

THE PERILS OF PRE-ARRANGED SALES AND HOW TO AVOID THEM

PGDC E-CAMPUS TWO-PART WEBINAR

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Phrases that Provide Important Clues

The case law pertaining to pre-arranged sales suggests there are certain questions and phrases which provide clues as to how the courts will construe a gift. This cheat sheet is to help you identify the phrases and questions and the answers to look for.

Conduit

- Is it a “...conduit through which to pass title”?¹ **If yes, then it may be treated as a pre-arranged sale.**

Two-prong test

- *2-prong test*: 1. Is it a valid, completed gift? 2. Was the donee legally bound or could be compelled to sell the appreciated property?² **To avoid a pre-arranged sale, the 1st prong must show a valid, completed gift, and the second prong must show that the donee was not legally bound and could not be compelled to sell the appreciated property.**

Valid, binding gift

- Was it a “valid, binding, and irrevocable gift”?³ **To avoid being a pre-arranged sale, the gift must be valid, binding, and irrevocable.**

Dominion and control

- “Did the donor part with all dominion and control over the donated property?” If so, the gift was complete.⁴ **If the donor retains dominion and control over the donated property, then it is likely a pre-arranged sale. If no vestige of control is retained, then there is no pre-arranged sale.**

Before property gives rise to income

- “When the foundation received the gift of stock from the petitioner, **no vote for redemption had been taken**”. While anticipated, expectation was not enough. The **presence of an actual gift and the absence of an obligation to redeem is sufficient.**”⁵

¹ Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

² Humacid Co. v. Commissioner, 42 T.C. 894 (1964).

³ Ankeny v. Commissioner, 53 T.C.M. 827 (1987).

⁴ Carrington v. Commissioner, 476 F.2d 704, 708 (5th Cir. 1973).

⁵ Palmer v. Commissioner, 62 T.C. 684 (1974).

Donee legally bound or compelled to surrender

- IRS will treat the proceeds as income to the donor **“only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.”**⁶
Court tells IRS to stick to its own ruling in Rauenhorst (see footnote 9).

Practically certain to occur turning property into right to income

- Was the tax event “practically certain to occur” rather than the “mere anticipation or expectation” before the donation?⁷ **Practically certain to occur depends on whether a right to income has “ripened”, depending on “realities and substance” of events. To avoid being labeled a pre-arranged sale, the property cannot have been converted into a right to receive income by the time of transfer.**

Tax planning doesn’t convert non-taxable event into taxable one

- Court said it is not so naïve to think tax planning happens. Of course it does. But it won’t cast two actual transactions into two fictional ones.⁸ **Substance still controls over mere form desired by IRS.**

Stick to your own ruling, IRS

- Was the Donee legally obligated, and compelled, to sell contributed property?⁹ **If no, that is a strong indication that the gift was not a pre-arranged sale.**

Has right to income “crystallized”

- Had the redemption and the shareholder’s corresponding right to income **“already been crystallized”** at the time of the gift?¹⁰ **If yes, then it can be treated as a pre-arranged sale. However, a pre-existing understanding does not convert a post-donation redemption into a pre-donation redemption.**

⁶ Rev. Rul. 78-197, 1978-1 C.B. 83.

⁷ Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999).

⁸ Grove v. Commissioner, 490 F.2d. 241 (2nd Cir. 1973).

⁹ Rauenhorst v. Commissioner, 119 T.C. 157 (2002).

¹⁰ Dickinson v. Commissioner, T.C. Memo 2020-128 (U.S.T.C. Sep 3, 2020).