9 T.C. 325 (1947)

When a taxpayer converts assets into U.S. Treasury notes solely to make a tax-exempt gift, the conversion is disregarded, and the gift is taxed as if it were made with the original assets.

Summary

Marie-Anne De Goldschmidt-Rothschild, a nonresident alien, converted domestic stocks and bonds into U.S. Treasury notes under a prearranged plan to make a gift in trust, believing the notes would be exempt from gift tax. The Tax Court held that the conversion was ineffectual to avoid gift tax, relying on the principle established in *Pearson v. McGraw*. The court reasoned that the conversion lacked independent business purpose and was solely aimed at tax avoidance. The court also held that as a nonresident alien, the petitioner was not entitled to the specific gift tax exemption.

Facts

Marie-Anne De Goldschmidt-Rothschild, a French citizen, fled France due to World War II and arrived in the U.S. in October 1940 on a visitor visa. She owned significant assets, including American securities held by a Dutch corporation. Upon arrival, her advisor recommended creating trusts for her children. A trust officer suggested converting her assets into U.S. Treasury notes to potentially create a tax-exempt gift. In January 1941, she sold domestic stocks and bonds and used the proceeds to purchase approximately $190,000 in U.S. Treasury notes. In February 1941, she transferred these notes into two trusts for her children.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Rothschild's gift tax liability for 1941, arguing that she was a U.S. resident and that the gifts were taxable. Rothschild contested this determination in the Tax Court. The Tax Court found that she was a nonresident alien but nevertheless upheld the deficiency.

Issue(s)

1. Whether the petitioner, a citizen and resident of France temporarily living in New York City, at the time of making gifts in trust, was a resident of the United States for gift tax purposes.
2. Whether the property transferred by gift consisted of bonds, notes, or certificates of indebtedness of the United States, thus making the gifts exempt from gift tax under the provisions of Title 31, United States Code Annotated, § 750, and the respondent's regulations.
3. Whether the petitioner was entitled to the specific exemption of $40,000 provided in section 1004 (a) (1) of the Internal Revenue Code in computing her net taxable gifts.

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Holding

1. No, because she maintained her domicile in France and intended to return there.
2. No, because the conversion of assets into U.S. Treasury notes was solely for tax avoidance and lacked independent business purpose.
3. No, because the specific exemption only applies to residents of the United States.

Court's Reasoning

The Tax Court determined that Rothschild was a nonresident alien based on her intent to return to France and her temporary visa status. However, the court, relying on *Pearson v. McGraw*, disregarded the conversion of assets into U.S. Treasury notes. The court reasoned that the sale of stocks and bonds and the acquisition of Treasury notes "had no functional or business significance apart from the * * * transfer." The court emphasized that Rothschild intended to make the gift when she sold her original assets, and the conversion was merely a step in a prearranged plan to avoid taxes. As such, the gift was taxable as if it consisted of the original assets. The court also denied the specific exemption because it is only available to U.S. residents.

Practical Implications

This case illustrates the "step transaction doctrine," where a series of formally separate steps are treated as a single transaction for tax purposes if they are substantially linked. *De Goldschmidt-Rothschild* demonstrates that taxpayers cannot avoid taxes by converting assets into tax-exempt forms when the conversion lacks a business purpose and is solely intended to facilitate a tax-free transfer. Courts will examine the substance of the transaction over its form. Tax advisors must counsel clients that artificial steps taken purely for tax avoidance are unlikely to succeed. Later cases have applied this principle in various contexts, reinforcing the importance of business purpose in tax planning.

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