Planning for Armslength Family Transactions

Thomas B. Lemann
Can there be such a thing as an armslength family transaction? Theoretically there can indeed; practically it may not be easy. If A employs his son B in the family business, we may expect a court to scrutinize closely B's compensation to see if it contains any element of gift, for human nature tells us that B is a natural object of A's bounty. Yet the Tax Court has said:

While a father in the normal course of events would be expected to want to benefit a son, it does not follow that every transaction with a son must be endowed with a conclusive presumption of suspicion.¹

The Commissioner routinely contends that family transfers constitute taxable gifts, and taxpayers frequently contend the contrary. In the leading case of Commissioner v. Wemyss² there was a transfer of property to the taxpayer's prospective wife in consideration of her promise of marriage and to compensate her for the loss of certain income that, upon her marriage, would be diverted to a child by a former marriage. The taxpayer argued that, under the circumstances, he had no "donative intent" and hence the transfer could not be a taxable gift. But the Court held that it was not an armslength transfer, realizing that donative intent, whatever it is, depends upon subjective, personal feelings, and that it goes against human experience to think that a man would not have such feelings toward his fiancée.

The Commissioner has asserted that "donative intent" is not required for a taxable gift since the Wemyss case was decided.³ But the Treasury Regulations still contain a reference to "donative intent" in § 25.2512-8:

However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which [sic] is bona

---

¹Morris M. Messing, 48 T.C. 502, 511 (1967).
²324 U.S. 303 (1945).
fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.

Wemyss is sometimes cited for the proposition that a transfer without donative intent may nevertheless be subject to gift tax; and the quoted Regulation seems to say that at least some transfers without donative intent are not subject to gift tax. There is certainly no "donative intent" requirement in the statute. But let us not be drawn into Cardozo's Serbonian bog or Tucker's semantical phantasmagoria: the question simply put is whether there is an armslength transaction, and hence whether one looks for "donative intent" or "less than adequate and full consideration in money or money's worth" is not really significant.

Although the Regulation speaks of "the ordinary course of business," the courts have interpreted the phrase to refer not solely to what is generally considered usual business or commercial transactions, but rather to armslength transactions, commercial or not, even in family contexts if the other tests are met. Thus in Rosenthal v. Commissioner the court held that payments for the benefit of children could be free of gift tax if made "in the ordinary course of business," saying:

[E]ven a family transaction may for gift tax purposes be treated as one 'in the ordinary course of business' as defined in the Regulation if each of the parenthetical criteria is fully met. The court in Rosenthal cited and relied on Harris v. Commissioner, in which the United States Supreme Court had observed that although the family transaction there presented was not "in the ordinary course of business" in any conventional sense, the expression as used in the Regulation is a term of art and does not require the actual conduct of a business.

Catherine S. Beveridge involved $120,000 transferred in trust from mother to daughter. The transaction was found to be in a purely armslength context since:

[I]n making the transfer petitioner was not actuated by love and affection or other motives which normally prompt the making of a gift.

5. 205 F.2d 505 (2d Cir. 1953).
6. Id. at 509.
8. 10 T.C. 915 (1948).
9. Id. at 918.
Accordingly, the Tax Court distinguished antenuptial transfers such as that involved in *Wemyss* and held that there was no taxable gift.

In *Shelton v. Lockhart* the taxpayer was an Osage Indian Princess of half-blood, who placed $300,000 in an irrevocable trust for her children as a result of negotiations with the Bureau of Indian Affairs. The Commissioner sought to impose a gift tax, which the Princess resisted on the ground that she had no donative intent, to which the Commissioner made his usual rejoinder that donative intent is no longer required in gift tax cases. Citing *Rosenthal*, the court held for the Princess and stated that even though no business was involved in the transaction, it should nevertheless be treated as one “in the ordinary course of business” within the Regulation, “since each of its three criteria is fully met.”

The latest case construing the Regulation is *Stern v. United States*, which involved not a family context but amounts expended in political campaigns. The Commissioner contended that such amounts were lacking in adequate consideration and were therefore taxable gifts. The court held for the taxpayer, finding that her political expenditures were bona fide, at armslength, and free from donative intent, and hence satisfied the requirements of the Regulation.

This line of cases gives rise to some speculative musings on the nature of a taxable gift. The statutory definition provides:

> Where property is transferred for less than an adequate and full consideration in money or money’s worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Thus, a gift requires a transfer, inadequate consideration in money or money’s worth, and presumably (though the statute does not explicitly say so) a donee. Suppose that A, a private individual favoring repeal of the graduated income tax, pays $10,000 for newspaper space to advocate his viewpoint. He has simply purchased newspaper space, received what he paid for, and all would doubtless agree that A has not made any taxable gift. If however the ad says at the bottom “Vote for B, he agrees with these views,” would that one-liner be enough to turn the transaction into a $10,000 gift to B? It could still be said that A has not made any transfer at all, but has only purchased newspaper space and received what he has paid for. But has not some sort of benefit been conferred on B? Does that turn it into

11. Id. at 248.
12. 436 F.2d 1327 (5th Cir. 1971).
the kind of transfer the gift tax statute was intended to tax? And suppose B is A's nephew?

