Buy-Sell Agreements

Gray Edmondson, J.D., LL.M.
Edmondson Sage Allen, PLLC
402 Enterprise Drive
Oxford, Mississippi 38655
(662) 371-4110

ESA LAW EDMONDSON SAGE ALLEN PLLC

1

Overview

- Judicial development of the (anticipatory) assignment of income doctrine
- Pre-*Hoensheid* takeaways
- *Hoensheid*
- Post-*Hoensheid* takeaways
- Statutory assignment of income doctrine

ESA LAW EDMONDSON SAGE ALLEN PLLC

2

2

Judicial development of the (anticipatory) assignment of income doctrine

EDMONDSON SAGE ALLEN PLLC

3

3

Generally

- Income tax is driven by substance rather than form. *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945).
- The basic principle of the income tax law is that it is a tax on income beneficially received.
- The Internal Revenue Code generally defines what is included and excluded from gross income.
- IRC §61 provides that, except as otherwise provided in the Code, gross income means all income from whatever source derived.

EDMONDSON SAGE ALLEN PLLC

4

4

Generally (cont.)

- The assignment of income doctrine is a court-developed doctrine used to determine which taxpayer realizes and recognizes gross income, not whether income is realized or recognized.
- The assignment of income doctrine taxes income "to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." *Helvering v. Horst*, 311 U.S. 112, 119 (1940).

ESA LAW | EDMONDSON SAGE ALLEN PLLC

5

5

Generally (cont.)

- Once a right to receive income has "ripened" for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income. *Ferguson v. Comm'r*, 174 F.3d 997 (9th Cir. 1997) (citations omitted).
- In other words, courts will not recognize for income tax purposes an "arrangement by which the fruits are attributed to a different tree from that on which they grew." *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

ESA LAW | EDMONDSON SAGE ALLEN PLLC

6

6

Generally (cont.)

But . . . .

- If the entire interest in the property is transferred and the transferor retains no incidence of either direct or indirect control, then the tax on the income rests on the transferee. *See Blair v. Comm'r*, 300 U.S. 5 (1937).
- Also, 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. *Humacid Co. v. Comm'r*, 42 T.C. 894, 913 (1964).

ESA LAW EDMONDSON SAGE ALLEN PLLC

7

7

Generally (cont.)

- Assignment of income issues arises in the context of pre-liquidity event (such as sales, mergers, corporate liquidations, lottery awards, compensation payments, etc.) transfers to charities (including donor advised funds) or family members.
- When an assignment of income occurs, a cash basis transferor should not recognize income until the transferee receives the payment (*see Helvering v. Eubank*, 311 U.S. 122 (1940)) unless the transferor gets a present benefit (*e.g.*, *Jones v. Comm'r*, 82 T.C. 586 (1984)).

ESA LAW EDMONDSON SAGE ALLEN PLLC

8

8

Example – charitable gift

- Taxpayer owns Blackacre with $100 FMV and $10 basis.
- Taxpayer donates Blackacre to Charity.
- Charity sells Blackacre for $100.

	Pre-arranged sale	No pre-arranged sale
Result	Donor recognizes $90 of gain and may get a $100 charitable deduction.	Donor gets a $100 charitable deduction and recognizes no gain.
Net Benefit	$15.40 net benefit (($100 x 37%) – ($90 x 24%))	$37 net benefit ($100 x 37%)

ESA LAW EDMONDSON SAGE ALLEN PLLC

9

9

General case law development

- Under the doctrine:
  - Income from personal service is included in the gross income of the person who ***performs*** the service. *See Lucas v. Earl*, 281 U.S. 111 (1930).
  - Income and gain from property is included in the gross income of the person who ***retains or beneficially owns*** the property. *See Blair v. Comm'r*, 300 U.S. 5 (1937); *Helvering v. Horst*, 311 U.S. 112 (1940).
  - Income is included in the gross income of the person who retains the ***control over the use and enjoyment*** of that income. *See Corliss v. Bowers, 281 U.S. 376 (1930); Comm'r v. Sunnen*, 333 U.S. 591 (1948).

ESA LAW EDMONDSON SAGE ALLEN PLLC

10

10

General case law development (cont.)

