

December 1952

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Recommended Citation

William T. Lively Jr., *Transferee Liability--A Capital Loss*, 55 W. Va. L. Rev. (1952).

Available at: <https://researchrepository.wvu.edu/wvlr/vol55/iss1/5>

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COMMENTS

TRANSFEREE LIABILITY—A CAPITAL LOSS

WILLIAM T. LIVELY, JR.*

A short time ago the writer was asked to represent a client who had undergone an agent's examination and had been informed by the agent that adjustments would be proposed which would result in a sizeable tax deficiency for the years 1949 and 1950. Through usual procedure, the taxpayer client received a copy of the report of the examining agent, along with the "30 day letter", and a timely protest was filed by the writer.¹ A conference in regard to this liability was held with a representative of the internal revenue agent in charge, and, since the taxpayer was satisfied with the outcome of this hearing, a settlement was reached and the remaining deficiency paid.

Among the agent's findings excepted to by the taxpayer was one which especially interested the writer and although the conclusions arrived at by the taxpayer and the conferee were exactly opposite, no definite agreement as to the solution was reached between the parties. A very recent decision by the United States Supreme Court has decided the matter in favor of the Treasury in an opinion which the writer feels is questionable, this feeling being substantiated by three dissents therein.

The facts in the local case were as follows. In 1935 "The XYZ Club", a West Virginia corporation, purchased at public sale approximately 3,760 acres of land in Upshur, Webster, and Randolph Counties. On March 1, 1941, "The XYZ Club" conveyed the remainder of the lands, after some sales had been made, to the taxpayer, its sole stockholder, and on the same day the corporation was dissolved. In 1946 the taxpayer sold the land for an approximate \$10,000 overall gain, which was reported by the taxpayer on his 1946 return as a long term capital gain, and taxes were paid accordingly. In 1949 the original grantor to "The XYZ Club" entered suit against the corporation and the taxpayer for an accounting of the proceeds received in the sale in 1946, on the ground that the grantor had received insufficient notice of the sale. The circuit court of Kanawha County, in January, 1950, ruled that the

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¹ 4 CCH 1952 FED. TAX REP. ¶ 4117 (5).

defendant taxpayer should repay unto the original grantor the gain realized on the sale. The taxpayer, after complying with the order, deducted the \$10,000 on his 1950 return, in full, as an ordinary loss under Section 23 (e) (2)² of the Internal Revenue Code. It was the Bureau's contention, however, that the loss was a long term capital loss under Sections 23 (g) (1),³ and 117 (a) (5),⁴ and deductible only to the extent allowed under Section 117 (d) (2)⁵ of the Internal Revenue Code. Since the taxpayer had no capital gains against which to apply the deduction, and since the deduction, if the government prevailed, could only be taken into account to the extent of fifty per cent,⁶ the nature of this loss was of utmost importance.

The facts seemed to be of first impression. Since the gain

² INT. REV. CODE § 23. "Deductions from Gross Income.

"
"(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"
"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

³ INT. REV. CODE § 23. "Deductions from Gross Income.

"
"(g) Capital Losses.—

(1) Limitation.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117."

⁴ INT. REV. CODE § 117. "Capital Gains and Losses.

"(a) Definitions.—As used in this chapter—

"
"(5) Long-term capital loss.—The term 'long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing net income;"

⁵ INT. REV. CODE § 117. "Capital Gains and Losses.

"
"(d) Limitation on Capital Losses.—

"(2) Other taxpayers.—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer of \$1,000, whichever is smaller."

⁶ INT. REV. CODE § 117 (b). Section 322 of the Internal Revenue Act of 1951 provides that the 50% limitation no longer applies. Under the new law, however, as under the prior law, net capital losses, whether long or short term, may be used to offset only \$1,000 of ordinary income, and the unused net loss may be carried forward as a short term capital loss in the five succeeding years under Section 117 (e) (1). It is well to remember, however, that a capital loss carry-over from the calendar year 1951 or before will be computed under the old law, and capital loss carry-overs for the calendar year 1952 or for any taxable year beginning on or after the date of enactment of the 1951 Act, will be computed under the new law.