Suppose A puts up a fence around his property to protect it. B, a neighbor, likewise receives the benefit of the fence on his side. Nevertheless it would probably be agreed by all that A has not made any taxable gift to B, for several reasons: there was no transfer to any donee; A's motive in constructing the fence was to protect his own property, not to confer a benefit on his neighbor; and A received full consideration—he got his fence.

If A wanted his gardener to build a boxwood maze and the gardener does not know how, and A has to send the gardener to Kew to learn how to build a maze, could the cost of the trip, which doubtless benefits the gardener, be a taxable gift? Or is it simply part of A's cost in getting his maze built? If A needed a heart operation and had to send his doctor to South Africa to learn how to perform it, has A made a gift to his doctor? Or is it just a part of the cost of getting his heart fixed? It seems little different from the situation of a lawyer sending his young associate to a seminar in a distant city. The lawyer pays for the plane ticket and the seminar fee, and the associate receives the benefits therefrom, but not even the cacistophbic Commissioner would contend that the associate has received a taxable gift under such circumstances. Whether it is said that the "ordinary course of business" exception applies, or that adequate consideration is received, or that no "transfer" has been made at all within the meaning of IRC § 2501(a)(1), the basic proposition that such expenditures are not gifts seems unassailable.

In the recent Tax Analysts case striking down the Treasury's approval of multiple gift tax exclusions for political committees, the court observed that political contributions are subject to gift tax because "regardless of what motivates the contribution, a benefit inures to the candidate." But the same can surely be said of the doctor sent to South Africa: a benefit inures to him yet it does not follow that a taxable gift has been made. The court in Tax Analysts went on to say:

It seems abundantly clear to the Court that win or lose, a candidate's personal career is enhanced by his candidacy, and since his candidacy is financed by contributions, a fortiori, a contribution creates a legal benefit.\(^1\)

---

16. Id. at 8859-22.
17. Id.
The statute, however, does not impose a gift tax on "legal benefit" but rather upon a "transfer" for "less than an adequate and full consideration." Even if the political candidate has received a benefit, so has the hypothetical doctor who went to South Africa, the gardener sent to Kew, and the law associate sent to a professional seminar; quære whether any of them have received taxable gifts.

Although the Commissioner's Regulations state that the application of the gift tax is "based on the objective facts rather than on the subjective motives of the donor," it seems likely that in difficult gift tax cases the courts really apply sub silentio a "dominant motive" test similar to the one the Supreme Court in Commissioner v. Duberstein has ruled must be applied in the income tax field. Examined in context, the facts should permit the inference of motives. Applying that rule to the newspaper ad case, if the dominant motive is to propagate the taxpayer's own viewpoint, the ad should not be treated as a gift even though someone benefits from it, while if the dominant motive is to help the nephew's campaign, or to treat the doctor to a trip, then the expenditure should be subject to gift tax. It seems likely that this is really the rationale of the taxing statute, the Regulation, and most of the cases that have considered the question of whether or not a gift has been made.

CLOSE CORPORATION BAILOUTS VIA CHARITIES

Suppose the owner of close corporation stock wishes to transfer some of it to his children. The obvious method to achieve that end is by giving it to them. That method, of course, involves gift taxes, which many are reluctant to pay even though the estate planning advantages are obvious.

If the children (or trusts for their benefit) already have funds of their own, the close corporation stock could be sold to them, but that method also has its drawbacks. First, the father will probably realize a substantial capital gain by such a sale, and may thus obligate himself for as much taxes, or more, as if he made gifts. Second, there

19. Id. at § 2512(b).
22. Not "gifting." We already have a perfectly good verb, namely "giving," and for those who wish variation, we have two other fine verbs, namely "donating," and in the case of charities, "contributing." We do not need to make up a new word. Cf. Galant, Planning Opportunity: The Gifting [sic] of Closely Held Stock to Charitable Organizations, 51 Taxes 645 (1973), an otherwise admirable article.
23. The sale method at least has the advantage of giving the transferees a stepped-up basis.
is the ever-present problem of valuation to be reckoned with whenever close corporation stock is transferred, whether by gift or sale. Furthermore, a sale does not foreclose the Commissioner from finding a donation in disguise, and assessing gift taxes, if the sale price was below fair market value.

Resourceful tax planners have therefore turned to other techniques. One such technique is for the owner to give the stock to a charity, and then have the children (or trusts for their benefit) purchase the stock from the charity. The desired transfer is accomplished, but instead of having to pay gift taxes or capital gains taxes, the transferor is allowed an income tax deduction for his gift to charity\textsuperscript{24} and he also confers a benefit on his favorite charity.

