DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTHERN CALIFORNIA DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Settlement of Tax Liabilities

This Field Service Advice responds to your memorandum dated October 26, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

T =
B =
C =

D =
E =

Year 1 =
Year 12 =
Year 14 =
Year 15 =
Year 16 =
Year 17 =
Year 18 =

ISSUES:

1. Whether excise and transfer taxes would be applicable if the corpus of C were invaded to pay the personal tax liability of T.

2. Whether the Service's self-imposed administrative stay of collection prohibits

the Department of Justice from foreclosing the tax lien in the absence of jeopardy.
3. If the Service's administrative stay of collection does not prohibit the Department of Justice from foreclosing the tax lien, whether the proposed settlement should be accepted.

CONCLUSIONS:

1. Excise and transfer taxes would be applicable under the proposed distribution, to the extent the distribution exceeds the unitrust amount.

2. The administrative stay of collection does not prohibit the Department of Justice from foreclosing the tax lien.

3. The proposed settlement offer should not be accepted.

FACTS:

In Years 1 through 12 and Years 15 and 16, T participated in a tax shelter promoted by B. On September 22, Year 14, T created C, a charitable remainder unitrust, and on October 10, Year 14, funded it with stock. Pursuant to the terms of the trust, the unitrust amount must be distributed in quarterly installments to T and the remainder paid to a contingent charitable beneficiary. Shortly after being funded, C sold the stock and used the proceeds to purchase a variable annuity contract with T as the annuitants. The charitable remainder unitrust is administered by D, and E is named as the contingent charitable beneficiary remainderman. It is likely that the transfer of stock to C rendered T insolvent.

On February 2, Year 18, the Internal Revenue Service Chief Operations Officer issued a memorandum unilaterally and voluntarily suspending collection action against investors for assessments flowing from adjustments to partnerships promoted by B, except for jeopardy situations. On May 24, Year 18, the Chief Operations Officer issued a memorandum clarifying the February 2, Year 18, memorandum. The May 24, Year 18, memorandum clarifies that the administrative stay of collection only applies to notices of levy and seizures and does not apply to actions such as defending and filing suits.

Pursuant to adjustments made on account of T's participation in the tax shelter, deficiencies were determined, and on December 3, Year 15, T and the government entered into a closing agreement. On April 28, Year 16, an assessment was made against T.

On May 19, Year 16, the Service filed a Notice of Tax Lien with respect to the tax assessments. On September 28, Year 17, the United States filed an action to reduce Tax Assessments to Judgment; Set Aside Fraudulent Conveyances; and Foreclose Federal Tax Liens. The action alleged that T's transfer of stock to C was intended to hinder, delay, or defraud the United States of present and future lawful taxes and that the transfers were made without fair consideration or in exchange for reasonably equivalent value and rendered T insolvent. Thus, the transfers were fraudulent and of no effect as to the United States. Accordingly, the United States seeks to foreclose on T's interest in the annuity contract held by C. T contended that they had legitimate reasons to establish the charitable remainder unitrust, including the avoidance of substantial capital gains on the sale of stock.

On January 22, Year 17, T filed a voluntary chapter 7 bankruptcy petition. Through the bankruptcy trustee, T has proposed to settle any tax liabilities by having the bankruptcy trustee invade the trust corpus and use such funds to pay the claims of the government. T would not be liable for any tax liability associated with such a distribution, such as recognition of capital gain or excise taxes imposed for self-dealing. In addition, the charitable contribution deduction claimed by T in Year 14 for the contribution of stock to C would not be disallowed in whole or in part. Finally, the parties would agree that T committed no fraud.

LAW AND ANALYSIS

1. Invasion of Trust Corpus

Through the bankruptcy trustee, T has proposed to settle any tax liabilities by having the bankruptcy trustee invade the trust corpus and use such funds to pay the claims of the government. The proposed settlement includes a provision that T would not be liable for any tax liability associated with such a distribution, such as excise taxes imposed for self-dealing.

A charitable remainder unitrust is a trust from which a fixed percentage,[1] valued annually, is to be paid not less than annually to one or more persons (at least one of which is not an organization described in section170(c) and, in the case of individuals, only to an individual who is living at the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individuals. I.R.C. § 664(d)(2)(A), (B). The payments are referred to as the "unitrust" amount. Following the termination of the unitrust payments, the remainder interest in the trust is transferred to, or for the use of, an organization described in section 170(c)(2). I.R.C. § 664(d)(2)(C).

