Dunn v. Commissioner, 70 T.C. 715 (1978)

This case addresses the distinction between activities engaged in for profit (trade or business) versus not-for-profit (hobby) for tax deduction purposes, and clarifies the conditions under which a stock redemption qualifies as a complete termination of interest, allowing capital gain treatment.

Summary

Herbert Dunn claimed deductions for losses from his harness horse racing and breeding activities, arguing it was a business. The Tax Court determined it was a hobby, disallowing the deductions. Separately, Georgia Dunn redeemed her stock in Bresee Chevrolet. The redemption agreement included restrictions imposed by General Motors (GM) to maintain the dealership franchise. The court held that despite these restrictions, Georgia's redemption qualified as a complete termination of interest because the restrictions were externally imposed by GM and her interest was that of a creditor, thus allowing capital gains treatment rather than ordinary income.

Facts

1. Herbert Dunn engaged in harness horse racing and breeding from 1968 to 1975, consistently incurring losses except for minor profits in 1974 and 1975 during liquidation.
2. Dunn was 76 years old in 1969 when he claimed he intended to make horse racing his business after retiring from the automobile industry.
3. Dunn hired trainers and an accountant and reported horse racing activities on Schedule C, but his winnings were minimal compared to expenses.
4. Georgia Dunn redeemed all her stock in Bresee Chevrolet, a dealership, due to pressure from GM to have her son own majority stock and for estate planning and income needs.
5. The redemption agreement included payment restrictions tied to Bresee's financial obligations to GM for maintaining its franchise.
6. Georgia Dunn filed an agreement under section 302(c)(2)(A)(iii) and did not remain an officer, director, or employee of Bresee.

Procedural History

1. The Commissioner of Internal Revenue determined deficiencies in the Dunns' federal income tax for 1970 and 1971, disallowing deductions related to Herbert's horse racing activities and arguing Georgia's stock redemption should be treated as ordinary income.
2. The Dunns petitioned the Tax Court to contest these deficiencies.
3. The Tax Court consolidated the issues of Herbert's hobby loss and Georgia's stock redemption for trial.

Issue(s)

1. Whether Herbert Dunn's harness horse racing and breeding activities constituted a trade or business or an activity not engaged in for profit during 1970 and 1971 for the purpose of deducting losses under section 162 or 183 of the Internal Revenue Code.
2. Whether the redemption of Georgia Dunn's stock in Bresee Chevrolet, Inc., constituted a complete termination of her interest in the corporation under sections 302(b)(3) and 302(c)(2) of the Internal Revenue Code, thereby qualifying for capital gain treatment.

Holding

1. No. The Tax Court held that Herbert Dunn's harness horse racing and breeding activities were not a trade or business but an activity not engaged in for profit because he lacked a bona fide expectation of profit, and it was more akin to a hobby.
2. Yes. The Tax Court held that Georgia Dunn's stock redemption constituted a complete termination of interest because despite payment restrictions in the redemption agreement, her interest was that of a creditor and the restrictions were imposed by a third party (GM), not designed for tax avoidance.

Court's Reasoning

1. **Hobby Loss Issue**: The court applied the test of whether Herbert Dunn had a "primary or dominant motive…to make a profit." It considered factors from Treasury Regulations, noting no single factor is conclusive. The court emphasized objective factors due to Herbert's inability to testify, finding a lack of bona fide profit expectation. Key points included:
– Consistent losses over many years with minimal winnings, even if horses won every race.
– Dunn's advanced age (76) when starting the 'business'.
– Long-standing personal interest in horses suggesting a hobby.
– Outward business manifestations (trainers, accountant) were deemed unpersuasive without evidence of a profit motive or plan for profitability.
– The court concluded, "Herbert's activities were not operated on a basis which supports the conclusion of good faith expectation of profitability and there is no evidence of a plan of development that would change this situation."
2. **Stock Redemption Issue**: The court addressed whether Georgia Dunn retained an interest other than as a creditor under section 302(c)(2)(A)(i). The court reasoned:
– The restrictions on payments were imposed by GM, an independent third party, to protect its franchise, not voluntarily contrived for tax avoidance.
– While the regulation 1.302-4(d) suggests dependence on earnings can disqualify creditor status, the court interpreted this example not to automatically apply when restrictions are externally imposed and bona fide.
– The court distinguished this situation from cases where payment contingencies are

voluntarily structured for tax benefits.
– The court found no evidence of subordination in the ordinary sense, as Georgia pressed for payments and received more than strictly allowed under GM restrictions at times.
– The court concluded, “We are satisfied that the inclusion of restrictions on payment, at least where they are imposed by an independent third party, should be simply one factor out of several in determining whether a person retains an interest ‘other than an interest as a creditor’.”
– The court emphasized the bona fide nature of the transaction, Georgia’s intent to sever ties, and the legitimate business purpose behind the redemption.

Practical Implications

1. **Hobby Loss Cases**: This case reinforces that to deduct losses, taxpayers must demonstrate a genuine profit motive, not just business-like activities. Advanced age and a history of personal enjoyment of the activity can weigh against a profit motive. Consistent losses and lack of a viable business plan are critical factors in hobby loss determinations.
2. **Stock Redemptions and Creditor Status**: *Dunn* clarifies that payment restrictions in redemption agreements, especially those imposed by external third parties for legitimate business reasons, do not automatically disqualify creditor status under section 302(c)(2)(A)(i). The focus should be on whether the restrictions are bona fide and not designed for tax avoidance. This case provides a nuanced interpretation of Treasury Regulation 1.302-4(d), emphasizing context over a strictly literal reading. It signals that externally imposed business constraints can be considered within the creditor exception, allowing for capital gain treatment in stock redemptions even with conditional payment terms.
3. **Tax Planning**: When structuring stock redemptions intended to be complete terminations, document any third-party imposed restrictions thoroughly to support creditor status. For taxpayers claiming business deductions, especially in activities with personal enjoyment aspects, maintaining detailed records of business plans, profit projections, and efforts to improve profitability is crucial to differentiate a business from a hobby.