The technique just outlined was employed in \textit{Crosby v. United States}\textsuperscript{25}. The taxpayer gave close corporation stock to a foundation and a hospital on two occasions and, in each case, within a month or two thereafter the same stock was sold to trusts for the taxpayer's grandchildren. The Commissioner contended that the donation and subsequent purchase constituted part of a step transaction, to be treated for tax purposes as though the taxpayer had sold the stock directly to the trusts, resulting in taxable capital gain measured by the amount the trusts paid less taxpayer's cost basis. Further, the Commissioner disallowed the charitable deduction taken for the contributions of the stock to the foundation and hospital.

Both the foundation and the hospital were essentially private charities,\textsuperscript{26} the taxpayer and his family constituting the governing boards of both organizations, and no one outside the family having ever made a contribution to either one. Both were duly qualified and exempt under § 501(c)(3).

The court found that the donations of stock to the foundation and hospital were "complete, unqualified, and irrevocable gifts, with no conditions attached or control retained."\textsuperscript{27} It also indicated there was "no evidence of any prior understanding or agreements that the charities would in turn sell the stock"\textsuperscript{28} to the grandchildren's trusts, and accordingly held that the contributions were fully deductible, and the taxpayer-donor was not taxable on the sale proceeds received by the charities when they sold the stock to the trusts.\textsuperscript{29}

\textsuperscript{24} The comparison is of course oversimplified in the interest of textual brevity, since if A sold the stock to his children he would likewise have some hard cash to put in his pocket—but only after paying capital gains taxes.

\textsuperscript{25} 73-1 U.S. Tax Cas. 80,927 (D. Miss. 1973).

\textsuperscript{26} The case involved tax years before the 1969 Act.

\textsuperscript{27} \textit{Crosby v. United States}, 73-1 U.S. Tax Cas. at 80,931.

\textsuperscript{28} \textit{Id.} at 80,934.

\textsuperscript{29} The case does not appear to have been appealed.
The court in Crosby cited and followed the colorful Sheppard racehorse case which involved similar contributions and buyouts of an interest in the standardbred stallion Star's Pride. Taxpayer had a half interest in Star's Pride, which was conceded to be worth $300,000 whole. He offered one-third of his half interest to each of two charities, the Sisters of St. Joseph and the University of Pennsylvania, both clearly public charities. On the same day in the case of the University, and on the following day in the case of the Sisters, taxpayer sent an offer to each donee, signed by himself as president of a family corporation, to purchase the respective one-sixth interests in Star’s Pride for $50,000 each. Both charitable donees accepted, thus making everyone happy except the ill-tempered Commissioner, who was of the opinion that the charitable contributions should be disallowed, or that the taxpayer should be liable for capital gains taxes as though he had sold directly to the family corporation, or both.

The Court of Claims held for the taxpayer, stating that the charitable donees did not act under legal obligation, express or implied, in accepting the corporation's offer of purchase, as such acceptance was not a condition to receiving the taxpayer's gifts. On the contrary, said the court,

[F]ollowing the gifts there was a period of time, albeit short in duration, when plaintiff had lost control of two-thirds of his interest in Star's Pride. During that period he was exposed to the possibility however remote he might have considered it, that [the family corporation] might not succeed in purchasing the donated interests short of increasing the amount of its offers.

The court thus refused to uphold the step transaction argument advanced by the Commissioner since there were no prearrangements or commitments on the part of the charities to sell their horse interests to taxpayer's corporation, despite the taxpayer's admissions that, as a practical matter, he felt confident they would do so.

There are several points of distinction between Sheppard and Crosby:

(1) The time interval elapsing between the contribution and the purchase. In Sheppard, it was one or two days; in Crosby, one or two months. The Crosby interval seems a lot safer, even allowing

31. A standardbred horse is bred for trotting, as opposed to a thoroughbred horse for running. Id. at 973 n.2.
32. Id. at 978.
for the fact that the Sisters of St. Joseph and the University of Pennsylvania had little use for a piece of a breeding horse.

(2) The relative closeness of identity between the donor and the ultimate purchaser. Because the taxpayer in Sheppard was president and owned 76.8% of the stock of the family corporation that bought the horse interests from the charities while the taxpayer in Crosby was one of several trustees of the grandchildren's trusts but had no beneficial interest, it would be easier to find the purchaser to be the alter ego of the donor in Sheppard than in Crosby.

(3) The independence of the charities. In Sheppard the two charities were a large university and a religious order, both clearly independent of the donor while in Crosby the two charities were controlled by the donor and his family.

The taxpayer's case in Sheppard was weak as to the first two points, but he was probably saved by the independence factor. On the other hand, Crosby involves facts evidencing less independence of the charities from the donor than might be desired, but he was doubtless helped by the time factor.

Four other recent cases illustrate the development of the law with respect to charity bailouts, all four representing taxpayer victories in three different circuits plus the Court of Claims.

