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# Tax: The Conflict between Netting Provisions of Section 1231 and the Uninsured Casualty Loss

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account stated, thus the creditor will be saved considerable time and money. This could well have been the reason why the Legislature restricted this statute allowing the recovery of an attorney fee to suits on "open accounts."

An additional problem is created by the one transaction debt, such as a single charge purchase or a single charge made for a service rendered. Will the court consider an action brought to recover the value of the service rendered or article sold an action on an open account? Although the court has not been faced with this problem the wording of the *Globe* case indicates the Court will probably hold that this is not an "open account" because there are not "running or concurrent dealings between the parties."[11] The court may also consider that the single transaction should be tried on the basis of an implied or oral contract.

The Oklahoma Supreme Court has laid down guidelines which will be beneficial in deciding what is an "open account." The attempt to bring the transaction in the *Globe* case within the statute is indicative of the challenge that faces the court.

*J. C. Joyce*

## TAX: THE CONFLICT BETWEEN "NETTING" PROVISIONS OF SECTION 1231 AND THE UNINSURED CASUALTY LOSS

There is a conflict between the courts and the Commissioner of the Internal Revenue Service in whether or not an uninsured loss is deductible as a casualty loss, or whether such loss must be offset against gains from the sale or exchange of business assets or involuntary conversions. In three actions, *A. B. Maurer v. United States*,[1] *G. H. Oppenheimer v. United States*[2] and *M. C. Morrison v. United States*,[3] the courts have held that uninsured casualty losses to trees and shrubs on residental property were fully deductible as nonbusiness losses under Section 165(c)(3).[4] The courts have refused to accept the Commissioner's contention that such losses should be offset against capital gains under Section 1231.[5]

[11] *Supra* note 6 at 647.

[1] A. B. Maurer v. United States, 284 F.2d 122 (10th Cir. 1960), rev'g and rem'g 178 F.Supp. 223 (D. Ka. 1959)

[2] G H. Oppenheimer v. United States, 220 F.Supp. 194 (W.D. Mo. 1963).

[3] M. C. Morrison v. United States, 230 F.Supp. 989 (E.D. Tenn. 1964).

[4] INT. REV. CODE OF 1954, § 165 provides:
(a) *General rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. . . . (c) *Limitations on losses of individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—... (3) Losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, *or other casualty,* or from theft.... (Emphasis added).

[5] INT. REV. CODE OF 1954, § 1231 provides:
(a) *General rule.*—If, during the taxable year, . . . the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole

The U. S. Internal Revenue Service, in announcing it would not follow the *Maurer* decision,[6] maintains that "involuntary conversion" of property as used in Section 1231 includes losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property, whether or not there is a conversion into other property or money, such as payment under the terms of an insurance policy. Authority, the Service says, for its treatment of the issue is in Section 1.1231-1(e)[7] of the Regulations covering the treatment of involuntary conversions.

The *Maurer* case, one of first impression, was first followed in the *Oppenheimer* decision, and then in *Morrison,* not withstanding intervening legislation.

In *Maurer,* the litigants were in agreement that the Taxpayer was entitled to a deduction. The question decided was whether the loss should be treated as an offset to capital gains taxable at a maximum of 25%, or allowed as a non-business deduction in arriving at taxable income taxed at ordinary income rates. The practical effect on the amount of tax saved is that if the loss is treated as an ordinary loss, the loss is fully deductible; while if Section 1231 were applied to the loss, it would, in effect, be treated as a long-term capital loss.[8]

To fully understand the problem which faced the 10th Circuit in deciding the *Maurer* case, it is necessary to compare the relevant sections of the Internal Revenue Code. Section 165(c)(3) permits taxpayers an ordinary loss deduction for losses of non-business and non-income-producing property occasioned by fire, storm, shipwreck, or other casualty, or by theft. Section 1231(a) (as it read prior to amendment by the Technical Amendments Act of 1958[9]), provided in substance that where there is an "involuntary conversion" of capital assets into "other property or money," the losses must be offset by gains incurred during the same period.

Read alone, one could readily conclude that Section 1231 applies only to gains and losses from compulsory or involuntary conversion *into*

or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of . . . capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sale or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection —... (2) losses... of property used in the trade or business or capital assets held more than 6 monthsshall be considered losses from compulsory or involuntary conversion.

[6] T.I.R. No. 304, February 16, 1961. REV. RUL. 61-54, 1961-1 CUM. BULL. 398.

[7] Treas. Reg. § 1.1231-1 (1959), as amended, T.D. 6394, 1959-2 CUM. BULL. 186, provides: . . . (e) *Involuntary conversion.* For purposes of Section 1231 . . . Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money.

[8] 284 F.2d at 124.

[9] Committee reports on the Revenue Act of 1958, 1958-3 CUM. BULL. 995, 1124.