realized on the sale was taxable as capital gain, it should follow that a refund of the same money by a court order resulted in a capital loss. The key to the matter, however, lies in the definition of a short term capital loss,⁷ and a long term capital loss,⁸ as defined in the Internal Revenue Code.⁹ It will be noted by the definition of such losses that, in order for a transaction to be treated as a long term or short term capital loss, there must be a *sale or exchange*.¹⁰

Until recently the leading case¹¹ analogous to the factual situation presented above bore this out, and hence should be closely studied. Four taxpayers were stockholders in X corporation which began liquidation in 1941. Each of the taxpayer's pro rata share of the liquidating distribution was correctly reported as long term capital gain for the taxable year 1941.¹² In 1942 the Bureau made a determination of income tax deficiencies against the corporation for the years 1940 and 1941. Since the corporation could not pay the deficiencies, the four taxpayers did pay as transferees of the corporate assets, and each deducted the amount paid as an ordinary loss in the year 1944 under Code Section 23 (e) (2).¹³

⁷ INT. REV. CODE § 117. "Capital Gains and Losses.

"(a) Definitions.—As used in this chapter—

"
 "(3) Short-term capital loss.—The term 'short-term capital loss' means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income;"

⁸ See note 4 *supra*.

⁹ It is to be noted that INT. REV. CODE § 117 does not provide for any additional losses. An individual is allowed to deduct a loss only if it comes within Section 23 (e). Section 117 merely determines whether a loss of an individual that is allowable under Section 23 (e) is to be taken as a capital loss or an ordinary loss.

¹⁰ Several sections of the Internal Revenue Code provide that transactions which are not in fact sales or exchanges will be treated as though they were. They are as follows:

117 (f) redemption of bonds;

23 (g) stock and rights which have become worthless;

23 (k) (2) debts evidenced by securities which have become worthless;

23 (k) (4) non-business bad debts;

115 (c) amounts distributed in complete or partial liquidation of a corporation;

115 (d) certain corporate distributions.

¹¹ Stanley Switlik, 15 T.C. 121 (1949) (Non-Aq. 1949-2 CUM. BUL. 6).

¹² INT. REV. CODE § 115 (c) states that generally distributions in liquidation are considered as amounts received in exchange for the stock and therefore treated as a capital gain.

¹³ See note 2 *supra*.

The commissioner contended that the amount of the deficiencies were capital losses because the payments by the taxpayers grew out of, were related to, and took their character from a capital transaction and therefore should be subjected to the same limitations as the original transactions (*i.e.*, the liquidation). The court held for the taxpayer, saying:

“The losses they sustained were not, however, capital losses, as they were not losses from the sale or exchange of capital assets, . . . and this is true even though the transferee liability which occasioned the losses arose out of distributions which resulted in capital gains in 1941.”

The court went on to say that the sale or exchange had occurred in 1941 and not 1944. The losses were therefore held to be ordinary losses.

Judge Disney dissented, writing a very persuasive opinion, and, among other things, said:

“Inquiry must be made into the character of the loss and such inquiry divulges the fact that it arises as a consequence of a distribution in complete liquidation in 1941 In seeking the nature of the loss we may, and should, ascribe to it the same character as that from which it arose, to-wit, the capital transaction in the corporate distribution In the taxable year here involved it is claimed as a loss, but this claim cannot conceal the fact that it represents merely diminution in the capital gain received on the distribution in the earlier year.”

The case was subsequently appealed to the third circuit court of appeals and the decision was affirmed.¹⁴ It is interesting to note that in the appeal the commissioner shifted his argument.¹⁵ It was his position that since only fifty per cent of the capital gain on the liquidation dividend was taken into account in 1941, to allow the deduction of the full amount of the payments in 1944, assumes that they are chargeable wholly to the portion of the capital gain taken into account in 1941. But the third circuit agreed with the Tax Court on the theory that the capital transaction was concluded in 1941, and since there was no sale or ex-

¹⁴ *Comm'r v. Switlik*, 184 F.2d 299 (3d Cir. 1950).

