27 T.C. 899 (1957)

The Internal Revenue Code disallows deductions for losses from sales or exchanges of property, directly or indirectly, between an individual and a corporation more than 50% of whose stock is owned by that individual, their family, or related entities.

Summary

In *McNeill v. Commissioner*, the U.S. Tax Court addressed two main issues: the deductibility of a loss from the sale of land to a corporation owned by the taxpayer and his family, and the classification of bad debts incurred by a practicing attorney. The court held that the land sale was disallowed under Section 24(b) of the 1939 Internal Revenue Code as an indirect sale between related taxpayers. The court reasoned that even though the sale was technically through the city of Altoona, McNeill's intervention in the transfer to Royal Village Corporation, which he and his family controlled, triggered the prohibition. Additionally, the court determined that the bad debts were not proximately related to the attorney's business and therefore were deductible only as nonbusiness bad debts subject to specific limitations.

Facts

Robert H. McNeill acquired land near Altoona, Pennsylvania, with the intention of developing and selling lots. Efforts to sell the land were unsuccessful. The county seized part of the property for unpaid taxes, later transferring it to the City of Altoona. McNeill's right of redemption in the property expired. Through McNeill's intervention, the City of Altoona sold the property to Royal Village Corporation, whose stock was primarily held by McNeill and his family. McNeill claimed an abandonment loss on his 1946 tax return. McNeill, also, made several loans and endorsements of notes which became worthless.

Procedural History

The Commissioner of Internal Revenue disallowed McNeill's claimed deduction for the abandonment loss and reclassified his claimed business bad debts as non-business bad debts. McNeill petitioned the U.S. Tax Court challenging the Commissioner's determinations. The Tax Court heard the case, making findings of fact and issuing an opinion disallowing the claimed loss and reclassifying the bad debts, resulting in a tax deficiency for McNeill.

Issue(s)

1. Whether McNeill's loss from the sale of land to the Royal Village Corporation is deductible, considering the provisions of Section 24(b)(1)(B) of the Internal Revenue Code of 1939 regarding sales between related taxpayers.

2. Whether bad debts incurred by McNeill are deductible as business bad debts, or are subject to the limitations of non-business bad debts under the Internal Revenue

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Code.

Holding

1. No, because the sale of the land to Royal Village Corporation was an indirect sale between related taxpayers, thus the loss was not deductible.

2. No, because the bad debts were not proximately related to McNeill's professional activities and were therefore subject to the limitations of non-business bad debts.

Court's Reasoning

The court determined that McNeill's loss from the sale of land to the Royal Village Corporation was not deductible. The court found that the transfer to the corporation, which was owned by McNeill and his family, constituted an indirect sale between related taxpayers, which is prohibited under Section 24(b)(1)(B) of the 1939 Internal Revenue Code. The court distinguished this case from *McCarty v. Cripe*, where a public auction was held, and there was no evidence of prearrangement. In McNeill's case, McNeill's intervention to have the land transferred directly to the Royal Village Corporation instead of taking title in his own name triggered the application of Section 24(b). The court also found that McNeill did not abandon the property, as he attempted to retain control over it. The court reasoned that the purpose of this section was to prevent taxpayers from creating tax losses through transactions within closely held groups where there might not be a genuine economic loss. The court stated: "We conclude that the purpose of Section 24 (b) was to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted."

Regarding the bad debts, the court determined that these debts were not proximately related to McNeill's law practice. The court found that McNeill was not in the business of lending money and that these transactions were isolated in character. The court, therefore, agreed with the Commissioner that these debts were personal in nature and deductible as nonbusiness bad debts.

Practical Implications

This case highlights the importance of carefully structuring transactions between related parties to avoid the disallowance of losses. Attorneys and tax professionals must advise their clients on the tax implications of such transactions, specifically considering the ownership structure and the potential application of Section 24(b) of the Internal Revenue Code (and its current equivalent). It also shows that the IRS and the courts will scrutinize the business connection for bad debt deductions. The case reinforces the need for clear documentation and evidence that a loss is genuine and not a result of transactions designed to manipulate tax liabilities within a family

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