***DeWitt v. Commissioner*, 30 T.C. 567 (1958)**

A sale of corporate stock is considered a bona fide sale, subject to capital gains treatment, unless the substance of the transaction indicates it was merely a disguised sale of the corporation's underlying assets to avoid ordinary income tax rates.

Summary

The IRS challenged the DeWitts' claim that the sale of their corporation's stock resulted in a long-term capital gain, arguing the transaction was a disguised sale of the corporation's car inventory, generating ordinary income. The Tax Court sided with the DeWitts, finding the stock sale was a legitimate transaction. The court focused on the substance of the transaction. The court determined that the transfer of cars from the partnership to the corporation was bona fide, motivated by legitimate business reasons such as avoiding the Chevrolet franchise repurchase clause and the DeWitts had not planned to sell the corporate stock at the time they transferred the car inventory to the corporation.

Facts

J. Roger and Mary Mildred DeWitt owned Dew Corporation, which operated as a Chevrolet dealership. Following the loss of its Chevrolet franchise, the corporation sold new and used cars, earning income from these sales. The DeWitts' partnership began accumulating cars. When Chevrolet decided not to renew their franchise, the DeWitts decided to sell the cars to Dew Corporation. Later, the DeWitts sold all the stock in Dew Corporation to W. O. Bankston. The IRS determined that the stock sale was actually a sale of cars, which would be subject to ordinary income tax rates.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the DeWitts' income taxes, asserting that the sale of their corporate stock was not a genuine sale but rather a disguised sale of assets, taxable as ordinary income. The DeWitts challenged the determination in the U.S. Tax Court.

Issue(s)

Whether the sale of the Dew Corporation stock was a bona fide sale of stock.

Holding

Yes, because the court found that the transfer of the cars from the DeWitts' partnership to the corporation was a legitimate business decision, independent of the subsequent stock sale. The sale was a bona fide sale of stock entitled to capital gains treatment, because it was not a conduit for a sale of the corporation's assets.

Court’s Reasoning

The court focused on whether the stock sale was a genuine transaction or a “conduit” used to convert ordinary income (from car sales) into capital gains. The court referred to *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), which stated that a sale cannot be transformed for tax purposes into a sale by another by using the latter as a conduit. The court examined the events leading up to the stock sale and determined the transfer of cars from the partnership to Dew Corporation was motivated by legitimate business reasons – primarily the need to protect the cars from being repurchased by Chevrolet. The court emphasized that DeWitt had no plans to sell the stock when the partnership transferred its inventory to the corporation.

Practical Implications

This case highlights that the substance of a transaction, rather than its form, determines its tax treatment. Corporate structures and transactions must be carefully planned and documented to reflect the true economic nature of the dealings. Taxpayers seeking capital gains treatment should demonstrate that their transactions have legitimate business purposes beyond tax avoidance. When assets are transferred to a corporation prior to a sale, it is important to show the transfer served an independent business purpose. This case emphasizes that a court will look beyond the surface of a transaction to determine its true nature. This analysis is important for corporate reorganizations, sales, and mergers, particularly when dealing with assets that could generate ordinary income if sold directly by the owners. Businesses need to maintain thorough records demonstrating the business rationale behind corporate transactions.