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In this report, Meyer explains why *Rauenhorst* may not have killed assignment of income issues for charitable gifts as completely as some tax planners may think. He argues that the IRS can still rely on *Ferguson* in the right context and that taxpayers with genuine charitable intent should still have little to fear.

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I. Introduction

Under the venerable doctrine of *Lucas v. Earl*,[1] a taxpayer who completes a gift of appreciated property after a tax realization event, such as an agreement to sell the property, is taxed on the appreciation, whereas a gift completed before realization is not taxed. The doctrine is of particular concern to charitable gift planners, because a major inducement to charitable giving is the ability to deduct the fair market value of appreciated property given to charity without being taxed on the unrealized gain. Unfortunately, the two leading cases on charitable assignment of income, *Ferguson*[2] and *Rauenhorst*,[3] have rationales that appear to be directly contradictory, leaving charitable gift planners with a quandary. The theoretical confusion is remarkable, given that all the charitable giving cases I have reviewed for purposes of this report (including many not cited) intuitively reached the clearly correct result.

These two cases can be satisfactorily harmonized by attending to the role that third parties play in the tax characterization of transactions. I begin by demonstrating the conflict between the rationales in *Ferguson* and *Rauenhorst*. Because *Rauenhorst* relies extensively on Rev. Rul. 78-197, 1978-1 C.B. 83, I will discuss why courts should respect the ruling's statement that it applies only in the unusual case without unrelated parties. Next, I show that much of the jurisprudential confusion is traceable to the baneful effects of *Rushing*,[4] which is not itself a charitable assignment of income case. *Rushing*

[1] 281 U.S. 111 (1930).

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

[3] *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

[4] *Rushing v. Commissioner*, 52 T.C. 888, *aff'd*, 441 F.2d 593 (5th Cir. 1971).

began an excessive emphasis on the rights of donees rather than the actions of the donor, an emphasis that unfortunately carried into Rev. Rul. 78-197. With this background, I harmonize *Ferguson* and *Rauenhorst* by noting that *Rauenhorst* insisted on a specific event manifesting an agreement to dispose of property as a necessary element of realization, while *Ferguson* cast a critical eye on the materiality of unfulfilled conditions that the taxpayer relied on to postpone realization until after the gift.

The Ninth Circuit's opinion in *Ferguson* overreacted to bad taxpayer conduct, and *Rauenhorst* overreacted to the Ninth Circuit's overreaction. The middle ground between *Ferguson* and *Rauenhorst* resolves uncertainty for taxpayers with genuine charitable intent and keeps charitable assignment of income consistent with general tax law while leaving the IRS with the necessary tools to deal with occasional abusive structuring.

II. A Review of *Ferguson* and *Rauenhorst*

The Ferguson family owned some 18.8 percent of the shares of a public company, AHC, and induced a private equity firm, CDI, to make a tender offer for AHC's stock. CDI conditioned its offer on a minimum tender of 85 percent of the stock. After announcing the merger, the Fergusons began a slow process of transferring some of their shares to charity, completing the process on the same day that more than 85 percent of the shares were tendered. The Fergusons claimed that realization could not occur before satisfaction of the 85 percent tender requirement and so their gifts were timely.[5]

The legal test for realization in this context has been variously stated, but the meaning is generally consistent. The Tax Court's opinion referred to two common statements of the tests: (1) Realization occurs when a transaction converting the form of property is practically certain to occur, and (2) "the reality and substance of a transfer of property govern the proper incidence of taxation and not formalities and remote hypothetical possibilities,"[6] despite the legal significance of those formalities.

Two key facts explain why the Tax Court concluded that realization in *Ferguson* occurred before the satisfaction of the 85 percent tender requirement. First, CDI continued with its offer even though AHC's factory burnt down. Second, "the central asset of AHC [was] Sybil Ferguson and the relationships that she had created."[7] The Tax Court concluded that once CDI was assured of Ferguson's services, the 85 percent tender requirement was essentially a formality. These two facts, plus the observation that the gift followed a tender by a majority of the shareholders, properly support the Tax Court's result.

Notably, other background facts in *Ferguson* are quite ugly and include destroyed and backdated documents and unverified representations to the SEC. On appeal, the Ninth Circuit released a powerful antiabuse screed, stating that courts could make a nearly unbounded probabilistic assessment of when realization had occurred. The Ninth Circuit did not disagree with the Fergusons' claim that "the logic of the Tax Court's decision implies that their [company] stock already might have ripened by some date even earlier than August 31, 1988 [the 50 percent tender date]. In essence, they note that there is no clear line demarcating the first date upon which a taxpayer's appreciated stock has ripened"[8] (meaning realization has occurred). In response to taxpayer's complaint that this uncertainty makes gift planning difficult, the Ninth Circuit simply warned donors about the danger of walking "the line between what is and what is not permissible" in planning a charitable transfer. The Ninth Circuit's dicta come perilously close to suggesting that the IRS can tax the mere contemplation of a transfer.

The IRS promptly recognized what an extraordinarily powerful attack the Ninth Circuit had authorized,[9] and in *Rauenhorst*, the agency chose to try it out. *Rauenhorst* exquisitely

[5] I sidestep, as did the Ninth Circuit and the Tax Court in *Ferguson*, the issue of what happens when a donative transaction is completed on the same day as a realization event.

[6] *Ferguson*, 108 T.C. at 257.

[7] *Id*. at 265.

[8] *Ferguson*, 174 F.3d at 1006.