In Behrend v. United States33 preferred stock in a family corporation was donated to a family foundation and some years later the stock was redeemed by the corporation. The court rejected the Commissioner's argument that the redemption was in substance effected by the donors themselves and therefore amounted to a constructive dividend. Although it was conceded that the entire transaction was planned as a unit, i.e. it was "understood" that the corporation would from time to time redeem the stock from the foundation, the court concluded that such an arrangement would not defeat the claimed tax benefits as "there was no binding obligation on the parties to carry through any step."34

In Carrington v. Commissioner35 the taxpayer owned all 100 shares of a close corporation, and donated 51 shares to his church, which were redeemed by the corporation just eight days later. Again the court, this time the Fifth Circuit, rejected the contention that the

---

33. 73-1 U.S. Tax Cas. 80,065 (4th Cir. 1972).
34. Id. at 80,067. The Behrend case involved tax years before 1969. Charitable bailouts should not be tried with private foundations nowadays. For one thing, there are restrictions on deducting the appreciation element.
35. 476 F.2d 704 (5th Cir. 1973).
redemption constituted a dividend to the donor.\(^6\) The Commissioner said it was obvious that here was the prototypical step transaction in all its infamously feculent, which no judge could fail to strike down or form would forever be exalted over substance. It was obvious that the entire maneuver was prearranged among the parties, and the Tax Court below agreed that the taxpayers "expected" the church to redeem the stock very shortly. But neither the Tax Court nor the Fifth Circuit was ready to accept the Commissioner's contention that the donors had received taxable income when the corporation redeemed the donated stock from the church. The Fifth Circuit said the issue was whether the donor had parted with all dominion and control over the donated property, for "if he did not retain any vestige of control, the gift was complete"\(^3\) and the subsequent redemption could not be taxed to the donor, there being no evidence of any "obligation" on the part of the church to tender the shares for redemption.\(^3\)

Another case that must have looked promising to the Commissioner is Grove v. Commissioner,\(^3\) in which the taxpayer had established a regular pattern, over ten years, of giving closely held stock to his college, which was regularly redeemed by his corporation about a year after each donation. The Commissioner no doubt figured that an agreement to redeem, which he had been unable to prove in the other cases, would have to be inferred from such a repetitive pattern of donation and redemption year after year, at very regular intervals. But the Tax Court,\(^4\) and a 2-1 majority of the Second Circuit,\(^4\) did not agree with him. Judge Kaufman, writing for the majority, sighed that the court was called upon again to "decipher the often intricate and ingenious strategies devised by taxpayers to minimize their tax burdens,"\(^4\) and reminded us that taxpayer ingenuity "is ground for neither legal nor moral opprobrium,"\(^4\) citing Judge Hand's maxim that there is no patriotic duty to increase one's taxes.\(^4\) The majority

\(^{36.}\) Certain factual variants are omitted as not germane to this discussion.\(^{37}\) Carrington v. Commissioner, 476 F.2d 704, 708-09 (5th Cir. 1973).\(^{38}\) One commentator finds a possible implication in the Fifth Circuit opinion that the Commissioner might have won if less than 51 shares had been given. 266-2d B.N.A. Tax Mgmt. at A-91 (1974). But taxpayers have succeeded in other cases without giving away a controlling interest, and the suggestion of any such implication seems unwarranted. Certainly no direct importance was attached to the control factor by the Tax Court or the Fifth Circuit.\(^{39}\) 73-2 U.S. Tax Cas. 81,908 (2d Cir. 1973), aff'd 31 CCH Tax Ct. Mem. 387 (1972).\(^{40}\) 31 CCH Tax Ct. Mem. 387 (1972).\(^{41}\) 73-2 U.S. Tax Cas. 81,908 (2d Cir. 1973)(Oakes, J., dissenting).\(^{42}\) Id. at 81,909.\(^{43}\) Id.\(^{44}\) Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935).
considered itself bound by the Tax Court's finding that there was no "agreement," formal or informal, between the donor and the college whereby the college would offer the stock to the corporation for redemption, despite the "systematic nature of the gift-redemption cycle."45 There was not even an "understanding." It was only "foresight and planning," said the court:

We are not so naive as to believe that tax considerations played no role in Grove's planning. But foresight and planning do not transform a non-taxable event into one that is taxable.46

Judge Oakes, dissenting, concluded that the donor should be taxed on the redemption, basing his view on "the economic realities of the entire transaction,"47 which, although in form a gift of stock followed by a redemption by the donor-controlled corporation, was in substance "a payment out of corporate earnings and profits to a charity designated by the donor."48 The dissenter believed the regular pattern of redemptions made it clear that the donor "could confidently expect" the college to redeem.49