*other property or money;*[10] and since the taxpayers in the three cases were not compensated for the damage, Section 1231 would seem inapplicable. Section 1231(a)(2) defines involuntary conversions as "losses upon the destruction . . . of capital assets held for more than 6 months. . . ." The effect of this paragraph, according to the Regulations,[11] is to extend Section 1231 to uncompensated losses. The trial court, in *Maurer,* was of the opinion that this latter subsection[12] extended the reach of the statute to include all involuntary conversions of capital assets whether compensated or not; and to so hold would accord unintended favorable treatment to an uninsured taxpayer.[13]

Chief Judge Murrah interpreted the relevant Code sections so as to create a definitive guide for future application. He stated, in part: "... (I)t seems clear that section 1231 is aimed at involuntary conversions where 'other property or money' is received in return, i.e., compensated losses, leaving Section 165 applicable to uncompensated losses."[14]

The court also considered the force and effect of Regulation §1.1231-1(e)[15] which says that involuntary conversions are to fall within Section 1231, "whether or not there is conversion into other property or money." The court stated that there were only "two possible conclusions, either the regulation is clearly inconsistent with the terms of the statute and invalid, or else it is inapplicable in this particular situation.[16] The court said further that it believed the regulation was applicable only to "involuntary conversions" and not in question in the *Maurer* case as the jury had characterized the deduction as a casualty loss.[17]

*Oppenheimer,*[18] which pertained to the 1956 taxable year, was heard upon stipulated facts leaving only the identical question of law to be decided. In deciding for the taxpayer, the court said: "Uniformity of decision and certainty in interpretation is no less desirable in the field of federal taxation than (elsewhere). . . . No aid or comfort will be given by this Court to those who choose not to accept the result of judicial decision in this field."[19]

Section 49 of the Technical Amendments Act of 1958[20] added a sentence to Section 1231(a) (effective for taxable years after 1957) to provide that totally uninsured losses to business property and income-producing capital assets from fire, storm, shipwreck, or other casualty, or theft, are not governed by Section 1231. Thus, such losses are always deductible as ordinary losses. There is no mention in the amendment of non-business or non-income-producing property. The Report of the Senate Finance Committee[21] makes it clear that the exclusion from Section

[10] INT. REV. CODE of 1954, § 1231(a).
[11] Treas. Reg. § 1.1231-1(e), *supra,* note 7.
[12] INT. REV. CODE of 1954, § 1231(a) (2).
[13] 178 F.Supp. at 224.
[14] 284 F.2d at 124.
[15] Treas. Reg. § 1231-1(e).
[16] 284 F.2d at 124.
[17] *Id.* at 123.
[18] 220 F.Supp. 194.
[19] *Id.* at 196.
[20] PUB. L. 85-866, 72 STAT. 1606, § 49.
[21] Committee reports on the Revenue Act of 1958, 1958-3 CUM. BULL. 995, 1124.

1231 of casualty losses to income-producing capital assets implies the inclusion of all other capital assets.

The government argued this same reasoning in defending the third case to be considered, *Morrison*,[22] which involved a casualty loss for damage to trees on residential property during 1960. In holding for the taxpayer, the court ruled that giving effect to the inference of inclusion by failing to specifically exclude non-income-producing property from Section 1231 would require a reading of that section as if it stood alone and in isolation from all other Code sections; and further, it would require "a rather involved process of rationalization and a series of inferences to conclude that Section 1231 treats an uninsured casualty loss to residential property as a 'compulsory and involuntary conversion' of a capital asset."[23]

From the decision in the *Morrison* case, it appears that the 1958 amendment did not correct the statutory gap in Section 1231 as hoped for by the Commissioner.[24] It is forseeable that because of the trend established by the courts, the Commissioner may ultimately be forced to change his position and withdraw Revenue Ruling 61-54. As stated in the *Maurer* case: "Section 165 (has) traditionally been the means for deducting uncompensated casualty losses from income where, as here, the property is non-income-producing."

To consider the question in another light, assume the sentence added by the 1958 Technical Amendments Act does require the offset of casualty losses to non-income-producing property under the "netting" provisions of Section 1231. How is the loss to be treated if such losses exceed gains? In the case of a sale or exchange of income-producing property, or involuntary conversion of property for which "money or other property" is received, any resultant loss would be fully deductible. However, the loss from the sale or exchange of non-income-producing or non-business property is never deductible as an ordinary loss or a capital loss.[25] To require the casualty loss to be offset against Section 1231 gains would require use of different standards for the measure of the same deduction. The legislative history of Section 1231 seems to indicate that it was not intended to apply to an uncompensated casualty loss.[26]

[22] 230 F.Supp. 989.

[23] *Id.* at 990.

[24] In a more recent case involving similar facts, the court said: "As . . . pointed out in Oppenheimer, the departmental refusal to abide by the Maurer decision is no reason for the district courts not to do so. Even if stare decis did not require it to do so, this court would be inclined to adopt the sound reasoning of Chief Judge Murrah in the Maurer opinion in any event. It follows that the plaintiffs were entitled to deduct the amount of their casualty loss fro mordinary income under I.R.C. (1954) 165." Robert S. Killebrew v. United States, CCH 1964 STAND. FED. TAX REP. (64-2 U. S. TAX CAS.) Para 9728 (E.D.Tenn. April 2, 1964).

[25] G.C.M. 16793, XV-2 CUM. BULL. 162.

[26] Section 1231 of the 1954 Code was taken without material change from § 117(j) of the 1939 Code. That section was first enacted in the Revenue Act of 1942. The report of the House Ways and Means Committee, 1942-2 CUM. BULL. 415, explains the purposes of proposed § 117(j) as follows: "Under existing law, the gain or loss from the sale or exchange of depreciable property is not treated as a capital gain or capitol loss, but as an ordinary gain or an ordinary loss. This rule