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Unrequited Gifts: The Tax Fallout

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the owner of more than 20% of a corporation's voting stock, a partnership's profits interest, or the beneficial interest of a trust is tainted by the substantial contributions of that entity.

Unrequited Gifts: The Tax Fallout

Tax cases, dealing as they do with well-aged transactions and strategies, may not often provide a source of creative inspiration, but they certainly offer both object lessons and useful maxims. Take the 885 Investment Company, subject of a recent Tax Court exegesis on defeasible gifts, jurisdictional collisions, and the tax benefit rule. (If any of those subjects seems less than self-defining, hang in there, and all will be explained anon.)

The 885 Investment Company was a California limited partnership, which in 1987 acquired some 178 acres in Sacramento. A few months prior to 885's acquisition, the Sacramento city council had adopted a land use plan providing for the maintenance of a scenic corridor along Interstate Highway 5. A small portion of 885's property lay within the proposed scenic corridor, and the partnership was soon approached about its willingness to donate that portion to the city.

Lesson One: A partnership is not a taxable entity; its charitable contributions flow through to the partners, and each takes as his own deduction a share of the total contribution, based upon his entitlements under the partnership agreement.

The city appeared to be serious about establishing the scenic corridor, and towards that end it purchased, in June 1979, some 2.33 acres within the corridor for $73,820. All other parcels thereafter acquired within the corridor were contributed, however, among them a slice measuring .664 acres contributed by the 885 partnership on December 21, 1979. That gift was conditioned, however, at the city's insistence, on ultimate use of the land as part of the scenic corridor; in the event that such use was not accomplished, the city had the right to "deed said real property back to the owner...." In respect of that gift, 885 claimed a $115,695 charitable contribution.

Maxim One: Beware of donees looking gift parcels in the mouth. This is hardly a typical reaction, and, at the least, the partnership should have asked, "What if...?" and played through the possible outcomes.

In February 1981, 885 agreed to donate an additional 5,523 acres. That donation was subject to the same possibility of reconveyance, should the scenic corridor plans come to naught. Not long thereafter, the city began to have second thoughts about the whole scenic corridor idea. The prospect of state funding had evaporated, and liability concerns had arisen. Hence it was determined in 1982 to reconvey to 885 the 1979 and 1981 gift parcels.

Lesson Two: Governments often change their minds. (This is a lesson, falling somewhat short of the maxim "Governments are not to be trusted"). But the reconveyance was complicated by further negotiations. 885 agreed to develop and maintain the returned parcels as a scenic corridor and to contribute to a fund to ensure their maintenance, and, in return, the city approved increased density for the partnership's developable property adjacent to the corridor. Under those conditions, the reconveyance was effected in 1983. As returned, the gift parcels were subject to use restrictions that left no alternative but maintenance as a "scenic landscaped corridor."

Lesson Three: The properties returned to 885 were far different from the parcels donated in 1979 and 1981. The newly imposed use restrictions drastically reduced their values (a circumstance astonishingly ignored in the Tax Court's analysis), and in gaining density approvals as a condition of its maintenance obligation, 885 obviously extracted consideration that would have defeated the original deductions entirely, had it been bargained for in connection with the 1979 and 1981 gifts.

The procedural setting for this adjudication was peculiar. Owing to the IRS' failure to assert in a timely manner a deficiency on account of the (allegedly flawed) 1979 deduction, the tax benefits attributable to that gift were not in issue, but the effect to the taxpayer of the return of the 1979 gift parcel was very much in focus. As to the 1981 gift, 885's asserted deduction of $962,328 was entirely denied by the Service on the ground that, on the date of the gift, the "possibility of occurrence" of a reversion of the property to the partnership was "not so remote as to be negligible," under applicable (and venerable) regulations. The court agreed, as it had little choice but to do. The "so remote as to be negligible" standard has been applied in dozens of cases, and an assistant Sacramento city manager testified for the government that, at the time of the 1981 donation, prospects for public funding of the scenic corridor were gloomy.

Maxim Two: Tax benefits at which large donations are aimed must be impervious to attack, except on valuation grounds. The 1981 donation was the main-event issue in this case, involving a challenge to federal income tax benefits (i.e., dollars saved on account of the 1981 donation) aggregating approximately $480,000 to the 885 partners. Had the partnership's advisors refused to accede to the city's requested reverter provision, the deduction

Lesson Four: The lessons of 885. Government requests for contributions are often made with the prospect of state funding having evaporated, and liability concerns having arisen. Hence it was determined in 1982 to reconvey to 885 the 1979 and 1981 gift parcels. But the reconveyance was complicated by further negotiations. 885 agreed to develop and maintain the returned parcels as a scenic corridor and to contribute to a fund to ensure their maintenance, and, in return, the city approved increased density for the partnership's developable property adjacent to the corridor. Under those conditions, the reconveyance was effected in 1983. As returned, the gift parcels were subject to use restrictions that left no alternative but maintenance as a "scenic landscaped corridor."