The most recent case on charitable bailouts is DeWitt v. United States.50 There the taxpayer donated some close corporation stock to a military academy, and it was repurchased about three months later by another corporation controlled by the donor.51 Perhaps because the reacquisition was not by redemption, the Commissioner in DeWitt did not claim that the repurchase of the stock constituted a dividend to the donor, as in the other cases, but instead disallowed the charitable deduction of the original contribution of stock to the academy, on the ground that the donor had not relinquished dominion and control over the stock. The Commissioner's contention was that the transfer of the stock was only conditional, the condition being that the academy was to retain the stock until the donor, through some controlled corporation, offered to repurchase it. But the court held that the evidence failed to establish any "agreement" between the donor and the academy that the stock would be offered back. Said the court in a footnote:

46. Id. at 81,913; see also 87 HARV. L. REV. 1041 (1974) in which the author discusses whether some level of understanding short of a legal obligation to redeem shares may make the donor taxable.
47. Grove v. Commissioner, 73-2 U.S. Tax Cas. 81,908 at 81,913 (2d Cir. 1973)(Oakes, J., dissenting).
48. Id.
49. Id. at 81,914.
50. 74-1 U.S. Tax Cas. 83,869 (Ct. Cl. 1974).
51. In pursuance of a § 334(b) liquidation.
DeWitt realized some risks existed, once he donated the stock to the Academy, that he might not be able to repurchase the stock from the Academy. He acknowledged that the risk was small since there was little, if any, market for the stock . . . . The presence of this risk factor supports the view that a bona fide gift of stock was given. [Citations] The fact that DeWitt and the Academy may have expected and anticipated that the shares would be repurchased . . . does not invalidate the gift made. (Emphasis added.)

In effect, then, the court upheld the charitable bailout even though both parties, not merely the donor, “expected and anticipated” that the stock would be repurchased by the donor’s corporation. The court also referred to the “tentative planning” of the donors in Sheppard, Grove, Carrington, and Behrend, and noted that the redemptions in Behrend had been “contemplated.” The court said there was no basis for challenging the original gift of stock simply because “the donor made known to the donee the road he hoped to travel in the future,” and further observed:

The most that can be said under defendant’s version of the facts is that an understanding may have existed that the Academy anticipated an offer from DeWitt and DeWitt expected to repurchase the stock. However, such an understanding on the part of the donor and donee imposed obligations on neither and thus cannot be said to affect the validity of the gift. (Emphasis added.)

In conclusion the court repeated its view that “prearrangements, understandings or tentative planning between the involved parties which do not impose legal obligations on them” cannot do any tax harm in the charitable bailout situation.

This line of cases therefore indicates that the charitable bailout has great advantages to recommend it. If the donee is a public charity, there is still a full deduction available for gifts of appreciated property. It is a true bailout of corporate earnings and profits since

52. DeWitt v. United States, 1974-1 U.S. Tax Cas. 83,869 at 83,877n.6 (Ct. Cl. 1974).
53. Id. at 83,878.
54. Id. at 83,879.
55. Id. at 83,881.
56. Since this paper was written, the Tax Court has decided Daniel D. Palmer, 62 T.C. No. 75 (1974), following the jurisprudence cited herein and reaching the same result in favor of the taxpayer. Stock was given to a controlled foundation and redeemed by the corporation the following day. The Tax Court held that the foundation was not the alter ego of the donor, that it had dominion and control over the stock, and that there was no obligation to have the stock redeemed.
the donor's interest in the corporation is reduced minimally or not at all; if he owns 100% of the stock, then the gift and redemption leaves him with the same 100%, whereas if he owns 90%, he may suffer an inconsequential dilution—to 88.8%, for example, if he gave away 10%. Or in a family situation, if the donor is already in the process of transferring corporate control to the next generation, and if, for instance, the children already have 70% of the corporation, the donor by reducing his interest from 30% to 20% via the charitable bailout route, can boost the children's interest from 70% to 77.7% without paying a dime of gift taxes, while reducing his own taxable estate and generating a charitable income tax deduction.57

Although the Commissioner has yet to win one, not all circuits have been heard from, nor has the Supreme Court spoken on the issue. The Commissioner can be expected to continue to litigate, at least in flagrant cases, and the best approach for the tax planner may be to avoid what is flagrant.

It is clear that a formal binding agreement that the charity will submit the stock for redemption would be fatal, but how far the parties can go short of that is presently an open question. The buyback may be "planned" or "understood" in advance (Behrend), or it may be "expected" (Carrington), or it may be in view due to "fore-sight and planning" (Grove), or there may even be "prearrangements" and "understandings" (DeWitt). But it seems doubtful that the Grove court would have reached the result it did had it found the "understandings" that the Court of Claims approved in DeWitt; after all, an understanding is hardly distinguishable from an implied or informal agreement.

Looking at the cases with a detached eye, one must conclude that often the parties had a "deal" worked out in advance, whether described as a prearrangement, an expectation, or an understanding, and whether legally enforceable or not. Since such deals are often vulnerable in tax contexts,58 it is prudent to avoid anything resembling a deal, especially since such a precaution usually involves no practical difficulties.