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[1] At the time the trust was created, the fixed percentage could not be less than five percent. Subsequently, section 664(d)(2)(D) was amended to provide that the fixed percentage to be distributed must be no less than five percent and no greater than 50 percent, and the remainder interest in such property must be at least 10 percent of the fair market value of such property as of the date of the gift. Pub. L. No. 105-34, sec. 1089.

No amount other than the unitrust amount may be paid to or for the use of any person other than an organization described in section 170(c). I.R.C. § 664(d)(2)(B); Treas. Reg. § 1.664-3(a)(2). The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Treas. Reg. § 1.664-3(a)(4).

A charitable remainder unitrust is subject to tax only with respect to unrelated business taxable income. I.R.C. § 664(c). Accordingly, C did not pay any capital gains tax upon the sale of the stock contributed to C by T.

An individual is entitled to a charitable contribution for the present value of the remainder interest of the trust. I.R.C. § 170(f)(2)(A); Treas. Reg. § 1.170A-6(b). Accordingly, in Year 14, T claimed a charitable contribution equal to the remainder interest in C.

A five percent excise tax on the amount involved is imposed on each act of self-dealing between a disqualified person and a charitable remainder unitrust. I.R.C. §§ 4941(a)(1), 4947(a)(2).[2] A 2 ½ percent excise tax is imposed on the participation of the trustee in any act of self-dealing between a disqualified person and the charitable remainder unitrust, unless such participation is not willful and due to reasonable cause. I.R.C. §§ 4941(a)(2), 4947(a)(2). Additional taxes are imposed on disqualified persons or the trustee if the act of self-dealing is not corrected. I.R.C. §§ 4941(b), 4947(a)(2). Self-dealing includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person, of the income or assets of a charitable remainder trust. I.R.C. §§ 4941(d)(1)(E), 4947(a)(2).

A tax of ten percent of the amount involved is imposed on a charitable remainder trust for each taxable expenditure. I.R.C. §§ 4945(a)(1), 4947(a)(2). A tax of 2 ½ percent is imposed on the agreement of any trustee to the making of an expenditure, knowing it is a taxable expenditure to the extent of the amount thereof, unless such agreement is not willful and is due to reasonable cause. I.R.C. § 4945(a)(2). Additional taxes are imposed under section 4945(b). A taxable expenditure includes any amount paid or incurred by a charitable remainder trust for any purpose other than one specified in section 170(c)(2)(B). I.R.C. § 4945(d)(5).

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[2] A charitable remainder trust which complies with section 664 and for which a deduction was allowed under section 170 is a split interest trust described in section 4947(a)(2) and subject to section 4941 and 4945 with respect to the charitable remainder interest. I.R.C. § 4947(a)(2).

As a result of the creation of C, T irrevocably gave a contingent remainder interest to E and retained only the interest in the unitrust amount. Only this interest, and not the entire trust corpus, is currently property of the bankruptcy estate.

Because the trust is a separate taxpayer from T, and has an independent legal existence, the bankruptcy trustee cannot disregard the trust as an entity and invade the interest T relinquished in creating the trust. Any invasion, alteration, amendment, or revocation of the trust for the benefit of any person other than an organization described in section 170(c) is prohibited. Treas. Reg. § 1.664-3(a)(4). In addition, because E has a vested contingent remainder interest in the trust, any invasion of the trust corpus without adequately providing for the vested remainder interest would be invalid.

In addition, a distribution of assets from C to settle T's tax liabilities would constitute an act of self-dealing as any distribution of an amount in excess of the unitrust amount would use C's assets for the benefit of T. I.R.C. § 4941(d)(1)(E). A distribution would also constitute a taxable expenditure as a distribution of charitable assets for a purpose not described in section 170(c). I.R.C. § 4945(d)(3), (5).[3] Accordingly, the bankruptcy trustee cannot invade the corpus of C without triggering the penalties for self-dealing and taxable expenditures. This result is inconsistent with the proposed settlement agreement.

2. Effect of the Administrative Stay of Collection

On September 28, Year 17, the United States filed an action to reduce Tax Assessments to Judgment; Set Aside Fraudulent Conveyances; and Foreclose Federal Tax Liens. The action alleged that T's transfer of stock to C was intended to hinder, delay, or defraud the United States of present and future lawful taxes and that the transfers were made without fair consideration or in exchange for reasonably equivalent value and rendered T insolvent. Thus, the transfers were fraudulent and of no effect as to the United States. Accordingly, the United States seeks to foreclose on T's interest in the annuity contract held by C.

