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A Cautionary Tax Planning Tale: Timing and Formalities Are Critical

A business owner learned the hard way not to dawdle or cut corners when it comes to tax plans involving the sale of a business.

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This cautionary tale is based upon the recent tax case of *Estate of Hoensheid v Commissioner*, TC Memo 2023-34. When owners of a company plan to sell their business, there is very often a desire to minimize the resultant income tax. This tax is effectively taxing the increase in the value of the business often earned over many years and decades into a single year. The resultant tax will often be at the highest marginal rate, substantially reducing the net proceeds to the seller.

Many of the tools used to minimize income tax in this situation have a charitable giving component. When properly planned and implemented, three separate goals are achieved.

First, a portion of the otherwise taxable gain on the sale becomes nontaxable because a portion of the asset being sold is transferred to an IRS-recognized charitable structure.

Second, there is an income tax deduction equal to the fair market value of the appreciated asset contributed to the charitable structure. This compounds the economic value of the tax savings structure. A portion of the gain is sold tax-free by the charitable organization, and the seller receives a charitable deduction equal to the fair market value of the asset contributed. For example, if we are selling a company for a $20 million taxable gain, we could expect a tax of $6 million based upon a 30% combined federal and state tax rate. This leaves net proceeds of $14 million.

Note also that the seller has no say in how the $6 million in tax is spent by the government. If we gift a portion of the company to an IRS-recognized charitable structure, then you could direct the funds to be used for the Wounded Warrior Project, the Make-A-Wish Foundation or any legitimate charitable cause that you wish. Note that those funds would need to be distributed to a 501(c)(3) charity focusing on that desired purpose.

If we transfer $5 million to a charitable structure before the sale, the taxable gain itself is now only $15 million. This is because the net gain is reduced by the $5 million contributed to charity. The stock owned by the charity is sold tax free. Then the taxable gain is further reduced by a charitable contribution deduction equal to the fair market value of the stock contributed to charity. This results in a net tax of approximately $3 million. However, this is only a small part of the story.

The third goal is where the magic happens. Contributing the appreciated asset to a well-planned charitable structure provides an economic benefit to the charity and builds substantial wealth for the family, typically due to the time value of money. These structures provide independent economic value or wealth to the family and to the charity. Careful consideration must be given to each client's financial and nonfinancial goals.

These charitable structures are typically referred to by acronyms, leading to a veritable alphabet soup of alternatives: CRTs (charitable remainder trusts), CLTs (charitable lead trusts), PIFs (pooled income funds), CHLLCs (charitable limited liability companies), to name just a few overall categories. For my clients, we always recommend a structure that provides the client investment control of the funds while invested within the charitable structure. These structures can also provide significant asset protection for the client and their family.

An example of a $7 million investment into an intergenerational split interest trust PIF (a form of a pooled income fund) would provide the following results for a family where Dad is 49 years old and has kids ages 28, 24 and 11:

- $7 million contribution
- Income tax deduction: $2,171,200
- Projected annual income of 6%: $420,000 per year to Dad for his entire life and, at his death, to his children for their entire lives
- Client can maintain investment control
- Trust can own investment income real estate, if desired

Alternatively, a $3 million investment into a deferred inheritance trust (a form of CLAT) could provide an overall benefit to the family of over $16 million. The charity would also receive over $8 million. A dollar-for-dollar income tax deduction is provided of $3 million. This provides an estimated tax savings of $1,289,100. With the tax savings, the net cost of the $3 million investment is only $1,710,900.

Here's how that would work: The client invests $3 million into the deferred inheritance trust. Of that amount, $150,000 is invested in municipal bonds to pay the required annual charitable distributions. $2,850,000 is used to acquire a life insurance policy within the deferred inheritance trust. This will provide over $8 million to the charity and almost $17 million to the client's children—income and estate tax free.

These are only a few of the economic possibilities available with this type of planning. The key is to first identify your financial and nonfinancial goals, such as establish minimum cash flow and not worth needs. Goals may include providing predictable safe, risk-free income for yourself and your kids or other loved ones, or asset protection for yourself or your loved ones. Then identify the alternatives that best satisfy those goals.

