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TAX DISALLOWANCE OF LOSS ON SALES BETWEEN RELATED COMPANIES OR INDIVIDUALS

SEYMOUR S. MINTZ *

Nowadays, tax factors necessarily affect the form, substance and timing of sales of property. It is the purpose of this paper to discuss some of the special tax considerations in sales made within a group of related companies or related individuals.

Ordinarily a corporation is treated for federal income tax purposes as an entity separate from its subsidiaries, from its individual or corporate stockholders, and from other corporations controlled by the same stockholders. This general rule is subject to a number of possible exceptions. One of these relates to the allowance of losses on sales or exchanges within the group of related corporations and individuals. The losses may be disallowed by specific statutory provisions (I.R.C. § 24(b)), or by reason of the concepts of good faith and business purpose, implicit in the Internal Revenue Code, requiring that the transaction be not an empty transfer of legal title, but a real sale, marking with finality the realization of an economic loss. The same problem as to allowance of loss arises upon transfers between husband and wife (or their companies) and between other taxpayers closely related by blood, by friendship, or by business or other interests, in fact wherever the relationship and circumstances are such as to suggest that the transferred property still may be under the domination and control of the seller, or that its fruits still may be enjoyed by the latter.

In determining whether loss will be allowed on a sale between related taxpayers, § 24(b) should be considered first. If its terms are applicable, the loss will be disallowed, and the study need go no further. If § 24(b) is not applicable to the transaction, additional analysis is needed, since the loss may nevertheless be disallowed because the transaction lacks good faith or business purpose.

Finally, §§ 45 and 129, I.R.C., should be considered. Section 45 authorizes the Commissioner of Internal Revenue to allocate losses within a controlled

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The first part of this paper is to appear in a book on tax procedures to be published by Prentice-Hall.

group but not to disallow the losses.[1] Section 129 provides in certain instances for the full or partial disallowance of a deduction, credit or other allowance which a taxpayer attempts to enjoy through the acquisition, on or after October 8, 1940, of the control of a corporation or the property of a corporation, the principal purpose of the acquisition being evasion or avoidance of federal income or excess profits tax by securing the benefit of the aforesaid deduction, credit or other allowance. Both §§ 45 and 129 are outside the scope of this paper.

SECTION 24(b)

Under this section, no deduction is allowed in respect of losses from sales or exchanges of property directly or indirectly between—

Members of a family.
The grantor and fiduciary of a trust.
The fiduciaries of two trusts, if the same person is grantor of each.
The fiduciary and beneficiary of the same trust.

A corporation and an individual owning (directly or indirectly) more than 50% in value of its outstanding stock (not applicable to distributions in liquidation).
Two corporations, if the same individual owns (directly or indirectly) more than 50% in value of the outstanding stock of each, provided either corporation was a personal holding company for its preceding taxable year (not applicable to distributions in liquidation).

Section 24(b) is *inapplicable* to transactions between a stockholder and a corporation, or between two corporations in which the same individual holds stock, if the stockholder owns in each instance precisely 50 per cent[2] (or less) of the stock, subject to the stock ownership rules discussed below.

"MEMBERS OF A FAMILY"

Section 24(b)(2)(D) states that the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. This list is important for two reasons: firstly, losses on sales or exchanges between "members of a family" are disallowed; secondly, an individual is considered as owning the stock owned, directly or indirectly, by or for his "family" (as well as by certain other persons), under the stock ownership rules below analyzed. These rules determine the circumstances in which stock in a corporation, a party to a sale or exchange, is to be considered as owned by a person other than the actual owner.[3]

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1. General Industries Corp., 35 B.T.A. 615 (1937); A. G. Nelson Paper Co., P-H 1944 TC MEM. DEC. ¶ 44,286 (1944).
2. See Hewitt Rubber Co. of Pittsburgh, P-H 1947 TC MEM. DEC. ¶ 47,317 (1947).
3. Lewis L. Fawcett, 3 T.C. 308 (1944) *aff'd*, 149 F.2d 433 (2d Cir. 1945).

The operation of § 24(b) is not affected by the fact that the purchasing member of the family occupies a special tax category in respect of the property, such as the status of a dealer in securities.[4]

Rules for Determining Ownership of Stock in a Corporation Which Is a Party to a Sale or Exchange

Section 24(b) disallows losses from sales or exchanges of property between certain persons, regardless of the nature of the property.[5] There are, however, specific provisions as to when a particular kind of property, i.e., corporate stock, owned by one person shall, in applying the section, be considered as being owned by another. These provisions are complex, and their application to individual cases should be carefully studied. The provisions may be illustrated as follows:

Example One. A owns 1% of the stock of a corporation. His wife, son, father, grandfather and partner each owns 10%. *A* is considered as owning 51% of the stock, and loss on a sale between *A* and the corporation will be disallowed.

Example Two. A owns none of the corporation's stock. His wife, son, father, grandfather and partner each owns 11%. *A* is considered as owning only 44% of the stock, the amount owned by his partner being ignored in these circumstances. Hence § 24(b) is not applicable to a transaction between A and the corporation.

Example Three. A individually owns none of *X* corporation's stock. He and an otherwise unrelated individual, however, own equally all the beneficial interests in another corporation, a partnership, an estate and a trust, each of which owns 20% of the stock of *X* corporation. The remaining 20% is owned by a member of *A's* family. *A* is considered as owning 60% of *X's* stock (half of the stock owned by the partnership, estate, trust and the other corporation, and all of the stock owned by the member of *A's* family). The result would be the same if a partner of *A* instead of a member of *A's* family owned the remaining 20%.

Example Four. A owns 50% of the stock of a corporation. His wife's father owns the other 50%. Hence *A's* wife is considered as owning 100%, but her husband and father are considered as owning only 50% each.

Example Five. A and his partner each own 50% of the stock of a corporation. Each is considered as owning more than 50% (i.e., 100%) and therefore § 24(b) is applicable to transactions between *A* and the corporation, or between the partner and the corporation. The section is not applicable,

4. Claire S. Strauss, P-H 1943 TC Mem. Dec. ¶ 43,217 (1943) (the taxpayer sold securities to her husband, a dealer in securities, claiming that his occupation made § 24(b) inapplicable. The loss was disallowed.)
5. Lewis L. Fawcett, note 3, *supra*.

however, to transactions between *A* and his partner, or between *A's* brother and the partner, or between *A's* brother and the corporation.[6]

In compliance with the stock ownership rules of § 24(b), it has been held that each of two brothers, who made separate purchases from a corporation, was to be considered as owning the stock of the other and the stock of his father and his other brothers, in determining whether he was the owner of more than 50 per cent of the seller's outstanding stock.[7] The decision made it clear that two individuals may be considered as owning the same shares at the same time.

