Bargain Sales: Traps for the Unwary

By William P. Wiggins

William P. Wiggins discusses the tax treatment of bargain sales.

I. Bargain Sales Between Corporations and Shareholders: Income Tax Consequences at the Shareholder Level

Introduction

What are the tax consequences of a corporation selling property to a shareholder at a bargain price? Will the “bargain” part of the sale be viewed as a constructive dividend to the shareholder? Must the corporation recognize gain when it sells appreciated property to a shareholder? Is the corporation allowed to deduct losses resulting from the sale? Could shareholders be viewed as making taxable gifts when a corporation sells property at a bargain rate? If one family member sells property to another family member at a bargain price, what are the tax implications? These and other questions hint at the sometimes menacing nature of bargain sales. Although a sale of property from a corporation to a shareholder (or from one family member to another) may seem innocuous on its face, there are traps to be avoided by tax professionals and their clients when considering such transactions.¹

Part I of the article presents an analysis of bargain sales between corporations and shareholders with a focus on the shareholder. Part II presents an analysis of bargain sales between corporations and shareholders, but emphasizes the corporation. Part III explores gift tax issues associated with bargain sales, while Part IV presents an overview of the concepts and practices related to the determination of fair market value, a critical aspect of any bargain sale. Common types of “traps” associated with bargain sales are described in each part of the article.² The traps are based on case examples and are illustrative of the kinds of problems taxpayers often confront in this arena.

Introduction

In general, when a corporation distributes property to its shareholders with respect to its stock, the shareholder receives a dividend.¹ The Internal Revenue Code (“the Code”) defines a “dividend” as a distribution of any property from a corporation to its shareholders out of its earnings and profits.³ Furthermore, the Code specifies that the term “property” includes money, securities, and other property; however, the term does not include the stock (or rights to acquire such stock) of the corporation making the distribution.³ Shareholders are responsible for including dividends in their gross income.⁴ Shareholders determine the amount to be included in their gross income by calculating the sum of money received plus the

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fair market value of all other property included in the distribution. If property is sold by a corporation to a shareholder for an amount less than the fair market value of the property (a so-called bargain sale), the difference in value may be treated as a dividend. This type of dividend is generally called a disguised or constructive dividend.

**Constructive Dividends—Historical Perspective**

The concept of a constructive dividend can be traced to a 1929 Supreme Court case. The case, *Old Colony Trust Company*, addressed the question of whether an employee was in “constructive receipt of income” when his corporate employer agreed to pay his income tax liability. The IRS argued that the employee was in constructive receipt of income. In holding for the government, the Court stated in pertinent part that:

> We think the question presented is whether a taxpayer having induced a third person to pay his income tax or having acquiesced in such payment as made in discharge of an obligation to him may avoid the making of a return thereof and the payment of a corresponding tax. We think he may not do so. The payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor. The form of the payment is expressly declared to make no difference.

Based on this foundation, the theory of constructive dividends has evolved during the past 80 years, mostly through court decisions involving a variety of fact patterns. While the Regulations and other administrative rulings provide some illumination, the main body of law regarding constructive dividends remains a product of the courts.

**It’s a Question of Fact—There Are No Bright Line Rules**

In determining whether a shareholder has received a constructive dividend, the analysis must focus on relevant facts. For example, in *Lengsfeld*, the court held that “whether or not a corporate distribution is a dividend or something else, such as a gift, compensation for services, repayment of a loan, interest on a loan, or payment for property purchased presents a question of fact to be determined in each case.” Aligned with the notion that the analysis must focus on facts, the courts instruct us not to concentrate on formalities. For example, in *Paramount-Richards Theatres Inc.*, the court held that:

> Corporate earnings may constitute a dividend notwithstanding that the formalities of a dividend declaration are not observed; that the distribution is not recorded on the corporate books as such; that it is not in proportion to stockholdings, or even that some of the stockholders do not participate in its benefits. Nothing in the statute or decisions warrants the view that a dividend distribution loses its character as such and becomes a deductible business expense merely because stockholders do not benefit equally from the distribution.