[9] FSA 200149007.

illustrates the depth of theoretical confusion in this area. One can imagine the government lawyers thinking they had an unbeatable case. The Tax Court in *Rauenhorst* did not deny that the controlling judicial test was whether the transaction was "practically certain to proceed" at the time of the gift, that the transaction in that case was practically certain to proceed,[10] or that the taxpayer in *Rauenhorst* had actually conceded the point.[11] And yet from every common-sense perspective, the deficiency notice was indefensible and the penalty assessment just outrageous. The Tax Court's opinion in *Rauenhorst* reacted to that overreach by rebuking the IRS for relying on the Ninth Circuit's opinion in *Ferguson* and held for the taxpayers on summary judgment. Unfortunately, although the holding was clearly correct, the Tax Court's rationale overreached in the opposite direction.

Only two dates in *Rauenhorst* are relevant. On October 22, 1993, the board of directors of a closely held corporation, which also held the vast majority of shares, adopted a resolution to negotiate a stock acquisition agreement with an acquirer. The taxpayer, a tiny minority shareholder, completed charitable gifts of warrants on November 12, 1993, shortly before either the corporation or shareholders reached any firm agreement with the acquirer. Unlike in *Ferguson*, the Tax Court in *Rauenhorst* did not make a finding about which of the subsequent events leading to the acquisition would have triggered realization. Instead, it held that realization had not occurred because the charitable donees were not legally obligated to tender their shares on November 12. The court dismissed the undeniable fact that the other 93 percent of the shareholders could have forced the transaction had the donees resisted.

In a bold move, the Tax Court in *Rauenhorst* sidelined the judicial test it upheld in *Ferguson* by holding that Rev. Rul. 78-197 is an institutional concession that binds the IRS. It held that the ruling creates a bright line test that looks solely at whether the charity is legally bound to complete a transaction involving the donated asset.[12] Read literally, *Rauenhorst* implies that the IRS unilaterally forswore reliance on the well-settled, Service-favorable judicial precedent holding that realization can occur before a legally enforceable obligation arises.[13] The rationale is an open invitation to abusive structuring of charitable gifts.

Of course, Rev. Rul. 78-197 did nothing of the sort. The ruling stipulates that it applies only "under facts similar to those in *Palmer*."[14] The *Rauenhorst* facts were dramatically different than those of *Palmer*. In *Palmer*, the taxpayer controlled a corporation and a private foundation. Under a single plan accomplished on the same day, the taxpayer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation at fair market values. *Palmer* involved no adverse or unrelated third parties. In *Rauenhorst*, unrelated shareholders had parallel interests with the taxpayers, and the acquirer was at arm's length to the shareholders in the aggregate. While some commentators see *Rauenhorst* as foreclosing the concerns raised by the Ninth Circuit's opinion in *Ferguson*,[15] the primary underpinning of *Rauenhorst* — Rev. Rul. 78-197 — does not support that conclusion.

III. The Need for a Better Theory

A charitable transfer in almost all cases presents limited opportunity for abuse. One might accordingly argue that there is no harm in accepting the "right up to binding agreement" interpretation of Rev. Rul. 78-197 and restricting the Ninth Circuit opinion in *Ferguson* to its admittedly extreme facts. The problem is that

[10] Shareholders owning roughly 93 percent of the shares supported the acquisition.

[11] A valuation statement attached to taxpayer's return said there was very little chance on the date of the gift that the transaction would not promptly close. *Rauenhorst*, 119 T.C. at 176.

[12] Rather discordantly, the *Rauenhorst* court claimed, 119 T.C. at 170 n.9, that its holding was consistent with its holding in *Ferguson*, in which it stated that "the fact that AHC shareholders may not have had a legal right to the merger proceeds prior to acceptance of the tendered or guaranteed shares by [CDI] does not change our conclusion." *Ferguson*, 108 T.C. at 264.

[13] *See, e.g.*, the discussion of *Court Holding*, below.

[14] *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on another issue*, 523 F.2d 1308 (8th Cir. 1975).

[15] Martin Hall and Jerry J. McCoy, "Setting the Stage for Charitable Giving," in American Law Institute-American Bar Association course of study "Charitable Giving Techniques," SR011 ALI-ABA 1 (July 9-10, 2009).

deploying Rev. Rul. 78-197 outside the *Palmer* facts makes hash of realization, a key tax concept, and makes charitable donation law incompatible with non-charitable donation law as stated by cases such as *Peterson*.[16]

The late Harold J. Berman argued that the legal community contributes to law by the "science" of rationalizing, harmonizing, and integrating precedent.[17] A society of professionals with long-engaged interaction with an organized body of rules and principles develops both an intuitive sense of what the resolution of some question ought to be, and the ability to formulate persuasive narratives about answers that seem wrong. In the context of law, the sense that reasonably dependable answers can and should be reached is fundamental to its legitimacy and an important social good. Predictable tax law has real benefits to voluntary compliance, whether the outcome of any particular standard favors the IRS or the taxpayer. Exceptions are obviously necessary but are satisfying only when the rationale is explicable.

Wide swaths of tax law rely on the adverse interests of parties dealing at arm's length to provide a reliable starting point for tax characterizations of a transaction. As but one example, courts will generally respect an enforceable agreement between an unrelated buyer and seller regarding the allocation of basis among assets in the sale of a trade or business.[18] We need a charitable assignment of income theory that can satisfactorily explain realization by reference to the actions of third parties, both those whose interests are parallel with the transferor, as well as those who are truly at arm's length. Surely Rev. Rul. 78-197, which presupposes no independent actors, is not the foundation for a general theory.

IV. Justifying the Rev. Rul. 78-197 Exception

An explanation of why the purported bright-line test of Rev. Rul. 78-197 focused on the donee rather than the donor will be postponed to the review below of the strange effect of *Rushing* on charitable assignment of income cases. When properly restricted within its narrow scope, however, the ruling provides for a wise result.