Time of Determining Stock Ownership

Where the corporate stock itself is transferred between corporation and stockholder, leaving the latter with not more than 50 per cent stock ownership at completion of the transaction, the courts have held that the stock ownership is to be determined as of the time the sale is made and not as of the time the transaction is completed.[8] This view has even been applied to disallow the loss in a case in which the stockholder transferred *all* his stock to the corporation, in a transaction which took the form of a sale.[9]

Valuation of Corporate Stock

In the case of a sale or exchange between stockholder and corporation, or between two corporations, it is actual or constructive ownership by the stockholder of more than 50 per centum *in value* of the outstanding stock, which may bring § 24(b) into operation. This test is also laid down in I.R.C. § 501(a)(2) relating to personal holding companies, and in I.R.C. § 331(a)(2), relating to foreign personal holding companies. Hence decisions under each of these sections ultimately may be of aid in construing the foregoing language in § 24(b).

At present writing, only two cases have involved the value element in the above-quoted language in § 24(b). In one,[10] the taxpayer claimed that the section was inapplicable because all the outstanding stock was worthless. The court disposed of the case without a decision on this point. In another,[11] the taxpayer's holdings of preferred stock would represent only 49.36 per cent in value of the outstanding stock if it were found that the corporation

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6. A literal reading of the statute might result in disallowance of a loss between A's brother and the corporation, but the regulations (Example (1) under U.S. Treas. Reg. 111, § 29.24-6(d)) (1943) adopt the view above illustrated.

7. Hosch Brothers Co., 3 T.C. 279 (1944). See, also, Tri-Borough Transportation Co., P-H 1946 TC Mem. Dec. ¶ 46,049 (1946).

8. W. A. Drake, 3 T.C. 33 (1944), *aff'd*, 145 F.2d 365 (10th Cir. 1944).

9. Bernard Rubin, P-H 1946 TC Mem. Dec. ¶ 46,075 (1946).

10. Butler Consolidated Coal Co., 6 T.C. 183 (1946).

11. Wolf Bergman, P-H 1947 TC Mem. Dec. ¶ 47,285 (1947).

possessed a certain amount of good will, enhancing the value of its common stock, none of which was owned by the taxpayer. The court concluded that the existence of good will was not proved, and therefore disallowed the loss.

MEANING OF "SALE OR EXCHANGE"

The words "sale or exchange" as used in § 24(b) are broad in scope. Hence they apply to many transactions which the unwary might not consider as being within the section.

In one case,[12] part of the estate of the taxpayer's father, consisting of securities and cash, was distributed to a joint account for the equal benefit of the taxpayer, his mother and two sisters. Some years later, the taxpayer withdrew from the joint account, and received therefrom in cash an amount representing the value of his interest. This amount was less than his cost basis. The loss was disallowed, on the ground that his receipt of cash (in excess of one-fourth of the cash in the account) resulted from a "sale" to his mother and sisters of his share in the securities held in the account.

The foregoing result could have been avoided, of course, if the joint account had been terminated by distribution in kind to each of the members, followed by the taxpayer's sale of his securities to an outsider. Or the joint account could have been maintained, but all of its assets reduced to cash before the taxpayer's withdrawal.

The withdrawal from a partnership also may amount to a sale, loss from which is disallowed by § 24(b).[13]

In the case of *M. Conley Co.*,[14] the taxpayer had funds on deposit in a bank which closed in 1931. In December, 1939, the amount of the final distribution to be paid to holders of claims was known. Because the taxpayer desired to write off its loss in 1939, it sold its claim to the holder of 69 per cent of its stock for $12,050, receiving his promissory note. Soon thereafter, the liquidator of the bank paid $12,050 to the taxpayer's stockholder, who in turn paid off his note to the taxpayer. On its return, the taxpayer reported a loss on the sale of a capital asset, but later claimed a bad debt deduction. The Tax Court held that the loss was from a sale, and was disallowed by § 24(b). If the taxpayer had not gone through the formal transaction with its stockholder, it probably could have taken the bad debt deduction in 1939.

Another transaction deemed to be a sale or exchange under § 24(b) was one in which a taxpayer, owner of a one-sixth undivided interest in unprofitable real estate, gave a quitclaim deed to his brother in return for the

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12. Henry V. B. Smith, 5 T.C. 323 (1945).
13. Nathan Blum, 5 T.C. 702 (1945).
14. P-H 1943 TC MEM. DEC. ¶ 43,008 (1943).

latter's assumption of all the taxpayer's liabilities in respect of the transferred property.[15]

The transfer of property in payment of, or for credit upon, a debt owed by the transferor, is a sale or exchange within the meaning of § 24(b).[16]

SALES OR EXCHANGES INDIRECTLY BETWEEN RELATED ENTITIES OR INDIVIDUALS

The statutory language disallows losses from sales or exchanges of property directly or *indirectly* between certain persons. If Smith sells 100 shares of corporate stock to a straw man from whom Smith's wife buys the same shares, it is considered that there was a sale indirectly between Smith and his wife, and loss thereon is disallowed. Suppose, however, that Smith sells his shares upon the stock exchange, and his wife buys upon the exchange a like number of shares in the same corporation. Under facts like these, the Tax Court held in the *McWilliams* case [17] that the husband did not sell to his wife but to an unknown purchaser. The circuit court reversed,[18] stating that the transaction was an indirect sale between members of a family, because at the end of the transaction the parties "were in the same position as if they had dealt directly with each other as buyer and seller," having transferred fungible property [19] from one to another at a substantially unchanged price and in accordance with a pre-existing design. The circuit court was upheld by the Supreme Court.[20] Its opinion is discussed in detail in a later section of this paper.

The Tax Court has held that there was a sale indirectly between members of a family where a husband bought from a bank certain stock owned by his wife and pledged by her nine years earlier, the sale being viewed as having been made under her authority.[21] The court reached the same conclusion as to a sheriff's sale of a farm to mortgagees, the taxpayer's brothers and sisters, who had brought foreclosure proceedings which the taxpayer unsuc-

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15. Charles J. Stamler, 45 B.T.A. 37 (1941). *Cf.* P-H 1940 B.T.A. MEM. DEC. ¶ 40,613 (1940).

16. See the opinion of the circuit court in Lakeside Irrigation Co. v. Commissioner, note 26, *infra*; and Stephenson Land Co., P-H 1946 TC MEM. DEC. ¶ 46,108 (1946).

17. 5 T.C. 623 (1945). *Accord:* Pauline Ickelheimer, 45 B.T.A. 478 (1941), *aff'd*, 132 F.2d 660 (2d Cir. 1943); and August Kohn, P-H 1945 TC MEM. DEC. ¶ 45,351 (1945), *rev'd*, 158 F.2d 32 (4th Cir. 1946).

18. 158 F.2d 637 (6th Cir. 1946).

19. The circuit court's opinion included the following statement: "No material change was made in the property rights held by the broker for the taxpayers, for a certificate for the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. Richardson v. Shaw, 209 U.S. 365, 378; Gorman v. Littlefield, Trustee, 229 U.S. 19, 23."

20. 331 U.S. 694 (1947).

21. Charles E. Cooney, P-H 1942 TC MEM. DEC. ¶ 42,589 (1942).

cessfully contested.[22] In a brief but pungent dissent, three judges pointed out that the sale was not made by the taxpayer but by the sheriff.

