August 2026

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Gift, Estate, & Income Tax Valuation Insights Newsletter

Charitable Gifting Before the Exit

Timing, Valuation, and Planning Pitfalls

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EXECUTIVE SUMMARY

For advisors to high-net-worth business owners, charitable gifts of appreciated business interests can offer significant tax advantages. They can also be among the more technically demanding charitable planning strategies.

Those opportunities, and the planning risks that can undermine them, were the focus of Mercer Capital's recent webinar, "**Charitable Gifts of Business Interests: Planning, Timing, and Valuation**," featuring **Bryce Erickson, ASA, MRICS**, Managing Director at Mercer Capital, and **Joel Smyer, JD, CEPA®**, President and General Counsel of the National Christian Foundation of North Texas. The discussion examined how charitable gifts of private company interests intersect with transaction planning, tax strategy, charitable structures, and business valuation, with particular emphasis on gifts made ahead of a potential liquidity event.

This article is largely based on the content presented during the webinar and is intended solely for informational purposes. Mercer Capital is not providing legal or accounting advice in this article. Readers should consult their attorney or CPA regarding any legal or accounting matters addressed in this article.

For many high-net-worth business owners, charitable planning and transaction planning converge when a potential sale or other liquidity event is on the horizon. A client may hold a highly appreciated interest in a private business and intend to devote either a portion of that interest or a portion of the eventual sale proceeds to charity. If structured properly, a contribution of the appreciated interest can qualify for a charitable deduction based on its fair market value and, in appropriate circumstances, allow the donor to avoid recognizing the gain attributable to the donated interest. Realizing those benefits, however, depends on much more than charitable intent.

When a client is considering a charitable gift in connection with a potential sale of the business, the gift must be completed before the sale process advances to the point that the transaction has become effectively committed, and the valuation must support both the economics and the

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tax reporting position. Because the value of a closely held interest can be substantially affected by ownership rights, expected liquidity, transaction status, and other facts specific to the gift date, the valuation should not be treated as a separate substantiation exercise. A key theme from the webinar is that legal, tax, charitable, transaction, and valuation considerations should be coordinated from the outset.

For advisors to business owners considering a charitable gift, the value of the gifted interest depends on the facts in place on the gift date. An interest contributed during an active sale process may have a materially greater expectation of near-term liquidity, put or buyback rights, or other transaction-specific features that would not exist in a comparable long-term estate planning context where no liquidity event is expected in the near term. Those differences can materially affect the value of the donated interest.

The Disconnect Between Business Interest Assets and Charitable Gift Funding

For many business owners, a substantial portion of personal wealth is concentrated in the operating business. Yet charitable giving is often funded with cash. The webinar highlights the planning opportunity created by that disconnect: when charitable intent is already established, the assets available to fund the gift need not be limited to cash. An appreciated business interest may offer a more tax-efficient way to accomplish the same charitable objective.

A client who intends to devote a portion of business-sale proceeds to charity may achieve materially different tax results depending on whether the gift is made with cash after the sale or with an appreciated equity interest in the business before the sale. In either case, the donor may be entitled to a charitable deduction. The additional potential benefit of contributing appreciated equity before the sale is that, if the gift is respected as a transfer of property rather than an assignment of sale proceeds, the donor may avoid recognizing the built-in gain attributable to the donated interest. For advisors to business owners considering a charitable gift, the charitable objective should be identified before the sale process advances too far. Waiting until the transaction is substantially advanced can eliminate much of the planning benefit.

The Valuation Must Address the Interest Actually Transferred

One of the most consequential mistakes in this area is valuing the wrong asset. For example, in some cases the closely held entity may be a limited partnership that functions as a real estate holding company. If a client contributes an interest in that partnership, the subject of the appraisal is not the underlying real estate. It is the partnership interest being contributed. The webinar identifies the failure to distinguish between the underlying asset and the entity “wrapper” as a serious planning error.

The same principle applies when the entity is an operating business. A client may own 100% of a company valued at $20 million and wish to donate 10% of the equity. That does not mean the gift is necessarily worth $2 million. A 10% interest may have no ability to compel distributions, initiate a sale, appoint management, amend governing documents, or otherwise exercise control. A minority interest can therefore have a different per-share value than a controlling interest because the economic rights are different.

For advisors accustomed to minority and marketability considerations in family transfer planning, the valuation principles are familiar. What can change is the fact pattern. An interest contributed during an active sale process may have a materially greater expectation of near-term liquidity, put or buyback rights, or other transaction-specific features that would not exist in a comparable long-term family transfer where no liquidity event is expected in the near term. Those features can materially affect value.

Expected Liquidity Can Affect Minority and Marketability Discounts

A central point in the webinar is that the appropriate minority and marketability adjustments depend on the circumstances affecting the interest on the valuation date, particularly the expected path to liquidity and any available exit rights.