Although not a charitable assignment of income case, *Court Holding*[19] is one of many cases holding that the assignment of income doctrine looks to substance and not legal formalities. In *Court Holding*, a corporation orally negotiated the sale of its sole asset, an apartment building, with a buyer but then distributed the building to its shareholders in liquidation. Although the oral agreement was unenforceable because of the statute of frauds, the shareholders sold the building on substantially the same terms to the same buyer. The Supreme Court disregarded the lack of a binding obligation and found that the corporation's oral agreement had realized income.

Suppose a taxpayer orally negotiates the tentative terms for the sale of a building with an arm's-length buyer and as a last-minute thought contributes it to charity. Assuming that the charity sells on the negotiated terms, *Court Holding* should control to keep charitable law consistent with broader realization principles. In opposition to the general rule, however, Rev. Rul. 78-197 provides that realization does not occur as long as the donor executes the formalities of a prearranged plan in the right order. The clear distinction between *Court Holding* and Rev. Rul. 78-197 is the absence of arm's-length bargainers.

When there is a meeting of the minds between arm's-length parties, an observable and datable process occurs. When one party can control an entire process, however, it is difficult to specify the "substance" of a transaction that moves it from thought to actuality. Given its premise that no adverse parties are involved in the transaction, Rev. Rul. 78-197 creates a disciplined and sensible exception to *Court Holding*. An aggressive reading of *Court Holding* in the spirit of *Ferguson*'s "what would likely happen," on the facts of *Palmer* and

[16] *Peterson Irrevocable Trust No. 2 v. Commissioner*, T.C. Memo. 1986-267.

[17] Harold J. Berman, *Law and Revolution: The Formation of the Western Legal Tradition* (1983).

[18] Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 10.31 (7th ed. 2000 and Supp. 2017-2).

[19] *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

those of the parallel cases cited in AOD 1977-16 acquiescing in *Palmer*[20] — all of which involved a taxpayer-controlled corporation and no arm's-length buyer — would mean any forethought could constitute realization. Rev. Rul. 78-197 is a wise policy decision not to require elaborate, one-handed window dressing to reach a desired tax result if the result is otherwise appropriate.

Although *Palmer* and the parallel cases involve facts before 1969, each was decided shortly after passage of the Tax Reform Act of 1969 and section 4941. Section 4941 prohibits most transactions between a disqualified corporation and a private foundation, such as the parties involved in *Palmer* and *Behrend*.[21] Section 4941(d)(2)(F), however, permits the same redemption transaction as occurred in *Palmer* and *Behrend* if specified safeguards are met. Although the *Palmer* opinion did not cite section 4941(d)(2)(F), the redemption exception indicates a congressional policy decision not to unnecessarily handicap charitable giving, a policy that probably influenced *Palmer* and Rev. Rul. 78-197.

Unquestionably, transactions between a charity and a donor can create opportunities for abuse. Some of these can be addressed by general tax principles,[22] but others require targeted provisions. Subchapter A of chapter 42, which includes section 4941, is a nearly comprehensive set of rules for the regulation of private foundations. The excess benefit rules of subchapter D address dealings between public charities and persons with substantial influence over the charity. Subchapter F provides sanctions for charitable engagement with tax shelters. Subchapter G provides rules for the operation of donor-advised funds. These provisions not only address potential abuses but also show that specialized rules often are needed to respond to transactions involving charities. In other words, as a special exception, Rev. Rul. 78-197 has considerable company.

Carving out an exception for the *Palmer* facts does little to disturb general assignment of income principles in most cases with adverse parties. The lack of genuine adversity between a donor and a charity clearly can lead to abuse, but a distortion of general assignment of income principles should not be one of the consequences.

V. The *Rushing* Diversion

Why considering the rights of a transferee can sometimes shed light on the taxation of the transferor is illustrated by *Humacid*.[23] *Humacid* states the general rule for the income taxation of gifts of appreciated assets as follows: "A gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of a sale,"[24] a proposition that does not mention the transferee. But the court in *Humacid* analyzed two similar transactions differently based on the strings attached to what one transferee received but not to the other. To convert ordinary gain into capital under then-applicable law, the taxpayer sold some notes of a subsidiary of his controlled company to an acquaintance under a scheme that guaranteed that the notes would in turn be redeemed in short order, and he gave other notes to charity. Because of the encumbrance, the acquaintance did not receive marketable title but only the proceeds of the donor's prior realized gain. In the second case, the transfer to charity was given without strings, and no gain was recognized despite a prompt redemption.

As a result of *Rushing*, however, some charitable assignment of income cases gave

[20] *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973), *aff'g* T.C. Memo. 1972-98; *Carrington v. Commissioner*, 476 F.2d 704 (5th Cir. 1973), *aff'g* T.C. Memo. 1971-222; *Behrend v. United States*, 470 F.2d 921 (4th Cir. 1972).

[21] *Behrend v. United States*, 470 F.2d 921 (4th Cir. 1972).

[22] *See* Rev. Rul. 80-233, 1980-2 C.B. 69; and Rev. Rul. 80-69, 1980-1 C.B. 55, disallowing inflated values for gifts of tangible property to charity and ruling that FMV is set by the prices of comparable sales between parties acting at arm's length. *See also* AOD 1977-16.

[23] *Humacid Co. v. Commissioner*, 42 T.C. 894 (1964).

[24] *Id.* at 913.

exaggerated attention to the posture of the transferee,[25] although *Rushing* itself did not involve a charitable donation. In *Rushing*, two shareholders owning all the stock voted to liquidate the corporation and shortly thereafter caused it to sell all its assets to an unrelated third party. The shareholders then sold all their shares to newly created trusts, reporting the gain on the installment method. The fact that the trustees had the power to reverse the liquidation process led the Tax Court to conclude that the taxpayers did not control the proceeds.

