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QUALIFIED APPRAISALS AND CHARITABLE CONTRIBUTION DEDUCTIONS: THE LESSONS OF *HOENSHEID*

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In *Estate of Hoensheid v. Commissioner*, the U.S. Tax Court found, among other issues, that a donation of stock made in anticipation of the sale of the underlying business did not qualify for a charitable contribution deduction because the appraisal of the donated property did not meet the requirements of a qualified appraisal.

Introduction

On March 15, 2023, the U.S. Tax Court (the "Tax Court") released its memorandum opinion in *Estate of Hoensheid v. Commissioner*. At issue was whether the donation of an appreciated noncontrolling interest in a business enterprise qualified for a charitable contribution deduction when the donation was made nearly contemporaneously with a sale of the underlying business enterprise.

In its memorandum opinion, the Tax Court presents discussions of a number of concepts of interest to corporate planners and valuation professionals, including:

1. the determination of the effective date of a gift,
2. whether taxpayers failed to report capital gain income that arose due to their right to receive proceeds from the sale of the underlying business,
3. the circumstances under which a taxpayer is entitled to a charitable contribution deduction, and
4. the application of civil penalties under Section 6662(a) of the Internal Revenue Code ("IRC").

Background

Commercial Steel Treating Corp. ("CSTC") was founded in 1927 by Ralph Hoensheid and other members of the Hoensheid family. By 2015, the owners of the business were three grandchildren of Ralph Hoensheid, each of whom owned one-third of the stock.

One of those shareholders, Scott M. Hoensheid, wished to retire. The two shareholders who would remain after the retirement of their brother, Craig P. and Kurt L. Hoensheid, did not want to burden the business with the debt associated with the buyout, so the Hoensheids began the process of selling the business.

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CSTC engaged a sell-side investment banking firm to act as its financial advisor, and the process resulted in multiple bids for CSTC, including a $92 million offer from a private equity group that ultimately led to the sale of CSTC.

Effective Date of Gift

As the sale process moved forward, Scott Hoensheid engaged an estate planning attorney to discuss the possibility of donating a portion of his CSTC stock to charity prior to the sale.

While the attorney advised him that “the deadline to assign the stock … is prior to the execution of the definitive purchase agreement”[1] and suggested getting the donation completed “well before the signing of the definitive purchase agreement,”[2] Mr. Hoensheid was concerned that if the deal did not close, he would wind up owning a smaller percentage of CSTC than his brothers. He stated that he “would rather wait as long as possible to pull the trigger”[3] and that he did not “want to transfer the stock until we are 99% sure we are closing.”[4]

The competing goals—completing the donation well in advance of the close of the transaction and not making a stock transfer until the closing was a virtual certainty—form the backbone of the dispute between Mr. Hoensheid and the Internal Revenue Service (“IRS”) regarding the date of the gift. Key dates include:

COMPLETING THE DONATION WELL IN ADVANCE OF THE CLOSE OF THE TRANSACTION AND NOT MAKING A STOCK TRANSFER UNTIL THE CLOSING WAS A VIRTUAL CERTAINTY FORM THE BACKBONE OF THE DISPUTE BETWEEN MR. HOENSHEID AND THE INTERNAL REVENUE SERVICE REGARDING THE DATE OF THE GIFT.

- On June 11, 2015, CSTC held its annual shareholders’ meeting, at which the shareholders approved both the pursuit of the transaction with the private equity group and the transfer of CSTC shares by Scott Hoensheid to the charitable organization. Immediately following the shareholders’ meeting, the same three individuals met as the board of directors of CSTC, approving the transfer of the shares to charity and approving other items necessary to the transaction.

- On June 12, 2015, the private equity group approved the acquisition of CSTC subject to due diligence. The due diligence process identified certain environmental issues, but negotiations continued, with drafts of the deal documents passing back and forth between CSTC and the private equity group.
- On July 6, 2015, the private equity group formed a new corporation to hold the CSTC shares to be purchased from the Hoensheids.
- On July 7, 2015, CSTC distributed a large portion of its cash to the Hoensheids.
- On July 13, 2015, an undated email stock certificate was provided to the charity.
- On July 14, 2015, CSTC paid an additional dividend to the Hoensheids.
- On July 15, 2015, the transaction officially closed, with CSTC being sold for $107 million.

IN THIS CASE, A REPRESENTATIVE OF THE INVESTMENT BANKING FIRM HIRED TO ACT AS FINANCIAL ADVISOR DURING THE CSTC SALES PROCESS PREPARED THE APPRAISAL.

Mr. Hoensheid had claimed the date of gift was June 11, 2015, but the Tax Court later found that the gift did not take place until the date the stock certificate was provided to the charity, July 13, 2015.

On his income tax filing for 2015, Scott Hoensheid claimed a noncash charitable contribution of nearly $3.3 million. The IRS challenged the claim and assessed a Section 6662(a) penalty in addition to more than $600,000 owed in back taxes. Mr. Hoensheid petitioned the Tax Court for relief in 2019. (Mr. Hoensheid subsequently passed away in 2022, leaving his estate to continue his case.)