The directive to find a “dividend in fact” was reinforced in *Noble* where the court held that “[d]ividends may be formally declared or they may be constructive. The fact that no dividends are formally declared does not foreclose the finding of a dividend-in-fact.” Adding depth to the judicial mandate to find a “dividend in fact,” the court in *Green* refused to adopt a bright line rule when determining if a shareholder was in receipt of a constructive dividend. Consequently, the determination of whether a shareholder has received a constructive dividend remains a question of fact to be answered on a case-by-case basis.

**Arm’s-Length Test**

Problems associated with constructive dividends are particularly troublesome for shareholders of closely held corporations. For example, in *Ingle Coal Corp.*, the court stated that transactions between sole shareholders and their corporations are subject to special scrutiny. In *Loftin & Woodard, Inc.*, the court noted that in the context of a closely held corporation, “the potential presence of a constructive dividend is a perennial problem.” The court observed also that constructive dividends are “commonly encountered in the context of closely held corporations whose dealings with their stockholders are, more often than not, characterized by informality.” Furthermore, case law instructs us that if the transaction is in the form of a sale, it
nonetheless may constitute a constructive dividend to the shareholder. For example, in *Dellinger*, the court stated:

[T]he basic inquiry is not whether there was in fact, a sale, but whether the corporation transferred to its shareholders, without cost, a part of its earnings and profits. Although, as a general rule, income does not arise from the purchase of property for less than its fair market value, a bargain sale to a stockholder by the corporation may result in a dividend to the stockholder to the extent that the fair market value of the property transferred exceeds the consideration paid therefor. Whether the transfer or sale of property to the stockholder constitutes a dividend to him for income tax purposes is not controlled by the intent of the parties to the transaction but depends upon the circumstances and actual effect of the particular transaction. It is *immaterial that the transfer assumes the form of a sale* or that there is no express or formal declaration of a dividend, especially where it is evident that the sale does not constitute an arm’s length transaction. [Emphasis added.]

**Two-Part Test**

The judiciary has developed a two-part test to determine the presence of a constructive dividend. The *Loftin* court, *supra*, described the test as follows:

We begin our review of this finding by noting that the determination of a constructive dividend entails two separate inquiries. First, the trial court must determine whether a constructive dividend was conferred. Then, and only then, need the trial court focus on a computation of the amount of such a dividend ... . While these determinations necessarily are entwined to a degree, it is impermissible to find the presence of a constructive dividend simply because the value of a benefit conferred exceeds the payments made in compensation. One of the underlying problems with the district court’s treatment of the constructive dividend issue in the present case is its apparent failure to demonstrate that it performed both segments of this two part operation.

The first part of the test requires an analysis of the facts to ascertain whether a constructive dividend has been received by a shareholder. The essence of this inquiry is to determine whether the particular economic benefit conferred by the corporation to the shareholder was primarily for the shareholder’s benefit or primarily for the corporation’s benefit. As noted by the court in *Crosby*:

> “Not every corporate expenditure incidentally conferring economic benefit on a shareholder is a constructive dividend.”

And, as noted by the *Crosby* court, “Unfortunately, the line between primarily for shareholder benefit and primarily for corporate benefit is one not susceptible to easy delineation.” (Emphasis added.) This point was reinforced in *Sammons*, where the court stated that:

> It is true that the line between shareholder benefit and corporate benefit is not always clear ... because some expenditures embody both elements; and an indirect [or an incidental] benefit to the shareholder should not by itself be treated as a distribution to him. ... But this does not mean that where the primary or dominant motivation for a distribution was to benefit the stockholder rather than the corporation that the articulation of a concededly subordinate business justification should cause the entire transaction to be recharacterized for tax purposes. To permit such a swallowing up of the greater by the lesser would require us to espouse a rule of law which ignores the substance of corporate transactions. ...

