Developments Involving Certain Transactions for Tax Advantage

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DEVELOPMENTS INVOLVING CERTAIN TRANSACTIONS FOR TAX ADVANTAGE

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A number of recent developments have occurred in the federal tax law affecting commonplace transactions intended to save income and/or estate taxes or transactions in which the parties may control the form and thereby possibly the tax result. This brief discussion deals with several such developments and the hazards they may involve.

Until an amendment of the Internal Revenue Code by the 1950 Revenue Act, few, if any, absolute transfers were assured of exclusion from a decedent's taxable estate, however excellent his health or cheerful outlook on the date of the gift or the length of time before his death. There was always the specter of contemplation of death reinforced by the legal presumption of the correctness of the commissioner's determination. If at the time of the transfer the donor made a will, took out life insurance or was a devotee of the obituary column, or in any way manifested an interest in death, the catch-all of contemplation of death might be an issue to confront his legal representatives. But now, with respect to estates of decedents dying after September 23, 1950, Section 811 (1) of the Code provides that: "If the decedent within a period of three years ending with the date of his death (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) transferred an interest in property, relinquished a power, or exercised or released a power of appointment, such transfer, relinquishment, exercise, or release shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of subsections (c), (d), and (f); but no such transfer, relinquishment, exercise, or release made prior to such three-year period shall be deemed or held to have been made in contemplation of death".

The three year rebuttable presumption against an estate replaces the similar two year presumption previously provided. Entirely new however, is what appears to amount to conclusive presumption that a gift made more than three years prior to a decedent's death is not in contemplation of death. If this provision is held to mean what it says, which perhaps would be a risky assumption, property transferred as a gift without any strings attached and otherwise complete

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to escape the estate tax should be excluded from a donor's taxable estate however abhorrent to the commissioner may be the motive for the gift, provided only that the donor can manage to keep alive for three years. Hence, it would seem that even the aged and infirm could, in anticipation of possible imminent death and solely with a motive to avoid estate taxes, dispose of their estates with the saving of estate taxes contingent only upon the ability to survive for the required period.

But before hurrying to sign away his property for an expected estate tax benefit, and while recognizing that time is of the essence, a donor especially if his health or age is against him would do well to consider the basis provisions in the income tax law. In some circumstances the effect of these rules could turn a gift into a tax loss instead of a savings.

Generally understood is the rule that a donee acquiring property by gift (after 1920) takes the donor's basis except in cases of loss incurred by the donee, where then the donee's basis is that of the donor or the fair market value of the property at the date of the gift, whichever is lower. Whereas a beneficiary acquiring property by inheritance or devise as a general rule takes as basis the fair market value of the property at decedent's death (or at the optional valuation date if used for the estate tax). But no doubt less familiar is what appears to be the law that the basis of a donee remains the same as above stated even though the property acquired by gift should be included in a donor's taxable estate and subjected to an estate tax on its value at the donor's death because made in contemplation of death. *Rose M. Everett,* 1945 P-H T. C. M. 45,154; 3 Mertens Law of Federal Income Taxation 407. Accordingly, where property has a low basis and has appreciated in value, its acquisition by beneficiaries at the owner's death would give them a stepped-up basis for gain, depreciation or loss at the cost of an estate tax. Weighing the income tax benefit resulting from an increased basis at death, especially in the case of property subject to depreciation allowance, a transfer by gift may result in a tax loss rather than a benefit. And in the painful event that property which has been transferred by gift is also included in the donor's taxable estate at death because made in contemplation of death the value in excess of donee's basis is subjected to a double tax. An estate tax is paid on this value which is also taxed later as income to the donee in the event of a subsequent sale. And for depreciation allowances, the donee also fails to get a stepped-up basis to compensate for the estate tax on the increased value. On the other hand if property has diminished or is expected to diminish substantially in value and below the donor's cost or other basis, a gift would preserve the high basis for the donee at least for gain or depreciation.