What was lost in the case of Estate of Hoensheid v Commissioner

Any possible benefit from the above type of planning was lost to the owners of Commercial Steel Treaty Corporation (CSTC). CSTC was owned by the taxpayer in the case and his two brothers (collectively, the business owners). The loss in planning benefits is directly attributable to the taxpayer's own conduct and behavior in waiting too long to implement and trying to save money on appraisal costs.

The business owners received a letter of intent on April 2015 from a buyer who would pay $92 million for their company. The business owners wished to make a contribution to utilize the type of tax planning referred to above, but only if the sale of the company actually closed or was completed. In correspondence with the tax attorney, the brothers indicated that they wanted to "wait as long as possible to pull the trigger" on the contributor. In part, because if the sale did not go through, then the contributor would own less stock than his two brothers and have less control over the company.

The stock was contributed to Fidelity Charitable two days before the sale actually closed. The taxpayer (probably hoping to save a few dollars) did not hire an IRS-recognized and qualified appraiser.

The court relied upon the "assignment of income doctrine" to determine that the sale had progressed too far for Fidelity Charitable to be an owner for income tax purposes. This means that the entire gain, including the portion transferred to Fidelity Charitable, is deemed owned by and taxed entirely to the taxpayer at closing for income tax purposes. In other words, the sale or deal was virtually certain to close or be completed even though the sale did not formally close for two more days.

The assignment of income doctrine is a long-standing "first principle of income taxation" that recognizes that income is taxed to those "who earn or otherwise create the right to receive it" and that tax cannot be avoided by "anticipatory arrangements and contracts however skillfully devised." The court believed that the charitable transfer of stock was subject to a pending, pre-negotiated transaction with a fixed right to proceeds in the transaction. The court did not believe that Fidelity Charitable or the taxpayer had any meaningful risk that the sale would not close.

A qualified appraisal is important, emphasis on "qualified"

The case itself is replete with damaging correspondence and testimony evidence that the taxpayer did not wish to contribute any amount if the sale did not close. The result is that our first goal above was lost because the entire sale was taxable to the owner. The court then went further and denied the charitable contribution deduction itself. The taxpayer did not comply with the regulatory requirements to substantiate the deductions found in Internal Revenue Code Section 170. In particular, the court determined that the taxpayer did not obtain a "qualified appraisal." The taxpayer obtained a price quote from a qualified appraiser, but used an unqualified, presumably cheaper, alternative.

The bottom-line result was particularly harsh for the taxpayer. Fidelity Charitable was contractually entitled to a portion of the sale proceeds even though the entire gain was taxable to the business owner. The business owner was also not even entitled to the charitable contribution deduction due to the failure to have a qualified appraiser/appraisal. Definitely not the desired economic result for the taxpayer and his family.

Three lessons to learn from this case

1. All planning should be implemented far sooner. All planning, particularly charitable and noncharitable alternatives involving a transfer of ownership prior to the sale, must be completed well before the formal closing of the sale or deal. If the sale or deal has progressed too far, you run the risk of any presale transfers being disregarded for tax purposes under the assignment of income doctrine. "Too far" means there is a meaningful possibility that the sale will not actually close.

The issuance of a letter of intent (LOI), which is not typically binding, begins a countdown for completion. Try to implement the plan before the LOI is issued, even though the LOI is subject to negotiation. Note that the best planning is done long before the sale is in progress. Some of the best results are obtained by planning at least two years prior to the sale.

2. Seek a qualified tax attorney's advice. A qualified tax attorney can guide you through the maze of decisions involved with business sales. Note that many mergers and acquisitions attorneys specifically say that they do not give tax advice. Retain and listen to the advice of your tax attorney. Be candid about concerns that you may have, such as the possibility that the sale may not close. Creative solutions may be available.

3. Carefully follow the IRS rules for the tax planning or structure. In tax planning and in life, we should strive to minimize risk and maximize benefits. Here, the taxpayer did not bother to use an IRS-qualified appraiser.

The appraisal itself did not include a statement that the appraisal was prepared for federal tax purposes, included an incorrect date of contribution (possibly as a result of the application of the assignment of income doctrine), included a premature date of appraisal, did not adequately describe the method of valuation, was not even signed by the appraiser, did not include the appraiser's qualifications, did not describe the property contributed in sufficient detail, and did not include an explanation of the specific basis for the valuation.

The simplest advice here is to dot the i's and cross the t's on a timely basis. The cheapest advice may actually be the more expensive, as happened here.

About the author:

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