Take the average close corporation. It is unlisted, it usually pays no dividends, it has no market. If the controlling stockholder gives a piece of it to his favorite charity, is there really any practical likelihood that the charity is going to run to the nearest brokerage house

to find a purchaser, or that the charity is going to refuse to sell if later approached by the corporation? It is hardly the kind of asset that a public charity will want to put in its permanent portfolio; it may be restricted in one way or another; it certainly is unmarketable and hence lacks liquidity; it probably pays no dividend; would not any charity be delighted to receive a respectable cash offer for it? Even in the unlikely event that some outsider made an offer for it, is the charity likely to run the risk of alienating its benefactor by selling stock in his family corporation to an outsider without first giving him a chance to bid? In short, if a charitable bailout is contemplated it seems much wiser to proceed ex parte so that the charity receives the gift quite out of the blue. By avoiding prior discussions altogether the taxpayer should be able to bypass the debate over whether such discussions amounted to foresight, planning, prearrangement, understandings, or agreements, without materially increasing the practical risks.

In considering the use of donation-redemption techniques, one should bear in mind two particular caveats. The first is that it is not feasible to donate stock to charity after the corporation has adopted a plan of liquidation under § 337 because the donor in such circumstances has been held taxable on the proceeds of liquidation when received by the charity, under the doctrine of anticipatory assignment of income. 5 The second is to avoid use of the donation-redemption method in a family situation. In Greenspan Trust v. United States 60 the court held that redemption of stock by a family corporation from trusts created by H and W for their children were taxable as dividends, though the corporation had donated the stock to the trust a full eight years earlier. Though such a result seems elementary under the attribution rules of § 318 and the Davis case, it is well to be reminded that a gift to children followed by a redemp-

---

5. Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1973); Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973). Cf. Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), declining to apply the assignment of income theory to an installment sale of stock to trusts for children after the adoption of a plan of liquidation. What the courts are saying, in effect, is that the countdown had started, the money is coming out, it was for practical purposes irreversible (even though in one case the donor no longer had the controlling stock interest). By contrast, in Behrend, Carrington, Grove and DeWitt, it could not be said that the countdown had irreversibly started. The distinction is between the taxpayer making a plan that he hopes to carry out, and the taxpayer actually pressing a button that sets those events irreversibly in motion.

60. 484 F.2d 462 (9th Cir. 1973), aff'd 326 F. Supp. 617 (C.D. Cal. 1971), incorrectly captioned by West as "Title Ins. & Trust Co. v. U.S."

tion, even if separated by many years and not prearranged, is not a feasible variant of the gift-bailout technique.\(^\text{62}\)

**Assignment of Income in Family Transactions**

Sometimes when funds are received by A, the Commissioner argues that their receipt gave rise to a tax upon B, particularly if A and B are in a family relationship or a stockholder-corporation relationship. The theory on which such a result is urged may vary and may be given different names, but the central question is who is taxable on the receipts.

One rationale may be the assignment-of-income theory, as in *Helvering v. Horst*,\(^\text{63}\) where bond interest coupons were transferred from father to son shortly before the due date and the Supreme Court held the interest, though received by the son, taxable to the father. That principle is well established and not really questioned: the income had already been earned before the transfer was made. Suppose the bond itself, rather than merely detached coupons, had been transferred from father to son shortly before the maturity date of the bond, and assume the donor’s cost basis was less than the redemption price. Surrender of the bond would then give rise to taxable income; would that income be taxed to the father or to the son?\(^\text{64}\)

The *Horst* case is clear enough, and hardly controversial today, but another Supreme Court decision of the same era has occasionally been misinterpreted because of its peculiar facts. That is *Commissioner v. Court Holding Co.*,\(^\text{65}\) which involved gain on the sale of real estate. The property was owned by a corporation, which conducted negotiations with a prospective purchaser. The parties had reached an understanding on the terms of the sale, and the facts showed an oral agreement existed, which of course was not enforceable with respect to real estate. The parties met to reduce the understanding to writing, whereupon the prospective purchaser was advised that the sale was being called off because of tax reasons. The next day the corporation distributed the property to its stockholders as a liquidating dividend, and the stockholders individually proceeded to consummate the previously contemplated sale. The Com-

---

\(^{62}\) Dividend treatment would not have been avoidable by having the trusts file a § 302(c)(2) agreement, because the attribution waiver thereby provided is limited to § 318(a)(1) attributions and does not extend to § 318(a)(2) attributions (which include trusts). Rev. Rul. 59-233, 1959-2 Cum. Bull. 106.

\(^{63}\) 311 U.S. 112 (1940).


\(^{65}\) 324 U.S. 331 (1945).
missioner successfully sought to tax the gain to the corporation, claiming that the stockholders were mere conduits.

