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Taxing the Donor upon the Sale of Donated Shares: '*Estate of Hoensheid*'

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When a corporation is to be acquired through a taxable sale of shares, a shareholder who is otherwise charitably inclined may be advised to contribute a portion of the corporation's stock to a charity or to a donor-advised fund that will thereafter make charitable contributions. The person making the contribution would be seeking to enjoy a double tax benefit: first, an income tax deduction for the charitable contribution equal to the fair market value of the donated shares, and, second, if the shares are appreciated, relief from the obligation to include the unrealized gain inherent in the contributed shares in gross income. (The donee, as a tax-exempt charitable organization, will also not be taxed on the gain recognized on the sale of the contributed shares to the buyer.)

In *Estate of Hoensheid v. Commissioner*, TC Memo 2023-34, however, a tax deficiency asserted by the Commissioner on the basis that a shareholder who donated some of his shares to a tax-exempt organization (a donor-advised fund) should be taxed on gain realized from the sale of those shares by the donee under the anticipatory assignment of income doctrine was sustained, notwithstanding that there appears not to have been any binding agreement to sell the stock of the corporation at the time of the donation. Further, the valuation obtained by the donor, from the investment bank that advised the sellers with respect to the sale of stock of the corporation, was found not to meet requirements under IRC Section 170(f)(11) for a qualified appraisal. Consequently, the Tax Court also sustained the IRS's denial of a charitable contribution to the shareholder.

Facts in *Estate of Hoensheid*

Commercial Steel Treating Corp. (CSTC) engaged in a manufacturing business, and its shares were owned, as of the beginning of 2015, by three brothers (one-third each). The shareholders decided to pursue a sale of CSTC and engaged FINNEA Group, a sell-side investment bank, to find a buyer and advise the sellers in connection with the sale.

FINNEA solicited bids for CSTC from private equity firms, and, on April 23, 2015, HCI Equity Partners and the three brothers signed a nonbinding letter of intent for the sale of the shares of CSTC for total consideration of $107 million.

Contemporaneously, Scott Hoensheid (one of the brothers) began to discuss with his personal financial advisers and attorney the donation of some of his shares of stock to a Fidelity Charitable donor-advised fund (Fidelity Charitable). E-mail correspondence quoted in the Tax Court decision indicates that Mr.

Hoensheid wanted to wait as long as possible before making the contribution, to minimize the potential that the sale might not be completed after the contribution.

Attorneys for CSTC and HCI began negotiation of the purchase agreement in mid-May, and, at a shareholders' meeting on June 11, the brothers (who were also parties to a buy-sell agreement restricting sale of the stock of CSTC) authorized the pursuit of the sale of all of the stock of CSTC to HCI. Mr. Hoensheid's request to transfer a portion of his shares to Fidelity Charitable was also approved under a Consent to Assignment agreement signed by the brothers. The Consent to Assignment document had a blank to be completed to state the number of shares for which such consent was being provided, but that information was not set forth in the consent at the time it was signed.

By July 7, a decision had been made to "sweep the cash from the company prior to the closing and distribute it to the brothers," according to an e-mail sent by Mr. Hoensheid that day. This decision was implemented through (i) the payment by CSTC on July 10 of $6.1 million of employee bonus payments under a change-in control bonus plan, and (ii) a distribution of more than $4.7 million by CSTC to the brothers on July 14. The distribution had the effect of removing from CSTC almost all of its cash.

The quantity of CSTC stock desired by Mr. Hoensheid to be transferred to Fidelity Charitable (1,380 shares) was apparently determined on or about July 9. A signed (though undated) stock certificate for these shares was delivered to Fidelity Charitable on July 13. Later that day, a purchase agreement for the sale of the Fidelity Charitable shares was executed on behalf of Fidelity Charitable, with the signature page being delivered on the following day to counsel for CSTC. Fidelity Charitable did not share in the distribution made by CSTC on July 14.

On July 15, the brothers and HCI signed a final purchase agreement; the agreement was approved by the shareholders and directors of CSTC that same day. Also on the same day, HCI agreed to fund CSTC Holdings, a holding company formed by HCI to acquire the stock of CSTC; the brothers transferred some of their CSTC shares to CSTC Holdings in exchange for stock in CSTC Holdings; and CSTC Holdings agreed to purchase the remaining outstanding shares of CSTC. An irrevocable stock power to transfer the CSTC shares owned by Fidelity Charitable to CSTC Holdings was also signed that day, and Fidelity Charitable received $2.9 million in cash proceeds from the sale.