The IRS argued that the liquidation vote was a realization event. The Fifth Circuit found the commissioner's reliance on the anticipatory assignment of income theory "entirely misplaced simply because no income was assigned."[26] The taxpayers had sold their shares and realized all of their gain. Viewing the issue strictly as one of recognition, the Fifth Circuit held for the taxpayers because they did not retain control over the proceeds, a finding that rested largely on the rights of the donee trustees.

Rushing cannot be reconciled with *Humacid*,[27] and the IRS has always maintained that *Rushing* was wrongly decided,[28] but still it influenced four charitable giving cases in the 1970s.[29] The taxpayers in *Hudspeth*[30] relied on *Rushing* to argue that a transfer of stock after the shareholders voted in favor of liquidation did not trigger an assignment of income. The Eighth Circuit cited several cases for the proposition that the shareholder vote is the "requisite legal step necessary to effect a 'realization.'" It then noted, however, that "a new dimension was added to this analysis in *W.B. Rushing*, . . . wherein the shareholders' vote was not found to be sufficient to constitute a realization." Rather than declining to follow the Fifth Circuit's flawed reasoning, the Eighth Circuit distinguished *Rushing* on the grounds that the charity in *Hudspeth* lacked the ability to reverse the transaction. Similarly, the taxpayers in *Kinsey*[31] relied on *Rushing*, and the Second Circuit also distinguished *Rushing* by noting that the donee lacked the power to reverse the transaction.

The Sixth Circuit in *Jones*[32] began to back away from the focus on the donee control over the transferred asset. Citing *Hudspeth*, the Sixth Circuit reiterated:

> The shareholders' vote is the critical turning point because it provides the necessary evidence of taxpayer's intent to convert his corporation into its essential elements of investment basis and, if it has been successful, the resulting gains. This initial evidence of the taxpayers' intent to liquidate is reinforced by the corporation's contracting to sell its principal assets and the winding-up of its business functions. In the face of this manifest intent, only evidence to the contrary could rebut the presumption that the taxpayer was, in fact, liquidating his corporation. Yet here the record is barren of any evidence that the taxpayer had any intent other than that of following through on the dissolution.[33]

Although a move in the right direction, the opinion reflects a failure to tie taxation to an objective event. This failure results in a focus on the taxpayer's intent both after as well as before the event, a focus that obscures what I describe below as suspending conditions. Judge Pierce Lively's dissent tellingly argues that if intent to realize gain is the decisive factor, a minority shareholder voting against a transaction should

[25] The Tax Court in *Rushing*, 52 T.C. 888, cited *Jacobs v. United States*, 280 F. Supp. 437 (S.D. Ohio 1966), *aff'd*, 390 F.2d 877 (6th Cir. 1968), for the proposition that realization does not occur when abandonment of the liquidation process is "possible." The *Jacobs* reasoning is quite weak. By looking to the donee's power to reverse the transaction, the Tax Court's opinion in *Rushing* gave the realization argument better theoretical footing. The donee's power to reverse became the relevant legal issue, not simply the possibility of reversal by those who put the plan into effect. The Sixth Circuit expressly overruled *Jacobs* in *Jones v. United States*, 531 F.2d 1343 (6th Cir. 1976).

[26] *Rushing*, 441 F.2d at 597.

[27] *Humacid*, 42 T.C. 894, notionally reversed the chronological order of the transactions involving the notes sold to an acquaintance. A similar analysis in *Rushing* would have made the installment election impossible.

[28] GCM 36862 (Sept. 27, 1976).

[29] *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972); *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973); *Jones*, 531 F.2d 1343; *Allen v. Commissioner*, 66 T.C. 340 (1976).

[30] *Hudspeth*, 471 F.2d 275.

[31] *Kinsey*, 477 F.2d 1058.

[32] *Jones*, 531 F.2d 1343.

[33] *Id*.

not recognize gain, at least not until proceeds are received.

Allen[34] finally closed the door on a taxpayer appeal to *Rushing*. Taxpayers argued that the donee charity received enough shares to reverse the liquidation. Quoting the Sixth Circuit's opinion in *Jones*, the Tax Court agreed that the "realities and substance of the events and not hypothetical possibilities should govern" the realization event. Rather presciently foreseeing the Ninth Circuit's opinion in *Ferguson*, the *Allen* court observed:

> We recognize that our approach may revitalize the principles of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), in an area not covered by the statutory antidote of section 337, thereby placing a premium on consulting one's lawyer early enough in the game. But, this has happened before (see *Waltham Netoco Theatres, Inc.*, 49 T.C. 399 (1968), *aff'd* 401 F.2d 333 (1st Cir. 1968)). We also realize that petitioners' suggested standard offers a clear-cut rule for decision which avoids the drawing of factual distinctions inherent in the rule we adopt. But, here again, the necessity of drawing lines is part of the daily grist of judicial life and should not influence us to adopt another rule simply to avoid difficulties in application. See *Estate of Lillie MacMunn Stewart*, 52 T.C. 830, 836 (1969), *rev'd on other grounds*, 436 F.2d 1281 (3d Cir. 1971).[35]

One wishes the IRS had fully processed the reasoning of *Allen* before issuing Rev. Rul. 78-197. But the *Palmer* fact pattern is the rare circumstance in which the postures of the donor and donee are equivalent in a way that does not exist on other facts. The ruling's restricted facts hide a logical fallacy. The rule of *Humacid* might be paraphrased as follows: If (A) the transferor did not commit to a transaction, then (B) the transferee cannot be compelled to complete it. Rev. Rul. 78-197 implicitly relies on the following invalid transposition of this test: If (B) the transferee cannot be compelled to complete a transaction, then (A) the transferor was not bound to it. Suppose the donor executes an agreement of sale for an asset subject to a contingency within the control of the donor and transfers the asset subject to the agreement to an unrelated charity. The buyer cannot require the transferee to go to closing until the contingency is released, yet realization will have occurred. Conditions to closing reveal the logical fallacy in Rev. Rul. 78-197's converse statement of the *Humacid* rule.

