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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT:

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LEGEND

Partnership =

Donors	=	
Sons	=	
Charity 2	=	
Charity 3	=	
Date 1	=	
Date 2	=	
x	=	

ISSUES

1. Whether a formula clause that allocates additional value to a charitable donee in the event the value of the transferred property is redetermined for federal transfer tax purposes will be respected for federal transfer tax purposes?

2. Whether the amount of a transfer may be reduced by the actuarial value of the estate taxes attributable to the potential section 2035(c) inclusion in the donors' gross estates?

CONCLUSIONS

1. The formula clause should not be given effect for federal tax purposes.

2. The amount of the gift may not be reduced by the actuarial value of the potential estate taxes because the fact of inclusion and the amount of any estate tax attributable thereto is too speculative.

FACTS

On Date 1, Donors and Sons formed Partnership. Donors transferred roughly $ x in assets to Partnership in exchange for approximately percent of the Class limited partnership interest. Sons transferred roughly $ x in assets in exchange for the general partnership interest and the remaining percent of the Class Interest. The terms of the Partnership agreement required the unanimous consent of the partners for the admission of an assignee of a partnership interest as a new partner, and permitted Partnership to redeem certain assignee interests held by charities at fair market value.

On Date 2, Donors transferred their entire Class interest to Sons, certain trusts for the benefit of Sons, and Charity 2 and Charity 3. Sons agreed to assume liability for the payment of any transfer taxes imposed on Donors as a result of the transfer. The transferred interest was to be divided among the transferees according to a formula that allocated the partnership interests among the donees based on value. The first $ x of value was allocated to Sons and their trusts, the next $ x of value was allocated to Charity 2 and all remaining value was allocated to Charity 3. As a result of the allocation, Sons and their trusts received a percent Class interest, Charity 2 received a percent interest and Charity 3 received a percent interest. No negotiation occurred between Sons and Charities 2 or 3 regarding the accuracy of the appraisal upon which the allocation was based.

Approximately six months later Sons redeemed Charity 2's and Charity 3's interests. Based on a second appraisal, Charity 2 received roughly $ x and Charity 3 received roughly $ x. Charity 2 and Charity 3 each executed a release acknowledging payment in full and releasing Partnership "of any and all obligations, including, but not limited to (1) any and all obligations pursuant to the call agreement and (2) any and all obligations pursuant to the [Partnership agreement] . . . "

On examination, the Commissioner determined that the value of the transferred interest was roughly $ x. Donors argued that in the event the Commissioner's determination is sustained, under the formula clause, any value in excess of $ x will pass to Charily 3, with the result that any valuation adjustment will be offset by an increased charitable deduction. This litigation followed.

LAW AND ANALYSIS

INTRODUCTION

Section 2511(a) of the Internal Revenue Code provides that the gift tax imposed by section 2501 applies to transfers in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Treas. Reg. § 25.2511-1(c)(1) provides that the gift tax applies to any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed. Treas. Reg. § 25.2511-1(h)(1) provides that a gift to a corporation is a gift from the donor to the stockholders of the corporation to the extent the gift exceeds the donor's interest in the corporation as a shareholder.

The legislative history accompanying the Revenue Act of 1932, which enacted the gift tax, provides, in pertinent part, that:

> The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense: [sic] the term "property" reaching every species of right or interest protected by law and having an exchangeable value.

> The words “transfer * * * by gift” and “whether * * * direct or indirect” are designed to cover and comprehend all transactions . . . that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.

H. Rep. No. 708, 72nd Cong., 1st Sess. (1932) 27-28, 1939-1 C.B. (Part 2) 457, 476-477.
“This legislative history reflects a clear intent on the part of Congress to apply the gift tax “in the broadest and most comprehensive sense.” Griswold v. Commissioner, 81 T.C. 141 (1983).

Taxpayers generally are free to structure a business transaction as they please, even if motivated by tax avoidance considerations. Gregory v. Helvering, 293 U.S. 465, 469 (1935). However, the tax effects of a particular transaction are governed by the substance of the transaction rather than its form. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). The simple expedient of drawing up papers does not control for tax purposes when the objective economic realities are to the contrary. Commissioner v. Tower, 327 U.S. 280, 291 (1946). "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939). The doctrine that the substance of a transaction will prevail over its form is applied in federal estate and gift tax cases. Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991)(transfer to third party who then retransferred to son was in substance a transfer to son); Kerr v. Commissioner, 113 T.C. 449, 463-68 (1999)(assignment of partnership interest was in substance a transfer of a partnership interest, as opposed to an assignee interest); Griffin v. United States, 42 F.Supp.2d 700 (WD Tex. 1999) (transfer to spouse who retransferred to child was in substance a transfer to child); Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (a transfer to daughter-in-law who retransferred to son was in substance a transfer to son); Sather v. Commissioner, T.C. Memo. 1999-29 (a transfer to brother’s children with the understanding that brother would make similar transfers to donor’s children was in substance a transfer from donor to his own children); Shepherd v. Commissioner. 115 T.C. No. 30 (October 26, 2000)(a transfer to a partnership was in substance a transfer to individual partners); Treas. Reg. § 25.2511-1(h)(1) (a gift to a corporation is in substance a gift to the shareholders).