Transactions Between a Partnership and a Corporation Controlled by the Members of the Partnership

Closely related to the problem of sales or exchanges indirectly between related entities or individuals is the matter of a sale between a partnership and a corporation controlled by the members of the partnership. Section 24(b)(1)(B) generally disallows loss on a sale or exchange between an individual and a corporation more than 50 per cent of the stock of which is owned by such individual. Does the term "individual" include a partnership? In the *Whitney* case,[23] the Tax Court indicated that it did not, but the Circuit Court of Appeals for the Second Circuit reversed the decision.[24]

The facts in the *Whitney* case were as follows: The thirteen members of a general banking partnership (J. P. Morgan & Co.) decided that their New York business should be incorporated as a trust company. The partnership sold assets, some at a gain and some at a loss, to a newly organized corporation (J. P. Morgan & Co., Incorporated), 78.2 per cent of the stock of which was owned by the partners and their relatives. If each individual member of the partnership had made the sale jointly with every other member, the loss would have been disallowed. The circuit court believed the result must be the same where the partnership made the sale. It considered that a differentiation between the aforesaid two sales was without "substance or reality" in view of the statutory method of treating partnerships for federal income tax purposes and in the light of the legislative purpose of § 24(b).

Gains on Sales: Separation of Gains and Losses in the Same Transaction

The fact that losses from certain sales or exchanges would be disallowed by § 24(b) does not serve to exempt from taxation any gains realized on such transactions.[25]

The section, moreover, cannot be avoided by offsetting within a single transaction gains and losses on separate pieces of property. In a leading case, a corporation, at one time and in one transaction, sold to a stockholder, considered as owning more than 50 per cent of its stock, four blocks of securities at market prices which resulted in gains as to two of the blocks and losses as to the other two, there being a small net gain on the entire transaction. The commissioner was upheld in treating the transfer of each block

22. Thomas Zacek, 8 T.C. 1056 (1947).
23. George Whitney, 8 T.C. 1019 (1947).
24. 169 F.2d 562 (2d Cir. 1948), *cert. denied*, 335 U.S. 892 (1948).
25. I.T. 3334, C.B. 1939-2, 180.

as a separate sale, with the result that the losses could not, by reason of § 24(b), be used to offset the gains.[26] This conclusion has been reached in other stock sales cases,[27] as well as in a case involving the sale of real estate.[28]

It is true that the above-mentioned cases merely lay down a general rule, for the courts concede that there may be instances in which separate properties could be substantially integrated, so that their sale would be an indivisible transaction. These instances, however, appear to be rare. The clearest case, of course, would be one of physical integration, as where two separately-acquired pieces of real estate are consolidated by the erection of a building partly upon each. A similar exception might involve a set of matched goblets, tapestries or other items having an aggregate status and value entirely distinct from its separately-acquired components.[29] A more unusual case, presenting not physical but practical integration, might be one in which the buyer, with business justification, refused except upon a lump sum basis to purchase or even to bid for certain assets, whose separate market value could not be satisfactorily determined.

Bona Fide Character of Transaction Under § 24(b)

Enough already has been said to make it obvious that, if its literal terms are met, § 24(b) will apply despite the fact that the transaction is consummated in good faith and for a fair consideration.[30]

The most authoritative indication to this effect was given by the Supreme Court in the *McWilliams* case.[31] There the Court stated that § 24(b) applies whether the sale is fictitious or real, since Congress evidently believed the individuals and entities described therein had a "near-identity of economic interests" and hence that "even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss."

26. Lakeside Irrigation Co., 41 B.T.A. 892 (1940), *aff'd*, 128 F.2d 418 (5th Cir. 1942) *cert. denied*, 317 U.S. 666 (1942).

27. M. F. Reddington, Inc., P-H 1942 B.T.A. Mem. Dec. ¶ 42,101 (1942), *aff'd*, 131 F.2d 1014 (2d Cir. 1942); B. O. Mahaffey, 1 T.C. 176 (1942), *rev'd* on another point, 140 F.2d 879 (8th Cir. 1944); W. A. Drake, Inc., note 8, *supra*; Morris Investment Corp., 5 T.C. 583 (1945), *aff'd*, 156 F.2d 748 (3d Cir. 1946), *cert. denied*, 329 U.S. 788 (1946). See, also, I.T. 3334, note 25, *supra*.

28. William F. Krahl, 9 T.C. 862 (1947).

29. The Tax Court would not necessarily hold that the articles had been integrated in this hypothetical case. In Krahl, note 28, *supra*, it held that there had been no integration although (1) the taxpayer had purchased the second piece of real property to protect the first piece against physical damage; (2) ownership of the two pieces would have permitted him to replace the existing buildings with one fronting on two streets; and (3) the aggregate sale value of the two properties was greater if sold as a unit than if sold separately.

30. See Nathan Blum, note 13, *supra*: Arizona Publishing Co., 9 T.C. 85 (1947); Claire S. Strauss, note 4, *supra*; Thomas Zacek, note 22, *supra*; Lakeside Irrigation Co., note 26, *supra*; M. F. Reddington, Inc., note 27, *supra*; Henry V. B. Smith, note 12, *supra*; Charles J. Stamler, note 15, *supra*; M. Conley Co., note 14, *supra*. In one case, Jordan C. Skinner, 47 B.T.A. 624 (1942), the amount received by the seller from his brother was almost twice as much as that offered by anyone else.

31. See note 17, *supra*.

BASIS OF PROPERTY FOLLOWING LOSS DISALLOWANCE UNDER § 24(b)

The loss disallowance under § 24(b) is permanent, not temporary, for the purchaser takes at his cost, there being no provision for carry-over of the seller's basis.[32] Nor can the parties rescind the transaction and thereby re-vest the old basis, if the sale originally was in good faith.[33]

METHODS OF AVOIDING SECTION 24(b) PENALTY

(a) *In general.*

As already indicated, the bona fide character of a transaction affords no immunity against § 24(b), for this section contains a rigid statutory formula. Because of such formula, avoidance is both "easy" and "impossible" of accomplishment, depending upon what one means by avoidance. For example, a sale to an outsider will "avoid" the § 24(b) penalty, i.e., loss disallowance. This sale, however, does not avoid, but actually complies with the statutory mandate, for the mandate is that a sale to an outsider is free of the section, the identity of such a buyer being accepted for purposes of the section as the proof of the seller's economic loss.

Regardless of rhetoric, it is clear that the seller will not be concerned with § 24(b) if sales at a loss are made to outsiders and only sales at a gain are made within the related group of taxpayers.

Means of avoiding § 24(b) penalty in several specific types of transactions also have been suggested in preceding sections of this article. The following paragraphs contain suggestions as to other possible steps.

