Johnson v. Commissioner, 86 F.2d 710 (7th Cir. 1936)

A gift is not complete for tax purposes if the donor retains dominion and control over the gifted property, even if formal legal transfers have occurred.

Summary

The Johnsons transferred stock to family members shortly before dividend declarations but then borrowed the dividends back. Despite formal transfers, the Tax Court found the Johnsons retained dominion and control over the stock and its proceeds. The key issue was whether the Johnsons truly relinquished control despite their actions. The court held that the gifts were incomplete for tax purposes because the Johnsons maintained control, evidenced by the timing of transfers, borrowing back dividends, and controlling the stock and notes. This case highlights that substance, not mere form, governs gift tax analysis.

Facts

Mr. and Mrs. Johnson transferred shares of stock in their company to their wives and children.
The transfers occurred shortly before substantial dividends were declared.
Almost immediately after the dividends were paid, the Johnsons borrowed back the dividend amounts from the transferees.
All stock certificates and notes representing the borrowed dividends were kept in the company's office, accessible and controlled by the Johnsons.
The Johnsons freely endorsed dividend checks made payable to the transferees and used the funds.
Instructions were given to destroy the notes representing the borrowed dividends and issue new ones.
There was a collateral agreement with the children that the notes would not be presented for payment until they reached certain ages, and even then, the boys would receive interests in the business rather than cash.
The Johnsons paid the income taxes due on the dividend income for all transferees.

Procedural History

The Commissioner of Internal Revenue determined that the stock transfers were not valid gifts for tax purposes.
The Johnsons appealed to the Board of Tax Appeals (now the Tax Court), which upheld the Commissioner's determination.
The Johnsons then appealed to the Seventh Circuit Court of Appeals.

Issue(s)

Whether the transfers of stock to family members constituted completed gifts for federal tax purposes, considering the donors' continued control and benefit from the transferred property.

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Holding

No, because the donors retained dominion and control over the stock and dividends, indicating a lack of intent to make a completed gift. The court emphasized the substance of the transactions over their form.

Court's Reasoning

The court focused on the practical effect of the transfers. Despite the legal formalities, the Johnsons continued to exercise exclusive management and control over the corporation and enjoy the dividends as if they still owned the stock. The court noted several factors indicating a lack of intent to relinquish control, including:

"Many things point to a lack of intent on the part of petitioners to relinquish dominion and control. Among these are the fact that in each year the transfers were made from four to fourteen days before the declaration of the substantia] dividends, which were in each case immediately borrowed back and used by the petitioners; the fact that all the stock and all the notes, those of the adult transferees as well as of the children, were kept in the corporate office, where they were under the control of the petitioners."

The court found that the Johnsons' actions, such as borrowing back the dividends, keeping the stock and notes under their control, and paying the transferees' income taxes, demonstrated that they never truly relinquished control over the gifted property.

Because the donors maintained significant control over the assets, the transfers did not qualify as completed gifts for tax purposes.

Practical Implications

This case underscores the importance of demonstrating a clear and unequivocal relinquishment of control when making gifts, particularly within family settings. Taxpayers must ensure that the donee has genuine control and benefit from the gifted property.

Subsequent cases have cited Johnson to emphasize the substance-over-form doctrine in gift tax cases. When analyzing similar situations, legal practitioners must look beyond the formal transfer and scrutinize the donor's actual behavior to determine whether they have truly surrendered control. This case serves as a cautionary tale for taxpayers seeking to reduce their tax liability through gifts while maintaining control over the assets.

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