VI. There's Many a Slip 'Twixt the Cup and the Lip

A. A Suggested Analytic Framework

I propose a two-component test for realization in charitable assignment cases. First, a realization commitment must have occurred. I define a realization commitment to be an observable manifestation[36] of an agreement to convert the form of an asset on terms sufficient to justify reliance by a counterparty. The legal rights of a transferor can be affected by the actions of parties with parallel interests, such as other shareholders, so a realization commitment can arise without specific action by a taxpayer. To avoid the unbounded "what if" of the Ninth Circuit opinion in *Ferguson*, a realization commitment cannot be determined by a probabilistic assessment, but, to the extent possible, as a datable event that either has or hasn't occurred.

Second, all suspending conditions must be resolved. By "suspending condition" I mean a condition imposed by an arm's-length counterparty that (1) has a significant uncertainty of fulfillment and (2) if left unfulfilled, would entitle and likely cause the counterparty to abandon the transaction. The release of all suspending conditions, if any exist, completes realization. The corollaries of my definition are that (1) there may be conditions, such as formalities, that preclude immediate legal enforcement of a transaction but still will not postpone realization; and (2) the assessment of

[34] *Allen v. Commissioner*, 66 T.C. 340 (1976).

[35] *Id.* at 346.

[36] *Peterson*, T.C. Memo. 1986-267 at 1144, cites several cases for the proposition that realization involving a gift requires "the occurrence of a specific event regarding property."

what conditions a counterparty would waive before fulfillment is probabilistic.

B. Carveout for Failed Delivery Cases

My theoretical framework becomes clearer when two issues are distinguished: failed delivery cases and transactions that unexpectedly fail to close. The requirement of effective delivery has some overlap with charitable assignment of income principles. The opinion in *Ankeny*[37] cited *Kinsey* and *Hudspeth* for the proposition that the assignment of income doctrine applies if the donor retained control over the asset after a purported transfer. The better analysis would have been that the donor in that case — who continued to collect rent on the allegedly transferred property — never parted with dominion and control and thus was the tax owner of the property at closing.

The Tax Court's opinion in *Palmer* provided an extended legal and policy-based argument why a transferor is deemed to part with dominion and control over an asset transferred to a controlled charity. The transferor, as either trustee or director, has fiduciary responsibilities to the charity and cannot use the transferred asset for his own benefit. If the transferor nevertheless takes personal advantage of the asset after the transfer and before closing, the IRS should argue that the delivery failed, in addition to whatever other remedy or theory may be available. Notwithstanding *Palmer*, the smarter practice for a transferor acting as a fiduciary of a charitable transferee would be to abstain from any vote affecting the transferred property.

Despite the overlap, failed delivery cases[38] should be easily distinguishable from assignment cases. *Ferguson* is as much a failed delivery case as an assignment of income case. The taxpayers indicated their intent to make a charitable gift fairly early in the process, a step that ordinarily would go far in preventing taxation from attaching to their gift. But delays in making effective delivery pushed the transfer date until after the collective decision to commit to a disposition.

C. Carveout for Unexpected Failures to Close

Although in principle it is possible to treat a deal that was unwound as two separate transactions for tax purposes,[39] this is rare and leads to issues beyond the scope of this report. Theory must allow for a realization event that becomes "unrealized" in the occasional case in which what is normally a formality results in an abandoned transaction and no taxation. Although theoretically untidy, the exception does not seem to present administrative or even counseling difficulties. I restrict "suspending conditions" to those with significant objective uncertainty.

VII. Realization Commitment

An agreement of sale is the ideal type of realization commitment, yet not all agreements are realization commitments. Contract law can weed out purported agreements when the buyer's or seller's reservations are so great that no real understanding was reached. Similarly, general principles can govern agreements founded on mistake. Some taxpayer conditions have independent economic significance and should be respected. For example, a taxpayer condition to closing based on the need to remove a restrictive covenant controlled by adverse parties or to obtain a private letter ruling should be respected to postpone realization despite the execution of an agreement. Anticipatory assignment cases are very similar to step transaction cases, and the IRS acknowledges that actions with independent economic significance are not vulnerable to step transaction characterization.[40]

With these and other circumstances exempted, a necessary condition to realization should be a bright-line test for taxpayer commitment. The importance of a bright line is understandably clearest in cases involving parties

[37] *Ankeny v. Commissioner*, T.C. Memo. 1987-247.

[38] In practice, delivery rules could use some updating. Reg. section 1.170A-1(b) provides that if an agent is employed to transfer physical certificates, the transfer is complete when the transfer is registered on the books of the corporation. Given that virtually all publicly traded stock now is transferred through the Depository Trust and Clearing Corp., however, it would be useful for the IRS to clarify that delivery is completed, regardless of the fact that legal title does not change, when the transferee can sell the transferred security. *See Calloway v. Commissioner*, 135 T.C. 26 (2010).

[39] David Hasen, "Unwinding Unwinding," 57 *Emory L.J.* 871 (2008).

[40] *See* GCM 38393 (May 30, 1980); and Rev. Rul. 79-250, 1979-2 C.B. 156.

with interests parallel to the taxpayer, and this point will be reviewed below, but the logic is broadly applicable. No tax attaches to the mere appreciation of property. The timing of the conversion of that value into another form is, in principle, entirely within the control of the taxpayer or group of taxpayers. Typically, the conversion of property from one form to another requires an agreement with a third party, and that agreement has the objective substance provided by general contract law. It can be precisely dated in theory, if not necessarily in practice.