**Bargain Sale As a Constructive Dividend**

Although the purchase of property for less than its fair market value does not generally result in a taxable event, a *bargain sale* of property by a corporation to a shareholder may result in a constructive dividend. When dealing with constructive dividends, the term *bargain sale* is not expressly defined in the Code or in the Regulations. However, an implicit definition of the term can be found in the Regulations:
**Transfers for less than fair market value.** If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value.33

In *Green*, the court expressly used the phrase “bargain sale” as part of its interpretation of the above Regulation:

Sections 316(a) and 301(c)(1) of the Code require a corporate shareholder to include dividends in gross income. Dividends may be in cash or in kind, and may also result when the corporation makes a “bargain sale” of its property to the shareholder at less than fair market value. When there is a “bargain sale,” the shareholder receives a dividend in the amount of the difference between fair market value and the price paid for the corporate property, assuming there are sufficient earnings and profits.34

Trap #1 illustrates some of the key concepts and practices presented in the above discussion.

### II. Bargain Sales Between Corporations and Shareholders: Income Tax Consequences at the Corporate Level

**Introduction**

In general, when a corporation distributes its stock, rights to acquire its stock or other forms of property to its shareholders, the corporation does not recognize gain or loss as a result of the distribution.35 On the other hand, if a corporation transfers property to a shareholder for an amount less than its fair market value, the shareholder is treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value.33

**Trap #1**

*A Corporation Sells Property to a Shareholder at a Bargain Price*  
(Consequence: the shareholder receives a constructive dividend)

**Case Illustration:** *R.T. Nelson*, 44 TCM 277, Dec. 39,141(M), TC Memo. 1982-361

**Issue**  
Whether the taxpayer received a constructive dividend from Nelco Manufacturing Corporation (“the Corporation”) as a result of a bargain sale of six porta-shot blast machines (machines) from the corporation to the shareholder (the taxpayer).

**Summary of the Court’s Findings**

The taxpayer initiated communications with a third-party for the sale of six machines. Negotiations continued for many months. As the negotiations continued, the taxpayer purchased from the Corporation six machines for $47,200. The taxpayer was a majority owner of the Corporation. It cost the Corporation about $3,500 to manufacture each machine for a total manufacturing cost of $21,000. The taxpayer and the third party finally reached an agreement whereby the taxpayer agreed to sell to the third party three machines along with various parts for $256,500.

In its notice of deficiency, the IRS determined that the taxpayer had purchased the six machines from the Corporation for an amount less than the property’s fair market value, resulting in the receipt of a constructive dividend in the amount of $217,938. Conversely, the taxpayer argued that the sale was “arm’s length” because the selling price was based on a formula that set the value of the machines at an amount that was “100-percent markup over cost.” Accordingly, the taxpayer argued that the price paid by him for the machines should be respected as representing the fair market value of the property at the time of sale.

**Summary of the Court’s Holding and Analysis**

- The sales of the machines by the Corporation to the shareholder were not arm’s-length transactions at fair market value.
- The fair market value of the machines when sold by the Corporation to the shareholder was $265,138.
- The Shareholder received a constructive dividend of $217,938 [$265,138 (FMV) less $47,200 (cost)] from the Corporation.

The Court dismissed the taxpayer’s assertion that the price paid for the machines, based on a cost formula, should be respected. In rejecting this argument the Court stated that a percentage markup does not indicate an arm’s-length fair market value, and that an internal 100-percent markup has no bearing on the determination of the fair market value of the property.
corporation distributes appreciated property to its shareholders, then gain is generally recognized to the extent that the fair market value of the property exceeds the adjusted basis in the hands of the distributing corporation. The underlying objective of these statutory provisions is to tax the appreciation in value arising while the corporation held the property.

**Historical Perspective—The General Utilities Doctrine**

Must a corporation recognize gain when it distributes appreciated property to its shareholders? When this question was first addressed by the Supreme Court, the Court responded by holding that a corporation was not required to recognize gain when it distributed appreciated property to its shareholders. This holding is commonly referred to as the “General Utilities doctrine.”