¹⁵ For the general rule in regard to raising an issue for the first time in the court of appeals, see *Hormel v. Helvering*, 312 U.S. 552 (1941).

change in 1944, the loss was deductible in full as an ordinary loss. The court felt that it was obliged to follow the language of the Internal Revenue Code in requiring that there be a sale or exchange before the capital loss provisions applied. Since the *Switlik* case the Tax Court has consistently followed its holding in analogous factual situations,¹⁶ but the commissioner refused to acquiesce¹⁷ and has continued to disallow this deduction as an ordinary loss. As will be seen from a study of the cases, the commissioner's argument has consistently been that the subsequent payments by the transferees represent merely a diminution of the capital gain received by the taxpayers at the time of corporate liquidation. This follows the theory advanced by Judge Disney in his dissent in the *Switlik* case.

The second circuit court of appeals recently decided two cases¹⁸ exactly contra to the Tax Court and the third circuit and flatly stated that it did not agree with the *Switlik* decision. The second circuit reversed the Tax Court in the *Bauer* and *Milliken* cases¹⁹ on the theory that the liabilities of the taxpayers as transferees represented diminution of the capital gain received on the distribution and were therefore capital losses. The court adopted the argument of Judge Disney and the commissioner where there was no distinguishable factual difference in the cases from the *Switlik* decision.²⁰

The Tax Court originally based its *Switlik* decision on a

¹⁶ Frederick R. Bauer, 15 T.C. 876 (1950); Seth M. Milliken, 15 T.C. 243 (1950); Frederick M. Paist, 10 T.C.M. 967 (1951); Tatem Wofford, 10 T.C.M. 692 (1951); and Lamar D. and Minnie Rhea Fain, 11 T.C.M. 11 (1952). The *Switlik* case was also followed by a district court of the United States in *Clifton v. Allen*, 101 F.Supp. 997 (D.C. Ga. 1952).

¹⁷ 1949-2 CUM. BULL. 4.

¹⁸ *Comm'r v. Bauer, et ux.*, 193 F.2d 734 (2d Cir. 1952), and *Milliken v. Comm'r*, 196 F.2d 135 (2d Cir. 1952).

¹⁹ See notes 16 and 18 *supra*.

²⁰ In the *Bauer* case the taxpayers had been required in 1944 to pay a judgment obtained against a corporation liquidated in 1940. Taxpayers sought to deduct this payment as an ordinary loss. The *Milliken* case was similar to the *Switlik* case in that the taxpayers had paid taxes owed by a liquidated corporation. In both decisions the second circuit held that these payments were deductible only as capital losses. Concerning the *Milliken* case, Judge Clark said, "Our theory was in short that the payment operated to reduce the amounts received in the corporation liquidation and were more properly considered as a loss suffered in the return of capital or as a reduction of the capital gain, rather than as an ordinary hardship of business."

series of cases handed down by the United States Supreme Court.²¹ The importance of these cases on the factual situation presented can be seen from the fact that the Tax Court cited and based its decision in the *Switlik* case on the *North American Oil* case,²² and the second circuit in the *Bauer* case recognized the rule of the *North American Oil* case as well settled, but distinguished the *Bauer* case. The rule as such was first brought out in *Burnet v. Sanford & Brooks*²³ wherein it was held that reimbursement of losses sustained in prior years was income to the taxpayer in the year of reimbursement. In the *North American Oil* case²⁴ it was stated that "if a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." This theory or rule has become known as "the single year as the unit of taxation" rule and has been affirmed by the United States Supreme Court as late as March 26, 1951.²⁵ The Tax Court and the third circuit cited the *North American Oil* case with approval and contended that their respective decisions in the *Switlik* case were in line with that decision. The second circuit, in the *Bauer* case, agreed with the rule of the *North American Oil* case, and admitted that the rule was well settled, but stated that the decision of the Supreme Court in the *North American Oil* case did not mean that an examination of the previous year's return could not be made so as to determine the "nature" of the "new fact" in order to determine how a gain or loss was to be "categorized" in computing taxable income for the year in which the new fact happened. The court then went on to say that in the *Bauer* case, con-

²¹ *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), and *United States v. Lewis*, 340 U.S. 590 (1951).

²² See note 21 *supra*.

