myStockOptions.com®

Donating Your Company Stock To Charities And Private Foundations (Part 1)

Joshua Husbands

Warren Buffet surprised the world in June 2006 by pledging to donate his considerable wealth in the stock of his company, Berkshire Hathaway, to the Bill and Melinda Gates Foundation. This was an unprecedented act of philanthropy, the likes of which had not been seen in recent history. In its wake, a great deal of interest has been expressed regarding the contribution of stock to charitable entities. Various factors are at play here, including tax and securities regulation issues, and you should consider all such aspects when contemplating the contribution of company stock to the charitable entity of your choice.

You have several alternatives when you consider gifting stock you own to charity. One technique available to you is the transfer of your stock to a charitable remainder trust or charitable lead trust. The rules for the taxation and governance of funding and operating a charitable remainder or lead trust are complex and fully explored in another article series published on this website, so they will not be rehashed here.

Aside from the intangible benefits, certain tax advantages are available to you when you transfer your stock ownership to a tax-exempt charitable entity.

The most straightforward and efficient choice is to contribute your stock to an existing publicly supported charity. This provides an immediate tax benefit, so this article series focuses predominantly on the direct contribution of your company stock or options to a charitable entity. Part 1 looks at these choices with an emphasis on foundations and donor-advised funds, and also examines the issues involved in transferring employee stock options or restricted stock to charities.

Aside from the intangible benefits of contributing stock to charity, certain tax advantages are available to you when you transfer your stock ownership to a tax-exempt organization. This article series covers the restrictions and ramifications of transfer during your lifetime rather than post-mortem transfers. Transfers during your lifetime are subject to greater restriction under securities laws, and those legal and tax issues are examined in Part 2.

Timing

There are different schools of thought on the optimal time for contributions of stock to charity. If you make the contribution during your lifetime, you will be able to determine that the assets you have given away are used in the way you want them to be. Of course, the contribution comes with an obvious cost, namely that you have divested yourself of ownership and no longer have the economic or other benefits provided by those assets. On the other hand, if you were to maintain ownership of the stock during your lifetime, you would reap its economic and other rewards but would have to be sure that others after your death would use the contribution in the fashion you intended. Additionally, the personal satisfaction that may come from seeing the results of your philanthropy during your lifetime is, clearly, unobtainable once you have shuffled off this mortal coil.

Choices

There are several types of charities to which you can contribute your stock:

- an existing public charity
- a private or public foundation formed by someone else
- your own newly formed private or public foundation
- a donor-advised fund

A public charity is one that is generally supported by a wide range of public donations and is approved as such by the IRS. Most names that come to mind when you think of a charity (hospitals, universities, aid and health organizations, etc.) are public charities. When you contribute stock directly to a charity, you need to contact your brokerage firm (or company if it is private) and the charity so that they can coordinate the transfer of shares.

> **Alert:** When contributing stock to charities for a year-end tax deduction, start the process earlier than usual, as this will take longer to coordinate than cash donations. If you are contributing closely held or otherwise restricted securities (if you are an affiliate for Rule 144 purposes, for instance), be sure to take all the necessary steps to obtain approval for the transfer prior to making the contribution.

Private Foundations

Private foundations, on the other hand, are more directly controlled by their founders and need not draw support from the general public. The downside to designation as a private foundation is that certain transactions between the foundation and select individuals, including substantial contributors (typically the founder), are prohibited as "self-dealing" and result in the imposition of a punitive excise tax. These prohibited transactions include the purchase or sale of property, including stock, between the "disqualified person" and the foundation. A "disqualified person" is, among other things, any person who gives an aggregate amount greater than $5,000, if that amount exceeds 2% of the total contributions made to the foundation in the same year; the definition includes certain relatives of the contributor and those who manage and work for the foundation. This limitation may apply to you if you wish to contribute company stock to the foundation and then buy it back or if you wish to contribute real property and rent it from the private foundation, among a number of other problematic arrangements.