- A right "ripens" when the realities and substance of events show the receipt of income is practically certain to occur—that is, the right has become a fixed right. *Ferguson,* 174 F.3d at 1003.
- A mere anticipation or expectation is insufficient to conclude that a fixed right to income exists. *Id*.
- But mere formalities and remote hypothetical possibilities will not be sufficient to conclude that a fixed right to income does not exists. *Id*. at 1004.

ESA LAW EDMONDSON SAGE ALLEN PLLC

11

11

General case law development (cont.)

- While the ability of a transferee to alter a prearranged course of disposition with respect to the transferred property provides good evidence of whether a fixed right to income existed at the time of transfer, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. *Rauenhorst v. Comm'r*, 119 T.C. 157, 166 (2002).

ESA LAW EDMONDSON SAGE ALLEN PLLC

12

12

General case law development (cont.)

- A donation of two forward sales contracts to a charity formed by the taxpayer did not result in an assignment of income when the donee charity sold the contracts to a third party. The charity negotiated the sales contract. *S.C. Johnson & Son, Inc. v. Comm'r*, 63 T.C. 778 (1975).
- Wellhouse loaned money to Welles. Welles died and Wellhouse filed a claim against Welles' estate. Wellhouse donated the note to a charity. About three months later, Welles' estate voluntarily paid the note. There was not assignment of income because of the "considerable legal doubt as to when the obligation would be paid, or if it would be paid at all." *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (S.D. Fla. 1961).

ESA LAW EDMONDSON SAGE ALLEN PLLC

General case law development (cont.)

- The transfer of stock to custodial accounts for taxpayer's children after a merger agreement had been signed resulted in an assignment of income. In so holding, the court noted

  > [A]t the time of transfer, the merger had been agreed upon by the directors and shareholders of both companies and there were no other necessary steps to be taken before the merger became effective. Any possibilities that the merger would be abandoned by the companies themselves or stopped by a regulatory agency were "remote and hypothetical."

  Estate of Applestein v. Comm'r, 80 T.C. 331 (1983).

ESA LAW EDMONDSON SAGE ALLEN PLLC

General case law development (cont.)

- Taxpayer donated corporate stock to a charity four months before the first liquidating distribution but after a plan of liquidation had been adopted by the board of directors and approved by the shareholders. It also appears that regulatory approval had been secured. The shareholders did retain the right to abandon the plan of liquidation. The court, finding that an assignment of income occurred, noted, “the liquidation plan was practically certain to be completed despite the remote and hypothetical possibility of abandonment.” *Jones v. U.S.*, 531 F.2d 1343 (6th Cir. 1976).

ESA LAW EDMONDSON SAGE ALLEN PLLC

General case law development (cont.)

- In *Blake v. Commissioner*, 697 F.2d 473, 480-481 (2nd Cir. 1982), the court, in dicta, suggests that in the Second Circuit a mere understanding between the contributing shareholder and the charity concerning the fact that the contributed stock would be redeemed should be enough to treat the shareholder as having received redemption proceeds.

ESA LAW EDMONDSON SAGE ALLEN PLLC

Palmer v. Comm'r, 62 T.C. 684 (1974)

- Dr. Daniel Palmer owned Palmer College, a for-profit chiropractic school.
- Dr. Palmer set up Palmer College Foundation as a non-profit chiropractic school.
- Dr. Palmer controlled both the corporation and the foundation.

ESA LAW | EDMONDSON SAGE ALLEN PLLC

Palmer (cont.)

- Dr. Palmer "engaged counsel to devise a plan that would accomplish the transfer of the college from the corporation to the foundation, that would enable the petitioner to maintain his control over the direction and operation of the college, and that would yield the most favorable tax consequences."
- Under the plan, Dr. Palmer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation.

ESA LAW | EDMONDSON SAGE ALLEN PLLC

Palmer (cont.)

- The IRS asserted both the step-transaction and assignment of income doctrines, but the court found for the Dr. Palmer noting,

  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 have been sufficient to give such gifts independent significance.

ESA LAW EDMONDSON SAGE ALLEN PLLC

Rev. Rul. 78-197

- The IRS acquiesced to *Palmer*, saying

  The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only **<u>if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption</u>**.
- While the IRS has adopted a bright-line test for redemptions in Rev. Rul. 78-179, the Tax Court has **<u>NOT</u>** adopted that bright-line test. *See Rauenhorst*, 119 T.C. at 165-6; *see also* CC 2002-043.

