T.C. Memo. 1954-035

Transactions within a family group are subject to special scrutiny to determine if they are, in economic reality, what they appear to be on their face for tax purposes, and a transfer that does not effect a complete shift in the economic incidents of ownership will be disregarded.

Summary

The petitioner, a mother, sold stock to her two children, structuring the sale to allow the children to pay for the stock out of dividends. The Tax Court determined that the transaction was not an arm's-length transaction due to the familial relationship and the informal manner in which the agreement was treated. The court found the mother retained effective control and benefit from the stock. Consequently, the dividends were taxable to the mother, not the children, as the transaction lacked economic substance and did not constitute a bona fide sale for federal income tax purposes. The court emphasized the lack of a down payment, absence of interest, delayed first installment, and the mother's payment of her children's increased income taxes.

Facts

The petitioner sold stock in a closely held company to her two children under agreements specifying a price of $150 per share, payable in annual installments of at least $4,000. The agreements did not specify who would receive dividends during the payment period. The children made no down payment, and no interest was charged on the unpaid balance. The first installment was not due until a year after the agreements were executed. The petitioner paid the increased income taxes incurred by her children as a result of receiving the dividends. The petitioner continued to vote the stock as she had before the sale, without explicit written instructions from her children.

Procedural History

The Commissioner of Internal Revenue determined that the dividends paid on the stock were taxable to the mother (petitioner) rather than the children. The petitioner challenged this determination in the Tax Court.

Issue(s)

Whether dividends paid on stock purportedly sold by a mother to her children are taxable to the mother, where the transaction is not an arm's-length transaction and the mother retains significant control and benefit from the stock.

Holding

Yes, because the agreements, while transferring technical title, did not constitute a

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bona fide arm’s-length transaction for federal income tax purposes, and the mother retained effective control and benefit from the stock.

Court’s Reasoning

The court reasoned that transactions within a family group are subject to special scrutiny to ensure they reflect economic reality. The court distinguished the case from prior cases involving stock sales between unrelated parties, emphasizing the familial relationship, the lack of a down payment or interest, and the mother’s payment of her children’s increased tax burden. The court found that the petitioner continued to control the stock and benefit from it, noting that she voted the stock as she always had. The court inferred from the circumstances that the parties did not intend to be strictly bound by the agreements, stating that “the parties to the agreements in this case treated them with such informality that we must conclude from the record as a whole that they did not intend to be bound by the provisions contained therein.” The court also considered that the sale price was likely lower than what would have been demanded in an arm’s-length transaction with an unrelated party, given the stock’s earnings and book value.

Practical Implications

This case highlights the heightened scrutiny that tax authorities apply to transactions among family members. It underscores the principle that merely transferring title to property is not sufficient to shift the tax burden if the transferor retains significant control or benefit. Lawyers structuring intra-family sales must ensure that the transactions are economically realistic, properly documented, and consistently followed. This includes establishing fair market value, requiring a reasonable down payment and interest, and ensuring the transferee exercises genuine control over the asset. Later cases cite Fry as a reminder to carefully examine the substance of intra-family transfers to prevent tax avoidance. “Transactions within a family group are subject to special scrutiny in order to determine if they are in economic reality what they appear to be on their face.”

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