanding shares of AHC stock had been tendered or guaranteed. At that time… We believe the reality and substance of the merger agreement and tender offer indicate that the stock of AHC was converted from an interest in a viable corporation to a fixed right to receive cash."

"We believe, instead, that when more than 50% of the outstanding shares of AHC stock had been tendered and guaranteed, which in effect was an approval of the merger agreement, and the Charities could not vitiate the intentions of the shareholders, who had tendered or guaranteed a majority of AHC stock…the right to merger proceeds matured."

By the time the *Ferguson* charities received the stock, not only had the 85% contingency been satisfied, the 50% control threshold was long surpassed, and the merger was a *fait accompli*. The charities were given a fixed right to receive $22.50 per share in cash. By the time the charities became shareholders, the acquiring corporation may still have been able to back out of the purchase, but the charities could not. Accordingly, the Tax Court ruled that the gain on stock sale should be taxed to the donors under the anticipatory assignment of income doctrine.

Dickinson v. Commissioner[5]

More recently, in 2020, *Dickinson v. Commissioner* delivers an expected result with some revelatory analysis. The Petitioner's husband was the CFO and shareholder of a privately owned company ("GCI") who donated appreciated shares to Fidelity Investments Charitable Gift Fund (Fidelity), a qualified charitable organization. In issuing its notice of deficiency, the IRS recharacterized the petitioner's stock donations as taxable redemptions followed by contributions of the cash redemption proceeds to Fidelity.

The facts of *Dickinson* are relatively straightforward. Before any donations, the GCI board of directors authorized shareholders to donate shares to Fidelity through written consent actions. In both consent actions, the Board acknowledged that Fidelity "has a donor-advised fund program which incorporates procedures requiring…[Fidelity] to immediately liquidate the donated stock…and, therefore, promptly tenders the donated stock to the issuer for cash." After each Board authorization, the taxpayer, still a full-time CGI employee, donated appreciated CGI shares to Fidelity. For each stock donation, the taxpayer signed a letter of understanding indicating that the transferred stock was exclusively owned and controlled by Fidelity, who is not under any obligation to sell or redeem the stock. Shortly after each donation, Fidelity redeemed CGI shares for cash.

In finding for the taxpayers, the Tax Court applied two tests, a control test, and a timing test.

The letters of understanding and other communications between the parties established that Fidelity had "exclusive legal control" over the donated stock. Fidelity's regular practice of redeeming shares shortly after each donation was not factually or legally persuasive, nor was the IRS's argument that Fidelity could have arranged the redemption in advance of the gifts. According to the Tax Court, "a preexisting understanding among the parties that the donee would redeem donated stock does not convert a post-donation redemption into a pre-donation redemption."

The timing test asks whether the taxpayer makes the donation before the stock generates income through a sale, potentially invoking the assignment of income doctrine.

> ***In* Dickinson*, the Tax Court cites* Palmer *and* Ferguson *in finding "where a donee redeems shares shortly after a donation, the assignment of income doctrine applies only if the redemption was practically certain to occur at the time of the gift, and would have occurred whether the shareholder made the gift or not." Further, "As in* Palmer*, the redemption, in this case, was not a* fait accompli *at the time of the gift."***

Interestingly, the *Dickinson* Court also explicitly rejects Rev. Rul. 78-197 and its bright line test hinging on whether a donee is “legally bound” or “can be compelled” to surrender shares for redemption. Further, in a footnote, the court suggests there may be more to the story with the anticipatory assignment of income cases.

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The Court of Appeals for the Ninth Circuit has gone a step further, asserting in dicta that stock sale proceeds are taxable to a shareholder who donates stock absent a binding obligation to sell if the facts and circumstances indicate that a tender offer and merger are “practically certain to proceed” in the immediate future.

Nevertheless, *Dickinson’s* ultimate question is whether the shareholder’s right to income had already crystallized at the time of the gift to Fidelity and the Tax Court found nothing to suggest the donor had any fixed right to income at the time of the donation.

The seemingly straightforward “legally bound” and “absence of compulsion” language in *Palmer* and Rev. Ruling 78-197 has evolved in subsequent case law. In *Blake*, the concept of enforceable promises merits scrutiny for a quid pro quo or prearrangement with the charity. With *Ferguson*, a transferee charity lacking control over deal contingencies and the ability to change the future course of events can trigger the assignment of income doctrine with all its adverse tax consequences. Finally, *Dickinson* teaches us that redemptions “practically certain to occur” at the time of donations are problematic for taxpayers and suggests that facts and circumstances may be determinative of that practical certainty.

On the whole, the case law demonstrates that once a deal has progressed to the point where a shareholder is directly or indirectly obligated to move forward with a sale or redemption, the ability to transfer stock to a charity and achieve specific tax goals is in jeopardy. With most deals, there will not be a bright line or an easily defined moment in time when merely late becomes “too late.”
As Shakespeare warned, “better three hours too early than a minute too late.”

Are letters of intent a yellow or red light?

The “How late is too late?” question often arises in the context of a Letter of Intent (LOI), a potential buyer’s written expression of interest in purchasing a business. The more specific question posed is: “Is it too late to donate family business stock to charity (and achieve the desired tax treatment) after an LOI has been signed?”

It is somewhat axiomatic to say Letters of Intent are merely expressions of intentions and aspirations. While LOIs are contractual agreements concerning a negotiation process, they are typically contracts to work in good faith to reach a final deal. LOIs usually contain a provision that explicitly states they are not legally binding with respect to actually consummating the sales transaction.