The assignment of income doctrine arises because after the commitment is made, some taxpayers attempt to rearrange the tax consequences by retroactively rearranging the original structure of the conversion agreement. To the extent that the assignment of income doctrine has an antiabuse function in the charitable context, the potentially abusive act occurs at the time of the donative transfer, not the prior commitment act. "Abuse" here may be nothing more than sloppy records; it is fair to require taxpayers to turn square corners even with charitable gifts. When the taxpayer's aim is to avoid the tax consequences of a prior agreement by introducing a tax-indifferent party, bargaining cannot be relied on to provide firm markers. Fortunately, this is not the typical case.

A. Addressing the Worry About Uncertainty

To keep charitable assignment of income cases consistent with precedent such as *Court Holding*, a charity that simply flips a donated illiquid asset to an identified buyer on pre-negotiated terms must be treated as acting as a conduit for the transferor. Yet charities generally wish to dispose of a donated illiquid asset[41] and invest the proceeds in accordance with their investment policies. Illiquid assets typically have economic, administrative, accounting, and tax risks and expense that few charities are equipped to handle. Donors to charitable remainder trusts (CRTs) similarly do not want the trust to hold an illiquid asset for any appreciable period. As a result, both donors and charities need the ability to cultivate a buyer in the wings, but much of the permissible tax benefit from charitable giving will be lost if cultivating a buyer in the wings triggers realization. Accordingly, charitable planners would like to know how close a donor can come to firm-deal terms with a buyer before triggering realization, so the charity can be relatively confident it will not be stuck by accepting an asset it cannot easily dispose of to a willing buyer.

Fortunately, asking "how close?" mistakes process for substance. To be sure, when the introduction of a charitable participant leads to atypical tax benefits,[42] courts need to scrutinize the transaction to determine if the charity's participation was timely or retrofitted into the transaction as window dressing. The key question in potentially abusive cases is whether the evidence supports a donor's commitment to making a gift before a commitment to converting the form of an asset. The taxpayer still must complete a charitable transfer before a binding agreement is reached,[43] but because it is sometimes difficult to distinguish between a negotiation and a renegotiation, it may sometimes be advantageous to frame the question as I have. Fortunately, in most cases the acquirer's arm's-length status can be respected.[44]

Understanding the charity's role in accepting illiquid gifts is the key to understanding that charitable gift planning should not be fraught with uncertainty about tax consequences. Only the most oblivious planner would come near to the finish of a real estate transaction, for example, before asking whether a charity would be willing to accept the asset. Involvement by a charity in planning is a strong signal that the charitable

[41] The rules for gifts of liquid assets are clear and rarely create uncertainty.

[42] The stakes are real. Without delving into complex specifics, inserting a charitable participant into a transaction can be transformative. Consider as but one example that under reg. section 1.1245-2(a)(8), ordinary recapture income embedded within an asset transferred to charity is effectively erased. The difference between tax benefits incidental to an intended charitable gift and a charitable gift incidental to intended tax avoidance is profound.

[43] Even under Rev. Rul. 78-197, the taxpayer must execute the formalities in the right order.

[44] The simpler the transaction in the typical case, the closer the transaction can come to nearly fixed terms without triggering assignment of income. Suppose that a donor transfers a painting to charity after receiving offers from several different buyers. Assuming the various bids are serious, the charity's ability to choose which offer to accept should be enough to prevent prior realization even though the charity's involvement in negotiation is minimal.

decision predominates. *Sheppard*[45] appears to be the first case that explicitly mentioned the charitable status of the donee in connection with an assignment of income analysis.[46] Although the donor and charities acted in close concert, the charities' involvement promoted their independent ends and not the facilitation of the donor's tax goals. Accordingly, the Court of Federal Claims declined the invitation to follow *Court Holding*, noting one charity's consultation with an attorney because it "did not wish to become involved with donors who had ulterior motives or to lend its tax-exempt status to any person who was trying to use it illegally."[47]

Good planning to make a successful gift — such as by locating a buyer in the wings for or with a charity — may appear quite similar to implementing a decision to sell to that buyer, but the two are fundamentally different when the donor intends an identified charity to accept the transfer. Except in cases in which the donor's tax benefits are atypically advantageous and the charity may be functioning as an accommodation party,[48] the charity's objectives are obvious to the buyer, the donor, and the IRS. When the donor's charitable intent is clear, the donor's negotiation of clear-deal terms can be analogized as actions of an agent on behalf of a disclosed principal. In any event, in those cases the "the realities and substance" of the transaction is the transfer of property, not the personal realization of the appreciation. There is a bright line — a binding legal agreement — that if crossed will trigger realization, but a donor accompanied by a recipient charity acting in good faith should be able to safely tiptoe up to it.

CRTs may not have an identified charity available to monitor, or partner with, a proposed charitable transaction. It is also not a trivial task to find an unrelated fiduciary willing to step into a role with expansive risks and very limited scope for indemnification, at least from the donated assets. On the other hand, the rigorous provisions of sections 664 and 4941 and the 100 percent tax rate on unrelated business income earned by a CRT provide considerable prophylactic protection. Because of these complex rules, typical transactions must be significantly adjusted to permit a CRT as a party. If negotiations did not address the inclusion of a CRT in a transaction at a reasonably early stage, changes to proposed deal terms when a CRT is inserted last minute into a transaction might be indicators of arbitraged tax savings. Fortunately, in many complex transactions with parallel co-owners there will be another ground for establishing a clear bright line.

B. Commitment Event by Parallel Parties

In cases involving co-owners, a collective "agreement" measured by vote or other process can replace an agreement reached with an acquirer. Contrary to Lively's dissent in *Jones*, realization occurs after a majority vote, even for a taxpayer who voted against the transaction. The fact that multiple parties may have differing tax consequences arising from the same set of facts means that consistency of result for all parties is critical.

