

# Assignment of Income – Planning for Timely Giving

The Northern California Planned Giving Council

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## Outline of Presentation

- Assignment of Income – What are we even talking about?
- The Pre-Arranged Sale Problem: Giving Too Late
- Evolving and Inconsistent Legal Standard in the Context for Charitable Giving
- Application to Common Planned Giving Scenarios



# Assignment of Income Doctrine

What is it? A judicial doctrine that income should be taxed at the source that generated it and cannot be anticipatorily signed to a third party.

“There is no doubt that the statute could tax salaries to those who earned them, and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skillfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it... we think that no distinction can be taken according to the motives leading to the arrangement by which the **fruits are attributed to a different tree from that on which they grew.**” Justice Holmes in *Lucas v. Earl*, 281 U.S. 111 (1930)

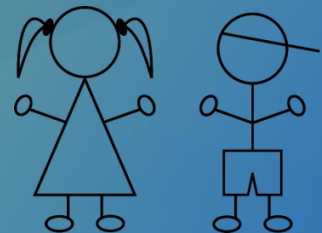
## TREE OWNER



## APPLE TREE



## FRUIT RECIPIENTS



### Assignment of Income Doctrine:

- If Tree Owner Gives the Apple (or Assigns the Right to Pick the Apple in Advance), **Tree Owner Pays the Tax**
- If Tree Owner Gives the Tree, **Apple Recipients Pay the Tax on Any Apples**



# Assignment of Income Doctrine

Why does it matter? From tax planning perspective, ideal charitable gift both:

1. Provides an income tax deduction
2. Shifts unrecognized gain to an entity that does not pay tax

**PHILANTHROPIST**



**APPRECIATED ASSET**



**CHARITY**



## Assignment of Income Doctrine:

- If Philanthropist Gives the Income (or Assigns the Right to the Income) From the Pending Sale of the Appreciated Asset, Philanthropist Pays the Tax
- If Philanthropist Gives the Appreciated Asset to Charity and Charity Recognizes the Income, No One Pays Any Tax



## Pre-Arranged Sale Problem

The Pre-Arranged Sale Problem arises when the donor waits so long that the income has been effectively earned before the gift happens:

Example:

- Donor owns real property X: \$10 Basis, \$100 FMV
- Donor enters into binding sales contract with respect to real property X
- One day before the closing date, with all conditions satisfied, Donor transfers property X to Charity.
- Charity sells X on the closing date
- **Result:** Even though the Charity was the technical seller of X, Donor is treated as having sold X, paying tax on the gain, and donating the cash sales proceeds.

Donor recognizes \$90 of gain and receives a \$100 deduction.



# Pre-Arranged Sale Problem

BUT, if you change the facts just a little, the donor still gets the optimal tax treatment

Example:

- Donor owns real property X: \$10 Basis, \$100 FMV
- Donor transfers property X to Charity (where Donor is the sole director and CEO)
- Donor, in her capacity as sole director and CEO of Charity enters into binding sales contract with respect to real property X
- Charity sells X on the closing date
- **Result:** Even though Donor, at the time of the gift, presumably knew he was going to sell X, Charity is treated as having received a gift of X and sold it.

Donor gets a \$100 deduction and recognizes no gain.



## How Late Is Too Late to Give and Still Shift the Income?

At Least for Pending Redemptions, Mergers, Etc., the “Right” Answer is the Standard in Revenue Ruling 78-197:

“Under facts similar to those in *Palmer*... (the assignment of income doctrine only applies) if (immediately following the gift) the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.”

### What were the facts in *Palmer*?

- Palmer had stock in Company, gave it to Foundation on Day 1; Company redeemed out the Foundation on day 2.
- Palmer had complete control over both Company and Foundation.
- IRS argued assignment of income (so taxable sale of stock to corporation, followed by donation of proceeds), but Tax Court found for taxpayer.
- Court: “Even though the donor anticipated or was aware that the redemption was imminent, the presence of an actual gift and the absence of an obligation to have the stock redeemed” is sufficient to give transaction substance.
- Court: Control as owner of company or fiduciary of foundation ≠ prearranged sale

With Rev. Ru. 78-197, the IRS acquiesced to *Palmer*, so under “similar” facts, taxpayers have a generous and objective standard.