Formation

The formation of a private foundation is not terribly complicated, but it can be very involved and must be done with some care.

If you are interested in forming your own private foundation, there are several things to consider. As discussed above, a private foundation will give you a flexible vehicle to carry out your philanthropic intentions, and can involve family members across (and through) generations while letting you keep control over where the assets are distributed. As long as the self-dealing rules are not violated, the directors can be paid reasonable compensation for services. All the assets must pass through annual grants to one or more charities, which can include individuals (the selection process for grants to individuals must be preapproved by the IRS) and foreign organizations.

However, the ultimate recipient organizations do not have to be decided up front when you create the foundation. You can make your deductible charitable contribution now (subject to the limitations already mentioned) without knowing exactly where the charitable gifts will be placed. You do need to annually pay out to charities the greater of the foundation's income or 5% of the fair market value of the foundation's investment assets.

The formation of a private foundation is not terribly complicated, but it can be very involved and must be done with some care. The first step is to form a nonprofit corporation (or in some cases a trust, though that is much less common today) in the state of your residence or choice. This is accomplished by filing the appropriate articles of incorporation with the secretary of state in the state of incorporation.

Once you have a validly established and existing nonprofit corporation, you must file a properly prepared Form 1023 with the IRS (see also the form's instructions). As long as the Form 1023 is filed within 27 months of the formation of the entity, the resultant tax-exempt status will relate back to the date the entity was formed. However, you are strongly encouraged to file the Form 1023 very soon after you form the nonprofit entity. If you fail to obtain tax-exempt status, none of your contributions to the entity will be deductible. Also, as a practical matter, no one else (family members or others) will be willing to contribute funds to an entity that has not received its approval of tax exemption.

The Form 1023 will require a fair amount of specific information. Among the information required will be the names of the initial board of trustees (directors), the exempt purpose of the entity, how it will operate, where its assets will pass if it is ever terminated, and fairly detailed financial projections. One item that is often very difficult is the requirement for several years of projected budgets. You should spend time considering the contribution and distribution levels well in advance of preparing the Form 1023. Annual information returns must be filed with the IRS, and similar returns are required by some states if the foundation is organized and conducts its business there.

Public Foundations

In some instances you may prefer to contribute your company stock to a public, rather than private, foundation. The typical rationale for doing so is that the tax treatment of contributions to a public foundation may be better than those made to a private foundation. The downside is that establishing a public foundation is more rigorous than forming a private one.

The rules of public foundations are byzantine. Usually a public foundation must be "controlled" by the organization it supports, so you will not have as much say in directing the foundation as you would with a private foundation.

A public foundation is typically established as a supporting organization for an established public "supported" charity. The rules governing qualification as a public foundation are byzantine. In most instances the public foundation must be "controlled" by the organization it supports, so you will not have the same magnitude of control over the direction of the foundation and its activities as you would with a private foundation. You will still be able to appoint a substantial minority of the foundation's directors (for instance, two out of five, or three out of seven), so your influence will be considerable—just not final. You might consider establishing a public foundation that supports a local community foundation, thereby ensuring a broad base of potential charitable recipients for the funds. The tax benefits of donating to a public foundation, discussed in Part 2, are considerable if you have a large amount of private company stock that you hold with a low basis. Therefore, you may not mind having a bit less control than you would with a private foundation.

Donor-Advised Funds

I suggest having available company stock and other assets worth at least $3 million to $5 million before you start a foundation. With lower amounts of capital, you may want to consider an outright donation to an existing charity or donor-advised fund (DAF). They are often offered by charities such as community foundations, and in some instances by mutual fund companies and other types of securities firms.

You can make a large, irrevocable up-front donation to a DAF and then decide later which charities to donate to and when. One advantage of gifting stock to a DAF instead of to a specific charity is that there is no setup cost to do so. Most DAFs have a minimum opening balance and small management fee along with the fees for individual funds. Additionally, a DAF provides the simplicity of dealing with one organization which can handle stock trades efficiently with low fees so that more of the fund is available for distributions to charities.