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would have been beyond challenge, except, perhaps, on valuation grounds.

The effects of the return of the 1979 property, although by no means as dramatic financially, are a tax student’s nightmare—the stuff of which final exams are made. On account of the reverter clause, the 1979 gift was as defective as the later and larger donation, but the IRS had failed to mount an attack before the statute of limitations for that year had run. Nonetheless, the game was far from over; the government sought to invoke the “tax benefit rule” to mitigate its earlier neglect.

In this context, the tax benefit rule essentially requires that where a taxpayer has had the benefit of a previous deduction (here, the 1979 contribution), which, in the fullness of time, turns out to be inconsistent with a later event (the return of the 1979 parcel), income is required to be reported in the later year. Under the Tax Court’s own prior interpretations of the rule, however, it only applies where the prior deduction was properly asserted. Since 885’s earlier gift was flawed by the possibility of reverter, it would seem that the government’s only remedy would have been to attack the deduction itself prior to the running of the statute of limitations.

Lesson Four: The judicial resolution of a tax controversy is a long and arduous road, often leading to surprising and/or unsatisfying conclusions.

But alas, despite the Tax Court’s own prior express views on the proper reach of the tax benefit rule, it has also determined to follow cases decided by the judicial circuit to which an appeal will run. An appeal in the 885 case would run to the Ninth Circuit, and that court has refused to limit the tax benefit rule to cases not involving prior erroneous deduction. Thus the Tax Court was constrained to hold that the return of the 1979 gift property produced taxable income in 1983. (You might expect something like this in “Godot Meets the Tax Collector,” but this is real life.)

Maxim Three: Courts frequently overlook things.

Having concluded that the 1983 recovery of the parcel gifted in 1979 is subject to inclusion in income, the final task facing the court was to determine how much that inclusion should be. Ignoring entirely the fact that the property recovered in 1983, unlike the 1979 gift, was burdened with elaborate development and use restrictions, and further, that the 1983 negotiations might well have been considered a “new deal” vitiating entirely the “reverter” construction on which tax benefit is premised, the court determined the value of the reconverted two-thirds acre by reference to the unencumbered 2.33 acres purchased by the city from an unrelated landowner for $73,820 in 1979! The prorated value arrived at for 885’s .664-acre parcel—$21,040—is thus the result of an exquisitely irrelevant computation. (The tax arbitrage was not bad, even so, since the $115,695 deduction in 1979 produced about $81,000 in tax benefits [at 70%] and the $21,040 deemed recovery produced a 1983 liability of about $10,500 [at 50%].)

What can one say about all of this? Maybe that if you have a prospective partnership transaction, absorb the lessons, observe the maxims, and don’t let anyone talk about the 885 case. And should it come up, assure them that you consider it a perfect example of the kind of planning you intend not to abet. 885 Investment Co., 95 T.C. __, No. 12 (August 16, 1990).—William T. Hutson

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Federal Claims Court Awards Millions in Damages to Landowners for Regulatory Taking

In two recent decisions with potentially far-reaching effects on government programs to preserve wetlands, a Federal claims court in Florida has awarded $1,029,000 and $2,658,000 in damages to two respective landowners for an alleged “regulatory taking” of their property. Florida Rock Industries, Inc. v. United States, 1990 U.S. Ct. Cl. LEXIS 281 (filed July 23, 1990); Loveladies Harbor, Inc. v. United States, 1990 U.S. Ct. Cl. LEXIS 280 (filed July 23, 1990). In both cases, the court held that the federal government’s denial of permits to fill wetlands on the landowner’s properties, pursuant to section 404 of the Federal Clean Water Act (see The Back Forty, September 1990), resulted in a taking that required the government to pay just compensation under the Fifth Amendment. These decisions are significant because they are among the first to award damages to a landowner as a result of permit denial under the Section 404 permitting program. In fact, in United States v. Riverside Bayview Homes, 474 U.S. 121, 128 (1985), the United States Supreme Court specifically declined to award damages for a taking claim under section 404 of the Clean Water Act.

The just compensation clause of the Fifth Amendment is intended to bar the government from forcing a few people to bear public burdens that “in all fairness and justice, should be borne by the public as a whole.” Armstrong v. United States, 364 U.S. 40, 49 (1960). Thus, when a particular governmental regulation causes values incident to property to be diminished by a “certain magnitude,” the United States Supreme Court has held that the government has in effect “taken” the property owner’s land by inverse condemnation, requiring just