2 T.C. 980 (1943)

A sale of stock before its redemption by a corporation is recognized as a bona fide sale for tax purposes, even if motivated by tax avoidance, provided the sale is genuine and transfers ownership before redemption.

Summary

W.P. Hobby sold preferred shares of Enterprise Co. shortly before they were scheduled to be redeemed by the corporation. Hobby structured these transactions as sales to friends at or slightly below the redemption price to realize long-term capital gains instead of short-term gains from redemption. The Commissioner of Internal Revenue argued these were not bona fide sales but attempts to avoid taxes, thus the gains should be taxed as short-term capital gains from liquidation. The Tax Court held that the transactions were indeed sales, and Hobby was entitled to treat the gains as long-term capital gains, emphasizing the formal validity of the sales and the transfer of ownership before redemption.

Facts

Petitioner W.P. Hobby owned preferred stock in Enterprise Co. that was set to be redeemed. Knowing redemption gains would be taxed as short-term capital gains, Hobby sought to treat the gains as long-term capital gains by selling the stock just before redemption. In four separate transactions, Hobby sold blocks of his stock to friends or associates. These sales occurred shortly before the scheduled redemption dates. Purchasers financed their acquisitions with bank loans secured by the stock itself, understanding the stock would be redeemed shortly after purchase, providing funds to repay the loans and generate a small profit. The corporation redeemed the stock from the purchasers as planned.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Hobby's income tax for 1939, arguing that the proceeds from the stock dispositions were short-term capital gains from partial liquidation. Hobby contested this, arguing the gains were long-term capital gains from bona fide sales. The Tax Court initially heard the case and issued the opinion.

Issue(s)

1. Whether the transactions constituted bona fide sales of stock, or should be disregarded as mere devices to avoid short-term capital gains tax on stock redemption proceeds.
2. Whether the taxpayer's primary motivation of tax avoidance invalidates otherwise valid sales transactions for tax purposes.

Holding

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1. Yes, the transactions were bona fide sales. The Tax Court held that each transaction was a valid sale because title and control of the shares passed to the purchasers before the redemption occurred.
2. No, the taxpayer's motivation to avoid taxes does not invalidate the sales. The court stated that while tax avoidance was a motive, the transactions were real sales with legitimate business purpose of realizing gain, even if collaterally for tax benefit.

Court's Reasoning

The Tax Court reasoned that in each instance, Hobby completed a sale of stock to another individual for an agreed price, and title was transferred before corporate redemption. The court emphasized, "*In each instance he in fact sold the shares to another individual for an agreed price, and they were delivered and title to them passed. The sales were completed before the corporation redeemed or retired the shares and at the time of such redemption petitioner was not the owner or in any other way related to them.*" The court rejected the Commissioner's argument that the sales lacked a "business purpose," stating, "*What kind of 'business purpose' must be shown as necessary to the recognition of a sale is not made clear, and there is no statutory requirement to that effect. The question is not one of purpose, but whether the transactions were in fact what they appear to be in form.*" Referencing *Chisholm v. Commissioner*, the court underscored that the transactions were indeed sales in form and substance. While acknowledging tax avoidance as a motive, the court found no lack of good faith between Hobby and the purchasers, as both intended a genuine transfer of ownership. The court distinguished cases cited by the Commissioner like *Gregory v. Helvering*, and instead found support in cases like *John D. McKee et al., Trustees* and *Clara M. Tully Trust*, which upheld similar transactions as valid sales.

Practical Implications

Hobby v. Commissioner clarifies that taxpayers can legally arrange their affairs to minimize taxes, including selling stock before redemption to alter tax characterization, as long as the transactions are bona fide and legally effective. This case highlights the importance of form in tax law; if a transaction is structured as a valid sale and ownership genuinely transfers, the tax consequences of a sale will generally be respected, even if tax avoidance is a primary motivation. However, dissenting opinions in *Hobby* foreshadow a stricter "substance over form" approach, cautioning that purely tax-motivated transactions lacking economic substance beyond tax reduction may be challenged. Later cases have distinguished *Hobby* by focusing more intensely on the economic substance and business purpose of transactions, especially in more complex tax avoidance schemes. This case remains relevant for understanding the boundaries between legitimate tax planning and impermissible tax avoidance, particularly in the context of asset dispositions before events that would trigger different tax consequences.

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