Here, the formation of the partnership, the transfer to Sons and to charity, and the redemption of the charitable interest was in substance a single integrated transaction the effect of which was to transfer a percent Class interest to the Sons. Petitioners and Sons were at all times in control of the transaction, and after the transaction, Sons were in control of the transferred interest. There is no evidence of any arm’s-length negotiations with charity; the transactional documents were accepted by charity as presented. Indeed, the sole purpose of the presence of Charity 3 was to imbue the appraisals, which were an integral part of the donative plan, with the patina of third-party reliance. Any additional transfer to charity under the formula clause was illusory, and charity acknowledged as much when it signed the release. Charity 3 has received all that it was ever intended to receive. Accordingly, the transaction is appropriately treated as the transfer of a percent Class interest to the Sons.

ISSUE 1

1.(a) THE CHARITABLE DEDUCTION

As noted above, petitioners argue that in the event the Commissioner's determination is sustained, under the formula clause, any increased value will pass to Charily 3, and thus be eligible for a charitable deduction.

The gift tax is supplementary to the estate tax; and the provisions of the gift tax statute and those of the estate tax statute are in pari materia, and must be construed together. Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939). Thus, judicial authorities and administrative practice pertaining to the adequacy of charitable gifts within the ambit of one statute may be considered in connection with charitable gifts falling within the ambit of the other.

The purpose of Congress in providing deductions for charitable gifts was to encourage gifts for charitable purposes; and in order to make such purpose effective, there must be a reasonable probability that the charity actually will receive the use and benefit of the gift. In Commissioner v. Sternberger's Estate, 348 U.S. 187 (1955), the Supreme Court, in dealing with a charitable testamentary gift noted:

> The predecessor of section 81.46 [of the Estate Tax Regulations under the 1939 Code] confined charitable deductions to outright, unconditional bequests to charity. It expressly excluded deductions for charitable bequests that were subject to conditions, either precedent or subsequent. While it encouraged assured bequests to charity, it offered no deductions for bequests that might never reach charity. Subsequent amendments have clarified and not changed that principle. Section 81.46(a) today yields to no condition unless the possibility that charity will not take is "negligible" or "highly improbable."

Commissioner v. Sternberger's Estate, 348 U.S. at 233.

Treas. Reg. § 25.2522(c)-3(b)(1) provides that if, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity on the date of the gift and the estate or interest would be defeated by the performance of some act or the happening of some event, the possibility of occurrence of which appeared on such date to be so remote as to be negligible, the deduction is allowable. If the donee or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so given by the donor, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

Treas. Reg. § 25.2522(c)-3(b)(2), Example (1) describes a situation in which A transfers certain property in trust in which charity is to receive the income for his life. The assets placed in trust by the donor consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family. The trustees of the trust and the remainderman are members of the donor’s family and the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. The example concludes that no deduction will be allowed. Similarly, if the trustees are not members of the donor’s family but have no power to sell or otherwise dispose of the closely-held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, the example concludes that no deduction will be allowed.

In several cases arising under the gift tax and estate tax laws, charitable gifts of trust income or trust corpus have been denied a deduction, where the courts have found it to be uncertain that the charity will receive anything. Such uncertainties have arisen in various ways. In Mason v. Commissioner, 46 B.T.A. 682 (1942), the trust instrument provided that the net income of the trust should be paid to a charity for the life of the settlor, but the corpus of the trust consisted of insurance policies that might or might not generate any income. The court held that, in such circumstance, no charitable deduction was allowable. In Commissioner v. Sternberger's Estate, 348 U.S. 187, the Supreme Court denied a deduction for a remainder to charity, which was contingent upon the death of a woman aged 27 without issue. The reason for the denial was that there was no reliable method for determining whether the contingency would occur. The Court explained its holding, in part as follows:

> This Court finds no statutory authority for the deduction from a gross estate of any percentage of a conditional bequest to charity where there is no assurance that charity will receive the bequest or some determinable part of it. Where the amount of a bequest to charity has not been determinable, the deduction properly has been denied.