You can exert less control over a DAF than over a private foundation, though you or a family member may serve on the fund's advisory board. The DAF will generally follow your desires for its donations but is not required to follow them. Another limitation of DAFs is that distributions can be made only to public US charities, while distributions from private foundations may be made to deserving individuals directly for scholarships or the like, as approved by the IRS. The donor-advised fund cannot pay members of its advisory committee for services.

Stock Options

In some instances you may be allowed to transfer vested stock options to a charity. These may be of value to the charity if it has the funds to exercise the options and if there is a readily available market for the subsequent sale of the stock by the charity to liquidate its investment. The deduction you are allowed would be the fair market value of the option at the time of transfer. If the options are not traded on a public market it may be very difficult, if not impossible, to obtain a reliable value to rely on for tax-reporting purposes.

It is also important to note that, under Internal Revenue Code requirements, incentive stock options (ISOs) may not be transferred without turning them into nonqualified stock options (NQSOs) and thus losing the tax-deferral benefits associated with the use of ISOs. A further problem for transferring stock options to any person, trust, or family entity is that the IRS has held that stock option transfers are not completed gifts for the purposes of gift tax. The exercise of the option by the donee of the gift (i.e., the charity) will result in income tax not to the charity but rather to the employee who transferred the option.

When you exercise NQSOs, you can immediately transfer the stock to the charity for sale, though you need to hold the stock for a year to get a tax deduction for fair market value.

Issues With Stock From ISOs, ESPPs, And NQSOs

Stock received from an ISO exercise or an employee stock purchase plan (ESPP) raises additional issues that must be carefully considered when you anticipate a transfer to charity. With ISO or ESPP stock, the transfer of the stock to the charity within one year of exercise/purchase and two years of grant is a disqualifying disposition (see the FAQs that explain this for ISOs and for ESPPs). A disqualifying disposition triggers ordinary income on the spread between the option price you paid and the value of the stock at exercise/purchase. While transferring stock after these ISO and ESPP holding periods are met would not be a disqualifying disposition, it would raise complications if any AMT were triggered at the exercise of ISOs.

Planning opportunities that are somewhat more appealing exist with nonqualified stock options (NQSOs). Once you have the NQSO stock from exercise, it is like any other company stock you may own. When you exercise NQSOs, you can immediately transfer the stock to the charity for sale, though you need to hold the stock for a year to get a tax deduction for fair market value. Also, neither you nor an entity you control should be the purchaser if the charity is a private foundation and you are a disqualified person. The sale of the shares by the charity would avoid gain, but the spread between the option exercise price and the value of the stock on the date of exercise would still be taxable to you at that time.

Restricted Stock

Many companies are starting to make grants of restricted stock or restricted stock units (RSUs) either instead of or in addition to stock options. These face some of the same limits on charitable contributions that stock options do. Companies tend to prohibit their transfer even to charity. Once vested, there are no inherent restrictions on the stock, though the restrictions of any shareholder agreement must still be considered. After vesting, the stock is like any company stock owned by the grantee and, as long as no restriction is posed by a shareholder agreement, may be transferred to or sold by the charity.

Next Article

Part 2 discusses the issues of taxation and securities law associated with donating company stock to charities and with using company stock to form private foundations.

Joshua Husbands *is a partner in the law firm Holland & Knight at its office in Portland, Oregon. He works in the areas of business, tax, business succession, and estate planning, including business reorganizations, acquisitions, and divestitures. This article was published solely for its content and quality. Neither the author nor his firm compensated us in exchange for its publication.*

People who read this article also read:

- Charitable Remainder Trusts (CRTs) And Your Company Stock (Part 1) mso+
- Charitable Remainder Trusts (CRTs) And Your Company Stock (Part 2) mso+
- Charitable Remainder Trusts (CRTs) And Your Company Stock (Part 3) mso+
- Gifts: Save On Estate Taxes With Transferable Stock Options mso+