18 T.C. 761 (1952)

Income from property is taxed to the true owner; a purported gift will be disregarded for tax purposes if the donor retains control or there is an implied agreement that the property or income will be returned to the donor.

Summary

Ken and Hilda Royce transferred construction equipment to Ken's parents, who then leased the equipment back to Ken's business. The parents reported the income from the equipment rentals and sales, and then made gifts to Ken and his family. The IRS argued that the income should be taxed to Ken and Hilda Royce. The Tax Court agreed with the IRS, holding that the purported gift was not a bona fide transfer because there was an implied agreement that the income and property would be returned to Ken and his family, thus the income remained taxable to the petitioners. The court emphasized that the substance of the transaction, rather than its form, controls for tax purposes.

Facts

Ken Royce, a construction equipment rental business owner, and his wife, Hilda, transferred title to 28 pieces of construction equipment to Ken's parents, Herman and Martha Royce, as a purported gift. Simultaneously, the parents leased the equipment back to Ken's company. Herman and Martha Royce reported the income from the equipment rentals and sales on their tax returns. Subsequently, Herman and Martha made substantial gifts to Ken, Hilda, and their son. The parents also executed wills naming Ken as the primary beneficiary.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Royces' income and victory taxes for the year 1943, arguing that the income from the equipment should be attributed to them. The Royces petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court ruled in favor of the Commissioner, finding that the purported gift was not bona fide.

Issue(s)

Whether the income from the sale and rental of construction equipment, which was purportedly gifted to Ken Royce's parents, should be taxed to Ken and Hilda Royce, the donors, or to Ken's parents, the purported donees?

Holding

No, because the purported gift lacked the essential element of bona fides and reality due to an implicit agreement that the property and income derived from it would be returned to the donors after the parents paid income taxes. Therefore, the income is

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taxable to Ken and Hilda Royce.

Court's Reasoning

The Tax Court emphasized that a valid gift requires a bona fide intent by the donor to give away absolutely and irrevocably the ownership, dominion, and control of the property. The court found that the Royces' actions indicated that the purported gift was not absolute and unrestricted. The court cited several factors: the parents' advanced age and dependence on their son, the immediate leaseback of the equipment, the systematic gifts back to Ken and his family, the fact that Ken's employee had power of attorney over the parent's bank account, the low valuation of the equipment for gift tax purposes, and the parents' wills leaving their property to Ken. The court found an implied agreement that the parents would return the income and property to Ken. Quoting *Richardson v. Smith*, the court stated, "All that need appear is that the donor did not intend to divest himself of control over the res, that the donee knew of the donor's intent and assented to it, and that the donor knew of the donee's assent. If all this is fairly inferrable [sic] from the relations, the gift, however formal, is a sham." The court concluded that the substance of the transaction indicated that the Royces retained control and enjoyment of the economic benefits of the equipment, thus the income was taxable to them.

Practical Implications

This case underscores the importance of scrutinizing purported gifts within families or closely held businesses. It serves as a reminder that the IRS and courts will look beyond the formal documentation of a gift to determine whether the donor truly relinquished control and dominion over the property. Taxpayers must demonstrate a clear and unequivocal intent to make a complete and irrevocable transfer. Subsequent actions that suggest the donor retained control or that there was an understanding of a return of the property or income will jeopardize the tax benefits of the gift. This case continues to be cited as an example of a sham transaction designed to avoid taxes, and reinforces the principle that transactions lacking economic substance will be disregarded for tax purposes.

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