CTUW Georgia Ketteman Hollingsworth, Georgia L. Ketteman Testamentary Trust FBO John M. and Jean B. Reineke, S. Preston Williams, Estate of John M. Reineke, Jean B. Reineke, William K. Hollingsworth, and Norma L. Hollingsworth v. Commissioner of Internal Revenue, 86 T. C. 91 (1986)

When property is transferred to a corporation for less than adequate consideration, the excess value is treated as a taxable gift to the shareholders.

Summary

In 1967, Georgia Ketteman transferred farmland to a closely held corporation in exchange for a promissory note, intending to benefit her heirs. The IRS argued that the property's fair market value exceeded the note's value, constituting a taxable gift. The Tax Court, after evaluating expert appraisals, determined the property's value at $726,122, resulting in a gift of $246,122. The court denied the applicability of lifetime and annual gift tax exemptions due to the nature of the gift as a future interest. However, it found reasonable cause for not filing a gift tax return, thus waiving the addition to tax penalty.

Facts

In 1967, Georgia Ketteman, an 80-year-old widow, owned 231 acres of farmland near the Kansas City International Airport. She sold the property to Ketteman Industries, Inc. , a newly formed corporation, for a $480,000 promissory note. The corporation's shareholders were Ketteman and her intended heirs. Leo Eisenberg had previously offered $460,000 for the land. Ketteman's decision to sell was influenced by estate tax planning advice. By 1968, the corporation sold its stock, effectively selling the land for $2. 5 million. Ketteman died in 1972 without filing a gift tax return for the 1967 transfer.

Procedural History

The IRS issued a deficiency notice in 1981, asserting a gift tax liability for the 1967 transfer. Ketteman's estate and beneficiaries, as transferees, contested the valuation and exemptions. The case proceeded to the U. S. Tax Court, which heard expert testimony on the property's value as of the transfer date.

Issue(s)

1. Whether the fair market value of the property transferred to the corporation exceeded the value of the promissory note received, resulting in a taxable gift.
2. Whether the $30,000 lifetime exemption from taxable gifts was available for the 1967 transfer.
3. Whether the $3,000 per-donee annual exclusion applied to the transfer.
4. Whether an addition to tax for failure to file a gift tax return was warranted.

Holding

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1. Yes, because the fair market value of the property was $726,122 on the date of transfer, resulting in a gift of $246,122 to the corporation's shareholders.
2. No, because the lifetime exemption had already been utilized for gifts made in 1972.
3. No, because the transfer to the corporation constituted a gift of future interests to the shareholders, ineligible for the annual exclusion.
4. No, because Ketteman's failure to file was due to reasonable cause, not willful neglect.

Court's Reasoning

The court applied the market data approach to determine the property's fair market value, rejecting adjustments proposed by Ketteman's expert for time, size, location, and improvements. It used comparable sales near the airport to value 100 acres at $5,870 per acre for commercial development and the remaining 131 acres at $1,062 per acre as farmland. The court cited IRC §2512(b) and case law to establish that a transfer for less than full consideration results in a gift to the shareholders. The lifetime exemption was unavailable as it had been used in 1972, and the annual exclusion was denied because the shareholders' interests were contingent and thus future interests. The court found Ketteman's reliance on her attorneys' advice and the Eisenberg offer constituted reasonable cause for not filing a gift tax return, citing IRC §6651(a)(1).

Practical Implications

This decision clarifies that transfers to closely held corporations for less than fair market value are taxable gifts to the shareholders. Practitioners must carefully value assets and consider the tax implications of such transfers, especially regarding exemptions and exclusions. The ruling emphasizes the importance of filing gift tax returns when transfers may result in taxable gifts, even if based on good faith valuations. It also highlights the court's willingness to scrutinize valuations in volatile real estate markets and the limited availability of exemptions once used. Subsequent cases have cited Hollingsworth for its valuation methodology and treatment of gifts to corporations.

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