(b) *Sales of property to certain relatives.*

Without risk of loss disallowance under § 24(b), property may be sold to a relative who is not a brother, sister, spouse, ancestor or lineal descendant of the seller. If, moreover, the sale is otherwise in good faith and for adequate

32. In this respect, § 24(b) is harsher than the wash sales provision (§ 118). See § 113(a)(10). The authors of MONTGOMERY'S FEDERAL TAXES, CORPORATIONS AND PARTNERSHIPS, 1948-49, make the following observation as to § 113(a)(10): ". . . a taxpayer may sell securities to a controlled corporation or a member of his family and purchase substantially similar securities within 30 days thereafter. The loss would be disallowed under both section 118(a) and section 24(b)(1). The authors believe, however, that the provisions of section 113(a)(10) should be controlling and the basis of the property sold should be carried forward, since the loss is nondeductible under section 118(a) regardless of the fact that it is likewise nondeductible under another section." (Vol. 1, p. 351).

33. Herberich, Hall, Harter Agency, Inc., P-H 1944 TC MEM. DEC. ¶ 44,146 (1944). If, under principles discussed later in this paper, a loss is disallowed because the transfer is deemed a sham, one would expect it to be considered a sham for all purposes, so that the taxpayer could re-establish his original basis by reversing the transaction. See Thal v. Commissioner, 142 F.2d 874 (6th Cir. 1944). However, if a transfer is deemed a sham because the taxpayer does not thereby realize loss in economic fact, although he does in form, the taxpayer may find himself bound by the form of his transaction. Higgins v. Smith, 308 U.S. 473, 477 (1940). *Cf.*: MONTGOMERY'S FEDERAL TAXES, CORPORATIONS AND PARTNERSHIPS, 1948-49, Vol. 1, p. 707; RABKIN AND JOHNSON, FEDERAL INCOME AND GIFT TAXATION, El § 2, p. 610a (1947).

consideration, any loss thereon will be allowed as well under the concepts of good faith and business purpose discussed toward the end of this article.

A son-in-law (or daughter-in-law) of an individual is not his lineal descendant and is not otherwise within the family definition in § 24(b).[34]

Care must be taken, however, to insure in the case of a sale to a son-in-law or daughter-in-law that the transaction is neither in substance nor in law a sale to the seller's descendant. In the *Simister* case,[35] the taxpayers sold a farm to their son-in-law *and* daughter. The Bureau of Internal Revenue contended that the buyers took as joint tenants, that each was vested with the property in its entirety, and, since one of the buyers was a lineal descendant of the sellers, that the entire loss should be disallowed. The Tax Court found it unnecessary to deal with the joint tenancy problem, for it concluded that under the applicable state law the buyers were equal tenants in common and hence that only one-half the loss was disallowed. The joint tenancy problem is as yet undecided, although one commentator has suggested that the court probably would have reached the same conclusion as it did in the case of the tenancy in common.[36] Others believe the court implied that the entire loss would have been disallowed had the buyers taken as joint tenants.[37]

The Tax Court extended the reasoning of the *Simister* case to one involving community property in *Arizona Publishing Co.*[38] There the taxpayer corporation sold real property to *X* who with his wife owned, as community property, 27 per cent of the corporation's stock. *X's* sister and her husband owned, as community property, 54 per cent of the corporation's stock. Since *X* paid the purchase price of the real property out of community funds, the property was deemed to have been sold to *X* and his wife as community property. Pointing out that under Arizona law a wife's title in community property is the equal of the husband's, the court held that loss was disallowed as to the portion of the property (one-half) sold to *X*, because he actually owned 13½ per cent of the corporate stock, and constructively owned his wife's 13½ per cent and his sister's 27 per cent, or a total of 54 per cent. The portion of the loss attributable to the property sold to *X's* wife was allowed (the price having been found to be fair), because her actual and constructive stock ownership included only the stock actually owned by her (13½ per cent) and that actually owned by her husband (13½ per cent).

A variation of the son-in-law transaction occurred in the *Saul* case.[39] Walter Saul gave to his daughters money which their husbands used to buy stock. The seller was Walter's brother. On these facts, the Bureau claimed that

34. Fervel Topek, 9 T.C. 763 (1947).
35. 4 T.C. 470 (1944).
36. TAX BAROMETER, Vol. 2, para. 21.
37. RABKIN AND JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION, S3 § 7 (1947).
38. See note 30, *supra*.
39. P-H 1947 TC MEM. DEC. ¶ 47,178 (1947)

the result was the same as if the stock had been sold to Walter who thereafter had given it to his sons-in-law. The Tax Court held that the sale was not between brothers, but between a seller and his brother's sons-in-law, who were not members of the seller's family. The Tax Court said:[40]

> We cannot agree with the respondent that the sale was in effect a sale to the petitioner's brother. There is no showing that the purchasers did not acquire full title or that they held the stock for the benefit of Walter Saul. If the result intended by all the parties was to place the stock in the hands of the sons-in-law of the petitioner's brother the parties had the right to choose the method actually adopted, a gift of the funds by Walter Saul to his daughters followed by the purchase of the stock by their husbands, in preference to the alternative method of a purchase by Walter Saul of the stock followed by a gift of the stock. This is not a case of doing indirectly what the parties cannot, without foregoing the deduction, do directly, but merely a choice between two alternative methods of accomplishing the same end. That they choose the method which results in a tax saving is their privilege. There is nothing inherently wrong in such a choice.

Similarly, the brother-in-law or sister-in-law of an individual is not a member of his family under § 24(b). In a claimed sale to a brother's wife, however, it was found that she was merely the nominal purchaser, her husband (the seller's brother) being the real buyer.[41]

An individual also may deal with his uncles, aunts and cousins, without § 24(b) penalty.

(c) *Sales and purchases upon the Stock Exchange.*

The *McWilliams* decision[42] effectively stopped avoidance of § 24(b) through prearranged stock exchange purchases and sales within a group of related individuals or entities. There is some danger, however, that revenue agents may attempt to invoke the § 24(b) penalty by extending this decision to cases involving materially different facts. Hence rather close scrutiny of the court's opinion is desirable.[43]

In general, losses from sales within the groups designated in § 24(b) are disallowed because Congress thought that these sales did not actually terminate the investment. While in the *McWilliams* case the members of the group sold to, and bought from, unknown persons, and stock certificates were received different from those sold, § 24(b) was held applicable because

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40. *Id.* at 47-646.

41. O. Phil Nordling, P-H 1947 TC MEM. DEC. ¶ 47,046 (1947), *aff'd*, 166 F.2d 703 (1948), *cert. denied*, 335 U.S. 817 (1948). To the same effect is Charles J. Stamler (note 15, *supra*).

42. See note 20, *supra*.

43. The text discussion of the McWilliams decision closely follows the thoughts expressed by this writer in REVIEW OF SUPREME COURT'S TAX DECISIONS, 1946-7 Term, Part 29 of Practical Aspects of Federal Taxation (Bureau of National Affairs), pp. 16-24; and IMPLICATIONS OF THE MCWILLIAMS CASE, N.Y.U. INSTITUTE ON FEDERAL TAXATION, pp. 1134-1139 (6th Annual ed. 1947).

it was prearranged that the respective members of the group would buy and sell identical property. The prearrangement was clear on the basis of the following facts: The properties of the several members of the group were managed by one of them; orders to buy and sell were issued simultaneously, and were isued to the same broker; the orders were to buy at as close to the sales price as possible; the sale and purchase were promptly consummated, each on the same day; the amount of money received by the selling member of the group and that paid by the purchasing member differed only in the amount of broker's commissions and excise taxes; the transactions were part of a pattern which the group had followed on a number of occasions; the broker was advised that the purpose of the transactions was to establish tax loss.