The webinar illustrates this point by comparing a 10% interest in the same company under two different fact patterns. In the charitable gift scenario, a liquidity event is expected within two to three months and a buyback or put feature exists. In the long-term family gift or estate planning scenario, liquidity may be years or decades away, with no comparable exit mechanism. The minority and marketability discounts are materially smaller in the near-term charitable gift scenario than in the long-term family gift or estate planning scenario.

That distinction matters when charitable gift planning occurs alongside broader estate planning. The same valuation principles apply in both settings, but the relevant facts may be materially different.

For advisors, the key point is that valuation conclusions from one planning context should not be carried into another without considering the facts affecting the interest as of the valuation date, particularly the expected path to liquidity and any transaction-specific rights or restrictions.

The LOI Is Evidence, Not the Answer

When a business owner is considering a charitable gift during an active sale process, advisors to the business owner may encounter the following question: “We have a letter of intent. Can’t we just use that value?” The answer is “no, not by itself.” During the webinar, the presenters explained that an LOI may be relevant evidence

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of value but does not by itself establish fair market value. Even a well-developed LOI remains subject to transaction-specific risks, including closing risk, financing risk, due diligence issues, counterparty risk, timing, breakup provisions, and the possibility of alternative bids.

For valuation purposes, the LOI is relevant because it provides a meaningful indication of market interest and can serve as an important input in assessing fair market value. But the business appraiser must evaluate the LOI in the context of the transaction terms, remaining contingencies, closing risk, and other relevant evidence and assess what a hypothetical willing buyer and willing seller would have agreed to for the subject interest on the date of the gift.

As the transaction advances, the contemplated sale becomes increasingly relevant to the valuation analysis, although transaction-specific risks must still be considered. At the same time, increasing certainty that the sale will occur raises the risk that the contribution may be treated as an anticipatory assignment of income. The same transaction developments that affect value can also affect whether the gift is respected as a transfer of property rather than an assignment of sale proceeds.

Hoensheid: A Cautionary Case on Transaction Timing

Estate of Scott M. Hoensheid v. Commissioner, T.C. Memo. 2023-34, is especially instructive for advisors to business owners considering charitable gifts during a sale process in that the taxpayer encountered a significant assignment-of-income problem. The case involved the contribution of appreciated shares of a closely held company to Fidelity Charitable shortly before the underlying company was sold. The Tax Court ultimately found that the gift was completed on July 13, 2015, only two days before the transaction closed. On the assignment-of-income issue, the Court focused on the realities of the transaction rather than the mere absence of a signed definitive agreement. It examined the steps already taken, the remaining contingencies, and the extent to which the sale had become practically certain. The Court concluded that by the time of the gift, the donor retained insufficient risk that the transaction would fall through.

Hoensheid does not establish a bright-line rule that the signing of a purchase agreement is always the decisive moment. Rather, the inquiry is fact-intensive and turns on how far the transaction has progressed and whether meaningful uncertainty remains that the sale will occur. For advisors to business owners considering charitable gifts during a sale process, that reinforces the need to identify and implement the charitable component before the client is effectively committed to the sale.

Hoensheid Highlights the Importance of Qualified Appraisal Compliance

Even if the assignment-of-income issue had been avoided, the taxpayers in *Hoensheid* still faced a separate problem: the charitable deduction was disallowed because the appraisal did not satisfy the qualified appraisal requirements. The defects were not minor. The appraisal report was prepared by an investment banker who did not regularly perform compensated appraisals. The Court concluded that he was not a qualified appraiser, noting that he also did not hold appraisal certifications or hold himself out as an appraiser.

The appraisal also contained significant deficiencies in required information, including the appraisal preparer's qualifications, the contribution date, and the valuation methodology. The valuation date was approximately one month earlier than the actual contribution date. During that interval, the company made approximately $6.1 million of bonus payments and the transaction advanced materially toward closing. Those events affected value. Therefore, the Court rejected the taxpayers' substantial compliance argument.

For advisors to business owners considering charitable gifts, *Hoensheid* is a reminder that qualified appraisal requirements are not clerical formalities. A sophisticated M&A advisor, investment banker, CPA, or company insider may possess deep knowledge of the business and still fail to meet the statutory definition of a qualified appraiser under Section 170(f)(11)(E), as supplemented by the Treasury regulations. Selecting a qualified business appraiser with the requisite appraisal experience is a substantive part of the planning process, not simply a compliance step undertaken when the tax return is prepared.

Engage the Business Appraiser Early in the Planning Process

The webinar makes an important distinction between engaging the appraiser and completing the appraisal report. The appraisal of the donated interest does not necessarily need to be completed before the contribution. Engaging the business appraiser early, however, can be critical. Early involvement allows the appraiser to understand the status, terms, and remaining uncertainties of a proposed transaction as the contribution date approaches and assess how timing, liquidity, and transaction risk may affect value. It also allows the appraiser to provide valuation input to the advisory team while planning decisions can still be made.