ESA LAW EDMONDSON SAGE ALLEN PLLC

Pre-*Hoensheid* takeaways

Pre-*Hoensheid* takeaways

- Make the transfer as early as possible before the liquidity event.
- Make the transferee negotiate its own liquidity event—that is, don't give an asset to a transferee who is powerless to reverse or revoke the decision to liquidate the asset.
- Build a good file as close in time as possible to the transfer, making sure that file includes a description of the legitimate conditions, contingencies, and uncertainties that surround the consummation of the liquidity event. Remember that the events and context around a transfer are easily lost.

Pre-*Hoensheid* takeaways (cont.)

- In a redemption transaction, make sure there is no legal binding commitment to sell the transferred asset at the time of the transfer.
- Educate your client about the pitfalls of emailing and texting.
- Make sure all transfers are valid and complete under applicable state law.
- Make sure all transfers are correctly documented, including correct descriptions, dates, signatures, delivery, etc.
- Apply the smell test, remembering income tax is driven by substance rather than form.

ESA LAW EDMONDSON SAGE ALLEN PLLC

23

23

Estate of Hoensheid v. Comm'r, T.C. Memo 2023-34

ESA LAW EDMONDSON SAGE ALLEN PLLC

24

24

Hoensheid

- 4/1/2015: Seller receives draft LOI.
- Mid-April 2015: Business owner begins considering pre-sale gift of stock.
- 4/16/2015: Donor's attorney emails "the transfer would have to take place before there is a definitive agreement in place."
- 4/23/2015: LOI signed.
- 6/1/2015: Valuation date and email from donor that "I do not want to transfer the stock until we are 99% sure we are closing."
- 6/11/2015: Approval of sale by shareholders/directors, buyer submits pre-sale filings to Sec. of State, purchase agreement forwarded to DAF, and charitable gift approved by shareholders.

Hoensheid (cont.)

- 6/12/2015: Buyer's investment committee and managing partners approve purchase.
- 7/6/2015: Donor emails that he is "not totally sure of the shares being transferred to the charitable fund yet."
- 7/7/2015: Corp. determines to make payments to employees under Change of Control Bonus Plan and almost all remaining cash to shareholders
- 7/9/2015 – 7/10/2015: Bonuses paid to employees, donor determines number of shares to gift to DAF, and stock certificate representing gift delivered to donor's attorney.
- 7/13/2015: Purchase agreement circulated agreeing to all substantive provisions and PDF stock certificate representing charitable gift emailed to DAF representatives.
- 7/14/2015: Corporate cash distributed to shareholders.
- 7/15/2015: Transaction closing.

Hoensheid – Rev. Rul. 78-197

In Palmer, the taxpayer had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the taxpayer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation….The Service will treat the proceeds of a redemption of stock under facts similar to those in Palmer 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.

ESA LAW EDMONDSON SAGE ALLEN PLLC

27

27

Hoensheid – Rauenhorst

In support of respondent's position that the right to sale proceeds had ripened to a practical certainty at the time of the contributions, he cites: (1) The September 28, 1993, letter of intent from WCP expressing its intention to purchase all the issued and outstanding stock of NMG; (2) the October 22, 1993, resolution by WCP's board of directors, which authorized its officers to negotiate and enter into the agreement for the purchase of all the issued and outstanding capital stock of NMG; and (3) a valuation report prepared by Houlihan, Lokey, Howard, & Zukin (Houlihan Lokey), which was attached to petitioners' 1993 return and which opined that, as of November 12, 1993, there was little chance the transaction involving WCP would not close on or before December 31, 1993. Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

ESA LAW EDMONDSON SAGE ALLEN PLLC

28

28

Hoensheid – Rauenhorst (cont.)

- "Revenue rulings are not binding on this Court, or other Federal courts for that matter…However, we cannot agree that the Commissioner is not bound to follow his revenue rulings in Tax Court proceedings." "[I]n the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law."
- "[W]e have indicated our reluctance to elevate the question of donee control to a talisman for resolving anticipatory assignment of income issues. For example, in *Allen v. Commissioner,* 66 T.C. 340, 347–348, 1976 WL 3625 (1976), we stated that the donee's power to reverse the donor's anticipated course of disposition was 'only one factor to be considered in ascertaining the 'realities and substance' of the transaction'… the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. "
- "[T]he ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer."