Because the doctrine provided corporate taxpayers with a vehicle for circumventing the two-tier system of taxing corporate income, Congress began passing legislation in 1969 aimed at limiting the effects of General Utilities. As an initial step, the Tax Reform Act of 1969 (“TRA 69”) closed a loophole relative to stock redemptions. The legislative history of TRA 69 includes the following language:

> Recently, large corporations have redeemed very substantial amounts of their own stock with appreciated property and in this manner have disposed of appreciated property for a corporate purpose to much the same effect as if the property had been sold and the stock had been redeemed with the proceeds of the sale. The appreciation is not taxed, however, on this type of disposition. ... The committee does not believe that a corporation should be permitted to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of the property in this manner. ... The committee amendments provide that if a corporation distributes property to a shareholder in redemption of part or all of his stock and the property has appreciated in value in the hands of the distributing corporation (i.e., the fair market value of the property exceeds its adjusted basis), then gain is to be recognized to the distributing corporation to the extent of the appreciation. ...
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**Trap #2**

**A Corporation Sells Property to a Shareholder at a Bargain Price**

*(Consequence: the corporation has capital gain income and is denied a compensation deduction)*

Case Illustration: *Thoni Service Corp.*, DC-FL, 96-1 USHC ¶50,168.

**Issue**

Whether the taxpayer should be allowed to re-characterize a reported bargain sale as a compensation payment to the president of the corporation for past services.

**Summary of the Court's Findings**

*Thoni Service Corporation* ("the Corporation") sold real property to its president and sole shareholder. The sale was based on a bona fide business purpose (to remove assets from the corporation in anticipation of civil judgments against it). On its federal income tax return, the Corporation reported the sales price to be $75,000 and the cost basis to be $55,083.06, recognizing a long-term capital gain of $19,916.94.

During the course of an audit by the IRS, the examining agent determined that a "bargain sale" had occurred and that the property sold had a fair market value of $1.6 million, the price at which the shareholder sold the property to a third party shortly after acquiring it. As a result, the agent determined that the Corporation had received $274,500 in ordinary income and $1,270,417 in long-term capital gain as the result of the sale to its president and sole shareholder.

The Corporation agreed to the IRS assessment and filed a refund suit in district court. The thrust of the Corporation's argument was that the sale was not really a sale, but was compensation for past services rendered by the shareholder in his capacity as president of the Corporation. Conversely, the government argued that the Corporation chose to sell the property to its owner and is bound by all the tax consequences of the sale, favorable or not.

**Summary of the Court's Holding and Analysis**

In holding for the government, the Court stated that a taxpayer must accept the tax consequences of its decisions; in this case a decision to sell property to its president and owner. The Court went on to note that it is well settled that taxpayers can organize their affairs as they choose, but they must accept the tax consequences of their choices, whether contemplated or not. Furthermore, the Court stated that the taxability of a transaction does not depend upon the possible existence of an alternative form. The Court noted that in this case the corporate taxpayer chose to organize its affairs through a sale, and therefore it is bound by that choice and the tax consequences must be accepted although not contemplated.

The Court went on to state that the taxpayer entered into a contract of sale for real property, not an employment contract or compensation agreement. It was strictly a sales contract and was reported as such on the taxpayer's federal income tax return. Furthermore, the Court stated that it is well settled that a taxpayer cannot elect a specific course of action and then, when finding himself in an adverse situation, extricate himself by applying the age-old theory of substance over form. Thus, the Corporation cannot escape the tax consequences of its sale of property to its president by re-characterizing the sale as payment for past compensation.

discovering that the sale would result in a tax being imposed at the corporate level, a decision was made to distribute the apartment house to its shareholders. Once the property was in the hands of the shareholders, the shareholders sold the property to the third party, on the same terms as negotiated earlier by the corporation. The IRS contended that the gain from the sale should be attributed to the corporation and the corporation should pay the attendant tax liability. The Tax Court held for the government, but the Fifth Circuit reversed. The Supreme Court then reversed the Fifth Circuit and held for the government. In its holding, the Court stated, in part:

[T]he transaction must be viewed as a whole, and each step, from the commencement of negotia-
tions to the consummation of the sale, is relevant. A sale by one person cannot be transformed into a sale by another by using the later as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. 44