The Supreme Court rendered a very short unanimous opinion, upholding the findings of the Tax Court inasmuch as "there was evidence" to support them. In response to the taxpayer's wail that its oral agreement was unenforceable, the Supreme Court said:

But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation.66

The Tax Court had also found that $1,000 had been paid to the corporation as part payment on the purchase price, and all the facts taken together showed that the stockholders were merely carrying out, as agents, an agreement made by the corporation. On the facts found by the Tax Court, the result seems justifiable, but the Court Holding case is sometimes cited for a proposition that goes beyond its holding, namely that if A negotiates for a sale and then transfers the property to B before any binding or consummatory acts are taken, and B concludes the sale, A will nevertheless be taxed on it. In Court Holding it was found as a fact that part of the purchase price had been received by the corporation and never returned. Had nothing been paid, and had the corporation merely announced to the prospective purchaser that it had decided to call the sale off for tax reasons, the subsequent liquidation and sale by the shareholders should not have given rise to tax liability by the corporation. Surely there is no law compelling a party to proceed with a contemplated transaction if he learns of its disadvantages in time to cancel it.

In United States v. Cumberland Public Service Co.67 a corporate liquidation followed by a sale by the stockholders was held taxable in accordance with its form. There had been some negotiations with the purchaser before the liquidation. First it was proposed to sell stock but the purchaser suggested a sale of assets instead. At that point, before there was any agreement, the format shifted and the parties agreed that the corporation would first liquidate and the stockholders would then sell the assets, which was done. The Commissioner, no doubt emboldened by his Supreme Court victory in Court Holding just five years before, urged the conduit theory again, but he failed because the trial court found as a fact that "at no time did the corporation plan to make the sale itself." The Supreme Court simply upheld the trial court's finding that the sale was indeed made

66. Id. at 334.
by the stockholders rather than the corporation, whereas the lower court in *Court Holding* had found that “the corporation never really abandoned its sale negotiations.” In short, the corporation in *Court Holding* did not really call it off and start over; the countdown was not stopped, but only interrupted briefly, and payment of part of the purchase price apparently confirmed its continuation.

Do mere negotiations start the countdown? Suppose A has a piece of property and says to B, “Are you interested in purchasing this property? If you are, we can discuss price but of course real estate contracts are not binding until written, and if we make an informal deal, I plan to give the property to my son and let him make the actual contract and receive the proceeds.” Is A starting a process that can never lead to the conclusion he seeks? Something very close to that situation took place in the Tax Court case of *Arnold Malkan*.88 The taxpayer father, in the course of a public offering of securities, transferred some of his stock to trusts for his children and other family members, and had the trusts contract with the underwriters. The court held that all the gains were realized by the taxpayer, none by the trusts.

As in *Court Holding*, the mechanics were not well handled. The father waited until the last possible moment to establish the trusts; he named himself trustee; the trusts were self-confected and most inartfully drawn; they had to be modified because of certain omissions, and were not finally reexecuted until the very day the registration statement became effective, only one day before the underwriting contract was signed. In light of the facts, the result is plausible, but some of the language used by the Tax Court is disquieting.

The court put the question as “who realized the gain, the four trusts or petitioner?”69 The taxpayer argued that since the trusts were executed before the underwriting agreement, the gain was realized by the trusts, but the court said the trusts were mere conduits and that all the sales were in substance those of the taxpayer himself. The court found that “the terms of the sale had been cast” before the trusts were established, saying:

Thus, prior to any transfer to the trusts petitioner had carried on negotiations and reached an understanding with the purchasers regarding the terms of the sale. [Citation.] All of these negotiations were handled by petitioner in his individual capacity and not as trustee; indeed, the trusts were not even in existence. (Emphasis added.)70

---

68. 54 T.C. 1305 (1970).
69. Id. at 1311.
70. Id. at 1313.
An opposite result was reached, on cleaner facts, in Martin v. Machiz, where the gain on a sale shortly after a transfer was held taxable to the transferee. Taxpayer, desiring to sell closely held stock, carried on negotiations with a prospective purchaser beginning in January 1960. On April 7 he established a charitable trust and transferred to it a portion of his stock; two days later a formal contract was entered into with the purchaser of the stock. The Commissioner unsuccessfully raised his conduit theory, arguing that the sale by the trust was in substance a sale by the taxpayer-grantor, who had negotiated the entire deal directly with the purchaser before the trust was created. But the court found that despite the negotiations, there was no commitment, even informal, to sell the stock for a specified price before the trust was created. The court further found specifically that on April 7, the date the trust was established, there were at least two areas of the transaction that had not been resolved with the purchaser, and that those unresolved matters were "substantial." Thus the court concluded, and found as a fact, that at the time the stock was transferred in trust "none of the parties thought there was a contract between them." Hence, the court said, "the substance of the transaction was precisely in accordance with its form.

