32 T.C. 1178 (1959)

When a corporation sells property to a shareholder at a price below fair market value, the difference between the fair market value and the purchase price is treated as a constructive dividend to the shareholder, taxable as income.

Summary

The United States Tax Court addressed whether a shareholder's purchase of land from a corporation at a below-market price constituted a taxable dividend. The court found that the difference between the fair market value of the lots and the price the shareholder paid constituted a constructive dividend. The court emphasized that the substance of the transaction, rather than its form, determined its tax treatment. The court also addressed the calculation of the available earnings and profits of the corporation to determine the extent of the taxable dividend.

Facts

Lester E. Dellinger (petitioner) owned a one-third stock interest in Lake Forest, Inc., a corporation that developed and sold land. Dellinger purchased three lots from the corporation at prices below their fair market value. One lot purchased for $250 was later sold by Dellinger for $2,445. Each time a lot was sold to a shareholder at cost, the remaining stockholders were also allowed to purchase a lot at the same price. Lake Forest, Inc. realized taxable income during the relevant period but did not declare formal dividends.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Dellinger's income tax, arguing that the bargain purchases constituted a constructive dividend. The Tax Court reviewed the case.

Issue(s)

1. Whether Dellinger's acquisition of lots from the corporation at bargain prices resulted in taxable income as a dividend.
2. If so, to what extent the corporation's earnings and profits available for distribution as dividends were less than the distributions to Dellinger.

Holding

1. Yes, because the bargain purchases of the lots constituted distributions of dividends to Dellinger, the value of which was the difference between the market value and the price paid.
2. No, because Dellinger failed to prove that the corporation's earnings and profits available for distribution were less than the amount of the distribution.

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Court’s Reasoning

The Tax Court reasoned that a bargain sale of property by a corporation to a shareholder could result in a constructive dividend. The Court cited 26 U.S.C. § 301 which addresses corporate distributions and defines dividends as distributions of property made by a corporation to its stockholders out of its earnings and profits. The court referred to Treasury Regulations section 1.301-1(j), which states that if a corporation transfers property to a shareholder for less than fair market value, the shareholder has received a distribution to which section 301 applies. The amount of the distribution is the difference between the amount paid and the fair market value. The court noted that the substance of the transaction is more important than its form, citing *Palmer v. Commissioner*, 302 U.S. 63 (1937). Applying these principles, the court found that the sales were not arm’s-length transactions and that the corporation was effectively distributing earnings and profits to Dellinger. The court found that the fair market value of the lots was substantially higher than the price Dellinger paid. The court also cited the upward and downward adjustments to earnings and profits under 26 U.S.C. § 312 to address Dellinger’s argument about the limit on the corporation’s earnings and profits and therefore the limits on the amount of the taxable dividends.

Practical Implications

This case is central to understanding how below-market transactions between corporations and their shareholders are treated for tax purposes. Attorneys and tax professionals should understand that, if a corporation sells property to its shareholder for less than fair market value, it will likely be treated as a constructive dividend, taxable to the shareholder. The key factors are fair market value and available earnings and profits. Bargain sales structured to benefit shareholders can lead to tax liability. This case underscores the importance of valuing property accurately to determine tax liability and the need for corporations and their shareholders to consider the tax implications of any transactions between them. Failure to do so can result in unexpected tax burdens.

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