Subsequent to its decision in Court Holding, the Supreme Court heard Cumberland Public Service Co. 45 In Cumberland, the shareholders desired to liquidate their holdings. Accordingly, they made an offer to sell their stock to a competitor, which was rejected. Following additional negotiations, the competitor offered to purchase Cumberland’s assets. This offer was rejected by Cumberland. Cumberland’s shareholders next offered to purchase the assets directly from its corporation. Because the General Utilities doctrine was in effect at the time, Cumberland decided to sell the assets directly to its shareholders, thereby avoiding the imposition of the capital gains tax. Once in the hands of the shareholders, they sold the assets to the competitor.

Armed with the Court Holding doctrine, the IRS used the imputed income rule to shift the gain from the shareholders to Cumberland. At trial, the Court of Claims refused to impute the gain to Cumberland. Based on a review of the facts, the Court determined that the sale had been made by Cumberland’s shareholders. The Supreme Court affirmed the decision of the Court of Claims, deferring to its evidentiary determination that the sale was, as a matter of fact, made by the shareholders rather than by Cumberland.

With the repeal of the General Utilities doctrine, the particular fact patterns presented in Court Holding and Cumberland are unlikely to have direct application to current bargain sale arrangements. However, as demonstrated in a recent case, Richardson, 46 the Court Holding doctrine continues to have life. In Richardson, the taxpayers transferred their personal and income-producing assets to a trust. After examining the purpose of the trust arrangement along with the resulting asset transfer, the Court disregarded the transfer, finding that the arrangement was a sham that lacked economic substance. Since the taxpayers’ relationship to both their physical assets and their income-producing activities remained essentially unchanged after the formation of the trusts, the trusts’ income and allowable expenses were taxable to the taxpayers. 47

In holding for the government, the Court used the occasion to reinforce many of the basic principles emanating from Court Holding:

In determining whether to attribute income to a taxpayer, the Code elevates substance over form, asking not what the surface of a transaction suggests but what the economic realities of the transaction show. See Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). Because even the most “patriotic” citizens do not have a “duty to increase [their] taxes,” Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), it “is entirely legal and legitimate” to minimize taxes through permissible means, Estate of Kluener, 154 F.3d 630, 634 (6th Cir. 1998). But if a transaction or entity has no “valid, non-tax business purpose,” id., nominally uses another person or entity “as a conduit through which to pass title,” Court Holding Co., 324 U.S. at 334, or “[b]rings about no real change in the economic relation of the [taxpayers] to the income in question,” Commissioner v. Tower, 327 U.S. 280, 291 (1946), the Commissioner has the authority to find that the transaction or entity lacks economic substance and disregard it for tax purposes, see Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1354 (Fed. Cir. 2006).

As stated loudly by the Court in Richardson, the Court Holding doctrine is alive and well, and is viewed by the federal courts as “a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.” 48 Therefore, tax professionals and their clients should consider the principles established by the Court Holding doctrine when planning transactions, particularly if the underlying purpose of the transaction may be lacking in economic substance.

Trap #3 illustrates some of the key concepts and practices presented in the above discussion.

III. Bargain Sales Between Corporations and Shareholders: Gift Tax Consequences

Introduction

There are at least three ways of viewing a gift: (1) common law gift; (2) federal income tax gift; and (3)
Trap #3

A Mother Sells Property to Her Son and Daughter-in-Law at a Price Equal to Fair Market Value, but the Transaction is Disregarded for Lacking Economic Substance

(Consequence: the mother has made a taxable gift to her son and daughter-in-law)

Case Illustration: L.G. Maxwell Est., CA-2, 93-2 USFC ¶60,145, 3 F3d 591

Issue

Whether a purported sale of property between related parties should be disregarded for lack of economic substance.

Summary of the Court’s Findings

Lydia Maxwell sold her personal residence to her son and his wife. Following the sale, Lydia continued to reside in the house until her death. At the time of the sale, she was 82 years old and was suffering from cancer.

