***Hook v. Commissioner, 58 T. C. 267 (1972)***

A transfer of stock to terminate a subchapter S election must be bona fide and have economic reality to be effective.

**Summary**

Clarence Hook transferred Cedar Homes stock to his attorney to terminate the corporation's subchapter S election, aiming to avoid tax liability on its income. The IRS challenged this, asserting Hook remained the beneficial owner. The Tax Court ruled that the transfer lacked economic reality and was not bona fide, thus the subchapter S election was not terminated. The court emphasized that for such a transfer to be effective, it must demonstrate real economic change and not be a mere formal device.

**Facts**

Cedar Homes, a corporation with Clarence Hook as its sole shareholder, elected subchapter S status in 1965. In 1966, facing financial difficulties and potential tax liabilities, Hook attempted to terminate this election by transferring stock to his attorney on December 30, 1966. The attorney received the stock without payment or performing services, and it was returned to Hook on July 20, 1967, without consideration. The transfer was not reported on any tax returns, and the attorney did not act as a shareholder beyond consenting to a name change.

**Procedural History**

The IRS assessed a deficiency against Hook for 1966, asserting the subchapter S election remained in effect. Hook petitioned the U. S. Tax Court for review. The court heard the case and issued its decision on May 10, 1972, ruling in favor of the Commissioner.

**Issue(s)**

1. Whether the transfer of stock from Hook to his attorney was bona fide and had economic reality, thus terminating Cedar Homes' subchapter S election under section 1372(e)(1) of the Internal Revenue Code.

**Holding**

1. No, because the transfer lacked economic reality and was not a bona fide transaction. The court found that the attorney took the stock as an accommodation to Hook, and Hook retained beneficial ownership throughout 1966.

**Court's Reasoning**

The court applied the rule that a transfer of stock to terminate a subchapter S

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election must be bona fide and have economic reality. It considered the timing of the transfer, the lack of agreement on the stock's value, the absence of consideration or services rendered, and the attorney's passive role as a shareholder. The court noted, "To be effective for the purposes of section 1372, a transfer of stock must be bona fide and have economic reality," citing *Michael F. Beirne* and *Henry D. Duarte*. The court also referenced the objective facts before and after the transfer, as highlighted in *Henry D. Duarte*, and determined that the transfer was merely a formal device, lacking substance.

**Practical Implications**

This decision clarifies that attempts to manipulate subchapter S elections through stock transfers must genuinely alter beneficial ownership. For legal practitioners, it underscores the importance of ensuring any stock transfer has economic substance and is not merely a tax avoidance strategy. Businesses must carefully structure transactions to avoid similar challenges. Subsequent cases like *Pacific Coast Music Jobbers, Inc.* have followed this precedent, reinforcing the need for real economic change in stock transfers to affect subchapter S elections.

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