After signing a potential buyer's LOI and proceeding with negotiations in good faith, a seller may still back away from the deal before a final sales agreement is executed. Savvy would-be buyers perform thorough due diligence, painstakingly uncover potential weaknesses in financial statements, and notoriously request additional concessions from the seller regarding price or terms. Many signed LOIs are not consummated in sales agreements between the putative buyer and seller, let alone within the exclusivity period, expected closing date, or under terms comparable to the originals. At least theoretically, and by the language of *Palmer*, *Blake*, and *Ferguson*, there is no legally binding commitment, there is no quid pro quo, and there is no guarantee of a sale occurring fixing a shareholder's right to proceeds. The legal certainties these leading cases rely on are not present the moment most LOIs are executed.

However, a signed LOI is often close enough in time and content to a final, binding sales agreement to signal any charitably inclined shareholder to proceed with caution concerning any pre-liquidation transfers. The vast array of facts and circumstances attending a particular signed LOI may make a shorthand answer to the question "How late is too late?" next to impossible. However, perhaps channeling Justice Potter Stewart's "I know it when I see it" mantra from *Jacobellis v. Ohio*[6] can assist you in the analysis.

Consider factors such as the following:

- Is the LOI a binding one? Or is it merely an agreement to work on an agreement?
- How specific is the LOI as to terms, notably price and price adjustments?
- How long is the exclusivity period of the LOI?
- How extensive is the due diligence process called for in the LOI?
- What's the period between the LOI and the closing sales agreement?
- How detailed is the LOI with respect to terms, valuation, payment structure, management, earnouts, holdbacks, escrows, insurance, reps, and warranties?
- What contingencies, if any, are outlined in the LOI? Are any within the seller's control?
- How is "good faith" defined in the LOI, and must the seller exercise good faith to satisfy contingencies?
- Did the LOI arise out of, or is it a part of, a competitive bidding process?
- Is the seller considering an inter-family transfer or management buyout as well?
- What's the overall complexity of the post-LOI process in terms of due diligence, legal expenses, negotiations over representations and warranties, etc.?
- What is the buyer's history concerning acquisitions and negotiations? Does the particular buyer have a history with the seller?
- Are the buyer or seller in a "must buy" or "must sell" position?

When is too late for state income tax savings?

As a corollary to business owners making charitable donations, there are other circumstances where shareholders may avail themselves of income tax savings by last-minute transfers of appreciated stock before sale or redemption. Timing is essential when transferring stock to specially designed trusts with some inherent asset protection and state income tax advantages. A Delaware Incomplete Gift Non-Grantor (DING) trust, for example, can reduce or even eliminate state income taxes in the right circumstances.

Since Delaware does not impose an income tax on a trust's accumulation of income for non-resident beneficiaries, a DING trust is an attractive strategy for business owners in certain states who are considering selling their appreciated stock in their closely held company. For the DING strategy to be effective, there are two critical legal hurdles to clear:

(1) The timing hurdle

(2) The 'resident trust' hurdle

The timing issues with DING trusts are similar to those in the charitable deduction arena. State taxation authorities may try to use the "step transaction" doctrine to collapse seemingly independent, legally significant steps into a single transaction and impute the trust's income to the grantor.

Similarly, they may invoke the "assignment of income" doctrine to argue that the sale was a "done deal" before the stock was transferred to the DING trust. Accordingly, the taxpayers should take pains to establish the business purpose of the DING and the substance behind the form of the transaction. Borrowing from the concepts applied in the charitable giving context, absent there being some quid pro quo between settlor and DING, the DING being legally obligated to sell its shares at the time of the gift, or the DING being unable to walk away from closing the transaction, the courts are loath to find that the taxpayer has made an anticipatory assignment of income.

However, resident trust status is new to our analysis and particular to the state income taxation issues associated with DINGs.
The income tax statutes of any state with a potential connection to the trust must be closely scrutinized. States look to tax "resident trusts" and define trust residency based on: (a) the trust settlor's residency when the trust is created or becomes irrevocable; (b) the residency of the Trustee; (c) the location or situs of trust administration; (d) the residency of trust beneficiaries; or (e) some combination of those criteria.

In designing DINGs, the challenge to taxpayers is avoiding sufficient "nexus" or connection between their trusts and the state where the settlor, trustee, and beneficiaries reside and where the trust is administered. Each of the states' statutory definitions of "resident trust" must be carefully evaluated. On the other hand, states looking to tax DINGs will have to demonstrate that they have enough nexus with a trust under the Due Process Clause and Commerce Clause of the U.S. Constitution to justify the imposition of its income tax. Without sufficient nexus to a trust, and provided the trust settlor made a timely transfer of shares — one that is not "too late" — states that may typically expect to tax an individual may be left empty-handed trying to tax the income of a DING that individual created.

For more information about how this might affect the plan for your business, contact your Family Office Director or visit key.com/businessadvisory.

About the Author

As Director of Family Wealth Consulting, Tim Malloy focuses on the estate, philanthropic, and business succession needs of Key Private Bank clients. He has over 30 years of experience in the legal and financial services industries, with the last 20 coming at Key Private Bank specializing in working with high-net-worth individuals, business owners, and corporate executives.

Tim specializes in providing complex estate planning, client philanthropic goals and initiatives, and the formation of trusts to mitigate taxes and help Key Private Bank clients accomplish their values-based financial goals.

Tim graduated cum laude (BA in Philosophy) from the University of Notre Dame and holds a JD from Georgetown University Law Center. He is a Certified Exit Planning Advisor and a Chartered Advisor in Philanthropy.

[1] Palmer v. Commissioner, 62 T.C. 684 (1974)

[2] Blake v. Commissioner, 697 F.2d 473 (1982)

[3] Greene v. United States, 864 F. Supp. 407 (1994)

[4] Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999)

[5] Dickson v. Commissioner T.C. Memo (2020 – 128)

[6] Jacobellis v. Ohio 378 U.S. 184 (1964)

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