

Timing is Critical to Good Tax Planning Strategies

By Bruce Givner

There are many ways to reduce, defer and, in a few cases, even eliminate taxes. Estate taxes are the easiest; Congress has provided powerful tools on the face of the Internal Revenue Code. Grantor-retained annuity and unitrusts in Section 2702(a)(2) are excellent devices to pass subchapter "S" stock and limited partnership interests to heirs.

Qualified personal residence trusts in Section 2702(a)(3) similarly are useful to pass principal residences and vacation homes to heirs. These tools are sophisticated because they require great care and appear to be relatively uncommon. However, they are not "aggressive," since they are on the face of the code.

Capital gains taxes are not as easy. However, again, statutory tools are available. Laymen and practitioners are familiar with Section 1031 tax-deferred exchanges. Many also are familiar with charitable remainder trusts. There are many other capital gains tax-planning techniques.

Income taxes are, of course, the most difficult. Statutory techniques are available: Recent legislation has favored profit-sharing plans in their many forms (Section 401(k)s and employee stock option plans are two examples) and pension plans (money-purchase and defined-benefit plans).

The most sophisticated planning of this sort maximizes contributions, minimizes mandatory distributions and minimizes the tax on distributions.

However, the Internal Revenue Service is always on the lookout for techniques that it deems to be too attractive. See Richard Lipton, "New Tax Shelter Disclosure and Listing Regulations Promise Headaches For Everyone," *Journal of Taxation*, at 5

(Jan. 2003).

Each type of tax planning discussed above has one prerequisite to getting a good result: timing. In general, the longer in advance that the planning is set in place, the more likely it is that the client will achieve a good result. Although this article discusses two relatively recent examples leading to bad results in capital gains tax planning, numerous examples could be cited from income tax and estate tax planning as well.

The most recent warning that advance planning is an important factor was presented by the IRS late last fall in Revenue Ruling 2002-83, 2002-49 I.R.B. 927 (Dec. 9, 2002). The ruling is set in the context of a tax-deferred exchange of real property under Section 1031 using a qualified intermediary.

There is a special rule for related-party exchanges. That rule provides that taxpayers who directly or indirectly exchange property with a related party must hold the exchanged property for at least two years after the exchange to qualify for nonrecognition.

If either party disposes of the property before the two-year period, any gain or loss that would have been recognized on the original exchange will be considered on the date that the disqualifying disposition occurs.

A revenue ruling is an official agency interpretation of the application of the law to a specific set of facts. Capital letters are used to denote taxpayers. The parties in this ruling are: A and B, who are related; C, who is unrelated to either of the other parties; and QI, who is the qualified intermediary.

There are two properties. The first has a \$150 fair market value and a \$50 adjusted basis. The second has a \$150 fair market value and a \$150 adjusted basis.

The timing of the steps taken by

the parties is compressed — only one week separates them. On Jan. 6, 2003, A transferred the first property to the qualified intermediary, and the intermediary sold it to C for \$150. On Jan. 13, 2003, the qualified intermediary bought the second property from B for \$150 and transferred it to A.

One might conclude from the facts — a mere one week separating the transactions — that the IRS needed no more to reach the negative conclusion in this ruling: "a tax-

legislative history, cited in the ruling, uses the "magic phrase" of step transactions: "a pre-arranged plan."

What is the lesson of this ruling? Simply that planning must be in place more than one week before the actual transaction? Certainly not.

The statutory step-transaction doctrine (Section 1031(f)(4)) warns that favorable treatment does not apply "to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection."



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payer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under Section 1031(a) if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property."

However, this relatively new restriction on related-party deferred exchanges (effective for transfers after July 10, 1989) has its own step transaction rule: "This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection." Section 1031(f)(4). The

No given amount of time between steps suffices to protect them from being viewed as being part of a series of transactions.

Even steps separated by many years can be integrated and treated as part of the same transaction. Howard Rothman and Pamela Capps, "Transfers to Controlled Corporations: In General," 758 *Tax Management Paragraph III.F.2.a(2)* at n.181 (Bureau of National Affairs, March 2003); see *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), cert. denied, 306 U.S. 661 (1939) (steps in one transaction occurred more than six years apart).

An even more catastrophic example of bad timing is illustrated by *Ferguson v. Commissioner*, 174 F.3d

997 (9th Cir. 1999), aff'g, 108 T.C. 244 (1997). This case is grounded in the assignment-of-income doctrine, rather than (as was the case with Revenue Ruling 2002-83) the step-transaction doctrine. However, it again drives home the importance of timing.

The Fergusons owned closely held stock that was the subject of a tender offer. The tender offer was conditioned on the acquisition of 85 percent of the stock. The final day for tendering the stock was extended to Sept. 9, 1988, on which date the Fergusons contributed some of their shares to three charities. The charities immediately tendered the shares to the acquiring corporation in exchange for cash.

The 9th U.S. Circuit Court of Appeals said the key issue was whether the stock gift was made before the stock had ripened into a fixed right to receive cash. When the Fergusons made the charitable gifts, only 57.2 percent of the shares had been tendered, and neither the board of the acquiring nor that of the acquired corporation had voted to approve the transaction. Yet the Tax Court decided that "it was practically certain that the tender offer and the merger would be completed successfully."

Many practitioners found this a surprising decision. They felt that it was not "too late," which is to say that the stock would not have "ripened" until all conditions had been satisfied, which, in this case, they surely had not been.

Not only was the decision surprising, but the Court of Appeals also made matters much worse. Toward the end of its decision, the court used language designed to chill the blood of any planner: "the Fergusons note ... that there is no clear line demarcating the first date upon which a taxpayer's appreciated

stock has ripened into a fixed right to receive cash. ...

"However, from the taxpayers' perspective, walking the line between tax evasion and tax avoidance seems to be a patently dangerous business. Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor. ...

"Therefore, we will not go out of our way to make this dangerous business any easier for taxpayers who knowingly assume its risks."

Perhaps this is the formal statement of a new doctrine: caveat tax lawyer.

The most destructive aspect of the decision was that the Fergusons were unable to get cash from the charities with which to pay the tax. So they were stuck paying income taxes on millions of dollars of gain for shares that they no longer owned.

The moral is that if you are going to engage in tax planning that might be susceptible to IRS attack as being too late, do not engage in last-minute charitable planning.

There is no magic time interval between the first and last step of a tax plan that is certain to yield the desired result. However, as a general matter, the longer in advance that the planning begins, the more likely you are to end up with a happy client.

Each professional should educate clients to recognize the opportunities far enough in advance so as to maximize the time period over which planning takes place.

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