Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:6:HOU:2:TL-N-118-01
LDBrigman

date: February 27, 2001

to: Harvey Malyn, Estate and Gift Tax Attorney
M.S. 4105-HOU

from: LILLIAN D. BRIGMAN
Special Litigation
Assistant

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subject: [redacted]
EIN: [redacted]

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Issue:

Whether a savings clause purportedly gifting limited partnership interests to be valued at $[redacted] should be recognized for tax purposes?

Short Answer:

No.

Facts:

You are examining the [redacted] gift tax return as well as an estate tax return in this case. The reported gifts are to the donor's two children, described as follows on the return:

> Gift of limited partnership interest in [redacted] [redacted], a Texas limited partnership, worth $[redacted], or a [redacted]% limited partnership interest. (See attached assignment and appraisal).

Unlike the gift tax return, the assignment does not set out the percent gifted to each donee. In pertinent part, the assignment follows:

> Grantor...do hereby give ... unto grantee ... a limited partnership interest in [redacted] LIMITED PARTNERSHIP that is equal in value on [redacted], to $[redacted]. This gift is to be satisfied from my percentage of ownership as a limited partner in [redacted] LIMITED PARTNERSHIP and by a transfer of the limited partnership interest transferred to [grantee] on the books of the partnership as of that date.

Each gift was valued at $[redacted] on the gift tax return. The taxpayer asserts that if the I.R.S. determines an increase in value, the percent gifted will correspondingly decrease so that exactly $[redacted] in value was gifted to each donee.

Date of Gift:

There is a question as to the date of the gift. The date of the gift reported on the return is [redacted]. However, the assignment documents, which are entitled "Irrevocable Assignment", were executed on [redacted] and [redacted] [redacted]. Unsigned and undated assignment documents were attached to the gift tax return. The irrevocable assignments are made retroactive to [redacted].

[redacted] is not the date of the gift because at that time the donor had not made completed gifts. She obviously retained dominion and control over the partnership interests, not having executed the irrevocable assignments. Whether she made completed gifts upon executing the irrevocable assignments is another question present in this case and is discussed at the end of this memorandum.

The date of the gift is important here because I.R.C. §§ 2001(b) and 2504(c) applies to gifts made after August 5, 1997. Although these sections apply, the taxpayer has consented to extend the statute of limitations to [redacted].

On December 22, 1998, the Commissioner issued proposed regulations governing the disclosure needed to commence the running of the statute of limitations. However these regulations are effective for returns filed after the after publication of the regulations in the Federal Register. Prop. Treas. Reg. § 301.6501(c)-1(f)(6). The proposed regulations were filed on December 22, 1998 and the final regulations were filed on December 3, 1999. The gift tax return in this case was filed in [redacted]. Because the return was filed before the regulations were published, they are not applicable to this gift.

Legal Analysis:

This clause is similar to the one at issue in Knight v. Commissioner, 115 T.C. No. 35 (November 30, 2000). The transfer document in Knight described the gift as the number of limited partnership units which equals $300,000 in value. Based on this language, the taxpayer argued that it barred the Commissioner from asserting that the value exceeded $300,000.

Although, the Commissioner argued the principle of Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944), the Tax Court disregarded the taxpayer's formula for other reasons and did not address the Commissioner's Proctor arguments.

The Tax Court ruled against the taxpayer for two reasons. First, the gift tax return reported a percent (22.3%) interest in the partnership. From this the Tax Court concluded that the taxpayers intended to gift 22.3 percent. Second, the taxpayer contended that the gift was worth less than $300,000, which was inconsistent with their reporting, opening the door to disregarding $300,000 as the maximum value gifted.

We recommend that the formula clause in this case should not be recognized and that the size of the gift be treated as [redacted]%, as stated on the gift tax return. Any increase in value will accordingly result in a gift tax deficiency. To give substance to this clause effectively nullifies our regulations, defeats the gift tax, obstructs justice, and hampers the administration of the tax laws.

Regulations

The old Treasury Regulations prescribing the information to

be provided on gift tax returns are at Treas. Reg. § 25.6019-4. They appear to apply, as discussed above. The basic thrust of the regulations is to require sufficient information to readily identify the gift. "The properties comprising the gifts made during the calendar year ... must be listed on the return and described in a manner that they may be readily identified." Treas. Reg. § 25.6019-4. These regulations are legislative regulations and therefore entitled to extra weight. True v. United States, 354 F.2d 323 (Ct. Cl. 1965).

In addition to the general requirement to describe the gift so that it is readily identified, the regulations require specific information for gifts of real estate, bonds, stocks, etc. While no specifics are provided in the regulations for descriptions of partnership interests, the information pertinent to stock should provide guidance. Descriptions of gifts of stock must include "number of shares, whether common or preferred, and if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold." Treas. Reg. § 25.6019-4.

At the very least, the description of the [redacted] and [redacted] gifts should provide the percent gifted. And, in fact, the gift tax return does so, along with a reference to an interest worth $[redacted]. However, the regulations under § 6019 do not grant the donor the latitude to select an either-or amount. That is, [redacted]%, if valued at $[redacted], or some percent less, if the I.R.S. values the [redacted]% interest at more than $1 million, as the taxpayer apparently contends. Based on Knight, the percent stated in the gift tax return is an admission that [redacted]% was gifted to each donee. We expect that the Tax Court will not permit the taxpayer to deviate from [redacted]%.[1]

To further pin down the facts, I suggest that you ask the taxpayer for a copy of the records of the percentage of interest in the partnership owned by each partner, which is required to be kept by Section 1.07(a)(1)(C) of Article 6132a-1, Texas Revised Limited Partnership Act. This section requires a domestic limited partnership to maintain certain records, including "the percentage or other interest in the partnership owned by each

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[1] Our argument that the reporting of [redacted]% on the gift tax return is an admission is buttressed by the fact that the income tax return of the partnership increased the donees' capital accounts by [redacted]% in [redacted], the year of the gifts.

partner." As a record required by State law, it should be readily available to the partnership.

