Estate of Redstone v. Commissioner, 145 T.C. No. 11 (October 26, 2015)

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No Taxable Gift Results From Bona Fide Arm's Length Settlement Free From Donative Intent

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Synopsis

A settlement of litigation resulted in a resolution of a dispute regarding the ownership of 100 shares of closely-held stock registered in the name of one shareholder. The settlement resulted in the company agreeing to pay $5 million for 66 2/3 shares to the shareholder, with the remaining 33 1/3 shares being held in a trust for that shareholder's children. The dispute centered around disagreements between the shareholder and his father, who was the president of the company, and who insisted that a portion of the shares were held in an "oral trust" for the benefit of the shareholder's children. The court concluded that the settlement constituted a bona fide, arm's-length transaction that was free from donative intent and that was "made in the ordinary course of business." The transfer was made "for a full and adequate consideration in money or money's worth," which was the recognition that the shareholder was the outright owner of 66 2/3 of the shares in the agreement and that the company would pay $5 million in exchange for the shares. (The fact that the shareholder's children were not parties to the settlement agreement - and therefore provided no consideration for the transfer of the shares - did not matter for purposes of determining whether the shareholder received full consideration in the settlement.) *Estate of Redstone v. Commissioner*, 145 T.C. No. 11 (October 26, 2015) (Judge Lauber).

Basic Facts

Edward sued a closely-held, family company to recover 100 shares of stock that were registered in his name. He felt that his father was intruding into his personal life in reaction to decisions Edward had made about his son (institutionalizing him for a period for psychiatric problems) and because Edward felt disrespected and was dissatisfied with his role at the company. His father (Mickey), who was President of the company, refused to transfer the 100 shares to Edward, arguing that the company had a right of first refusal on the shares and contending at that least half the shares were held from the outset in an "oral trust" for Edward's children. After months of negotiations, Edward sued. The parties tried to reach a settlement, with the company agreeing to buy back Edward's shares from him, but the father insisted that Edward recognize that some of the shares were held in trust for his children. The litigation became quite adversarial, and Edward's attorney eventually concluded that "Mickey would not be placated unless Edward acknowledged the supposed 'oral trust' and placed some of the disputed shares in trust for his children." 145 No. 11, at 11.

A settlement was ultimately reached, with the parties agreeing that Edward owned 66 2/3 of the shares outright and that 33 1/3 shares were held by Edward for the benefit of his children in trust. The settlement agreement provided that the company would pay Edward $5.0 million for his 66 2/3 shares, and that Edward would execute irrevocable trusts for his children and 16 2/3 shares would be distributed to each of the two trusts for Edward's two children.

Edward's son subsequently sued in a separate lawsuit, claiming that all of Edward's 100 shares should have been held in trust for his children. The court in the subsequent lawsuit disagreed that an oral trust was ever created. *O'Connor v. Redstone*, 896 N.E.2d 595 (Mass. 2008). Edward testified in that subsequent litigation with his son that he thought he had never held any shares under an oral trust for his children, but that "he had been forced to acknowledge the existence of an oral trust in order to placate his father and settle the litigation."

Apparently as a result of the litigation with the son, the IRS became aware of the transfer of stock to the children's trust in 2010 and claimed that Edward made taxable gifts. Edward died in 2011, and after a gift tax audit the IRS in 2013 assessed $737,625 in gift tax, $368,813 as a fraud penalty, $36,881 as a negligence penalty (an alternative to the fraud penalty), and a $184,406 penalty for failure to file a gift tax return.

Analysis

1. **Burden of Proof**. The taxpayer had the burden of proof and did not contend that the burden shifted to the government.

2. **"Ordinary Course of Business for Full Consideration" Exception**. A gift results from a transfer of property for less than an adequate and full consideration. §2512(b). The regulations provide an "ordinary course of business" exception:

   > However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arms length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Treas. Reg. §25-2512-8.

   A transfer within a family group receives close scrutiny, but a transfer meeting the criteria described in the regulation will treated as "in the ordinary course of business."

3. **Litigation Settlement Context**. Various cases have recognized that a transfer made in settlement of bona fide unliquidated claims was made for "a full and adequate consideration" because it was a transaction in the "ordinary course of business." Factors that the courts have considered in a litigation settlement context include:

   > whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. 145 T.C. No. 11, at 20.