Several of the listed prearrangement factors have only corroborative significance. These include the factor as to a pattern of similar transactions, and the disclosure as to tax motivation. Other factors, including single management of the transactions, were essential to this particular kind of prearrangement; but in some instances prearrangement might be proven by showing a tacit understanding among the members of the group. Prearrangement likewise was implicit in the employment of a single broker, and in the specific orders given him as to price. The use of separate brokers, however, would not alter the situation, if other essential elements of prearrangement were present. It is believed, in other words, that in regard to the aforementioned factors at least, the courts probably will not closely limit the *McWilliams* doctrine to the precise facts of such case.

Other elements, such as the time factor, are of more than casual significance. The orders to buy and to sell were simultaneously issued, and were executed on the same day. It is clear, however, that the courts will not restrict the *McWilliams* principle precisely to these facts.[44] Suppose, on the other hand, that a full 30-day interval elapsed between the sale by one member of the group and the purchase by another. It might be argued that in such circumstances the loss should be allowed, since the seller would be allowed the loss if *he* repurchased after 30 days. If § 24(b) were complementary to § 118 (the wash sales provision), the loss would be allowed. Technically, however, the aforesaid sections are independent. Hence it is concluded only that, if Congress had studied this in detail, it might have said that 30 days as effectively breaks the continuity of the investment when a group is involved as when one person is involved, and therefore that as a practical matter the deduction should be allowed in the hypothetical case. In a marginal note, the Court re-

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44. This is indicated by the Supreme Court's statement as to why it granted certiorari. It said it did so because the decisions of the circuit courts in *McWilliams* and *Kohn* (note 17, *supra*) conflicted with those in *Ickelheimer* (note 17, *supra*). In both the latter cases, the sale by one member of the group and the purchase by another occurred on successive days.

fused to express any views as to such case, involving a time interval of 30 days or longer.

It is difficult to say that one member of the group sold to another unless the consideration paid by the one and that received by the other is approximately the same. The price difference which will permit the group to escape § 24(b) is difficult to compute by any general yardstick, just as is the time interval. Interpretative color will be lent each of these vital elements by the other factors present and by the general background of the transaction.

Doubtless the Bureau will assume that prearrangement was present in every transaction in which one member of a group buys property at or near the date and at or near the price at which like property is sold by another member. It should be possible to invalidate this assumption by establishing that when the first member of the group bought or sold the other member did not intend to take converse action, and thereafter did so independently of the first member, and perhaps only in the light of later events such as a change in economic or business circumstances. It is doubtful that the courts will sanction the disallowance of losses in transactions which are actually free from prearrangement. The issue is factual, and it may be assumed that the Tax Court will not be too sympathetic with attempted extensions of the *McWilliams* doctrine.[45]

(d) *Stock transfers prior to sale of the property in question.*

Section 24(b) problems in connection with sales between an individual and his controlled corporation, or between two controlled corporations, may in some instances be eliminated by antecedent transfers of stock. The corporate stock distribution may be such that, prior to the stockholder's sale of property to the corporation or the sale of its property to him (or the sale by one corporation to another), the stockholder may be willing to enter into a bona fide sale to an outsider or to a relative not listed in § 24(b)(2)(D), or to have redeemed, enough of his stock to bring to 50 per cent or less the amount which he is considered as owning. This might be accomplished by bona fide gift as well as by sale.

(e) *Sales between corporations.*

Regardless of common control, sales between two corporations are free of § 24(b) if neither corporation was a personal holding company (including a foreign personal holding company) in its preceding taxable year. The status or non-status as such a company on the date of the sale or exchange

45. This conclusion is based upon the Tax Court's decisions originally favorable to the taxpayer in this field, and also by the reasoning in its memorandum decision in the *Saul* case (note 39, *supra*), handed down after the Supreme Court decision in *McWilliams*.

is irrelevant.[46] It will in certain cases be desirable, and even necessary, to delay the sale, in order that proper steps may be taken to insure that neither corporation has personal holding company status for the year preceding the sale.

(f) *Sale by or to an estate.*

It would seem that an estate is not an individual within the meaning of the provision disallowing loss from a sale or exchange between an individual and a corporation 50 per cent of the stock of which is owned by such individual.

The only decision on the foregoing point (*Estate of Charles C. Ingalls* [47]) reaches the conclusion that the loss is allowed, but does so upon the basis of reasoning which is disturbing. In this case involving an estate's sale of bank stock to a corporation more than 50 per cent controlled by the estate, the Tax Court referred to the rule [§ 24(b)(2)(A)] that stock owned by an estate shall be considered as being owned proportionately by its beneficiaries. The court construed this rule as requiring it to look through the trust to determine the indirect owners of the stock sold, whereupon it found that "the stock was sold not by 'an individual,' but by a group of individuals, and, further, no 'such individual' owned 'more than 50 percentum in value of the outstanding stock' of the purchasing corporation." [48]

The Tax Court reasoned differently as to § 24(b)(2)(A) in *Lewis L. Fawcett,* where it said: [49]

> Under the first three subparagraphs of paragraph (2), the ownership of stock in a corporation, a party to the sale, is attributed to persons other than the actual owners under certain circumstances. These provisions have no reference to stock which is the subject of a sale or exchange.

It is believed that the later reasoning of the court, as contained in the *Fawcett* opinion, is correct; and it is submitted that the court has inferentially repudiated its statement in *Ingalls* that the stock sold by an estate is to be regarded under § 24(b)(2)(A) as having been owned and sold by the beneficiaries.

(g) *Transaction between fiduciary of one trust and beneficiary of another.*

By its terms, § 24(b)(1)(F) relates to sales or exchanges "between a

46. See U.S. Treas. Reg. 111, § 29.24-6(b) (1943).
47. 45 B.T.A. 787 (1941), *aff'd,* 132 F.2d 862 (6th Cir. 1943).
48. *Id.* at 793; RABKIN AND JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION, S3 § 7 (1947) comments upon the *Ingalls* case as follows: ". . . the Board indicated that the loss could be disallowed if a beneficiary of the trust owned a 50% interest in the property sold. This conclusion, it is submitted, was due to an erroneous interpretation of the constructive ownership provisions of the statute; the latter provisions are to be used only in determining whether the individual has the requisite stock ownership in the corporations involved in the transfer, not in determining whether the individual is a constructive owner of the property transferred."
49. 3 T.C. 308, 309 (1944).

fiduciary of a trust and a beneficiary of such trust," and not to sales or exchanges between a fiduciary of one trust and a beneficiary of another trust, even though both trusts were created by the same grantor. Moreover, § 24(b) (1)(E) specifically provides for the disallowance of loss on sales or exchanges between fiduciaries of separate trusts, "if the same person is a grantor with respect to each trust." Application of standards of statutory construction might dictate, therefore, that Congress specifically intended that transactions between a fiduciary of one trust and a beneficiary of another trust, even though the same person be grantor with respect to each trust, be free from § 24(b). The question, however, has not yet been presented for decision to any court.[50]