ESA LAW | EDMONDSON SAGE ALLEN PLLC

29

29

Hoensheid (cont.)

Hoensheid moved away from language highlighted above:

> While we consider a donee's legal obligation to sell as "significant to the assignment of income analysis," … it "is only one factor to be considered in ascertaining the `realities and substance' of the transaction…. Instead, "the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer…." We thus look to several other factors that bear upon whether the sale of shares was virtually certain to occur at the time of petitioners' gift. In this case the relevant factors include (1) any legal obligation to sell by the donee, (2) the actions already taken by the parties to effect the transaction, … (3) the remaining unresolved transactional contingencies, … and (4) the status of the corporate formalities required to finalize the transaction….

ESA LAW | EDMONDSON SAGE ALLEN PLLC

30

30

Hoensheid (cont.)

Hoensheid went on to say:

- "On the particular facts of this case, we do not find respondent's arguments to be sufficiently contrary to Rev. Rul. 78-197 to constitute a disavowal of his published guidance."
- Footnote 21 distinguishes *Palmer* and Rev. Rul. 78-197 by stating "the Commissioner advised that, "under facts similar to those in *Palmer*," he would treat a charitable contribution of stock followed by a redemption as an anticipatory assignment of income "only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." *Palmer* involved a taxpayer's contribution of shares of stock in his controlled corporation to a charitable foundation of which he was a trustee, followed by a redemption of the shares by the corporation."

ESA LAW | EDMONDSON SAGE ALLEN PLLC

Hoensheid (cont.)

- Distributions to owners and certain bonuses paid in conjunction with sale, concluding all pre-sale financial transactions
- Corporate formalities approving the sale had been completed prior to the charitable donation, sale contingencies were complete, and transaction documents had been substantially approved.

ESA LAW | EDMONDSON SAGE ALLEN PLLC

Hoensheid (cont.)

- All that remained was to sign the closing documents
- "On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing eliminated any such risk and made the sale a virtual certainty."

ESA LAW EDMONDSON SAGE ALLEN PLLC

33

33

Hoensheid – Completed gift requirement

IRC §170 deduction allowed only if transfer satisfies six essential elements of bona fide inter vivos gift:

- a donor competent to make the gift;
- a donee capable of taking the gift;
- a clear and unmistakable intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion, and control of the subject matter of the gift, in praesenti;
- the irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee, so that the donor can exercise no further act of dominion or control over it;
- a delivery by the donor to the donee of the subject of the gift or the most effectual means of commanding the dominion of it; and
- acceptance of the gift by the donee.

ESA LAW EDMONDSON SAGE ALLEN PLLC

34

34

Hoensheid – Completed gift requirement (cont.)

In determining validity of gift, Michigan law requires:

- Donor intent to make gift
- Actual or constructive delivery of subject matter of gift
- Donee acceptance

Hoensheid – Completed gift requirement (cont.)

Donor intent to make gift:

- Whether testimony credible based on objective facts, reasonableness of testimony, consistency of witness' statements, and witness' demeanor
- If contradicted by objective facts in record, not accept self-serving testimony

Hoensheid – *C*ompleted gift requirement (cont.)

Delivery:

- Whether constructive or actual, delivery "must be unconditional and must place the property within the dominion and control of the donee" and "beyond the power of recall by the donor"
- Email PDF of shares "placed the shares of CSTC in Fidelity Chari table's dominion and control, by providing Fidelity Charitable with an instrument that it could present to CSTC and exercise its rights as shareholder. Nor did any postdelivery retention by petitioner of a stock certificate render delivery ineffectual."

ESA LAW EDMONDSON SAGE ALLEN PLLC

37

37

Hoensheid – *C*ompleted gift requirement (cont.)

Acceptance:

- Acceptance presumed
- Fidelity backdated receipt at donor's request, but court disregarded because no present intent or delivery then
- "Fidelity Charitable typically required receipt of a stock certificate as a precondition to its acceptance of a gift when dealing with a contribution of closely held, certificated securities"
- "After receiving the stock certificate ... Fidelity Charitable executed the Minority Stock Purchase Agreement under warranty of good title. That act is sufficient to establish acceptance ...."