The transaction was structured as follows:

- The residence was sold by Lydia to her son and daughter-in-law for $270,000.
- Simultaneously with the sale, Lydia forgave $20,000 of the purchase price, which was equal in amount to the annual gift tax exclusion to which she was entitled.
- The son and daughter-in-law executed a $250,000 mortgage note in favor of Lydia.
- The son and daughter-in-law leased the premises to Lydia for five years at a monthly rental of $1800.
- The son and daughter-in-law were obligated to pay and did pay certain expenses associated with the property following the sale, including property taxes, insurance costs and unspecified other expenses.


As can be observed the rent paid by Lydia to her son and daughter-in-law came remarkably close to matching the mortgage interest which they paid to Lydia. In 1984 Lydia paid her son and daughter-in-law only $675 less than they paid her; in 1985 she paid them only $1,033 more than they paid her, and in 1986 she paid her son and daughter-in-law only $1,125 more than they paid her. Not only did the rent functionally cancel out the interest payments made by Lydia’s son and daughter-in-law but they were at no time called upon to pay any of the principal on the $250,000 mortgage debt; it was forgiven at Lydia’s death in its entirety. Additionally, in each of the years preceding her death, Lydia forgave $20,000 of the mortgage principal.

Lydia reported the sale of her residence on her 1984 federal income tax return. Lydia continued to occupy the house by herself until her death. At no time during her occupancy did Lydia’s son or daughter-in-law attempt to sell the house to anyone else, but shortly after Lydia’s death, they sold the house for $550,000.

Summary of the Court’s Holding and Analysis

We agree with the Tax Court that where, as here, there is an implied agreement between the parties that the grantee would never be called upon to make any payment to the grantor, as, in fact, actually occurred, the note given by the grantee had “no value at all.” As the Supreme Court has remarked, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. There can be no doubt that intent is a relevant inquiry in determining whether a transaction is “bona fide.” As another panel of this Court held recently, construing a parallel provision of the Internal Revenue Code, in a case involving an intrafamily transfer: “when the bona fides of promissory notes is at issue, the taxpayer must demonstrate affirmatively that there existed at the time of the transaction a real expectation of repayment and an intent to enforce the collection of the indebtedness.” In our judgment, the conduct of Lydia and her son and daughter-in-law with respect to the principal balance of the note, when viewed in connection with the initial forgiveness of $20,000 of the purported purchase price, strongly suggests the existence of an understanding between them that Lydia would forgive $20,000 each year thereafter until her death, when the balance would be forgiven by her will.
federal gift tax gift. For purposes of this article, the basic principles of a common law gift will be analyzed. Following that review, the basic principles of a gift for federal gift tax purposes will be examined. Although important, the concept of gift for federal income tax purposes falls outside the purview of this article.

Common Law Gift

A gift in the common law sense requires donative intent on the part of the donor, delivery by the donor to the donee, and acceptance by the donee. For example, to find a valid gift of property, there must be a gratuitous and absolute transfer of the property from the donor to the donee, which takes effect immediately and is fully executed by delivery of the property by the donor and acceptance thereof by the donee. Furthermore, as a general rule, common law gifts must be fully and completely executed, and a present donative intent normally must be executed by a complete and unconditional delivery of the property which is the subject of the gift.

For example, under California law, to establish a common law gift, the donee must show by clear and convincing proof the intent of the donor to make a gift, delivery of the gift pursuant to the donor's intent, and acceptance of the gift by the donee. A gift is a voluntary transfer of property by one person to another, where the donor manifests the intent to make such a gift and irrevocably delivers the property to the donee. In addition to competency of the donor, a common law gift requires the donor's intent to make an immediate and absolute gift, delivery by the donor and acceptance by the donee, and completion of the donation with nothing left undone.

Federal Gift Tax

As a general rule, transfers reached by the federal gift tax are not confined to those that would be termed gifts under the common law. Code Sec. 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the year by an individual. Thus, property transferred by gift by one individual to another individual is subject to federal gift taxation.

