Hill v. Commissioner, 52 T. C. 629 (1969)

Purchases of stock in an insolvent corporation do not qualify for Section 1244 ordinary loss treatment if the transaction lacks economic substance and is primarily for tax benefits.

Summary

In Hill v. Commissioner, the Tax Court ruled that stock purchases in the insolvent DeVere Corporation did not qualify for Section 1244 ordinary loss treatment. The petitioners, who had invested in and loaned money to DeVere, attempted to claim ordinary losses on new stock purchases made after the company's failure, which were used to pay off debts. The court found these transactions lacked economic substance and were primarily designed to generate tax benefits, thus disallowing the ordinary loss deductions. The decision highlights the importance of economic substance in transactions intended to qualify for tax benefits under Section 1244.

Facts

Petitioners invested in DeVere Corporation, formed to operate a trailer court during the 1962 Seattle World's Fair. They purchased stock and made loans to the company, which proved unsuccessful. Facing insolvency, DeVere's directors authorized a new stock offering under Section 1244. Petitioners bought this new stock, using the proceeds to pay off existing debts, including bank loans they had guaranteed. They sold the stock shortly after to a partnership formed by their attorneys, claiming ordinary losses under Section 1244.

Procedural History

The IRS disallowed the ordinary loss deductions claimed by the petitioners, allowing them instead as capital losses. The petitioners contested this in the Tax Court, which heard the case and issued its opinion.

Issue(s)

1. Whether the petitioners' purchases of DeVere's stock in December 1962 qualified as Section 1244 stock, entitling them to ordinary loss treatment upon its sale.
2. Whether the petitioners realized any losses on the sale of the December 1962 stock, either as ordinary or capital losses.
3. Whether the petitioners realized gains upon the purported redemption of DeVere's notes.
4. What deductions, if any, were available to the petitioners for their loans and guarantees to DeVere.

Holding

1. No, because the stock purchases lacked economic substance and were primarily

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for tax benefits.
2. No, because the transactions in the December 1962 stock were not genuine investments and thus did not result in any deductible losses.
3. No, because the purported redemption of DeVere's notes did not result in any taxable gain to the petitioners.
4. Each petitioner was entitled to deduct their share of DeVere's net operating loss and a nonbusiness bad debt loss from their loans and, for Hill and Coats, from their guarantees of bank loans.

Court's Reasoning

The court applied Section 1244, which allows ordinary loss treatment for losses on stock in small business corporations, but emphasized the need for economic substance in such transactions. It cited Congressional intent to encourage genuine investments in small businesses, not to provide tax deductions for bailing out creditors of failed ventures. The court found that the petitioners' transactions with the December 1962 stock were not investments but attempts to convert already suffered capital losses into ordinary losses, as evidenced by the immediate resale of the stock to a straw buyer at a nominal price. The court also noted that DeVere had ceased operations, further undermining the claim that the stock purchases were investments. The decision relied on precedents like Wesley E. Morgan, which similarly denied Section 1244 treatment for stock purchases in insolvent corporations lacking economic substance.

Practical Implications

This decision underscores the importance of economic substance in transactions intended to qualify for tax benefits under Section 1244. Legal practitioners must ensure that stock purchases in small businesses are genuine investments, not merely tax-driven maneuvers. The ruling impacts how similar cases are analyzed, emphasizing that transactions must have a legitimate business purpose beyond tax benefits. Businesses should be cautious about issuing stock in distressed situations, as such offerings may not qualify for favorable tax treatment. Subsequent cases have cited Hill v. Commissioner to distinguish between genuine investments and transactions lacking economic substance, influencing the application of Section 1244 and related tax provisions.

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