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TAXATION-INCOME TAX-DEDUCTION FOR WORTHLESS STOCK-OBJECTIVE v. SUBJECTIVE TEST

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TAXATION—INCOME TAX—DEDUCTION FOR WORTHLESS STOCK—OBJECTIVE v. SUBJECTIVE TESTS—The taxpayer held stock in a corporation which had been in receivership for five years, and which had, during all of that time, liabilities substantially exceeding its assets. When the receivership was ended and when a derivative suit against the management was compromised, the taxpayer declared the stock to be worthless and claimed a deduction for 1937. The commissioner denied the deduction on the ground that the stock had not become worthless in 1937. The Tax Court sustained this ruling and the circuit court of appeals affirmed. *Held*, the value of the stock should be determined by an objective test based on "identifiable events" rather than by the subjective test based on the taxpayer's reasonable and honest belief supported by his conduct, and the finding on this question of fact by the Tax Court should be conclusive. The decision of the lower court affirmed. *Lillian Boehm v. Commissioner of Internal Revenue*, (U.S. 1945) 66 S.Ct. 120.

Under the Revenue Act of 1936 a deduction for worthless stock under section 23 (e) was allowed "for losses sustained during the taxable year and not compensated for by insurance or otherwise." [1] The *Regulations* in force required that losses "must be evidenced by closed and completed transactions fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed." [2] In the absence of a definite statutory rule the worthlessness of stock is a question of fact and the factual elements of each case taken as a whole are determinative of the time at which loss occurred.[3] In such cases the taxpayer has the burden of proof which he must sustain not only by showing that the commissioner was wrong but by demonstrating that the deduction was taken in the proper year.[4] The kind of evidence to sustain such a burden of proof is of prime importance. Here it was proved that the corporation had suffered large operating losses for two years which resulted in the appointment of a receiver in 1932. The receiver's reports showed that in 1934 the liabilities of $707,403.67 exceeded the cash assets of $39,000, that a similar condition existed in 1935 when a distribution of 4 per cent was made to creditors and that in 1937, at the time of the final report, there was only a small amount of cash on hand. In 1932 a $500,000 shareholders' suit was started against the board of directors for mismanagement which was not settled until 1937 with a compromise of

[1] 49 Stat. L. 1648 at 1659 (1936), 26 U.S.C. (1940) § 23 e.

[2] TREAS. REG. 94, art. 23 (e) 1, under Revenue Act of 1936.

[3] Volker v. United States, (D.C. Mo. 1929) 40 F. (2d) 697.

[4] Jones v. Commissioner of Internal Revenue, (C.C.A. 9th, 1939) 103 F. (2d) 681; Nicholson v. Commissioner of Internal Revenue, (C.C.A. 8th, 1937) 90 F. (2d) 978; Munson v. Commissioner, (C.C.A. 2d, 1938) 100 F. (2d) 363; Mahler v. Commissioner of Internal Revenue, (C.C.A. 2d, 1941) 119 F. (2d) 869.

$50,000. There is no evidence that this suit was considered an asset of the corporation. The taxpayer's contention, overruled both by the Tax Court [5] and by the Circuit Court of Appeals for the Second Circuit [6] was that the question was not whether the stock had any actual value but whether the taxpayer honestly believed that it had some value until the litigation was terminated. Precedent for this view is to be found in one of the two conflicting sets of cases in the lower federal courts. This line of authority relies on the subjective test as a proper standard of determining value. It proceeds on the assumption that, since there is no definite test prescribed, a practical rather than a legal test should be followed.[7] These courts have interpreted this to mean that the view of the taxpayer, as evidenced by his actions, should be controlling. In a recent case, valuation was made to depend on the taxpayer's appraisal of the corporation's possibilities of future successful operation and the possible recoupment of his investment.[8] This case in turn relied on others which held that a suspension of business [9] and an advance of funds by a person willing to pay company debts [10] were not "identifiable events" because the shareholder believed there was a "prospect of . . . survival." [11] The other line of cases and the one relied upon by the Court in the principal case looks to the language of the statute and to the *Regulations* to find an objective standard determined by the words "identifiable event." But in the interpretation of these two words, fine distinctions must be drawn. Fluctuations in value,[12] a deficit,[13] operation at a loss,[14] inflated book values,[15] receivership,[16] sale for a nominal price,[17] pending litigation with possible insolvency,[18] a petition in bankruptcy,[19] or reorganization [20] are not in themselves determinative of value. The true test is the excess of liabilities over assets when they have

[5] T.C. Memo. Op. Doc. 111621, October 23, 1943.

[6] (C.C.A. 2d, 1945) 146 F. (2d) 553.

[7] Lucas v. American Code Co., 280 U.S. 445, 50 S. Ct. 202 (1930).

[8] Smith v. Helvering, (C.C.A. D.C. 1944) 141 F. (2d) 529.