The partnership record probably duplicates the income tax returns filed by the partnership. For our purposes, it will advance our position that ████% was gifted if ████% consistently appears in the partnership's internal records, the partnership's income tax returns, and the gift tax return.

Defeat of the gift tax; public policy

The courts have refused to respect clauses designed primarily to defeat the gift tax as violating public policy. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), the taxpayer transferred property in trust for the benefit of his children. The trust instrument provided that, if any court determined that a portion of the transfer was taxable, then that portion of the property would revert to the donor. The Fourth Circuit, in refusing to respect this adjustment provision, concluded that such a condition subsequent was void because it was contrary to public policy. See also Ward v. Commissioner, 87 T.C. 78 (1986); Estate of McLendon v. Commissioner, T.C. Memo. 1993-459, rev'd. on other grounds, 77 F.3d 477 (5th Cir. 1995). In these cases, courts have found savings clauses to be against public policy because officials would be discouraged from attempting to collect the tax where the only effect would be to defeat the gift. Moreover, giving effect to the savings provision would obstruct the administration of justice by requiring the court to address a moot case.

This case is similar to the clause in Proctor. Although, not explicit, one could assume that the percent representing the difference between the I.R.S. determined value and the ████% reported should revert to the donee. If so, there is no need to audit the gift tax return and the clause would control the amount that a Court could find. Both results illustrate why the clause is against public policy and cannot be accepted.

Tax Administration

There are practical problems as well. If we were to give effect to the formula clause, what happens to the portion we calculate now as not gifted to donees? For example, if we say for illustration purposes, that 3% per donee is not gifted, in order to make the gifted value equal to $████████, what happens to that 3%? If it reverts to the donor, income tax returns filed by the donees and donor, on the assumption that ████% was transferred to each donee, are now incorrect. Because the statute of limitations on the early income tax returns has run,

they cannot be corrected. This could potentially have serious consequences in cases where substantial distributions have been made because distributions in excess of a partner's basis in the partnership (outside basis) is income to the partner, as one example. The percentage interest owned at the death of the donor is also changed. Obviously, this impacts estate and Texas inheritance tax. Administration of the tax laws would become unduly complicated if we accept savings clauses like the one in this case.

The Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 827 (1997), amended sections 2001, 6501(c)(9) and 7477 of the Code, so that gifts reported on a return may not be revalued for either gift or estate tax purposes after the expiration of the gift tax statute of limitations. Returns subject to the Act must now be examined currently, and no longer may be examined as part of the estate tax examination. Fair administration of the gift tax will become even more difficult if formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect. Giving effect to the formula clause here will serve as precedent that will govern the administration of gift tax returns that are subject to the 1997 legislation.

Alternative argument: Incomplete gifts

A gift is not considered complete until the donor has parted with dominion and control so as to leave the donor with no power to change its disposition. Treas. Reg. § 25.2511-1(b). State law determines whether the donor has parted with dominion and control. Estate of Dillingham v. Commissioner, 88 T.C. 1569, 1575 (1987), aff'd, 903 F.2d 760 (10th Cir. 1990).

I was unable to find Texas case law delineating the relinquishment of dominion and control of a partnership interest. However, a gift of corporate stock should be analogous. The test in Texas is a facts and circumstances test, going beyond possession of the stock certificate. An important fact is whether the donor can gain access to the stock certificate in order to make another disposition of the shares purported already gifted. Brown v. Fore, 12 S.W.2d 114 (Tex. Comm'n App. 1929). In Brown, the donor executed an assignment form purportedly transferring the shares. This assignment was detachable from the stock certificate, which was not completed on the back. Because the donor could gain access to the stock and make another gift of the same certificate, the court found that the donor retained dominion and control.

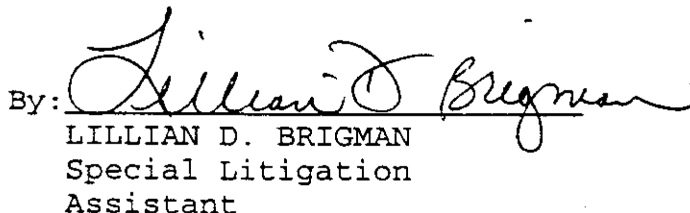
Estate of [redacted] has similarities to Brown. The donor's

assignment document only refers to limited interests equal in value to $[redacted]. No mention is made of the percentage needed to equal $[redacted] on the assignment form. What percentage of limited interests the donor parted with is subject to change, depending on valuation. As we all know, valuation is an art, not a science. Depending on the requisite number of shares, the donor certainly had the power to gift another set of limited interests that could exceed the number she retained after the [redacted] and [redacted] transfers. In other words, the donor's failure to set a percentage in the irrevocable assignment means she had the ability to reject her own valuation and give away the same interests that she had purportedly gifted already.

We therefore suggest that you make an alternative argument. Namely, no completed gifts were made in [redacted] and the purported gifts are included in her estate.

Do not hesitate to call if you have any questions. My number is 281-721-7311.

Area Counsel
(Small Business/Self-Employed:Area 6)



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