Where the saving of income taxes to the donor also prompts the gift, the commissioner, of course, is ever on the alert to preserve the revenue from that angle. In trying to prevent the shifting of income for a tax advantage, he has come up with a different method of attack in ruling that where a donor makes a gift of property which he has raised for sale he thereby, in making the gift, realizes taxable income to the extent of the fair market value of the property at the time of the gift. In I. T. 3910 it was ruled that the fair market value of agricultural products contributed by a farmer to an exempt organization is includible in the gross income of the donor. The ruling states that "it is believed that the satisfaction derived from a contribution of such property to an organization described in Section 23(o) or Section 23(q) of the Code results in the enjoyment of income". Later the same rule was applied to a bona fide gift from father to son of cattle raised and held for sale. I. T. 3932. A sale was made by the son about eight months following the gift. The fair market value at the time of the gift was held to have been realized as taxable income by the donor, and the donee to take such value as his basis which is deemed a required adjustment of the usual basis of a donee. The ruling states: "Inasmuch as the father made a valid gift of cattle which he raised for the production of income, the father realized income by such disposition, and he may not escape taxation thereon merely by reason of the fact that he derived a benefit by means of a gift rather than by sale or exchange . . . . . Accordingly, it is held that the fair market value of the cattle on the date of the gift is includible in the father's gross income for the taxable year in which the gift was made". Carrying this idea further, in *Estate of W. J. Farrier*, 15 T. C. 277, the commissioner, while unsuccessful, attempted to apply this rule even though no subsequent sale had been made by the donee and, as the court found, there was no evidence or contention that at the time of the gift there was any contract for sale or any thought of a sale of the property donated. In these situations the government is not taxing the donor on his earned income or right to income such as an interest coupon. Nor is it taxing to the donor a profit realized upon a sale by the donee. Instead, and while recognizing the transfer to be a valid gift, it nevertheless treats the transaction as a taxable event for income taxes and the donor is deemed to realize taxable income from the gift the same as if it were a sale at fair market value. To prevent a double income tax, the donee is allowed a stepped-up basis. But whether such transfers will otherwise be treated as made without valuable consideration for gift and estate taxes is not clear. These income tax rulings deal with property raised for sale, but if upheld, the government may be encouraged to extend them to apply to gifts of other types of property in which a donor has an unrealized profit.

Another recent development aimed at transfers for income tax advantage is a 1951 Amendment to the Code dealing with a sale or exchange to a wife or to a controlled corporation to obtain the income tax benefit of increased depreciation allowances. Applicable to sales or exchanges of property subject to the allowance for depreciation made after May 3, 1951, and to taxable years ending after April 30, 1951, Code Section 117(o) now denies capital gain benefits to gains from sales or exchanges directly or indirectly, between husband and wife or between an individual and a corporation more than eighty per cent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren. To be caught napping in this not uncommon family device might well be serious in some situations.

The redemption of all the stock of a retiring shareholder is another type of transfer where a recent development is noticed to be on guard. For years the regulations have stated that a distribution by a corporation in redemption of all of the stock of a particular shareholder so that the shareholder ceases to be interested in the affairs of the corporation does not effect a distribution of a taxable dividend. Reg. 111 Sec. 29.115-9. But now the Treasury Department has proposed to amend such regulation to provide that: "A cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, will generally not effect a distribution of a taxable dividend; however, where such shareholder is closely related to remaining shareholders, that factor will be considered along with all other circumstances of the case in determining whether the distribution is essentially equivalent to a dividend". 515 CCH 6215. This amendment may be warning merely of a closer examination of such transactions or may presage efforts to broaden the taxability of such distributions as the equivalent of dividends. Since the retiring individual shareholder parts with a consideration irrespective of the form of the transaction and the remaining individual shareholder may be in a position to use corporate funds for his personal benefit, the latter would seem more likely to be affected by the circumstances and relationship of the parties. Without benefit of the previously unqualified regulation, the retiring shareholder in family or other close corporations, may now deem it even more in his interest to sell his stock to the remaining shareholder rather than to the corporation. But in such case, if the latter shareholder expects the corporation to provide the wherewithall, he may be exposed to even greater tax risks. The rule of course is well established that a distribution of earnings to discharge a shareholder's obligation is taxable to him as a dividend. This has been applied against a remaining shareholder, who, after contracting to buy the stock of another shareholder, assigned his contract to the corporation which assumed and paid his obligation. *H. F. Wall v. U. S.*, 164 F.(2) 462. In view of this means of reaching the remaining shareholder and the indication of close examination of all facts surrounding this type of redemption, the remaining shareholder would be advised to exercise care in negotiations leading to an agreement. In the not unusual situation, shareholders in family or other close corporations neglect corporate formalities and negotiate these transactions between themselves as individuals. Under such circumstances, the revenue agent should be interested in any facts suggesting that the corporation was used by a remaining shareholder to discharge his personal obligation. Investigation might also follow other lines to see if the distribution includes a consideration for some other benefit entirely personal to the remaining shareholder. *Fred F. Fischer*, 1947 P-H T. C. M. 47,131.

While two taxable transactions could not be expected to add up to a non-taxable transaction, not infrequently in tax law two non-taxable transactions consummated as part of a plan may result in a tax. As an illustration, if, according to plan, a remaining shareholder has his corporation purchase all the stock of a retiring shareholder, then the corporation distributes the stock as a stock dividend, the commissioner might with success contend that the net effect of the two transactions viewed as a whole in substance amounts to a distribution of funds as a dividend constructively received by the remaining shareholder to pay for the stock.

As the regulations suggest, the government is expected to scrutinize all the facts and circumstances in these stock redemptions to ascertain if the net effect of the distribution to purchase or redeem the stock amounts in substance to a taxable dividend to any shareholder. Whether this portends any effort by the commissioner to extend the application of the principles of net effect and constructive receipt in these transactions, at least it is clear that there is no intention to relax his vigil.