## How Late Is Too Late to Give and Still Shift the Income?

### Cases That Make It All a Little More Complicated:

#### *Blake (2<sup>nd</sup> Circuit, 1982): What Does “Legally Bound” Even Mean?*

- Founder of Friendly's, S. Prestley Blake, wants Charity to end up with his yacht, but also has a lot of appreciated Friendly's stock.
- Attempted Solution: Donor gives the stock to Charity, Charity Sells It, Uses Proceeds to Buy the Vessel → Charity Gets the Yacht and Donor Pays No Tax on Appreciated Stock
- IRS and Court: Sale of Stock was Prearranged; Donor Taxed on Gain From Sale of Friendly's Stock.
- The troubling part is that the 2<sup>nd</sup> Circuit said: *“Where there is, as here, an expectation on the part of the donor that is reasonable, with an advance understanding that the donee charity will purchase the asset with the proceeds of the donated stock, the transaction will be looked at as a unitary one. A wooden view that would require legal enforceability of an understanding or obligation to purchase the asset contemplated to be donated ab initio is not what the tax law contemplates. At least, this circuit will not take it to do so.”*





## How Late Is Too Late to Give and Still Shift the Income?

### Cases That Make It All a Little More Complicated:

#### *Ferguson (9<sup>th</sup> Circuit, 1997): Is There Still a Subjective Test?*

- Donor gave stock in company subject to a merger agreement that would result in acquisition of company and redemption of shareholders if enough shareholders tendered their shares as part of a tender offer.
- At time of gift, more than 50% had donated, which was enough to cause merger and redemption of donation shares to move forward, BUT only if either 85% of shareholders tendered or the acquirer waived the 85% requirement (i.e. at time of gift, there was still a contingency).
- 9<sup>th</sup> Circuit Adopts What Appears to be a Subjective Test: *“A court must consider the realities and substance of events to determine whether the receipt of income was **practically certain to occur (at the time of the gift)...**”*. In making that determination, *“remote and hypothetical”* contingencies are irrelevant.
- So, when we are outside the facts in *Palmer* and in the Ninth Circuit, the **“practically certain”** standard seems to apply.



## How Late Is Too Late to Give and Still Shift the Income?

### Cases That Make It All a Little More Complicated:

*Rauenhorst* – Tax Court: No, the Objective Test Applies, At Least When It’s Close to Palmer (IRS in Notice 2003-014: Fine.)

- Donor gave stock in NMG warrants to 4 different charities
- Company signed letter of intent to engage in sale of its outstanding stock to WCP on September 28; Gift to the four charities was made on November 9; on November 18, the charities signed an agreement with WCP to sell their warrants to WCP.
- IRS argued assignment of income applies because the redemption was a “practical certainty” at the time of the gift – tries to distinguish from Rev. Rul. 78-197 by saying it does not apply to “global transactions”
- Tax Court says
  - 1. You can’t distinguish from *Palmer* that easily – “global transaction” not a meaningful distinction
  - 2. Although we (Tax Court) consider the “objective test” just a “factor” and would consider practical certainty, you (the IRS) have said in Rev. Rul. 78-197 that it’s the only factor and need to stick to it.
- Notice 2003-014: IRS Notice to its litigators in Chief Counsel’s office: citing *Rauenhorst*, need to follow our own published guidance – cannot derivate, even there’s a disagreement must be resolved internally.



## How Late Is Too Late to Give and Still Shift the Income?

### Cases That Make It All a Little More Complicated:

*Marc Chrem – Case in Progress Where the IRS is Again Arguing (and so far, the Tax Court is listening) that Subjective Standard is a “Relevant Question”*

- Donor’s family owned closely held company, in anticipation of the company’s acquisition (and with an open tender offer with 87% of shareholders tendering) by a company related through common management, donates shares in company to a charity.
- Donor agreed with acquiring company to “use all reasonable efforts” to cause the charity to tender shares to acquiring company (charity’s shares needed for acquisition to go through).
- Donor says they donated shares before JCF unconditionally agreed to tender the shares (though IRS disputes that)
- In considering assignment of income issue, court says:
  - “One relevant question is whether the prospective acquisition is a mere expectation or a virtual certainty” (*subjective test*)
  - “Another relevant question is whether the charity is obligated, or can be compelled by one of the parties to the transaction, to surrender the donated shares to the acquirer (*objective test; citing Rev. Rul. 78-197*)
  - Also cites *Blake* for the proposition that an “understanding” can be enough, even if not “legally enforceable under state law”).



# Examples





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