Feeling Detached and Disinterested? – Then Gift Giving Is for You!

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Overview

Soon the Christmas season will be upon us. With that comes the joy of gift giving. But not according to the IRS. If you gift assets, either as part of an estate plan or for purposes of setting up another person in business or for other reasons, you must be "detached and disinterested." That sounds as if it saps the joy right out of gift giving. Thanks, IRS!

But, what does "detached and disinterested" mean? When is a transfer of funds really a gift? Why does it matter? It matters because the recipient of a gift doesn't have to report the value of the gifted amount into income. If the amount transferred is not really a gift, then it's income to the recipient and the value of the gifted property is still in the estate of the person making the gift. When large amounts are involved, the distinction is of utmost importance.

When is a transfer of funds a gift? It's the topic of today's post.

Definition of a "Gift"

Under the Internal Revenue Code ("Code"), gross income is income from whatever source derived unless otherwise excluded. *I.R.C. §61(a).* However, gross income does not include the value of property that is acquired by gift. *I.R.C. §102(a).* In *Comr. v. Duberstein, 363 U.S. 278 (1960),* the U.S. Supreme Court defined a gift under I.R.C. §102 as a transfer that proceeds from a "detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses." As a result, the Supreme Court concluded that the most important consideration in determining whether a gift has been made is the donor's intent. That's a broader inquiry than simply looking at how the donor characterizes a particular transaction. A court will examine objectively whether a gift occurs based on the facts and if those facts support a donor that intended a transfer based on affection, etc. Detached and disinterested generosity is the key. If the transfer was made out of a moral duty or some sort of expectation on the recipient's part, it is not a gift under I.R.C. §102 because it did not arise out of a detached and disinterred generosity. Similarly, when the recipient has rendered services to a donor, a payment for services is not a gift even if the transferor had no legal obligation to pay the remuneration for the services.

Apart from the Court's analysis in *Duberstein*, a particular transaction may amount to a "common law" gift. A common law gift requires only a voluntary transfer without consideration. If the donor had no legal obligation to make the payment, the transfer is a gift under the common law standard. That's an easier standard to satisfy than the Code definition set forth in *Duberstein*.

Example – Tax Court Decision

In *Kroner v. Comr., T.C. Memo. 2020-73* illustrates how the courts examine whether a particular transfer constitutes a gift and the consequences of misreporting the transaction(s) for tax purposes. The petitioner was the CEO of a business that bought and sold structured settlement payments and lottery winnings. The company would buy structured payments from lottery winners and resell the payments to investors. The petitioner had historically worked in the discounted cashflow industry and, as a result, met a Mr. Haring, a wealthy British citizen, sometime in the 1990s. Their business relationship lasted until 2007.

In 2003 and 2004, the petitioner was interested in protecting his assets and an attorney recommended the use of an "offshore" trust to hold the petitioner's assets. An offshore trust is often associated with tax scams, but I reserve that discussion for another post in the future. In any event, the petitioner established the "Kroner Family Trust" in a small island in the Caribbean. The petitioner was the beneficiary of the trust along with his son. In 2007, the petitioner established another trust in the Bahamas to hold business assets. From 2005-2007, the petitioner received wire transfers from Mr. Haring totaling $24,775,000. Some of the transferred funds went directly to the petitioner, but others went to the trust in the Caribbean Island and still others went to the petitioner's business. The lawyer that set up the offshore trusts "advised" the petitioner that the transfers were gifts that the petitioner didn't have to report as taxable income. The attorney's legal "analysis" which led him to this conclusion was a conversation he had with the petitioner and a note that he drafted for Mr. Haring stating that the transfers were gifts. The attorney also advised the petitioner of the requirements to file Form 3520 every year that he received a transfer from Mr. Haring to report the gifts from a foreign person. A CPA prepared the Form 3520 for the necessary years. The petitioner never reported any of the transfers from Mr. Haring as taxable income.

The petitioner was audited for tax years 2005-2007. The IRS took the position that the transfers were not gifts, should have been reported as taxable income, and assessed accuracy-related penalties on top of the tax deficiency.

The Tax Court agreed that the transfers should have been included in the petitioner's taxable income. They were not gifts. The Tax Court noted that Mr. Haring's intention was the most critical factor in determining the status of the transfers. The petitioner bore the burden to establish Mr. Haring's intent by a preponderance of the evidence. However, Mr. Haring never appeared at trial and didn't provide testimony. Instead, the petitioner tried to establish the gift nature of the transfers by his own testimony. The petitioner and Mr. Haring had operated some business interests together in the 1990s, and the petitioner acted as a nominee for Mr. Haring for certain of Mr. Haring financial interests. He even formed a trust in Liechtenstein for Mr. Haring in 2000. Mr. Haring also provided a loan for the petitioner's credit counseling business in 2000. That loan was paid off in 2007. Mr. Haring also held about a 70 percent equity interest in the petitioner's cashflow industry business in exchange for providing funding and loan guarantees. He later liquidated his interest for $255 million.

The petitioner last saw Mr. Haring in 2002 and testified at trial that he didn't know where he lived and that he didn't know his telephone number. He did, however, receive a telephone call from Mr. Haring

in 2005 that lasted no more than three minutes. The petitioner claimed that Mr. Haring told him during the call that Mr. Haring had a "surprise" for the petitioner. The petitioner later met with Mr. Haring's associate and they set up the ability to receive wire transfers from Mr. Haring into the petitioner's bank account. That's when the attorney drafted a note to the petitioner from Mr. Haring stating that the transfers would be gifts.

The Tax Court didn't buy the petitioner's story, finding that neither the petitioner nor the attorney were credible witnesses. The Tax Court stated that the petitioner's testimony was self-serving and that the attorney's testimony was "simply not credible." There was no supporting documentary evidence. In addition, the attorney represented both Mr. Haring and the petitioner. The Tax Court also noted that the attorney was "evasive in his answers and in his selective invocation of the attorney-client privilege with regard to the legal advice provided to Mr. Haring about the transfers." The Tax Court also doubted the authenticity and credibility of the 2005 note allegedly from Mr. Haring but drafted by the attorney regarding his desire to gift funds to the petitioner. Thus, the note carried little weight in determining whether the transfers were gifts.

The Tax Court also determined that the petitioner failed to prove that the transfers were made with disinterested generosity. The record was simply devoid of any credible evidence to prove that Mr. Haring transferred the funds to the petitioner with detached and disinterested generosity. The Tax Court noted that timing of some of the transfers with liquidity events of the petitioner's business of which Mr. Haring was an investor. That raised a question as to whether Mr. Haring was acting as the petitioner's nominee.

The Tax Court determined that the petitioner need not pay the 20 percent accuracy-related penalty because the IRS failed to satisfy its burden of production under I.R.C. §6751(b).

Conclusion

The *Kroner* case is a textbook lesson on what constitutes a gift – detached and disinterested generosity. The burden of establishing that a transfer is a nontaxable gift is on the party asserting that the transfer amounted to a gift. The case is also a lesson into the messes that sloppiness and questionable lawyering can get a client into. When the amount of the gift (or gifts) is as large as that involved in the *Kroner* case, attention to detail is a must. The income tax consequences from being wrong are enormous.

For gifts you make this Christmas season, remember that the resulting tax consequences to you are likely to be better if you remain "detached and disinterested."

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