T.C. Memo. 1947-244

The donor of a business remains liable for income tax on the business's profits if they retain dominion and control over the business's assets and operations after the gift.

Summary

J.M. Henson transferred his business to his wife via a gift. The Commissioner argued that Henson maintained enough control over the business after the transfer that he should still be liable for the income tax on the profits. The Tax Court agreed with the Commissioner, noting that Mrs. Henson had no prior business experience and Mr. Henson continued to manage the business. Despite the gift, Mr. Henson's continued control dictated that he was still responsible for income tax liability on the business profits.

Facts

J.M. Henson owned and operated a business, J.M. Henson Co. On August 1, 1943, Henson gifted the business to his wife. Mrs. Henson had no prior business experience. After the gift, the business operations continued substantially as before, with Mr. Henson in full directing charge. Mr. Henson filed a gift tax return reporting the gift and paid the tax, and the Commissioner determined a deficiency in the gift tax, based on a higher valuation than Henson reported.

Procedural History

The Commissioner assessed income tax liability to Mr. Henson for the business profits after the date of the gift. Mr. Henson contested the assessment in Tax Court. The Tax Court sided with the Commissioner, holding that Mr. Henson's continued control over the business made him liable for the income tax.

Issue(s)

Whether the donor of a business remains liable for income tax on the business's profits when they retain dominion and control over the business's assets and operations after the gift.

Holding

Yes, because despite the gift, the donor maintained such dominion and control over the subject matter of the gift as to make him taxable with the profits of the business.

Court's Reasoning

The court relied on precedents such as *Lucas v. Earl*, *Helvering v. Clifford*, *Lusthaus v. Commissioner*, and *Commissioner v. Tower*, which establish that income is taxed

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to the one who earns it and controls the underlying assets, regardless of formal assignments. The court found the case of *Robert E. Werner, 7 T.C. 39*, particularly persuasive. Similar to *Werner*, Mrs. Henson had no business experience and took no part in the management of the business after the gift. The court highlighted that after the transfer, Mr. Henson continued to exercise full dominion over the business. The court noted from *Simmons v. Commissioner, 164 Fed. (2d) 220*, "The gift of only a part of his interest left undisturbed the taxpayer's economic interest in the partnership. Thereafter as before, he had the same supervision and control; he still continued to speak for the joint interest. But the gift of his whole interest removed the petitioner altogether from the partnership. Following the transfer the taxpayer had no vestige of right or control in the partnership, and it is undisputed that he in fact exercised none."

Practical Implications

This case highlights that simply gifting a business does not automatically shift income tax liability. The IRS and courts will scrutinize the arrangement to determine who actually controls the business's operations and assets. If the donor retains significant control, they will likely remain liable for income tax on the business's profits, regardless of the gift. This decision emphasizes the importance of ensuring the donee has the requisite experience and actually exercises control over the business after the gift. Later cases applying this ruling will likely focus on the degree of control retained by the donor and the donee's actual involvement in the business's management.

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