Commissioner v. Sternberger's Estate, 348 U.S. at 235-36. To the same effect, see Humes v. United States, 276 U.S. 487(1928). Likewise, in Norris v. Commissioner, 134 F. 2d 796 (7th Cir. 1943), the Seventh Circuit denied a charitable deduction on the principal ground that the testamentary trustees had sole and absolute "discretion and option" to name the charities that would receive funds and the amount that each charity would receive. Similarly, in First Trust Co. of St. Paul v. Reynolds, 137 F. 2d 518 (8th Cir. 1943), the Eighth Circuit denied a deduction for a bequest to charity where the decedent's will contained a provision that the bequest was to become effective only if his surviving spouse gave her consent thereto in writing. See also Hamm v. Commissioner, T.C. Memo. 1961-347, aff'd, 325 F.2d 934 (8th Cir. 1963), in which the court denied a charitable deduction due to the improbability that anything would ever reach charity.

Analogous cases, which do not involve charitable deductions, address the question of whether the amount of a gift may be reduced by the amount of the donor's reserved income or reversionary interest, where there is uncertainty as to whether the reserved interest will ever yield any benefit. See Robinette v. Helvering, 318 U.S. 184 (1946)(amount of gift held not reduced by a reversionary interest dependent upon a contingency, the occurrence of which it was impossible to forecast). See also Herzog v. Commissioner, 116 F. 2d 591 (2nd Cir. 1941), and Deal v. Commissioner, 29 T.C. 730 (1958), (both denying a reduction from total gifts for the donors' retained income interests, where the trustees had sole discretion as to what amounts would be paid over to the donors).

In the subject case the conclusion is inescapable that, both as of the date of the gift and today, Charity 3 would not receive any additional value should the Commissioner successfully determine that the value transferred was greater than that reported. Initially, we note that, as of the date of the gift, the partnership agreement precluded the receipt of any additional partnership interest in Charity 3 in the event that Charity 3 disagreed as to the amount that Partnership would pay to redeem its interest. The partnership provisions which permit a redeemed charity to contest the value assigned to its interest do not control those relating to the reallocation of partnership interests, which apply only to partners. There is no evidence that Charity 3 was ever admitted as a partner. Thus, even as of the date of the gift, Charity 3 had no right to anything other than the cash it actually received.

Moreover, under petitioners' own documents nothing further can pass to charity. Nothing in the Partnership agreement or the releases provides a mechanism for Charity 3 to obtain any additional consideration for its redeemed interest in the event the value of the transferred interest is redetermined. Charity 3 has released the Partnership "of any and all obligations, including, but not limited to (1) any and all obligations pursuant to the call agreement and (2) any and all obligations pursuant to the [Partnership agreement] . . . " Neither Charity 3, Partnership, Sons, or Son's trusts are parties to this proceeding and thus, would not be bound by the findings of the court. Indeed, petitioners have now admitted that Charity 3 cannot now obtain any additional payment. Accordingly, no further charitable deduction is allowable.

1.(b) THE FORMULA CLAUSE

The courts have refused to respect clauses designed primarily to defeat the gift tax as violative of public policy. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), the taxpayer transferred property in trust for the benefit of his children. The trust instrument provided that, if any court determined that a portion of the transfer was taxable, then that portion of the property would revert to the donor. The Fourth Circuit, in refusing to respect this adjustment provision, concluded that such a condition subsequent was void because it was contrary to public policy. See also Ward v. Commissioner, 87 T.C. 78 (1986); Estate of McLendon v. Commissioner, T.C. Memo 1993-459, rev'd. on other grounds, 77 F.3d 477 (5th Cir. 1995). In these cases, courts have found savings clauses to be against public policy because officials would be discouraged from attempting to collect the tax where the only effect would be to defeat the gift. Moreover, giving effect to the savings provision would obstruct the administration of justice by requiring the court to address a moot case.

Though Procter involved a savings clause as opposed to a formula clause, the principles of Procter are applicable to this case. If formula clauses like the one at issue actually function to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they recharacterize the transaction in a manner that would render any adjustment nontaxable. A valuation increase resulting from an examination would serve only to increase the charitable deduction, but would not otherwise generate any gift tax deficiency. Moreover, the adjustment would substantiate a claim for an increase in the income tax charitable deduction claimed by the donor. The sole justification for the Commissioner's examination would be to insure that charity received all that it was entitled to under the transfer documents. This would place federal tax administrators in the position of policing charitable transactions, a role more appropriately performed by the states' attorneys general.

The Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 827 (1997), amended sections 2001, 6501(c)(9) and 7477 of the Code, so that gifts reported on a return may not be revalued for either gift or estate tax purposes after the expiration of the gift tax statute of limitations. Returns subject to the Act must now be examined currently, and no longer may be examined as part of the estate tax examination. Fair administration of the gift tax will become even more difficult If formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect. While the subject case is admittedly not governed by the 1997 changes, giving effect to the formula clause here will serve as precedent that will govern the administration of gift tax returns that are subject to the 1997 legislation.

ISSUE 2

2.(a) 2035(c) DISCOUNT

As a condition of receiving the gift, Sons agreed to assume liability for the payment of any transfer taxes imposed on Donors as a result of the transfer. Section 2035(b) (formerly section 2035(c)) includes in the gross estate the amount of any gift tax paid on transfers made within three years of death. In light of the Sons' potential liability in the event that the Donors died within three years of the transfer, petitioners discounted the value of the gift by the actuarial value of the potential estate tax liability.

In Harrison v. Commissioner, 17 T.C. 1350, 1355 (1952) the court held that the obligation to pay income tax where the imposition of the tax was a certainty, although the amount was uncertain but estimable, could reduce the amount of the gift.

In Rev. Rul. 75-72, 1975-1 CB 310, the Service held that gift tax attributable to the transfer of property may be deducted from the value of that property in arriving at the amount of the gift where it is shown, expressly or by implication from the circumstances surrounding the transfer, that the donor attached payment of the tax by the donee (or out of the transferred property) as a condition of the transfer. Thus, if at the time of the transfer, the gift is made subject to a condition that the gift tax be paid by the donee or out of the transferred property, the donor receives consideration for the transfer in the amount of gift tax to be paid by the donee. Under these circumstances, the value of the gift is measured by the fair market value of the property passing from the donor, minus the amount of the gift tax to be paid by the donee.

In Ripley v. Commissioner, 105 T.C. 358, 367 (1995), rev'd on other grounds, 103 F.3d 332 (4th Cir. 1996), the taxpayers, who had been recipients of a gift of real property, contested their liability as transferees for unpaid gift taxes. The taxpayers argued that the amount of the gift should be reduced by the amount of gift tax they would be required to pay. The Tax Court rejected their reasoning, holding that there was no such encumbrance on the property when it was transferred. The taxpayers' liabilities as transferees did not arise until the donor failed to pay the gift tax. Even though the Code placed a lien on the transferred property in the event the gift tax was not paid, the lien was not an encumbrance that reduced the value of the gift. The court concluded that, "[d]onee liability in contrast [to an encumbrance such as a mortgage] does not reduce the value of property when given, and should not be taken into account when valuing a gift." Id. at 368.

In Frank Armstrong Jr. Trust v. United States, 87 AFTR2d ¶ 2001-447 (WD Va. 2001), the donor gifted stock to his heirs. The heirs assumed liability for any estate tax obligations flowing from the inclusion of the gift tax in the donor's gross estate. The heirs claimed that the possibility of death within three years, with the attendant 2035(c) liability, reduced the value of the transfer. The court rejected this argument, holding that any potential estate tax liability was entirely speculative at the time of the transfers and not subject to any reasonable calculable estimation.

Thus, if a tax liability is a certainty, it may be appropriately taken into account in determining the amount of the gift. Harrison v. Commissioner, 17 T.C. 1350; Rev. Rul. 75-72. On the other hand, where the liability is contingent, the burden is on the taxpayer to demonstrate the fact and amount of the reduction. In Robinette v. Helvering, 318 U.S. 184 (1943) where the court held that the amount of a gift could not be reduced by a contingent reversion, the court said:

> Actuarial science may have made great strides in appraising the value of that which seems to be unappraisable, but we have no reason to believe from this record that even the actuarial art could do more than guess at the value in question.

Robinette v. Helvering, 318 U.S., at 188. Here, petitioners' discount is based upon the possibility that Sons will have to pay a portion of Donors' estate tax. These are the facts of Armstrong. As in Armstrong, there is no way of knowing if the Donors will have a taxable estate and, if so, at what rate it will be taxable. Further, any estate tax payment is contingent on Donors' death within three years of the gifts. If donors survived (and indeed they have) no estate tax would be payable. Petitioners are claiming a reduction from the amount of the gift for an amount which, viewed as of the date of the gift, was contingent and may never be paid, and viewed currently, will never be paid. As was the case in Commissioner v. Sternberger's Estate, 348 U.S. 187, any reduction should be limited to non-contingent amounts that, viewed as of the date of the gift, will actually be paid. Accordingly, the potential estate tax liability is too speculative to be taken into account for purposes of valuing the transferred interests.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call if you have any further questions.

By:JOHN D. MacEACHEN
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