In addition to the non-statutory tests of good faith discussed in subsequent sections of this paper, the application of the principle of *Higgins* v. *Smith*[51] also should be considered. If one or both of the trust entities should be disregarded as a sham or fiction, application of other paragraphs of § 24(b)(1) conceivably might operate to disallow loss between the persons acting through the disregarded entities.[52]

(h) *Partial liquidation of a corporation.*

Where the property transferred to a corporation is its own stock, special circumstances exist. May loss disallowance be avoided in this case by consummating the transaction as a stock redemption in partial liquidation of the corporation? There have been no decisions on this point.[53] The statutory provision [§ 24(b)(1)(B)], it should be noted, excepts losses in the cases of distributions in liquidation.[54] Under I.R.C. § 115(c), distributions in liquidation may be in complete or partial liquidation of a corporation.[55] Hence the exception in § 24(b) appears broad enough to cover partial liquidations. The Treasury, however, narrowly construes the term "partial liquidation," and recent decisions under statutory provisions other than § 24(b) have tended to support the Government's view. It is believed likely, nevertheless, that the cancellation or redemption of all the stock of a stockholder, leaving neither him nor a "member of his family" interested in the affairs of the corporation,[56]

50. See MERTENS, LAW OF FEDERAL INCOME TAXATION, § 28.49, n.45 (1948).
51. Note 67, *infra.*
52. *Cf:* Shelden Land Company, 42 B.T.A. 498, 503 (1940).
53. In the *Rubin* case, note 9, *supra,* the Tax Court mentioned that no claim had been made that the sale of taxpayer's stock to a corporation effected a liquidation of the corporation.
54. The same exception is contained in § 24(b)(1)(C), generally disallowing loss on sales between certain corporations if the same individual owns more than 50 per cent of the outstanding stock of each.
55. See further the definition of "partial liquidation" in Int. Rev. Code § 115(i), as read in connection with § 115(g), which treats some distributions in connection with a cancellation or redemption of stock as essentially equivalent to the distribution of a taxable dividend.
56. *Cf.* the following statement in U.S. Treas. Reg. 111, § 29.115-9 (1943): ". . . a

would be considered as being within the exception in § 24(b)(1)(B) relating to distributions in liquidation. A more difficult case under the exception is one in which a "member of the family" of the transferring stockholder retains stock in the corporation,[57] particularly an amount in excess of 50 per cent.[58]

(i) *Liquidation of a partnership.*

As above indicated, the statutory provisions disallowing loss on sales or exchanges between individuals and their controlled corporations, or between controlled corporations, specifically except "distributions in liquidation." The natural assumption is that this exception was intended to cover only distributions in liquidation of corporations. In the *Whitney* case,[59] where a partnership liquidated after selling assets to a corporation controlled by the partners, the latter argued that the exception applied to the liquidation of the parnership. The circuit court indicated that, assuming the exception did apply to the liquidation of a partnership, the transaction between the partnership and the corporation in this case nevertheless was a sale, which under the facts was merely one of the *steps* in the liquidation of the partnership.

Another court already had held that loss from a sale *in aid* of corporate liquidation and distribution was outside the statutory exception, which covered only losses from the liquidating distribution itself.[60]

The partners also argued that each of them had sustained a loss upon the partnership liquidation, measured by the adjusted cost of his interest in the partnership and the amount (practically all in cash) which he received in liquidation, and that section 24(b) did not apply to this loss. The circuit court rejected this reasoning also, saying in part: [61]

> We do not think such deductions may be made by the individual taxpayers either in the light of the proper construction of § 24(b)(1)(B) or, beyond that, as a proven loss upon the partnership investment. Since the whole basis of the refusal of the deduction under § 24(b)(1)(B) is that the transfer is not such a change of economic interest as to be considered executed or closed to the point of realization of loss to the former owner, there is nothing which would change the prohibition by the added fact, obviously a usual one in the situation, of termination of the partnership. There

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cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." In these circumstances, the transaction is treated as a partial liquidation under § 115(c).

57. Some tax practitioners prefer not to rely solely on the above-quoted sentence (note 56, *supra*) as protection against § 115(g), when close relatives of the transferring stockholder retain a substantial block of stock in the corporation.

58. If the transaction effects a liquidation, it is within the statutory exception in § 24(b)(1)(B), and the retention of stock by another member of the family should make no difference. The question, of course, is whether the transaction is a liquidation. On this, see the preceding note.

59 Note 24, *supra*.

60. Mathews v. Squire, 59 F. Supp. 827 (W.D. Wash. 1945).

61. Commissioner v. Whitney, 169 F.2d 562, 570 (2d Cir. 1948).

> can be little reason for a transfer in substantial amount of firm assets to a corporation except the substitution of the corporate way of doing business for the former partnership one; and the prohibition of § 24(b)(1)(B), unless it is to be meaningless, must be held to apply then equally or especially. But further, we do not see the basis for finding a partnership loss upon this liquidation in any of the amounts stated. . . .
>
> As the Commissioner suggests, since all adjustments of the partners' interest or capital account are assumed to have been duly made, his interest at dissolution would always equal his distributive cash. Actually any additional loss must be a loss upon some specific property which then is non-deductible under the circumstances here by reason of § 24(b)(1)(B).

The court's denial of a loss to the partners on their liquidation of the partnership, as distinguished from the sale of the partnership assets, has been criticized.[62] It is possible that this problem has not been laid wholly at rest by the Supreme Court's refusal to grant certiorari in the *Whitney* case.

(j) *Avoidance of partnership status.*

In determining whether § 24(b) applies when a corporation is a party to a sale or exchange, as already explained, a stockholder is considered as owning the stock of his "partner." Hence it is important that individuals not fall unwittingly into partnership status.

In *Homes Beautiful, Inc.*,[63] the corporate stock was owned by *X* (50%), *Y* (25%), and *Y's* wife (25%). The corporation sold property to *X* and *Y*, each assuming liability for one-half the purchase price, and the corporation claimed a loss on the transaction. *X* and *Y* thereafter developed the property and sold it at a profit. They claimed they were merely co-purchasers, but the Tax Court held that they had not overcome the Commissioner's findings that they were partners. The corporation's loss was disallowed *in toto*, because each of the purchasers was considered as owning the stock of the other, so that each owned more than 50 per cent.

To avoid partnership status for purposes of §24(b), it may be desirable that individuals execute documents setting out in detail their relationship to each other and to any jointly-owned property.

(k) *Summary.*

To safeguard tax losses, the best procedure is to sell to strangers. If the taxpayer insists on selling to relatives or to corporations in which he, a member of his family or his partner has an interest, a copy of § 24(b) had better

62. See THE TAX BAROMETER, Vol. 5, para. 426, stating in part: ". . . taxpayers' contention that they sustained losses on liquidation of the old firm merited far more consideration than it received. The winding up of the old firm and the distribution of its assets in cash was a closed transaction under Sec. 29.113(a)(13)-2 of the regulations. It is doubtful whether the mere continuation of the business in a corporation (in which others acquired a minority interest) requires disallowance of that loss."

