3 T.C. 33 (1944)

A loss sustained on the sale of property between a corporation and a shareholder owning more than 50% of its stock is not deductible for income tax purposes under Section 24 of the Internal Revenue Code, regardless of the bona fides of the sale.

Summary

W. A. Drake, Inc. sold two farms to Frank Bartels, a major stockholder, using the corporation's stock as primary consideration to reduce interest payments on encumbered properties. The sale of one farm resulted in a loss. The Commissioner disallowed the loss deduction under Section 24(b)(1)(B) of the Internal Revenue Code, as Bartels owned, directly or indirectly, more than 50% of the corporation's stock at the time of the sale. The Tax Court upheld the Commissioner's determination, finding that the loss was not deductible, irrespective of the transaction's legitimacy or Bartels' reduced ownership post-sale. The court emphasized Congress's intent to prevent tax avoidance through related-party transactions.

Facts

W. A. Drake, Inc., a farming corporation, sought to alleviate its heavy debt burden. Frank Bartels, a stockholder who, along with relatives, owned a significant portion of Drake's stock, entered into agreements to purchase two of the corporation's farms (Anderson and Carlson) on October 11, 1940. The agreed purchase price would be paid primarily in shares of the corporation's stock and the assumption of existing mortgages. Prior to the sale, Bartels obtained stock certificates from his sisters, granting him control over more than 50% of the outstanding shares. The sale of the Anderson farm resulted in a loss of $15,955.60. After the stock transfer, Bartels owned less than 50% of the outstanding stock.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in W. A. Drake, Inc.'s income tax and declared value excess profits tax for the fiscal year ending June 30, 1941. The Commissioner disallowed the loss claimed by W. A. Drake, Inc. from the sale of the Anderson farm. W. A. Drake, Inc. petitioned the Tax Court for a redetermination. The Tax Court upheld the Commissioner's determination, disallowing the loss.

Issue(s)

Whether a loss sustained by a corporation on the sale of a farm to a stockholder, who directly or indirectly owned more than 50% of the corporation's stock at the time of the sale, is deductible from gross income under Section 24(b)(1)(B) of the Internal Revenue Code.

Holding

No, because Section 24(b)(1)(B) of the Internal Revenue Code disallows deductions for losses from sales or exchanges of property between an individual and a corporation when the individual owns more than 50% of the corporation's stock, regardless of the transaction's bona fides.

Court's Reasoning

The Tax Court reasoned that the sale occurred on October 11, 1940, when the agreements were executed and a substantial portion of the consideration (the corporation's stock) was transferred. At that time, Frank Bartels, directly or indirectly, controlled more than 50% of W. A. Drake, Inc.'s stock. The court rejected the argument that the contracts were mere options, emphasizing the mutual obligations created by the agreements. It further dismissed the argument that the sale should be divided into multiple parts, stating that the various steps were part of a single transaction. The court acknowledged the potential harshness of the ruling but emphasized its duty to apply the law as written by Congress, citing Lakeside Irrigation Co. The court examined the legislative history, noting that Congress intended to close loopholes related to tax avoidance through transactions between related parties. The court stated, "We believe that 'the design and purpose' of the legislation was to deny the loss under such facts as those presently before us and that the test of bona fides of the sale or of the loss can not be applied."

Practical Implications

This case illustrates the strict application of related-party transaction rules in tax law. It highlights that the bona fides of a transaction are irrelevant when determining deductibility under Section 24(b) (now Section 267) of the Internal Revenue Code. Legal practitioners must meticulously analyze stock ownership, including indirect ownership rules, when advising clients on potential sales or exchanges between corporations and their shareholders. This case serves as a warning that losses from such transactions may be disallowed, regardless of legitimate business purposes or fair market value considerations. It remains a key precedent for interpreting and applying Section 267 and similar provisions designed to prevent tax avoidance. Later cases have continued to apply this strict interpretation, reinforcing the importance of careful planning in related-party transactions.