Taking into account the nature and value of the contributed property, a valuation of the shares contributed to Fidelity Charitable had to be obtained in order for Mr. Hoensheid to claim a charitable contribution deduction, and that valuation had to comply with the requirements for a "qualified appraisal" as set forth in regulations under Section 170. The valuation was obtained from FINNEA, which provided it without any additional charge in addition to the fees that had been paid to FINNEA in connection with the transaction with HCI.

Following an audit, the IRS issued a notice of deficiency disallowing the claimed charitable contribution deduction. After a petition was filed by Mr. Hoensheid and his spouse to seek review by the Tax Court of the deficiency, the Commissioner asserted an additional deficiency on the basis of the assignment of income doctrine, arguing that the donor had a fixed or vested right to the gain from the sale of the donated shares at the time of the donation and therefore should be taxed on that gain notwithstanding the transfer of the shares to Fidelity Charitable prior to the closing with HCI.

Analysis

The court agreed with the petitioners that the 1,380 shares had been transferred to Fidelity Charitable as a gift, but rejected, as contrary to other evidence before the court, petitioners' assertions that the transfer had been made on June 11; indeed, the opinion described Mr. Hoensheid's testimony bearing on the date of transfer as self-serving and incredible. The court concluded found that the gift had occurred on July 13, upon the delivery of a stock certificate for the shares to Fidelity Charitable. In a footnote to the opinion, the court stated that certain documents produced during the audit appeared to have been modified and backdated to support an earlier date for the donation than that indicated by other documents and characterized the resulting inconsistencies as significant in its evaluation of the petitioners' assertion that the gift occurred on June 11.

The court further concluded that, by July 13, actions approved by Mr. Hoensheid and his brothers indicated that it was virtually certain that the closing would occur on the terms that had been negotiated with HCI. The draft documentation for the overall transaction was essentially complete (apart from one minor change made before closing) by July 13, and the actions taken by the brothers and CSTC -- such as the payment of transaction bonuses on July 10 and the approval before July 13 of the distribution of almost all the available cash that was effected on July 14 -- had significant business and tax consequences that would not have been acceptable but for virtual certainty that the transaction with HCI would be closed within a few days.

The petitioners argued that the Commissioner's position was contrary to Rev. Rul. 78-197 (1978-1 C.B. 83), in which the IRS stated that it would not treat a charitable contribution of stock followed by a redemption of the stock under facts similar to those in *Palmer v. Commissioner* (62 T.C. 684 (1974), affirmed (without consideration of this issue), 523 F.2d 1308 (8th Cir. 1975)) as an anticipatory assignment of income unless "the donor is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." The Tax Court noted, however, that revenue rulings were not binding on this court (or other courts), and further found that, on the particular facts of *Hoensheid*, the Commissioner's arguments were not "sufficiently contrary to Rev. Rul. 78-197 to constitute a disavowal of his published guidance."

The court thus found that, notwithstanding its acceptance of the petitioners' contention that the government had failed to establish that Fidelity Charitable had any obligation to sell the shares at the time of the gift, the anticipatory assignment of income doctrine was applicable, and that the petitioners were accordingly obligated to recognize gain on the sale of Fidelity Charitable's shares.

The court further upheld the Commissioner's assertion that no charitable contribution deduction was allowable. The court agreed with the petitioners that the doctrine of substantial compliance could excuse a failure to strictly comply with the qualified appraisal requirements under Section 170, but found that the valuation obtained by the petitioners from their investment bank failed to comply with several key substantive requirements for such appraisals.

In particular, it was not established that the person who prepared the valuation report was a qualified appraiser; and the report did not describe the preparer's qualifications as an appraiser or valuation experience. Further, the report misstated the date of contribution. The court also found that developments during the time interval between the date as of which the stock was valued and the actual date of contribution, including (i) the bonus payments of more than $6 million and (ii) other developments giving rise to virtual certainty (in the court's analysis) that the closing with HCI would occur, were likely to have significantly affected the value of the stock. In light of these intervening developments (as well as the other shortcomings of the valuation noted above), the court concluded that the petitioners had failed to demonstrate that the report was in substantial compliance with the governing provisions of Section 170, and upheld the Commissioner's denial of the charitable contribution deduction.

Observations

The finding in *Hoensheid* that the valuation did not meet the requirements of a qualified appraisal under section 170 is not surprising, under the circumstances described in the opinion, and the discussion in the opinion underscores the need to engage a qualified appraiser and for such further steps as are necessary to be taken to assure that the appraiser's report complies with the requirements of a qualified appraisal.

The court's conclusion that the assignment of income doctrine applied is more surprising, although the petitioners' apparent efforts to persuade the court to determine at least one potentially critical fact (the date of the donation) in a manner contradicted by other evidence before the court likely did not help in their attempt to persuade the court that the doctrine should not be applied in the circumstances before the court. Regardless, this decision should be kept in mind by similarly situated sellers and their advisers.

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