63. P-H 1947 TC MEM. DEC. ¶ 47,166 (1947).

be kept at hand. The taxpayer may, without fear of § 24(b), sell to relatives not deemed members of his family, friends, partners or other business associates, fellow-stockholders, fellow-beneficiaries of a trust or estate, many other persons with whom he shares monetary or social interests, or to outsiders. One controlled corporation may sell to another, and a parent corporation may sell to a subsidiary, if in each instance neither corporation was a personal holding company for its taxable year preceding the sale. All such sales free of § 24(b), however, must be made in good faith. In addition, sales between stockholder and corporation, or between controlled corporations, must have a business purpose.

Good Faith and Business Purpose

Prior to the enactment of § 24(a)(6) of the Revenue Act of 1934 [the predecessor to § 24(b)] losses from transactions between related taxpayers and entities were disallowed under general principles inherent in the income tax statute. These principles, and the decisions construing them, are still important in so far as they apply to transactions falling outside § 24(b).

Consider the case of a sale between a parent corporation and its subsidiary, or between two corporations controlled or dominated by the same interests, and assume that § 24(b) is inapplicable because neither corporation was a personal holding company for its taxable year preceding the sale. Nevertheless the loss in each case may be disallowed under the general principles of good faith and business purpose, inherent in the income tax statute, as enforced in the courts. In the application of these principles, the corporation claiming the deduction may be required to answer a number of basic questions, some of which overlap. The same would be true if the sale were between related individuals, or between an individual and his corporation. The major questions, under the heading of good faith, are as follows:

> Recognizing the relationship between the two parties to be a highly special one, precisely what was and is that relationship? Is the relationship such that one would be unlikely to act independently of, and adversely to, the other? Was the transaction of sale consummated at arms'-length, that is, did the parties act in a business like manner, as would two unrelated persons? Was the price a fair one? Did the transferee pay at once, or was the transaction on credit? If on credit, when did the transferee liquidate its obligation, and from what source? If it paid at once, did it use funds loaned or contributed by the transferor? If there was a loan from the transferor, has the loan been repaid? If the transferor contributed the funds to the capital of the transferee prior to the transaction, was the contribution conditioned upon the money being used to acquire the property? Did title actually pass? And did the dominion and control of the transferor accordingly cease in a legal sense? In an economic sense? Was the transaction final, or was there an understanding, tacit or otherwise, that the property would be reconveyed? Was it ever reconveyed? If so, for what price, and

for what reason? What has been the history of similar transactions between these parties, or between them and other related persons?

The answer to no single one of these questions will be decisive on the issue of good faith, but the aggregate answers largely will be determinative.

Many of the points arising under the concept of good faith also are involved under the concept of business purpose. Yet the two are essentially separate problems. Unlike the good faith issue, which may arise whenever a sale is made to one not a stranger, the business purpose inquiry in this field largely is limited to sales between an individual stockholder and his controlled corporation, or between two corporations controlled by the same interests, or between parent and subsidiary corporation. A basic problem in such instances is whether the transaction is business-motivated or tax-motivated. If tax-motivated, the deduction for loss upon the sale may be disallowed, even though all the customary indicia of good faith are present, and even though tax-motivation normally is of no concern in a sale between individuals.

The business purpose doctrine in this field stems in material part from the decision in *Higgins v. Smith*.[64] In this case, the Supreme Court held that a taxpayer did not sustain a deductible loss from a sale of securities to his wholly owned corporation. The corporation, however, had been created and was operated under the taxpayer's control and direction to achieve tax advantages for its stockholder, and in carrying out the transaction in question, the taxpayer had in mind the tax consequences to himself.

The *Higgins v. Smith* decision gave rise to three possible tests of deductible loss:

First, the court said that:[65] "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction. . . ."

Second, the court found a precedent in the *Gregory* case[66] "for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability . . . which [does] not vary control or change the flow of economic benefits. . . ."

Third, on trial, the jury found that the sale was not a transfer from the taxpayer to something that existed separate and apart from him. The Supreme Court found sufficient evidence to support this conclusion.

With respect to the first test, a number of cases have arisen since *Higgins v. Smith* in which the Commissioner contended that a corporation, a party to a sale or exchange, was unreal or a sham. In the first such case to

64. 308 U.S. 473 (1940).
65. *Id.* at 477.
66. *Id.* at 476.

arise, the Smith of *Higgins v. Smith*, and his corporation, were again involved, and the court concluded that the corporation "not only conducted no business enterprise but had no justification for existence even as a holding company."[67] It might, therefore, be reasoned that a corporation may not be disregarded as a sham or unreal if it carries on legitimate business activity This reasoning is supported by recent statements of the Supreme Court. In *Moline Properties, Inc. v. Comm'r*,[68] during the discussion of a related question, the Court declared that where the purpose of a corporation "is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

In *National Investors' Corp. v. Hoey*,[69] Judge Learned Hand, speaking for the court, asserted that "the gloss then [in *Moline Properties, Inc.*] put upon *Higgins v. Smith* . . . was deliberate and is authoritative." In the *National Investors' Corp.* case the Commissioner was denied the right to disallow loss on a liquidation between jointly controlled companies, so long as the second corporation carried on business activity. The Tax Court, too, has followed the same reasoning. See *Rhode Island Hospital Trust Co.*[70]

Since *Higgins v. Smith*, there have been a number of decisions which follow the second test in that case and therefore disregard sales made to controlled companies for no purpose other than tax avoidance. In one, *Continental Oil Co. v. Jones*,[71] sales were disregarded because found to have been made by a refining corporation to its wholly owned distributing subsidiary for the sole purpose of avoiding an excise tax. In another, *Wickwire v. United States*,[72] stock sales were disregarded where made to a machinery manufacturing corporation by two men, each of whom owned 47.5% of the stock of the corporation, the sales having been made for the sole purpose of achieving deductible losses. Other courts have expressed their agreement that this is a proper interpretation of *Higgins v. Smith*.

The Tax Court adopted this view in *Crown Cork International Corp.*[73] In that case the taxpayer attempted to show an independent purpose for the transaction, but the court rejected this evidence and concluded that the only motive shown was tax savings.

In later decisions the Tax Court has applied this test for loss disallowance as a matter of course, but twice recently this test has resulted in decisions for the taxpayers. See *Anderson, Clayton & Co.*[74] and *Brost Motors, Inc.*[75]

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67. Commissioner v. Smith, 136 F.2d 556, 559 (2d Cir. 1943).
68. 319 U.S. 436, 439 (1943).
69. 144 F.2d 466, 467 (2d Cir. 1944).
70. 7 T.C. 211 (1946), *acq.* 1946-2 C.B.4.
71. 113 F.2d 557 (10th Cir. 1940), *cert. denied*, 311 U.S. 687 (1940).
72. 116 F.2d 679 (6th Cir. 1941).
73. 4 T.C. 19 (1944), *aff'd*, 149 F.2d 968 (3d Cir. 1945).
74. P-H 1948 TC MEM. DEC. ¶ 48,162 (1948).
75. P-H 1948 TC MEM. DEC. ¶ 48,226 (1948).