²³ See note 21 *supra*.

²⁴ See note 21 *supra*.

²⁵ *United States v. Lewis*, note 21 *supra*. In this case a taxpayer who reported a bonus as income in the year received, and who later was forced to return it, was not allowed to recompute his earlier tax liability. It was stated that the repayment, however, could be taken as a loss deduction in the year of repayment.

sidering the events of the previous year and of the taxable year the losses in the taxable year did arise out of a sale or exchange.

Another case bearing strongly on the subject matter is the famous *Dobson* case.²⁶ Although subsequent to the *North American Oil* case, the opinion does not cite or refer to the "single year as the unit of taxation rule". It does establish a principle, however, which seems to be in addition to or superimposed upon the unit theory. The principle as stated by Justice Jackson is that "not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. They are limited by definition to gains from the sale or exchange of capital assets." Strangely enough the *Dobson* case was not mentioned in the majority opinion of the Tax Court in the *Switlik* case though it was cited with approval by the third circuit. The second circuit did not cite the *Dobson* case in its opinions in the *Bauer* and *Milliken* cases, but Judge Disney, in his dissent in the *Switlik* case, attempted to distinguish the *Dobson* case by saying that in the *Dobson* case there was no "intimate relation" between the original transaction and the later payment of the tax as there was in the *Switlik* case. The writer submits that what is meant by the words "intimate relation" as used by Judge Disney, if used as a test, would only lead to further costly litigation in determining when such relation existed.

On November 19, 1951, the Tax Court decided the *Mace Osenbach* case.²⁷ This case is hard to contrast with the *Switlik* and *Bauer* decisions due to the fact that a special code section was in issue—112 (b) (7). But the opinion was written by Judge Disney and his wording is interesting indeed. In that case the taxpayer was a stockholder in a corporation which liquidated in one month under the provisions of Section 112 (b) (7). The taxpayer had received in kind certain loans, discounts, mortgages, and other claims. Collections were subsequently made on these assets and

²⁶ *Dobson v. Comm'r.* 320 U.S. 489, 321 U.S. 231 (1944). The facts generally were as follows: The taxpayer in 1929 acquired some stock from the National City Company. In 1930 and 1931 the taxpayer sold some of the stock and sustained deductible losses. In 1936 he learned of facts indicating that he had been induced to purchase the stock by fraudulent representations, and he filed suit against the seller. In 1939 the taxpayer was given a recovery allocable to the stock sold in 1930 and 1931. The Court held that the recovery in 1939 was taxable as ordinary income.

²⁷ 17 T.C. 797 (1952).

the question arose as to how these collections were to be returned—as capital gain or ordinary income. Judge Disney stated that the liquidation was a closed matter and that in order for capital gain rates to apply there must be a sale or exchange, and since there was no sale or exchange the collections were taxable as ordinary income. Applying the rule of the *Dobson* case, and the single year as the unit of taxation theory, this case seems to be correctly decided, but applying the reasoning of Judge Disney's dissent in the *Switlik* case there seems to be a closer "intimate relation" in the *Osenbach* case than in the *Switlik* case, which relation would render the collections taxable as capital gain. In the *Osenbach* case, which has been appealed by the taxpayer to the fourth circuit court of appeals, it was held that the nature of the gain depended upon the facts concerning the subsequent gain realizing transaction and was not dependent at all upon the nature of the prior transaction.

It is interesting to note that in one case²⁸ decided by the Tax Court, the taxpayer tried to argue exactly what the government in effect advocates in the *Switlik* line of cases, *i.e.*, the payment of a subsequent tax deficiency represents mere diminution in the capital gain received in the earlier year. In 1947 the taxpayer paid a deficiency as transferee of a corporation liquidated in 1945. The government refused to allow the taxpayer to reduce the gain on the liquidation of the corporation by the amount of the taxes on the 1945 income of the corporation paid by the petitioner as transferee in 1947. The court held for the government and said:

"If the petitioner's contention that the capital gain should be adjusted were to be followed, the result would be to hold in abeyance the final determination of the capital gain on a corporate dissolution until the final corporate income tax had