ESA LAW EDMONDSON SAGE ALLEN PLLC

38

38

Hoensheid — Property being sold

- *Rauenhorst* faulted the IRS' nonspecific allegations of an informal agreement or understanding between the donees and other parties.
- In *Hoensheid*, IRS proved exactly how far along sale was.
- Court seems to be moving away from Rauenhorst and instead saying to taxpayers, "You can't get a deal totally worked out, take all of the economic steps consistent with being totally ready to close, pause for a day to figure out who you want to be taxed on the sale, rearrange ownership, then the next day close with new owners who will be taxable instead of you."

ESA LAW EDMONDSON SAGE ALLEN PLLC

Hoensheid — Appraisal and Form 8283

- Appraiser not "qualified"
- Appraisal report did not mention qualifications.
- Appraiser only infrequently preformed valuations, did not hold himself out as an appraiser, and held no certifications from professional organizations

ESA LAW EDMONDSON SAGE ALLEN PLLC

Hoensheid — Appraisal and Form 8283 (cont.)

- Incorrect date of contribution and taxpayer "knew or at least should have known that the shares were not contributed"
- Appears that appraiser used because he charged no separate valuation fee
- Above factors together preclude substantial compliance

EDMONDSON SAGE ALLEN PLLC ESA LAW

41

41

Hoensheid — Appraisal and Form 8283 (cont.)

- Charitable deduction denied
- But IRS did not prove penalty because counsel relied on *Rauenhorst*; disregarding counsel's advice to avoid risk by doing earlier did not prevent reliance on *Rauenhorst.*

EDMONDSON SAGE ALLEN PLLC ESA LAW

42

42

Post-*Hoensheid* takeaways

ESA LAW EDMONDSON SAGE ALLEN PLLC

43

43

Post-*Hoensheid* takeaways

- Make the transfer as early as possible before the liquidity event.
- Make the transferee negotiate its own liquidity event—that is, don't give an asset to a transferee who is powerless to reverse or revoke the decision to liquidate the asset.
- Build a good file as close in time as possible to the transfer, making sure that file includes a description of the legitimate conditions, contingencies, and uncertainties that surround the consummation of the liquidity event. Remember that the events and context around a transfer are easily lost.

ESA LAW EDMONDSON SAGE ALLEN PLLC

44

44

Post-*Hoensheid* takeaways (cont.)

- Don't get too comfortable with the "no legal binding commitment" concept of Rev. Rul. 78-197. *See Estate of Powell v. Comm'r*, 148 T.C. 392, 423 (2017) and *Estate of Moore v. Comm'r*, TC Memo 2020-40 (where the Tax Court, *sua sponte*, raised double inclusion under IRC §2043).
- Educate your client about the pitfalls of emailing and texting.
- Make sure all transfers are valid and complete under applicable state law.

ESA LAW EDMONDSON SAGE ALLEN PLLC

45

45

Post-*Hoensheid* takeaways (cont.)

- Make sure all transfers are correctly documented, including correct descriptions, dates, signatures, delivery, etc.
- Don't argue or let your client argue a revisionist history of the facts—stick to the facts as they are.
- Apply the smell test, remembering income tax is driven by substance rather than form.

ESA LAW EDMONDSON SAGE ALLEN PLLC

46

46

Statutory assignment of income doctrine

ESA LAW EDMONDSON SAGE ALLEN PLLC

47

47

Codified assignment of income doctrine

- Personal service corporation rules under IRC §269A.
- Transfer pricing rules under IRC §482.
- Grantor trust rules under IRC §§672-679.
- Subchapter K
  - Substantial economic effect rules under IRC §704(b).
  - IRC §704(c) allocations.
  - Family partnership rules under IRC §704(e).
  - Closing of the books v. proration method under IRC §706(d).
  - Anti-abuse rules under Reg. §1.701-2.
- Subchapter S
  - Family allocation rules under §1366(e).
  - Closing of the books v. proration method under §1377(a)(2).

ESA LAW EDMONDSON SAGE ALLEN PLLC

48

48