Winter 2016 Bulletin

TRANSFER TO SHAREHOLDER'S CHILDREN TO SETTLE DISPUTE IN FAMILY BUSINESS WASN'T A GIFT

The Tax Court, rejecting IRS's claim that a taxpayer's transfer of stock to trusts for the benefit of his children was a taxable gift, has concluded that the transfer was made in the ordinary course of business and for full and adequate consideration in money or money's worth. The stock transfer was the result of a settlement of a dispute over the taxpayer's ownership of stock in the family-run business. Under the settlement, the family acknowledged the taxpayer's outright owner of two-thirds of the disputed shares and agreed to redeem those shares for $5 million.

Background. Code Sec. 2501(a) imposes a tax on the transfer of property by gift. Reg. § 25.2511-1(g)(1) provides that the gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth. Where property is transferred for less than full and adequate consideration, the amount by which the value of the property exceeds the consideration constitutes a gift. (Code Sec. 2512) Taxable gifts include sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given. (Reg. § 25.2512-8)

A transfer of property will be regarded as occurring "in the ordinary course of business" and, thus, will be considered to have been made "for an adequate and full consideration in money or money's worth" only if it was: (1) bona fide; (2) transacted at arm's length; and (3) free of donative intent.

A transfer of property within a family group normally receives close scrutiny. (Estate of Frazee, (1992) 98 TC 55498) In applying Reg. § 25.2512-8 to settlements of family disputes, the Tax Court has identified the following as examples of certain subsidiary factors that may also be relevant: (A) whether a genuine controversy existed between the parties; (B) whether the parties were represented by and acted upon the advice of counsel; (C) whether the parties engaged in adversarial negotiations; (D) whether the value of the property involved was substantial; (E) whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and (F) whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. (Estate of Natkanski, (1992) TC Memo 1992-380TC Memo 1992-380)

Facts. IRS determined a gift tax deficiency against the Estate of Edward S. Redstone, who had worked in his family business with his father, Michael "Mickey" Redstone, and his brother, Sumner Redstone. The business was reorganized in 1959 as National Amusements, Inc. (NAI). Upon NAI's incorporation, Edward Redstone's father contributed a disproportionate amount of capital, but the three were each listed as registered owners of one-third of NAI's shares.

Edward Redstone was eventually forced out of the business. On his departure, he demanded all of his 100 shares of NAI stock, which his father refused to deliver. Citing the disproportionate capital

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Transfer to Shareholder's Children to Settle Dispute in Family Business Wasn't a Gift

contributions in 1959, his father insisted that a portion of Edward Redstone's stock had been held since NAI's inception in an "oral trust" for the benefit of Edward Redstone's children. After lengthy negotiations and the filing of two lawsuits, in 1972 the parties reached a settlement on advice of their respective counsel. Under the settlement, Edward Redstone transferred one-third of the disputed shares into trusts for his children (the Michael David Edward Redstone Trust and the Ruth Ann Edward Redstone Trust), in consideration of which Edward Redstone was acknowledged as outright owner of two-thirds of the disputed shares, which NAI redeemed for $5 million.

IRS determined that Edward Redstone's transfer of stock for the benefit of his children was a taxable gift. While agreeing that Edward Redstone transferred the stock in settlement of a bona fide dispute, IRS contended that the transfer was not made "in the ordinary course of business" or "for a full and adequate consideration in money or money's worth," under Reg. § 25.2511-1(g)(1), because no consideration was furnished by Edward Redstone's children, the transferees of the stock.

Court's conclusion. The Tax Court held that Edward Redstone's transfer of stock was made in the ordinary course of business and for a full and adequate consideration in money or money's worth—namely, recognition by Edward Redstone's father and brother that he was the outright owner of two-thirds of the disputed shares and NAI's payment of $5 million in exchange for those shares. The Court reasoned that Edward Redstone transferred 33 1/3 shares of NAI stock to two trusts for the benefit of his children in a bona fide, arm's-length transaction that was free from donative intent and was thus "made in the ordinary course of business" under Reg. § 25.2512-8.

The transfer was bona fide; the parties were settling a genuine dispute as opposed to engaging in a collusive attempt to make the transaction appear to be something it was not. There was no indication that the dispute within the Redstone family was a sham—rather all the evidence pointed in the opposite direction. Edward Redstone was genuinely estranged from his father and his brother, and this estrangement grew worse as time went on. While Edward Redstone had a reasonable claim to all 100 shares registered in his name, his father had possession of these shares and refused to disgorge them, forcing Edward Redstone to begin litigation. Further, the "oral trust" theory put forth by the father had some historical support: at NAI's inception, Edward Redstone was listed as a registered owner of 33.33% of NAI's shares even though he had contributed only 25.6% of its assets.

There was arm's-length bargaining. They were represented by and acted upon the advice of counsel; they engaged in adversarial negotiations for a protracted period; the compromise they reached was motivated by their desire to avoid the uncertainty and embarrassment of public litigation; and their settlement was incorporated in a judicial decree that terminated the lawsuits.

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The evidence clearly showed that Edward Redstone transferred stock to his children, not because he wished to do so, but because his father demanded that he do it. The transfer of stock in trust for Michael and Ruth Ann was prompted by Edward Redstone's father's desire to both ensure his grandchildren's financial security and keep the Redstone family business within the Redstone family. At the time of the settlement, Edward had no desire to transfer stock to his children. He was forced to accept this transfer in order to placate his father, settle the family dispute, and obtain a $5 million payment for the remaining 66 2/3 shares.

The Court further held that Edward Redstone received adequate consideration even though that consideration was not furnished by his children. Code Sec. 2512(b) and its implementing regs require that the donor receive an adequate and full consideration; they make no reference to the source of that consideration. Noting that the parties had not brought to its attention and its research had failed to discovered any Tax Court precedent addressing this issue, the Tax Court, , concluded the source of the consideration was irrelevant.

Accordingly, the Tax Court held that Edward Redstone did not make a taxable gift and was not liable for any gift tax for the period at issue.

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