It is important to note that donative intent is not a prerequisite to imposing the federal gift tax, which tells us much about the potential traps surrounding transfers of property in situations where the parties may not be intending to make a gift. Code Sec. 2511(a) provides in part that the tax imposed by Code Sec. 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible. Code Sec. 2512(a) provides that the value of the gift at the date of the gift shall be considered the amount of the gift. Furthermore, Code sec. 2512(b) provides in part that "where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year." Thus, there are many different ways of making a gift subject to the federal gift tax.

The reach of the gift tax is broad and deep, often reaching transfers in which the parties did not plan or intend to make a gift. Again, remember that while donative intent is a critical element of a common law gift and is an aspect of a gift for income tax purposes, it has essentially no role to play in determining a gift for gift tax purposes. Rather, the operative part of the provision is merely to find a situation in which the value of the property transferred by one party is greater than the value transferred by the other party, i.e., an imbalance in the fair market value of the properties transferred. This imbalance is the alert (red flag) for one to be sensitive about regarding the possibility of a gift situation for federal gift tax purposes.

A gift for federal gift tax purposes encompasses sales and other exchanges of property in which the value of the property transferred is more than the value of the consideration received. As stated by the Supreme Court, the "Congress intended to use the term 'gifts' in its broadest and most comprehensive sense" and "dispensed with the test of 'donative intent'" in lieu of "a much more workable external test, that where 'property is transferred for less than an adequate and full consideration in money or money's worth,' the excess in such money value 'shall, for purposes of the tax imposed by this title, be deemed a gift.'"

The federal gift tax, however, does not reach all transfers of property where the value of the property exceeds the consideration received in exchange. For example, the federal gift tax does not attach to a transfer of property that is made in the ordinary course of business. For this purpose, a transfer occurs "in the ordinary course of busi-
ness” only when it is *bona fide*, at arm’s length and free from donative intent. The regulations at Reg. §25.2512-8 provide:

Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money’s worth of the consideration given therefore. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is *bona fide*, at arm’s length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money’s worth. A consideration not reducible to a value in money or money’s worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift. ...

While gift taxation may not be a topic often associated with sales between parties, such as corporations and shareholders, the gift tax is sometimes seen as an insidious element of transfers taking place in situations that are not arm’s length, such as in closely held corporations and intra-family transfers.

Trap #4 illustrates some of the key concepts and practices presented in the above discussion.

**Trap #4**

**A Corporation Sells Property to a Shareholder at a Bargain Price**

*(Consequence: the shareholder has received a constructive dividend and has made a taxable gift)*

**Case Illustration:** *H.L. Epstein*, 53 TC 459, Dec. 29,892-B

**Issues**

- Whether the fair market value of properties sold by United Management Corporation (“the Corporation”) to certain trusts exceeded the price paid for the properties by the trusts.
- If so, whether the difference between the fair market values of the properties sold and the consideration received constitutes a constructive dividend to the taxpayer.
- If the taxpayer was the recipient of a constructive dividend, whether the ultimate receipt of such properties by the trusts should be treated to the extent that no consideration was paid therefor, as a taxable gift from the taxpayer to each of the trusts.

**Summary of the Court’s Findings**

By declarations of trust, the taxpayer created two trusts for the benefit of his children. Concurrently, the Corporation sold two of its rental properties to the newly created trusts. The taxpayer is both a trustee of the trusts and a majority stockholder of the corporation.

**Summary of the Court’s Holding and Analysis**

It has been long recognized that when a corporation makes a transfer to a member of a stockholder’s family, whether it be directly or in trust, the stockholder has enjoyed the use of such property no less than if it had been distributed to him directly. Accordingly, we must sustain the IRS’s assertion that the taxpayer has received a constructive dividend.

Pursuant to the terms of the trust declarations, the trusts were irrevocable and not subject to any alteration or amendment. Upon the termination of such trust, after 20 years, the corpora thereof are to be distributed to the taxpayer’s children. The taxpayer has not contended, nor can we find, that any of the trust provisions, including those relating to the taxpayer’s powers as a trustee, resulted in such retention by him of any dominion or control over the trusts as would preclude the imposition of gift tax liability on any transfers to such trusts. Accordingly, we must sustain the IRS’s assertion of gift tax liability on the transaction here involved.
IV. Fair Market Value: An Overview

Because the determination of fair market value is such an integral part of bargain sale arrangements, an overview of some of the law in this area is presented. However, given the breadth and depth of the concept of fair market value determinations, a more comprehensive review of the topic falls outside the purview of this article.