[9] Benjamin v. Commissioner of Internal Revenue, (C.C.A. 2d, 1934) 70 F. (2d) 719.

[10] Rassieur v. Commissioner of Internal Revenue, (C.C.A. 8th, 1942) 129 F. (2d) 820.

[11] Id. at 825-6.

[12] Brown v. Commissioner of Internal Revenue, (C.C.A. 6th, 1938) 94 F. (2d) 101.

[13] Union C. DeFord v. Commissioner of Internal Revenue, 19 B.T.A. 339 (1930).

[14] Royal Packing Co. v. Lucas, (C.C.A. 9th, 1930) 38 F. (2d) 180.

[15] Henning Bruhn, 11 B.T.A. 809 (1928).

[16] Gowen v. Commissioner of Internal Revenue, (C.C.A. 6th, 1933) 65 F. (2d) 923, cert. denied, 290 U.S. 687, 54 S. Ct. 123 (1933). Edward C. Lawson v. Commissioner of Internal Revenue, 42 B.T.A. 1103 (1940).

[17] Frank C. Rand v. Commissioner of Internal Revenue, 40 B.T.A. 233 (1939), affirmed, (C.C.A. 8th, 1941) 116 F. (2d) 929, cert. denied, 313 U.S. 594, 61 S. Ct. 1120 (1941).

[18] E. J. McMillan, B.T.A. Memo. Op. Doc. 97724, March 28, 1940.

[19] Atlantic Coast Line Railroad Co. v. Commissioner of Internal Revenue, 4 T.C. 140 (1944).

[20] Jeffrey v. Commissioner of Internal Revenue, (C.C.A. 6th, 1933) 62 F. (2d) 661.

been properly valued.[21] Thus, a prudent businessman is presumed capable of analyzing a company's balance sheet, and, after careful reflection upon the financial condition evidenced by it, of determining whether the company is a going concern. This has been termed the "reasonable hope and expectation" test.[22] In the principal case there would have been no possibility of the company's paying off the creditors and leaving a surplus for the shareholders even if the shareholders' suit had been included as an asset and the amount of the damages claimed therein had been fully recovered. This was apparent in 1934 but became certain in 1935. Where it is certain that a company is in a very depressed condition there is no need to wait until the receivership or until the liquidation is completed.[23] The principal case sustains the second line of authorities on the ground that it is the more practical from an administrative point of view. The standard is flexible and, although the taxpayer's attitude and conduct are not ignored, they are not made paramount. However, the taxpayer using even the objective standard upheld here is in a perilous position because he cannot take a partial deduction as in the case of bad debts [24] and because he must, when confronted by several identifiable events, properly time the deduction or possibly risk the loss of the deduction benefit because of time limitations on filing amended returns or claiming refunds.[25] He may well be guided by Judge Augustus N. Hand's suggestion: "In cases like this the taxpayer is at times in a very difficult position in determining in what year to claim a loss. The only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of it being applicable to the income in those years." [26] Also, he may be guided by the rule that the stock must have some value at the beginning of the year for which a deduction is claimed.[27] Uniformity of approach and result becomes possible to the extent that cases are heard by the Tax Court whose decision on this question was here held to be conclusive under the rule of the *Dobson* case.[28] The Court in adopting the so-called objective approach is attempting in lieu of a statutory definition of value to prescribe a criterion of evidentiary facts which, although less tenuous than the beliefs of the taxpayer, is, nevertheless, difficult of application. The adoption of a statutory remedy, as suggested in this case,[29] or of the proposed presumption of worthlessness when the stock is written off,[30]

[21] Forbes v. Commissioner of Internal Revenue, (C.C.A. 4th, 1933) 62 F. (2d) 571.

[22] Sterling Morton v. Commissioner of Internal Revenue, 38 B.T.A. 1270 (1938), affirmed, (C.C.A. 7th, 1940) 112 F. (2d) 320.

[23] In re Harrington, (D.C. Mo. 1924) 1 F. (2d) 749.

[24] 5 MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 28.65 to 28.69 (1942).

[25] Cooley Butler and LaRue Butler v. Commissioner of Internal Revenue, 45 B.T.A. 593 (1941).

[26] Young v. Commissioner of Internal Revenue, (C.C.A. 2d, 1941) 123 F. (2d) 597 at 600.

[27] Roosevelt Investment Corp. v. Commissioner of Internal Revenue, 45 B.T.A. 440 (1941).

[28] Dobson v. Commissioner of Internal Revenue, 320 U.S. 489, 64 S. Ct. 239 (1943), rehearing denied, 321 U.S. 231, 64 S. Ct. 495 (1944).

[29] Principal case at 122.

[30] Lynch, "Losses Resulting from Stock Becoming Worthless—Deductibility under Federal Income Tax Laws," 8 FORDHAM L. REV. 199 (1939).

that is now applicable to banks,[31] might remedy a situation which is confusing to courts and taxpayers alike.

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[31] TREAS. REG. 101, art. 23 e-4.