Storm Warning: IRS Challenges Potential Prearranged Sale

BY RUSS WILLIS

The IRS briefing on cross-motions for summary judgment in the recent *Dickinson*[1] case may portend closer scrutiny of prearrangements in the disposition of noncash charitable contributions. Let's examine the legal history that has led to this case.

The tax code provides a rather strong incentive for contributions of appreciated property to exempt organizations other than nonoperating private foundations. A deduction is allowed at fair market value, offsetting ordinary income, even though the transferor does not recognize long-term gain. Yes, the deduction is subject to a lower percentage limitation, but with the five-year carryforward, in most cases this is merely a timing issue.

If the transfer is to a charitable remainder trust in which the transferor retains an income interest, the gain is recognized, but it is spread out in the manner of an installment sale. Similarly, if the property is transferred in exchange for a gift annuity, that portion of the gain allocated to the exchange element is spread out over the transferor's table life expectancy.

Russ Willis

With an outright gift, even to a donor advised fund over which the transferor retains a right to recommend grants, there is no gain recognition at all. Whether this is good tax policy is a conversation for another day. But now let us introduce a complicating factor.

See STORM WARNING: Page 8

Prearrangement

Typically, the recipient organization will want to sell the contributed property almost immediately, to diversify its investment portfolio. If there is not a ready market, the organization will want an exit plan mapped out before accepting.

In the case of stock in a closely held corporation, or an interest in a partnership or a limited liability company, often the exit plan will be a redemption. In the case of real property, there might be a ready buyer "in the wings."

The reader might not be familiar with the precise details of the 1974 Tax Court decision in *Palmer*,[2] or with a 1978 revenue ruling[3] acquiescing in the result. However, most gift planners have at least a general sense that if an exempt organization accepts a contribution of appreciated property and immediately sells it to a buyer who was already lined up when the gift was made, the IRS may try to recharacterize the transaction as a sale on which the transferor incurs capital gains tax, followed by a contribution of the proceeds. The very thing she was trying to avoid.

The question will be whether the prearrangement was enforceable, and if so by whom. In *Palmer*, the Tax Court focused on whether at the time of the gift the transferor already had an enforceable right to proceeds of a pending stock redemption. Whether, in other words, the transfer was effectively an assignment of income.

One could quarrel with the result in *Palmer*. The taxpayer had contributed a controlling interest in a closely held corporation to a private foundation he also controlled, which was then able to force the anticipated redemption. Or, as the court noted, to prevent it.

The court accepted that the taxpayer in his role as foundation manager had acted consistently with his fiduciary responsibilities in approving the redemption. The IRS could not expect an appeals court to disturb this finding and withdrew its cross appeal.

Reversing Figure and Ground

With Rev. Rul. 78-197, the IRS acquiesced in the result in *Palmer*, but shifted the focus from whether the transferor had an enforceable right to proceeds to whether the recipient organization had accepted the stock subject to an existing obligation to tender it for redemption. If not, the ruling said, the IRS would not seek to recharacterize the transaction.

And of course, the ruling is widely understood to apply to nominally unenforceable prearrangements well outside the immediate context of stock redemptions. It is only a slight exaggeration to say that an entire industry has been built on this ruling.

More than once, the Tax Court has said it has not adopted the logic of the revenue ruling. On the other hand, the court has treated the revenue ruling as a concession on the part of the IRS, which it cannot disavow in litigation.

Thus, for example in *Rauenhorst*,[4] a reviewed decision in 2002, the court said the agency would not be heard to argue that the anticipated purchase of contributed stock by a third party was already a "practical certainty" at the time the contribution was made, because this would entail disavowing the "bright-line" test it had articulated in the revenue ruling, on which the court said taxpayers are entitled to rely.

In support of its argument, the Commissioner had cited two appeals court opinions, each affirming a decision of the Tax Court itself, adverse to the taxpayer, but in each case on somewhat different grounds.

In its 1982 opinion in *Blake*,[5] the 2nd U.S. Circuit Court of Appeals suggested that the 1978 revenue ruling had conceded too much, saying it should be sufficient that there is an understanding between the parties, on which the transferor can reasonably rely. The 9th Circuit in its 1999 opinion in *Ferguson*[6] took this a step further. This court held that the proceeds should be taxed to the transferor if at the time of the transfer the tender offer and merger were "practically certain to proceed," despite the need in the particular case to waive certain emergent contingencies.[7]

In each case, however, these statements were "dicta," that is, they were not necessary to the appeals court's ruling, because in each case the court had already determined that the recipient organization had in fact accepted the contributed property subject to an existing obligation to sell.[8]

Promissory Estoppel

One might think these are two sides of the same coin. A contract enforceable by one party should be enforceable by the other. But not every contract arises through a formal process of offer and acceptance. Sometimes it is the performance by one party in response to an offer that creates the obligation.