I discuss *Peterson* further below in connection with suspending conditions, but its discussion of the need to identify a specific event that satisfies the realization commitment in entity transactions is pertinent here:

> We explained that the date of stockholder approval was crucial. After the merger was approved, stockholders of the acquired corporation knew that, after the effective date of the merger, their stock could be exchanged pursuant to the merger. Thus, after stockholder approval, the transferred stock was nothing more than a vehicle for receipts of the merger proceeds. *Estate of Applestein v. Commissioner*, *supra*, 80 T.C. at 345.
>
> We relied on a number of cases holding that a transfer of stock following the adoption of a plan of liquidation is an anticipatory assignment of income and results in recognition of gain to the

[45] *Sheppard v. United States*, 361 F.2d 972 (Ct. Cl. 1966).

[46] The Court of Federal Claims categorized the case under the step transaction doctrine, but the opinion sounds more in the assignment of income line. The charity's freedom to sell the transferred property to others at a higher price was the key fact, and the court primarily relied on the assignment of income aspect of *Humacid*, 42 T.C. 894.

[47] *Id*. at 976.

[48] I am all in favor of atypically advantageous tax benefits, provided they are planned in advance, not retroactively engineered with a "flexible" charity.

> transferor. [Citations omitted.] These and other cases suggest that the occurrence of a specific event regarding property (shareholder approval in the above cases) creates a right to income from the property such that a subsequent transfer of the property does not shift the tax on such income to the transferee.[49]

The action of other parallel owners creates a very bright line demarking when a realization commitment occurs. The bright line cannot be assessed woodenly as simply majority action, of course. If, for example, the *Ferguson* facts had included an enforceable shareholder agreement that no change of control could occur absent the affirmative vote of 85 percent of the shareholders, the *Ferguson* gift would have been timely. Similarly, if a shareholder agreement with drag-along rights allows a controlling but not majority owner to trigger the sale of stock, the commitment by the controller would suffice.

Illiquid business interests in an entity undergoing a transformation create the most significant problem for charities, with unknown risks ranging from potential securities law violations to buyer indemnification, clawback provisions, and many others. Gearing up as a business outsider to evaluate these concerns is extraordinarily expensive. The preferred course is for the charity to identify an equity owner similarly situated to the charity and, if possible, obtain a representation that the charity will be treated identically with that owner. A similarly situated equity owner is one who would not participate in management in the future and would not receive meaningful remuneration connected to the transaction for reasons other than her equity. Precedent is solid that in cases in which formal collective action is necessary, the collective action creates a reliable bright line.

Unfortunately, for closely held entity cases, what constitutes formal action is not always entirely clear. If the representative owner described above is actively negotiating terms when the donation is made, this should be conclusive evidence that realization has not yet occurred. The charity should be allowed to tag along on the representative's negotiations without itself negotiating.

VIII. Suspending Conditions

For a sale of a small block of publicly traded stocks, the realization commitment and the realization event occur simultaneously. Matters are otherwise when a third-party purchaser imposes a suspending condition or the sellers impose a condition with significance independent of the transaction. I have not found a charitable assignment case that expressly postponed the realization event because of a suspending condition. The lack of authority is not surprising: (1) transactions that do not close as a result of unsatisfied conditions do not create tax cases; (2) taxpayers who plan properly can generally avoid assignment of income; and (3) the IRS probably does not pursue cases in which a taxpayer can point to an important unsatisfied condition. *Peterson* provides the closest support I can find for the proposition that a suspending condition can prevent assignment of income despite a prior clear realization commitment. It is helpful to approach this point somewhat obliquely by considering the line of cases addressing the taxation of assigned litigation claims.

Cold Metal[50] decided that the assignment of a judicially impounded fund did not create income to the assignor. The IRS has come to understand *Cold Metal* as standing for the proposition that "a taxpayer's right to income on a judgment is not earned or does not ripen until all appeals with respect to the judgment have been exhausted."[51] As quoted by that private letter ruling, the court in *Schulze*[52] stated that "the outcome of a lawsuit is rarely, if ever, certain or free of doubt," although the *Schulze* court noted that the facts there did not involve a gift. While the Fifth Circuit in *Jones*[53]

[49] *Peterson*, T.C. Memo. at 86-1144.

[50] *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957).

[51] LTR 200427009.

[52] *Schulze v. Commissioner*, T.C. Memo. 1983-263.

[53] *Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962).

expressly found that the chances of success on the litigation there were seriously in doubt, it cited *Wellhouse*[54] (a charitable contribution case) for the proposition that legal doubt about the collectability of a transferred note alone barred the assignment of income even in the absence of litigation and over the IRS's argument that the payer had already waived all defenses.[55] Once one grants the premise that litigation is per se unpredictable, the applicable lesson for my purposes is that transfer of the right to sufficiently uncertain income does not constitute taxable assignment of income.

In *Peterson*, the taxpayer and associates executed an agreement to tender their shares if the acquirer made a tender offer on the agreed terms. The court treated the agreement by these majority shareholders as the equivalent of a vote, implicitly deeming it to be the realization commitment for all shareholders. The agreement was still not the realization event. The teaching of the case lies in the court's probabilistic assessment of conditions to the transaction that were satisfied either before or after the taxpayer made a donative transfer of shares subject to the agreement to trusts for his family.

The Tax Court stated that the controlling test was "whether by the time of the gifts, the sale was practically certain to be completed" — language that first appeared in *Jones*[56] and was echoed in *Estate of Applestein*,[57] *Greene*,[58] and *Ferguson* and by the IRS in *Rauenhorst*. The taxpayer primarily relied on *Cold Metal* to argue that the income was sufficiently uncertain as to preclude assignment, pointing to numerous contingencies in the agreement that were unresolved at the time of the gift.