When Martin v. Machiz was cited to the Tax Court in Malkan, it was distinguished not primarily on the ground that the Machiz court had found that the parties were still arguing over the terms of the sale at the time the trusts were set up, but on the ground that in Machiz the concept of the charitable trust originated independently of the sale of stock, whereas in Malkan the sale and the trusts were not independent but integral parts of a single plan. The Tax Court did observe that the Malkan trust had been executed "only after all of the sale had been agreed upon" which was not the case in Machiz, but more emphasis was placed on the relationship between the trusts and the sales. That seems to be a red herring. Suppose in those cases there had been no trusts, but rather outright gifts, to children in Malkan and to charity in Machiz. It is hard to see how that should change the results. The question in both cases was whether the taxpayer made a deal first and a transfer next, or a transfer first followed by a deal.

There are, of course, a number of cases in which a donor was held to have been in substance the seller, where the transfers did not take

72. Provisions concerning indemnities and the security to be provided therefor.
74. Id. at 390.
place until subsequent to the signing of some sort of contract or memorandum by the donor with the third-party purchaser. For instance, in *Susie Salvatore* a widow executed on July 24 a written agreement with Texaco to sell her gas station. On August 28 the widow conveyed a one-half interest in the property to her five children, and thereafter everybody sold out to Texaco. The court held that the widow had made an anticipatory assignment to her children of half the income from the sale of the property, since she had already contracted to sell it to Texaco before making the transfers to the children, and she could therefore be taxed on the entire gain.

Similarly, in *Harry C. Usher* there was signed on January 28 a “Memorandum of Understanding” whereby taxpayer’s wife Myrtis agreed to sell her stock in Sarong Inc. to an outside purchaser, and on February 9 she transferred the same stock to a trust for her children subject to a private annuity. The court held that the “Memorandum of Understanding” was a binding contract, and since the trust was not free to do anything but convey the stock in accordance with that agreement, the trust “must be considered as a mere conduit to carry out the sale for [the grantor] and apply the proceeds according to her direction.”

The line of cases exemplified by *Salvatore* and *Usher* presents little difficulty, because we can readily accept the idea that a binding contract cannot be assigned without adverse tax consequences. Situations like *Malkan* and *Machiz* lie in the gray area involving an informal and unenforceable agreement, not consummated even in part, followed by a transfer. The question is whether the gain should be attributed to the transferor.

Obviously, from a tax planning standpoint, no one wants to test

---

77. Accord, John E. Palmer, 44 T.C. 92 (1963), aff’d per curiam, 354 F.2d 974 (1st Cir. 1965).
78. 45 T.C. 205 (1965).
79. *Id.* at 216. Compare the noble endeavor attempted by the taxpayer in *James M. Hallowell*, 56 T.C. 600 (1971). He had some appreciated IBM stock, which if sold would have given rise to considerable capital gain. His family corporation, however, had substantial NOL carryovers, and he held some old demand notes of the corporation. He conceived the bold idea of turning over the IBM stock to the corporation as contributed capital (no tax consequences), having the corporation sell the stock (gains offset by NOL carryovers), and use part of the proceeds to pay off his notes (no tax consequences). Had the plan succeeded the taxpayer would have reduced his appreciated IBM stock to cash without paying any taxes. The court held the gains attributable to the taxpayer-transferor. But as Paoli the Corsican used to say to Boswell, quoting Ovid, “Magnis tamen excidit ausis”—it was however in a great venture that he failed.
the grayness of the gray area, and it is certainly better to start nowhere down the road to sale before disposing of property.\textsuperscript{80} Moreover, it seems reasonably clear that mere ex parte preplanning should not be dangerous. For example, if \textit{A} decides to dispose of some stock, there is nothing to prevent him from first deciding to dispose and then deciding that rather than sell the stock he will give it to his children or a foundation and have the transferee sell. The transaction is conceived as a disposition, and \textit{A} may think of the donee as a conduit, but if it is carefully executed there should be no tax difficulties. The gift should be made first, should comply with all formal requirements, and then only after the gift is completed should someone acting on behalf of the donee\textsuperscript{81} give the appropriate sale instructions. Such a procedure is quite customary when dealing with listed stock. If close corporation stock is involved, the gray area is likely to reappear because it may be difficult or undesirable for the owner to make the transfers before embarking on any negotiations, and the \textit{Malkan} case waves a very bright red flag. Nevertheless, \textit{Malkan} does not hold that any prior negotiations at all will cause the sale to be attributed to the transferor, and \textit{Machiz} indicates that considerable prior negotiations can take place as long as there are at least some open questions at the time the property is given away. In addition to leaving some sale terms unresolved, another precaution might be to condition the negotiations explicitly on completion of the contemplated gift. The court in \textit{Malkan} implied that would have helped the taxpayer's case.\textsuperscript{82}

The jurisprudence will no doubt develop on lines primarily factual, as the courts are called upon to make case-by-case determinations. Practitioners should have the existing guidelines in mind, and advise caution.

\textsuperscript{80} Concerning transfers in the course of corporate liquidations, see note 58 and supporting text supra.

\textsuperscript{81} There is no reason why it cannot be \textit{A} himself if properly authorized.

\textsuperscript{82} Arnold Malkan, 54 T.C. 1305, 1315 (1970).