The third test of loss disallowance suggested by *Higgins v. Smith* is whether the transferee has existence "separate and apart from" the transferor. The court said:[76]

> Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.

The earlier decisions following *Higgins v. Smith* seem to have accepted this language with little or no qualification. Further, as late as 1944, the Tax Court relied upon this aspect of the decision to deny a loss deduction to a taxpayer corporation which completely dominated and controlled its transferee corporation. This was in the *Crown Cork International case*,[77] already cited on another point. However, in 1946, the Tax Court indicated that there must be something more than complete domination and control of the transferee if loss is to be disallowed. In *Rhode Island Hospital Trust Co.*,[78] the transferor corporation owned all the stock of the transferee and had interlocking officers and directors with it. Yet each corporation carried on a separate business as a separate entity. On these facts, the court said:[79]

> . . . we are unable to find here that kind of domination and control which would warrant a disregard of the separate corporate existence. . . .

A recent decision by the Supreme Court seems to have justified the Tax Court's reluctance to apply the exact language of *Higgins v. Smith.* This was in *National Carbide Corp. v. Comm'r.*[80] In this case, a corporation wholly owned several subsidiaries which in turn owned properties, purchased with loans from the parent. The subsidiaries manufactured and sold related products under contract with the parent requiring that they return to the parent all but a nominal amount of income. The officials of the parent occupied similar positions in the subsidiaries, and the directors of the subsidiaries met only to ratify the actions of the parent. The subsidiaries contended that they were not taxable on the income turned over to the parent, and the Tax Court sustained that contention upon the basis of the close relationship between the parent and its subsidiaries. The court of appeals reversed, and the Supreme Court agreed with it on the ground that:[81]

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76. 308 U.S. 473 at 475 (1940).
77. See note 73, *supra.*
78. See note 70, *supra.*
79. *Id.* at 217.
80. 336 U.S. 442 (1949).
81. *Id.* at 429.

> Complete ownership of the corporation, and the control primarily dependent upon such ownership—the important ingredients of [*Southern Pacific Co.* v. *Lowe*]—are no longer of significance in determining taxability.

On its face, *National Carbide Corp.* is not concerned with loss disallowance between controlled companies. However, *Moline Properties, Inc.*, is subject to the same comment, and yet, as already noted, Judge Learned Hand found it appropriate to say of language in that opinion: ". . . the gloss then put upon *Higgins v. Smith* . . . was deliberate and is authoritative." In support of a similar interpretation of *National Carbide Corp.*, it may be urged that the Court therein treated *Southern Pacific Co. v. Lowe* [82] as overruled by *Moline Properties, Inc.* and proceeded to cite *National Investors' Corp. v. Hoey* with approval. The presumed familiarity of the court with the relation of the problems involved, and the breadth of the language quoted above would lend additional support to such an argument.

In any event, the Tax Court relied upon *Southern Pacific v. Lowe* in deciding *Crown Cork International Corp.* At the least, therefore, the decision in *National Carbide Corp.* will call for some re-examination of the Tax Court's position in *Crown Cork.* It is believed that, in the light of recent cases, the courts might properly abandon the separate entity test of *Higgins v. Smith* in favor of the other two tests, particularly the business purpose test, since this also will largely determine whether a corporate party to the transaction was a sham or unreal.

Perhaps the results of the cited cases presently may be distilled roughly as follows: To establish the loss deduction in this field, it should be shown:

(1) That the parties are separate from, and independent of, each other to a degree which justifies the recognition of one as seller and the other as buyer;
(2) That the particular transaction is in good faith, and
(3) Where a corporation is a party, that the transaction is a business transaction and is not motivated solely by tax considerations.

In establishing (1), (2), and (3), the proof tends to be the same, and therefore no particular effort will be made to maintain any segregation in respect of these three elements in the course of the remaining comments.

One should study the tax and business background of the parties to the transaction, ascertaining particularly whether they have in the past had similar dealings with each other or with any related individuals and corporations. If they have, and these were not at arms'-length, the immediate problem is made more complicated, for in these circumstances the tax authorities may begin with the assumption that the present transaction is part of a pattern of irregularities.

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82. 247 U.S. 330 (1918).

The related parties should in all instances anticipate that they will be asked to supply evidence as to the reality of the transaction, and should govern themselves accordingly. Evidence of separate identity should be readily available, including charter provisions of corporations, the history as to their creation (particularly the purposes) and operations, their separate books, records, corporate minutes, bank accounts, physical plant, methods of financing, etc. If possible, the particular transaction should be consummated without borrowings within the group of related taxpayers, although this is not essential. Where two corporations are involved, it should be made clear, in so far as feasible, that the officers and directors of each corporation considered the transaction upon its merits. This is easier of accomplishment, of course, if the two corporations maintain separate organizations, and have entirely different officers and directors. Even with much overlapping in the corporate organizations and directorates, however, it still may be shown that in practice the two corporations could reach decisions independently of each other and independently of their stockholders, and accordingly, that there was not such dominance and control as to make the transaction unreal. Again, the background will be of help in this aspect. If the original organization and separation of the two corporations was for a business purpose, and the transaction in question was also for a business purpose, and was consummated upon terms fair to both parties, the dominance and control of one party by the other (or dominance and control by common interests) seems to lose much of its significance in the eyes of the courts. There is in these circumstances a disposition to view the corporations as separate entities and to conclude that the transaction is marked by the requisite finality. This is true also of transactions between a corporation and an individual stockholder.

Conversely, even when there is independent management of the corporation or corporations, a loss from a transfer within the related group is not recognized as real and final if the transfer lacks a business purpose. Hence, in this type of transaction one cannot overestimate the importance of having a clearly defined and unassailable business purpose, as distinguished from a tax purpose.

If, on the other hand, continuing beneficial ownership of property is not involved, as where one sells at a fair price to a complete stranger, the purpose of the transaction is totally irrelevant, even though the seller's sole purpose be the taking of a tax deduction.

Good faith, which must always be present, is further evidenced by fair terms and a fair price, viewed from either side of the transaction. When the market value of the property at the time of the proposed transaction is not definitely known and publicly accepted, it is generally wise to have an evaluation made by independent appraisers, whose opinion will be respected by the courts. Finally, there should be nothing in the terms of transfer, or in the surround-

ing circumstances, indicating that the transferor intends to recapture the property with the cooperation of an amenable transferee.

In summary, losses from bona fide sales or exchanges between related taxpayers generally will be allowed, if § 24(b) is inapplicable. In the case of a transaction between a corporation and its stockholders, or between controlled corporations, a business purpose is necessary. In some instances, moreover, the commissioner may under § 45, I.R.C., reallocate the loss among the related taxpayers.