28 T.C. 1222 (1957)

Section 24(b)(1)(A) of the Internal Revenue Code disallows tax deductions for losses resulting from the sale of property, either directly or indirectly, between members of a family.

Summary

The United States Tax Court disallowed tax losses claimed by John and Gwendolen Shethar. They engaged in a prearranged plan where each spouse purchased shares of stock identical to those owned by the other, and then sold their original shares. The court, following the Supreme Court's decision in *McWilliams v. Commissioner*, determined that these transactions constituted an indirect sale between family members, thus falling under Section 24(b)(1)(A) of the Internal Revenue Code, which prohibits the deduction of losses from such sales. The court rejected the Shethars' argument that the transactions were not indirect because of the way they were structured. The case emphasizes the substance-over-form principle in tax law, holding that the overall plan determines the tax consequences.

Facts

John and Gwendolen Shethar, husband and wife, each owned securities that had declined in value. They devised a plan to establish tax losses without relinquishing their ownership of the securities. John had a margin account with Wellington and Co., and Gwendolen had a cash account with the same firm. On October 14, 1953, John pointed out the potential tax benefits of selling their depreciated stocks. They agreed that John would buy shares of Amerada and Gwendolen would buy shares of Canadian. John then directed Wellington to purchase 500 shares of Amerada for his account and to purchase 1,500 shares of Canadian for Gwendolen's account. The purchases were made on October 15, 1953. On October 16, 1953, after getting an opinion from Wellington's tax accountants and deciding that the market conditions were favorable, John ordered the sale of his Canadian stock and Gwendolen's Amerada stock. Both spouses then claimed losses on their 1953 tax return, which the IRS subsequently disallowed.

Procedural History

The Commissioner of Internal Revenue disallowed the Shethars' claimed deductions for losses. The Shethars petitioned the United States Tax Court, challenging the disallowance. The Tax Court, after reviewing the facts and legal arguments, ruled in favor of the Commissioner, upholding the disallowance of the loss deductions. This is the decision that is presented here.

Issue(s)

Whether the losses claimed by the Shethars resulted from the sales of securities "indirectly" between members of a family, thereby disallowing the deductions under

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Section 24(b)(1)(A) of the Internal Revenue Code of 1939.

Holding

Yes, because the court held that the sales of the securities were part of a prearranged plan designed to create losses between family members, even though the sales occurred through a broker on the market. The court held that the transactions constituted an indirect sale.

Court's Reasoning

The court relied heavily on the Supreme Court's decision in *McWilliams v. Commissioner*. The court found the Shethars' transactions to be substantially similar to those in *McWilliams*, where a husband, managing his and his wife's properties, arranged for the sale and purchase of identical stocks by each spouse, resulting in a disallowance of loss deductions. The Tax Court emphasized that the intent was to create a tax loss while maintaining family control of the securities. The court considered it irrelevant that the Shethars used the stock market to execute the trades and that one spouse purchased the shares before the other sold them. The court also rejected the argument that the difference in market (New York Stock Exchange vs. over-the-counter) for the different stocks involved made a difference. The court focused on the overall prearranged plan. The court stated, "The important thing is that the sale and purchase were parts of a single prearranged plan, upon the consummation of which one spouse emerged owning an identical number of shares of the same stock which the other spouse had owned in the first place." The court also noted that the timing of the sales and purchases were closely connected.

Practical Implications

This case is critical for understanding the "indirect sale" provision of the Internal Revenue Code. It demonstrates that tax deductions can be disallowed even when transactions are executed through a stock exchange if they are part of a plan designed to transfer property between family members to create a tax loss. Taxpayers cannot avoid disallowance simply by using an intermediary. The case emphasizes the importance of looking beyond the form of transactions to their substance. Taxpayers must carefully consider the potential tax implications of any transactions between related parties. Attorneys advising clients on estate planning, investment strategies, or other financial matters must carefully examine the related-party rules to avoid unintended tax consequences. It also reinforces the need to document the intent and motivations behind financial transactions.

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