4. **Bona Fide**. The settlement was "bona fide" because the parties "were settling a genuine dispute as opposed to engaging in a collusive attempt to make the transaction appeared to be something it was not." *Id.* at 21. Edward was genuinely estranged from his father, and the parties had legitimate business grievances against each other. Although Edward had a reasonable claim to all 100 shares registered in his name, the company had possession of the shares and refused to disgorge them. The father passionately believed the "oral trust" theory and there is some justification for that theory because Edward was registered as the owner of one-third of the company's shares even though he contributed only 25.6% of its assets.

5. **Arm's Length**. A transfer is at "arm's length" as long as the taxpayer acts "as one would act in the settlement of differences with a stranger." *Id.* at 22. Edward was genuinely estranged from his father. The parties were represented by counsel and engaged in adversarial negotiations for many months. Both parties recognized the compromise as "advantageous economically." The compromise was motivated by their desire to avoid the uncertainty and embarrassment of public litigation, and the settlement was incorporated in a judicial decree that terminated lawsuits.

6. **Absence of Donative Intent**. Although donative intent is not a prerequisite to a gift, the absence of donative intent is essential for a transfer to satisfy the "ordinary course of business" exception. "Generally, donative intent will be found lacking when a transfer is 'not actuated by love and affection or other motives which normally prompt the making of a gift.'" *Id.* at 24. Although Edward's children were objects of his affection, a transfer to one's children is not necessarily imbued with donative intent. There have been many cases recognizing that transfers to children were nevertheless made "in the ordinary course of business." Edward transferred stock to his children not because he wished to but because his father demanded it. At the time of the settlement, Edward had no desire to transfer stock to his children but was forced to accept this transfer in order to black placate his father, settle the family dispute, and obtain a $5 million payment for his 66 2/3 shares.

7. **Source of the Consideration**. The IRS made the argument that Edward's two children were not parties to the litigation or settlement, and as a result "they did not provide (and cannot have provided) any consideration to Edward for the transfer of the shares. Because no consideration flowed from the transferees,… Edward's transfer was necessarily a 'gift.'" This argument finds no support from the regulations, which instead focus on whether the transferor received consideration; "they make no reference to the source of that consideration." No prior cases have directly addressed this "source of consideration" theory. In *Shelton v. Lockhart*, 154 F. Supp. 244 (W.D. Mo. 1957) the taxpayer agreed to place disputed funds into a trust for her children to receive a certificate of competency from the Bureau of Indian Affairs. The IRS contended that the transfer in trust for her children was a taxable gift, but the court disagreed, finding it irrelevant that the taxpayer's children were not parties to the dispute or settlement.

Observations

1. **Common "Scary Concern."** Almost every settlement of litigation in a family related context at some point raises consternation among the planners as to whether any parties are making taxable gifts as a result of the settlement. Transfers in compromise and settlement of genuine trust or estate disputes typically will be treated as transfers for full and adequate consideration that do not result in gifts. The IRS has issued a number of favorable private letter rulings finding no gift tax exposure in a variety of settlement contexts. *E.g.*, PLR 201342001, 201104001, 200845028, 200825007, 200638020, and 200209008. Some experts have summarized that planners often worry about the gift issue in settlement discussions, but "this is one of the scariest things that almost never happens." The IRS's approach in *Redstone*, though highlights why this is such a scary issue - the IRS not only asserted that the settlement resulted in significant gift tax, but also asserted fraud, negligence and failure to file penalties from a settlement of hostile protracted family litigation.

2. **Factors Considered.** The Tax Court in *Redstone* summarized factors that the courts often consider in determining whether litigation settlements constitute taxable gifts. Planners will try to satisfy as many of these factors as possible to avoid gift treatment:

   - whether a genuine controversy existed between the parties;

   - whether the parties were represented by and acted upon the advice of counsel;

- whether the parties engaged in adversarial negotiations;
- whether the settlement was motivated by the parties’ desire to avoid the uncertainty and expense of litigation; and
- whether the settlement was finalized under judicial supervision and incorporated in a judicial decree.