[3] The bankruptcy trustee, insofar as the trustee assumes control over the trust corpus, would literally fall within the definition of foundation manager. Participation in a court-supervised settlement of the case likely would be viewed as reasonable cause so that the bankruptcy trustee would not be liable for the section 4941(a)(2) and 4945(a)(2) taxes on foundation managers.

On February 2, Year 18, the Chief Operations Officer issued a memorandum suspending collection action against investors for assessments flowing from adjustments to partnerships promoted by B, except for jeopardy situations. On May 24, Year 18, the Chief Operations Officer issued a memorandum clarifying the February 2, Year 18, memorandum. Because the administrative stay only applies to notices of levy and seizures and not to actions such as defending and filing suits, the government's suit to set aside the fraudulent conveyance is not affected by the Service's administrative stay of collection. In addition, the administrative stay of collection does not invalidate or nullify collection actions taken prior to issuance of the memorandum establishing the voluntary stay.

3. <u>Consistency With Resolution of Fraudulent Conveyance Cases</u>

In Years 1 through 12 and Years 15 and 16, T participated in a tax shelter promoted by B. On September 22, Year 14, T created C, a charitable remainder unitrust and on October 10, Year 14, funded it with stock. Pursuant to adjustments made on account of T's participation in the tax shelter, deficiencies were determined, and on December 3, Year 15, T and the government entered into a closing agreement. On April 28, Year 16, an assessment was made against T.

California follows the Uniform Fraudulent Transfer Act (Act). The government's complaint to set aside the fraudulent conveyance alleges actual intent to defraud pursuant to California's State Civil Code section 3439.04(a). Section 3439.04(a) provides as follows:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation incurred, if the debtor made the transfer or incurred the obligation as follows:
>
> (a) With actual intent to hinder, delay, or defraud any creditor of the debtor,
> (b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>   (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction, or
>   (2) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

For purposes of this analysis, it is assumed that the government can prove that the transfer of T's stock to C was a fraudulent transfer and that the government can trace the purchase of the annuity contract and the proceeds therefrom to the stock transfer. A successful suit to set aside the fraudulent transfer and to foreclose the federal tax liens would have the effect of voiding the transfer, including the transfer of the contingent charitable remainder interest. Thus, the government could foreclose its tax liens against the annuity contract or proceeds therefrom.

In the Ninth Circuit, whose law is controlling in this case, the Service became a creditor as of the close of the respective taxable year at issue. Edelson v. Commissioner, 829 F.2d 828 (9th Cir. 1987) (Service becomes a creditor at the close of the taxable year). Cf. Hartman v. Lauchi, 238 F.2d 881 (8th Cir. 1956) (Service becomes a creditor on the date the return is filed); United States v. St. Mary, 334 F.Supp. 799 (E.D. Pa. 1971) (Service becomes a creditor on the date the tax return is due to be filed). At a minimum, the tax liabilities had accrued before the transfer of stock from T to C, and the fact that the transfer occurred prior to the tax liens arising and prior to the filing of notices of federal tax lien is of no consequence. Moreover, pursuant to section 3439.04, whether the claim arose before or after the fraudulent transfer was made is irrelevant.

If successful in its suit to set aside the fraudulent conveyance, T's transfer of stock to C would be voided and, therefore, the United States could invade C's corpus to pay the Service's claim. In the absence of the stock having been transferred to the trust, the sale of the stock would have occurred in the hands of T. There is no Code provision that would release T from reporting capital gain upon the sale of the stock. In addition, to the extent stock was not transferred to the trust, T would not have been entitled to claim a charitable contribution deduction.

Under the proposed settlement agreement, T would not be liable for any capital gain. In addition, the charitable contribution deduction claimed by T in Year 14 for the contribution of stock to C would be allowed. Finally, the parties would agree that T committed no fraud. The proposed settlement agreement is directly contrary to the tax result that should occur if the conveyance were considered fraudulent and the transfer voided. In addition, the inclusion in the proposed settlement agreement that T committed no fraud is directly contrary to the rationale upon which voiding the transfer must be based. Given these overarching and irreconcilable inconsistencies, we recommend that you do not accept the proposed settlement offer.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By: PATRICK PUTZI
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