Epstein v. Commissioner, 53 T. C. 459 (1969)

A sale of corporate assets to trusts created by controlling shareholders for less than fair market value can result in constructive dividend and gift tax consequences.

Summary

In Epstein v. Commissioner, controlling shareholders of United Management Corp. sold rental properties to trusts they established for their children at below market value. The Tax Court held that the difference between the properties' fair market value and the consideration received by the corporation constituted a constructive dividend to the shareholders. Additionally, the portion of the property transferred without consideration was treated as a taxable gift from the shareholders to the trusts. This case illustrates the tax implications of non-arm's length transactions and the potential for constructive distributions and gift tax liability when assets are transferred at less than fair market value.

Facts

Harry Epstein and Robert Levitas, controlling shareholders of United Management Corp. , created trusts for their children on September 20, 1960. On the same day, the corporation sold rental properties in San Francisco and San Jose to these trusts for $515,000, payable in installments over 20 years without interest. The properties were valued at $325,000 and $95,000, respectively, exceeding the discounted present value of the consideration received by the corporation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Epsteins' and Levitases' income and gift taxes for 1960, treating the difference between the properties' fair market value and the consideration received as a constructive dividend and a taxable gift. The taxpayers petitioned the Tax Court, which upheld the Commissioner's determination on the constructive dividend and gift tax issues but adjusted the valuation and discount rate used.

Issue(s)

1. Whether the fair market value of the properties sold by United Management Corp. to the trusts exceeded the fair market value of the consideration received by it from such trusts.
2. If so, whether the difference between the fair market values of the properties sold and consideration received constituted a constructive distribution of property to petitioners Harry Epstein and Robert Levitas.
3. If Harry Epstein was the recipient of a constructive distribution of property, whether the ultimate receipt of such property by the trusts should be treated as a taxable gift from him to each of such trusts to the extent that no consideration was paid therefor.

4. Whether Estelle Epstein, who consented on her husband's 1960 gift tax return to have one-half of his gifts considered as having been made by her, is liable for an addition to tax pursuant to section 6651(a) by reason of her failure to file a gift tax return for 1960.

Holding

1. Yes, because the court found the fair market value of the San Francisco and San Jose properties to be $325,000 and $95,000, respectively, while the discounted present value of the consideration received was $357,037. 30, resulting in a difference of $62,962. 70.
2. Yes, because the shareholders enjoyed the use of the property by having it transferred to their children's trusts for less than full consideration, which is equivalent to a distribution to them directly.
3. Yes, because Harry Epstein's control over the corporation and the transfer of property to the trusts he created for his children without full consideration constituted a taxable gift to the extent of the difference between the properties' value and the consideration received.
4. Yes, because Estelle Epstein failed to file a separate gift tax return despite consenting to split gifts with her husband and having made gifts of future interests, which required both spouses to file returns.

Court's Reasoning

The court applied the principle that a corporation's transfer of property to a non-shareholder at less than fair market value can be treated as a constructive distribution to the controlling shareholder. The court found that the difference between the properties' value and the discounted present value of the consideration received ($62,962. 70) was effectively distributed to Epstein and Levitas. The court also treated this as a taxable gift from Epstein to the trusts he created, as he enjoyed the use of the property through the trusts. The court rejected the taxpayers' arguments on valuation and discount rate, finding that the fair market values and a 5% discount rate were appropriate. The court upheld the addition to tax for Estelle Epstein's failure to file a gift tax return, as required when spouses consent to gift splitting and make gifts of future interests.

Practical Implications

This decision emphasizes the importance of ensuring that transactions between related parties, especially those involving corporate assets and trusts, are conducted at arm's length and at fair market value. Controlling shareholders must be aware that the IRS may treat below-market transfers as constructive dividends and taxable gifts. When analyzing similar cases, attorneys should focus on the fair market value of assets transferred and the adequacy of consideration received. The case also serves as a reminder of the gift tax filing requirements when spouses consent to split gifts, particularly when future interests are involved. Later cases have cited

Epstein in determining the tax consequences of non-arm’s length transactions and the application of constructive dividend and gift tax principles.