What is fair market value? While the term has been defined differently over the years, a commonly used definition is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. As one can imagine, determining the fair market value of property is a frequently litigated topic, and judicial interpretations. For example, the Court in Helvering v. Safe Deposit Co. noted that fair market value is an approximation derived from all relevant evidence.

In Spruill Est., the court observed that a sale of the property close in time to the valuation date is the best evidence of fair market value. The court, in Kaplin Est., stated that a sale of the property after the valuation date is highly relevant evidence of value if there are no material changes in the interim. In Stanley Works & Subs., the court interpreted fair market value to be the “highest and best use” of the property at the time of its valuation. Additionally, courts will generally apply a discount for lack of marketability where there is no ready market for shares in a closely held corporation.

Expert opinions may assist courts in determining the fair market value of property. As noted in Helvering v. National Grocery Co., courts may reject expert testimony or be selective in deciding what part of an expert’s opinion it will accept. The Tax Court has stated that it evaluates expert opinions in light of the demonstrated qualifications of the expert and all other evidence of value in the record, noting that it is not bound by the opinion of any expert witness when that opinion contravenes the Court’s judgment. Although the Tax Court may accept the opinion of an expert in its entirety, the Court has made it clear that it also may be selective in the use of any portion thereof. Thus, courts are free to take into account expert opinion testimony only to the extent that it aids them in arriving at the fair market value of the property.

Conclusion

Despite the best intentions of tax professionals and their clients, they sometimes fall into the unforeseen traps set by bargain sale arrangements. Because there are few bright line rules in this area of practice, professional tax advisors would be wise to consider the possibility of unknowingly walking into these traps whenever their clients are contemplating a bargain sale. In the end, most of the traps are avoidable. However, advisors must be cognizant of the potential of wading into these deep waters before they can avoid them.

ENDNOTES

1 A specialized type of bargain sale (namely, bargain sales to charitable organizations) falls outside the purview of this article. This article focuses on bargain sales to noncharitable entities and organizations.
2 The “traps” presented in the article are in summary form. While they present many of the common problems associated with bargain sales, the author acknowledges that they may not include all of the legal concepts related to bargain sales.
3 Code Sec. 316(a).
4 Code Sec. 317(a).
5 Code Secs. 61(a)(7) and 301(c).
6 Code Sec. 301(b).
7 Reg. §1.301-1(j).
8 Reg. §1.301-1(j).
10 Old Colony Trust Co., SCt, 1 ustc ¶408, 279 US 716.
11 Id., at 721.
12 R.T. Lengsfeld, 231 F2d 508, 57-1 ustc ¶9437.
13 Id., at 510.
14 Paramount-Richards Theatres Inc., CA-5, 46-1 ustc ¶9170, 153 F2d 602.
15 Id., at 605.
16 C.C. Noble, CA-9, 66-2 ustc ¶9743, 368 F2d 439.
17 Id., at 442.
18 G.G. Green, CA-5, 72-1 ustc ¶9429, 460 F2d 412.
19 Id., at 418.
20 Ingle Coal Corp., CA-7, 49-1 ustc ¶9267, 174 F2d 569.
21 Id., at 571.
22 Loitin, supra note 9.
23 Id., at 1211.
24 Id.
26 Id., at 1180.
27 Loitin, supra note 9, at 1212.
28 R.H. Crosby, CA-5, 74-2 ustc ¶9550, 496 F2d 1384.
29 Id., at 1388.
30 Crosby, supra note 28, at 1389.
31 C.A. Sammons, CA-5, 73-1 ustc ¶9138, 472 F2d 449.
32 Id., at 473.
33 Reg. §1.301-1(j).
34 Green, supra note 18, at 416.
Bargain Sales: Traps for the Unwary

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