²⁸ Roberta Pittman, 14 T.C. 449 (1950). See also *Estate of Hetty B. Levy, et al.*, 17 T.C. 731 (1952). See also the decision of the second circuit in *Comm'r v. Hartfield, et al.*, 194 F.2d 662 (2d Cir. 1952). In the *Hartfield* case the taxpayers had received \$30,000 in 1945 as salary from a corporation wholly owned by them, and that sum was reported on their individual returns for that year and a tax paid accordingly. The Commissioner subsequently disallowed the corporation as a deduction, \$10,000 of the \$30,000 paid, and the taxpayers as transferees paid the resulting deficiency for the corporation in 1947. The taxpayers then sought a refund for their individual overpayment of taxes in 1945. The court held that a refund could not be obtained and affirmed the claim of right theory as set out in the *North American Oil* and *Lewis* cases, *supra* note 21.

been paid. This would place an unwarranted burden on the tax collection process."

From these cases it would seem that this fairly common factual occurrence had no ready tax answer. But due to the square conflict between circuits the Supreme Court granted certiorari in the *Bauer* case,²⁹ and on November 10, 1952,³⁰ handed down its decision affirming the second circuit and overruling the *Switlik* decision by inference.³¹ The majority opinion was written by Justice Black with Justices Jackson, Frankfurter, and Douglas dissenting. Indeed the simplicity of the majority opinion, which cites only three cases in support thereof, lends credence to the thoughts expressed in the dissenting opinions. For example, after stating the facts, Justice Black writes that "I. R. C. § 23 treats losses from sales or exchanges of capital assets as 'capital losses,'" whereas a careful study of § 23 would show that that section has nothing to do with the treatment of capital losses other than to say that they "shall be allowed [as deductions] only to the extent provided in section 117." It is Sections 117 (a) (3) and 117 (a) (5)³² which define capital losses and treat them as such.

The majority opinion seems to base its decision on the premise that had the liabilities of the taxpayers as transferees occurred during the same taxable year as the liquidation, there would be no question that the loss would have been properly treated as a capital loss and the payment of the liability would simply have reduced the amount of capital gain the taxpayers received during that year. Justice Jackson in his dissent effectively answers this argument by pointing out that the adoption of the decision of the majority penalizes the taxpayer because of two factors:

"(1) Since capital losses are deductible only against capital gains, plus \$1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond \$5,000; and

"(2) had the liability been discharged by the corporation, a portion of it would probably in effect have been paid by the Government, since the corporation could have taken it as

²⁹ 72 Sup. Ct. 1075 (1952).

³⁰ *Arrowsmith et al. v. Comm'r of Internal Revenue*, 73 Sup. Ct. 71 (1952).

³¹ For a short statement of the facts in the *Arrowsmith* case, see note 20 *supra*.

³² See notes 4 and 7 *supra*.

a deduction, while here the total liability comes out of the pockets of the stockholders.”

The majority opinion also states that the annual unit of taxation rule is not breached by considering the liquidation events in order to properly classify the nature of the 1944 loss for tax purposes. But Justice Douglas in his dissenting opinion says that there were no capital transactions in the year in which the losses were suffered and since it is the law that each year is a separate unit for tax accounting, then that law should be observed, regardless of who may gain or lose from it in a particular case. The *Dobson* and *Osenbach* cases are examples of situations where, under the majority opinion, the taxpayers would benefit from the rule of the *Arrowsmith* case.

The decision in the *Arrowsmith* case indicates a probable need for new legislation. It is very difficult to reconcile this new decision with the *Dobson*, *North American*, and *Lewis* cases, and the principles they establish. This is not to say that the *Arrowsmith* case is incorrectly decided on principle, several writers having already expressed agreement,³³ but it seems to qualify, if not overrule, several precedents established by the Supreme Court itself. The opinion does not go far enough and it seems to create an alluring loophole which Congress might wish to close.

³³ See Schwartz, *Transferee Liability Following Corporate Liquidation; The Income Tax Consequences to the Former Stockholders*, 7 TAX L. REV. 504 (1952). Also, see Mandell, *Not a Gain Again, Again and Again*, 30 TAXES 433 (1952).