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Donations of Private Stock: Timing is Everything

The ability to receive an income tax deduction for donations of private company stock can be a useful tax planning tool for founders. Assuming the stock has been held for more than one year, a founder can generally deduct the fair market value of the stock when contributed to a tax-exempt public charity (including a donor advised fund). The amount of the deduction for private company stock is generally capped at 20% of the founder's adjusted gross income, with the ability to carryforward for five-years any amount not deductible in the year of donation. By making a donation of stock, the founder also generally avoids paying income tax on unrealized gains – *i.e.* the appreciation that has occurred from the time the founder acquired the stock until the time it is donated. In effect, the founder receives two benefits – (i) the founder does not have to pay tax on the unrealized gains in the gifted stock and (ii) the founder receives a charitable deduction for the fair market value of the gifted stock that can be used to reduce tax on the founder's other income.

Often founders want to donate private stock when the founder's company is being sold. If a transaction is imminent, the value of the stock is likely at its peak, which will enable the founder to maximize the charitable deduction from the gift. In addition, the founder is likely to have large capital gains in the year of the transaction which can be offset by the charitable deduction. Lastly, charitable organizations are most willing to accept donations of private stock when there is a clear path to liquidity.

Notwithstanding these advantages, it is important for a founder to be mindful of the timing of a donation of private stock to a charity. If the donation is made too late, the Internal Revenue Service may argue that the "anticipatory assignment of income" doctrine applies, in which case the founder will have to pay tax on the gain realized by the charity when it sells the stock received from the founder. In that circumstance, the first benefit mentioned above would be lost, thereby significantly limiting the impact of the donation.

A fundamental principle of tax law is that once the right to receive income has "ripened" for tax purposes, the taxpayer who earns that income is taxed on it. A 1997 tax court case, Ferguson v. Commissioner, provides a useful illustration. Ferguson involved the stock of a corporation that was subject to a tender offer in connection with a proposed merger. The donors had contributed stock to their church prior to the close of the tender offer. The court found that at the time of the contribution, the tender offer was a fait accompli given the number of shareholders that had already voted in favor of the tender offer and shareholders were effectively guaranteed a fixed cash payment for their shares. Despite the fact that the shares had been contributed before the donors received any cash from the merger, the court ruled that the donors could not assign their income to the charity to avoid paying tax on capital gains.

How late is too late? Unfortunately, there is no bright line rule and each case depends on the facts and circumstances. If all material issues have been resolved and a deal is "fully baked," the anticipatory assignment of income doctrine would likely be triggered. If due diligence is ongoing and there are unresolved material issues under negotiation, there would be a good argument that the founder's right to receive the income from the sale has not yet ripened for tax purposes. A founder should keep in mind that the charity that is receiving the stock will likely need to undertake its own legal and financial due diligence on the gift, which can take several weeks. The founder should be sure to identify the recipient of the gift and make contact well in advance of the date the transaction is expected to close.

Contributions of private stock are a powerful tax planning tool. Founders should consult with their tax and legal advisors to consider whether the timing or structure of the gift could implicate the anticipatory assignment of income doctrine.

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact the following attorney or call your regular Patterson contact.

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