This is what happened in *Blake*. The Tax Court determined, and the appeals agreed, that the recipient organization had undertaken an obligation under equitable principles of promissory estoppel, to tender the contributed stock for redemption and to use the proceeds to purchase a yacht from the taxpayer at a price well in excess of its fair market value. The contribution, in other words, was conditioned on that understanding and would not otherwise have been made.

Of course, not every scenario is quite as transparent. For an interest in a closely held entity, it may well be that the transfer to the exempt organization is conditioned, at least impliedly, on an expectation that the organization will tender the contributed interest for redemption, without the necessity of a formal call. And the organization will be glad to be rid of it, as it usually will be a minority or nonvoting position, with passthroughs taxed as UBTI.

So, What About *Dickinson*?

Which brings us finally to *Dickinson*. On the surface, this case is the typical situation in which the taxpayer contributes highly appreciated stock in a closely held corporation to a donor advised fund. The fund sponsor, Fidelity Charitable, then almost immediately tenders for redemption. Informal prearrangement, yes; enforceability, maybe not.

And you might think, *Rauenhorst*. Revoke or modify the revenue ruling or go home. It is not as simple as that. The IRS wanted to build a case that Fidelity had in fact received the stock subject to an existing, enforceable obligation to tender it for redemption, even though there had been no formal call.

You might not quite gather that from the text of the opinion but it is clear from the briefing on the cross motions for summary judgment on which the case was decided.[9] What we find in the agency's brief in support of its motion is an argument that …

(a) the shareholders' agreement restricted ownership of stock to a handful of select, full-time employees;[10] therefore,

(b) a transfer of stock to Fidelity would require consent of the board of directors, which would likely be conditional on a prompt redemption;

(c) the board had also reserved a unilateral right to call the stock of any shareholder; and crucially,

(d) the transaction at issue was one of a series of similar transactions engaged in by several shareholders under blanket consents given by the board.

There was an express understanding that Fidelity would implement its own policy "to immediately liquidate the donated stock [by] promptly tender[ing it] to the issuer for cash" without the necessity of a formal call. This understanding enabled the board to consider the arrangement "consistent with the prompt repurchase of shares following a transfer by the shareholder, consistent with [the shareholders' agreement]."

Arguably a condition, in other words, somewhat analogous to the situation in *Blake*. That is to say, the board might not have approved the transfers had it not been assured that Fidelity would immediately tender the stock for redemption.

What happened here might almost be seen as some kind of incentivized stock buyback. On a more fully developed record, it might even have emerged that the buyback was leveraged. However, the taxpayer filed its motion for summary judgment while informal discovery was still in its early stages, and the commissioner did not have an opportunity to develop these facts.

Summary judgment may have been premature here, in other words, and it is possible an appeals court might remand to allow further discovery. The taxpayer had already been arguing that the commissioner was slow in launching discovery and has only himself to blame.

At this writing, it remains to be seen whether the IRS will take an appeal but it does appear we might be seeing early signs of an emerging policy at the IRS to challenge more of these transactions as prearranged.

STORM WARNING *continued from Page 9*

Endnotes

1 *Dickinson v. Commissioner*, T.C.Memo. 2020-128 (09/03/20).

2 *Palmer v. Commissioner*, 62 T.C. 684, aff'd on other grounds, 523 F.2d 1308 (8th Cir. 1975).

3 Rev. Rul. 78-197, 1978-1 C.B. 83.

4 *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

5 *Blake v. Commissioner*, 697 F.2d 473 (2d Cir. 1982), aff'g T.C.Memo. 1981-579.

6 *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997).

7 The Tax Court itself has embraced the idea that there may be an assignment of income if the anticipated acquisition is "virtually certain" to occur. See, e.g., *Chrem v. Commissioner*, T.C.Memo. 2018-164. That case was ultimately closed on a stipulation somewhat favorable to the taxpayer.

8 Note that in *Blake*, the Tax Court had stopped short of finding an enforceable prearrangement, instead ruling that the purported gift was conditional and therefore incomplete.

9 The author has posted copies of all four briefs to the landing page for his newsletter, at https://www.plannedgiftdesign.com/jack-straw-fort-nightly.html

10 While the shareholder agreement did allow for the transfer of stock to a trust or other entity "for estate planning purposes," the individual shareholder would be required to retain the voting rights, which of course did not occur here and would have been a nonqualified partial interest if it had.