That is especially important where the client is considering a contribution during an active sale process. The business appraiser can help the advisory team assess how closing risk, marketability, transfer restrictions, buyback rights, and transaction timing may affect fair market value of the contributed interest. The legal structure of the gift and the associated tax strategy are matters for the estate planning attorney and tax advisor, rather than the business appraiser. Valuation input can, however, provide important context for those decisions. It can help the estate planning attorney and tax advisor evaluate whether the proposed structure is economically supportable and whether the resulting tax reporting position can be supported by the facts and circumstances existing on the contribution date.

A Better Planning Process

For the advisory team, the most defensible process is typically one in which the charitable objective is identified early, the exact asset to be contributed is defined, the donee's ability to accept the interest is confirmed, transaction timing is understood, and valuation is incorporated before the timing of the gift becomes critical. The planning sequence discussed in the webinar can serve as a useful coordination tool, helping the advisory team address charitable, transaction, valuation, and tax-reporting considerations while there is still time to make informed planning decisions.

A number of mistakes can undermine that process. Timing errors include waiting too long or making the gift after the transaction economics are effectively fixed. Valuation errors include treating an LOI as risk-free, mechanically applying the ownership percentage to the company's equity value without analyzing the specific interest being donated, or applying generic or rule-of-thumb discounts without considering the rights, restrictions, and liquidity characteristics of that interest. A related mistake is assuming that a valuation conclusion from an earlier estate-planning appraisal remains applicable without considering changes in transaction status, expected liquidity, or the rights associated with the interest. The common thread is a failure to reassess the relevant facts as the transaction develops, which can weaken both the tax planning and the support for the valuation conclusion.

Valuation Can Be Part of Charitable Gift Planning, Not an Attachment to It

For advisors involved in charitable gift planning, business valuation should be treated as an input to the planning process, not merely as a substantiation requirement that follows it. Early involvement by the business appraiser can help the advisory team understand how the company's value, the rights and restrictions associated with the contributed interest, expected liquidity, and the status of any pending transaction may affect both the economics and timing of the proposed gift. That valuation perspective can inform the legal, tax, and charitable analyses while planning decisions are still being made. Because those considerations can change materially as a sale process advances, the value of the appraiser's input extends well beyond substantiating the charitable deduction.

For business owners considering a charitable contribution of a closely held business interest during a sale process, the difference between a well-coordinated gift made at the appropriate time and one made after the transaction has advanced too far can be significant. The objective is to establish a defensible fair market value for the interest actually transferred, at the appropriate point in the transaction, using a qualified appraiser and a process that can withstand scrutiny.

Conclusion

Mercer Capital has extensive experience valuing closely held business interests for charitable gifts and other gift and estate tax planning matters, including contributions made in anticipation of a potential liquidity event. Engaging business appraisers early can help business owners and their advisors understand how ownership rights, transfer restrictions, expected liquidity, and transaction timing may affect fair market value and the qualified appraisal process. We work with attorneys, CPAs, and charitable planning professionals to provide independent, well-supported valuation opinions based on the facts and circumstances existing as of the contribution date.

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Learning Objectives: Upon completion of this webinar, participants should be able to:

- Identify the key valuation provisions that should be addressed in a buy-sell agreement, including standard of value, level of value, valuation date, appraiser qualifications, and appraisal standards.
- Distinguish between formula-based pricing provisions and appraisal-based valuation processes and evaluate the strengths and limitations of each.
- Compare single-appraiser and multiple-appraiser structures and assess how each affects timing, cost, uncertainty, and the potential for disputes.
- Evaluate how payment and funding terms, life insurance proceeds, entity tax treatment, and valuation discounts can affect the economics of a buy-sell transaction.
- Recognize common drafting and process failures that can lead to inconsistent valuation conclusions, shareholder disputes, or litigation.
- Apply a practical "stress-test" to an existing buy-sell agreement to identify unresolved valuation, procedural, and implementation issues before a triggering event occurs.

CLE Accreditation

The Florida Bar: This course has been approved by The Florida Bar for 1.0 CLE credit hours (General).

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Attorneys licensed outside Florida and Texas may be eligible to receive CLE credit through their state's reciprocity or self-application process and are encouraged to consult their state bar for specific requirements.

CPE Accreditation

- **Program Description & Learning Objectives**: See above
- **Instructional Delivery Method**: Group Study
- **Recommended CPE Credits**: 1.0 CPE credit
- **Recommended Field of Study**: Specialized Knowledge
- **Prerequisites**: None | **Advanced Preparation**: None
- **Program Knowledge Level**: Basic
- **Official Complaint/Concern Policy**: Contact Barbara Price at priceb@mercer-capital.com to voice issues, concerns, or complaints.
- **Attendance Monitoring Disclaimer**: Participants must remain logged in for at least 50 minutes and respond to a minimum of 4 random polling questions to receive the 1.0 credit.

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- Charitable Contributions – Reg. §1.170A – 13(c)(2)
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- Compensation Planning – IRC §§83(b) and 409A
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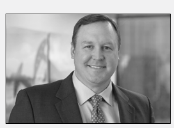

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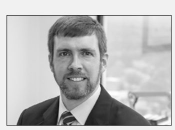

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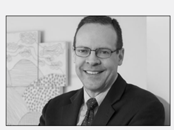

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