Anticipatory Assignment of Income

Based on a date of gift of July 13, 2015, the Tax Court concluded that Mr. Hoensheid did not, as of the date of the gift, bear a risk that the transaction would not close: “We are convinced that that petitioners’ delay in transferring the CSTC shares until two days before closing eliminated any such risk and made the sale a virtual certainty. Petitioners’ right to income from the sale of CSTC shares was thus fixed as of the date of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the … appreciated shares of CSTC stock.”[5]

Charitable Contribution

Even though the Tax Court found that Mr. Hoensheid had made an assignment of income to the charity rather than a gift of appreciated shares of stock, there was still the possibility of a charitable contribution deduction. Because the value of the gift exceeded $500,000, Mr. Hoensheid was required to provide a contemporaneous written acknowledgement of the gift and a qualified appraisal. The Tax Court agreed with Mr. Hoensheid that a contemporaneous written acknowledgement was provided.

However, the IRS argued that the appraiser in the matter was not qualified, and the Tax Court agreed. In this case, a representative of the investment banking firm hired to act as financial advisor during the CSTC sales process prepared the appraisal, and no additional fee was charged.

The Tax Court found that “mere familiarity with the type of property being valued does not by itself make [an appraiser] qualified.” The Tax Court elaborated that the appraiser in question “does not have appraisal certifications and does not hold himself out as an appraiser” on its way to concluding that he does not “regularly perform appraisals for which [he] receives compensation.”

The IRS and the Tax Court also criticized the appraisal report itself. The shortcomings of the report included the following:

- The report failed to describe the relevant qualifications and experience of the appraiser.

- The report failed to include a statement that it was prepared for federal income tax purposes.

- The report states an incorrect date of contribution. In the appraiser's defense on this one, the date of contribution was an area of disagreement between Mr. Hoensheid and the IRS. Mr. Hoensheid took the position that the date of the contribution was over one month prior to the date on which the IRS argued that the contribution took place, and the Tax Court agreed with the IRS.

  Given the extent of the fact finding and legal analysis evident in the Tax Court's conclusion of the effective date of the contribution, it is difficult to believe that any appraiser, no matter how qualified, would have pieced together evidence from correspondence unlikely to have been shared with the appraiser to arrive at an independent conclusion regarding the date of the contribution.

- The report did not sufficiently describe the method for the valuation.

- The report was not signed.

- The report did not describe the property in sufficient detail.

- The report did not include an explanation of the basis for the valuation conclusion.

- The decision mentions at several points that the appraisal was not a paid appraisal.

Regarding whether Mr. Hoensheid had reasonable cause to rely on the appraisal, the Tax Court found he did not.

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The Tax Court found that because Hoensheid "made a business decision" to have the appraisal performed "gratis," instead of hiring a paid appraiser, "such a decision did not demonstrate ordinary business care and prudence."

Because "petitioners did not have reasonable cause for their failure to procure a qualified appraisal," the Tax Court disallowed the charitable contribution deduction.[6]

Accuracy-Related Penalty

The Tax Court then went on to conclude that a 6662(a) penalty for underpayment of tax related to the anticipatory assignment of income did not apply in this case. This result is somewhat surprising given the tone of the memorandum. The penalty does not apply if the taxpayers had reasonable cause and acted in good faith, and the Tax Court memorandum does not present a glowing assessment of Mr. Hoensheid on either front.

However, because the IRS did not mention a 6662(a) penalty in its original note of deficiency—only in its response to Mr. Hoensheid's complaint—the IRS bears the burden of proof for this particular accuracy-related penalty.[7] Consequently, the IRS had to show one of three things in this case: (1) Mr. Hoensheid's tax attorney was not a competent professional with sufficient expertise to justify reliance, (2) the attorney was not given necessary and accurate information, or (3) Mr. Hoensheid did not rely in good faith on the judgment of the attorney.[8]

The first two of these could not be shown. For all its criticism of the appraisal in this case, the Tax Court concluded that no evidence existed that showed the attorney made the decision to hire the unqualified appraiser or advised Mr. Hoensheid to rely on the appraisal regardless of the appraiser's qualifications, so the appraisal's quality was immaterial.[9]

In the case of the third issue, the Tax Court found, "The anticipatory assignment of income issue … was the subject of contention by the parties in this case. We do not consider the anticipatory assignment of income issue to be so clear cut that petitioner should have known it was unreasonable to rely on …" the advice of Mr. Hoensheid's attorney.

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Conclusion

Estate of Hoensheid v. Commissioner provides a wakeup call for taxpayers and their planners regarding the donation of appreciated property. From a valuation standpoint, the main lesson is clear that legal counsel should seek an opinion of value from a fully qualified valuation professional from a reputable firm. That would remove any potential denial of a claim based on the lack of a qualified appraisal.

But it is also a reminder that valuation professionals should make sure that they have followed all necessary and appropriate steps in providing the appraisal to avoid the same issues that affected Mr. Hoensheid.

References:

1 Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023), 4.
2 Ibid.
3 Ibid.
4 Ibid.
5 Ibid., 34.
6 Ibid., 45.
7 Ibid., 46-47.
8 Ibid., 48.
9 Ibid., 45.

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