The taxpayer gifted his shares approximately two months after the agreement, approximately two weeks after a competitor firm waived its right of first refusal over the proposed acquisition and two days after the acquirer made the expected tender offer. As in *Ferguson*, the acquirer in *Peterson* did not want to buy the company, but acquiring it was the only way to gain the taxpayer's highly desirable services as a chief executive. The court found that as of the date of the tender offer, the acquirer and the taxpayer had reached a deal on the taxpayer's employment and concluded that the acquirer would waive all the many other conditions to the transaction. The opinion strongly implies that a gift before either the waiver or the tender offer would not have triggered realization. In other words, the competitor's right of first refusal was sufficiently uncertain to be satisfied that a gift made before that right lapsed would not have triggered income. This analysis makes sense of cases like *Ferguson*. If conditions to an agreement are irrelevant for purposes of assignment of income analysis, the court wouldn't have needed to conclude that on those facts, and the acquirer would have waived the 85 percent requirement.

Other than seller-side conditions with independent significance, conditions directly tied to the terms of the deal should ordinarily be viewed as under the buyer's control. In *Peterson*, for example, the court implicitly treated the employment issue not in terms of when the taxpayer agreed to be hired but when the acquirer felt sufficiently sure of its goals to crystalize its intent to proceed by making the tender offer. Evaluating the resolution of any deal-related condition from the perspective of the arm's-length party is consistent with the general tax principle of relying on adversity of interests to control characterization. By analogy to *American Nurseryman*,[59] one could also reason that the IRS is in effect a party to the taxpayer's sufficiently objective and definite manifestation of a decision to realize gain, such that the agency's consent is required before the taxpayer could unilaterally postpone realization. This approach respects material conditions but reduces the taxpayer's ability to game "formalities."

The motive for retroactive planning is highest in the hiatus between an agreement and closing. In the many liquidation cases, it was the awareness that a large tax bill loomed that

[54] *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (S.D. Fla. 1961).

[55] *Id*. at 742. *See also Dodge v. United States*, 443 F. Supp. 535 (D. Ore. 1977); *Weller v. Brownell*, 240 F. Supp. 201 (M.D. Pa. 1965); and LTR 201232024.

[56] *Jones*, 531 F.2d 1343.

[57] *Estate of Applestein v. Commissioner*, 80 T.C. 331, 346 (1983).

[58] *Greene v. United States*, 806 F. Supp. 1165 (S.D.N.Y. 1992).

[59] *American Nurseryman Publishing Co. v. Commissioner*, 75 T.C. 271 (1980).

prompted the taxpayers to make gifts. In Peterson's case, he was willing to relinquish his shares only after he was assured of a successful transition to new employment. As noted above, the potentially abusive act occurs at the time of the donative transfer, not the prior realization commitment. Consistent theory requires judicial discrimination between contingencies that are meaningful and those that are formalities.

IX. Harmonizing *Ferguson* and *Rauenhorst*

The core of the Tax Court's opinion in *Ferguson* was the probabilistic determination that the acquirer would waive the condition that 85 percent of the shares be tendered. Following a long line of cases, the Tax Court concluded that tender by a majority of other shareholders acted as a collective decision that bound the taxpayer. In terms of my model, the majority vote was the realization commitment. While the taxpayer argued the 85 percent requirement was what I call a suspending condition, the court found that the requirement was not sufficiently uncertain to be fulfilled to postpone realization. In the absence of a suspending condition, the realization commitment alone served to mark the realization event. The taxpayers gambled that the tender requirement excused their lackadaisical delivery, and the Tax Court responded by making a supportable adverse assessment of the odds. The mistake made by the Ninth Circuit lay in suggesting that a realization commitment as well as a putative suspending condition could be predicted rather than observed. Planning by the taxpayer — let alone by others, as in *Rauenhorst* — does not equal "the occurrence of a specific event regarding property." The taxpayer's own virtual certainty that the transaction would proceed simply does not count.

The Tax Court in *Rauenhorst* properly insisted that taxation could not precede an observable agreement to convert the form of an asset. Where the Tax Court went too far was in suggesting that Rev. Rul. 78-197 precludes the IRS from any inquiry into the circumstances that produced the agreement or the conditions attached to closing.

Agreements reached with third parties acting at arm's length should be respected. An agreement that contemplates a charitable transfer negotiated with monitoring or participation by a charity, or the statutory stand-ins of sections 664 and 4941, is highly likely to be at arm's length. This is not to say that a taxpayer who introduces a charity to a transaction immediately before the execution of a binding agreement will automatically be deemed to have assigned income, but I believe that the IRS should not be barred from asking questions. The facts of *Blake*,[60] in which a charity participated in what was basically a fraudulent tax avoidance scheme, demonstrate that charities are not perfect gatekeepers.

Blake gave stock to a charity with the transparent understanding that the charity would use the proceeds to purchase a yacht from him at an inflated price. To my mind, better window dressing by the taxpayer in *Blake* would have made it much harder to apply the step transaction doctrine relied on by the Second Circuit. The assignment of income doctrine, flexibly understood, would have been a more appropriate analysis. The transfer of stock was a realization commitment.[61] The taxpayer would be allowed a deduction if the charity had been unlikely to buy the yacht. The taxpayer essentially treated the charity's decision to buy the yacht as a suspending condition. The court correctly disregarded the condition.

It is possible that the Second Circuit felt compelled to resort to step transaction law to distinguish the taxpayer's reliance on *Palmer* and Rev. Rul. 78-197. A better understanding of those authorities would go far in clarifying this branch of tax jurisprudence. ■

[60] *Blake v. Commissioner*, 697 F.2d 473 (2d Cir. 1982).

[61] This notional reordering of events is similar to the analysis in *Humacid*, 42 T.C. 894, regarding the encumbered notes.