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TAXATION - FEDERAL INCOME TAX - DEDUCTIONS - LOSS UPON SALE TO CORPORATION WHOLLY OWNED BY TAXPAYER

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TAXATION — FEDERAL INCOME TAX — DEDUCTIONS — LOSS UPON SALE TO CORPORATION WHOLLY OWNED BY TAXPAYER — In 1932 the taxpayer sold to the *X* corporation, which he wholly owned and controlled, certain shares of stock in partial payment of a debt which he owed to *X* corporation. The selling price, which was the market value of the stock, was less than the stock had cost the taxpayer. It was found that the sale was entered into with the intent of creating a deductible loss and thus reducing the taxpayer's taxable income. In computing his taxable income for 1932, the taxpayer deducted the amount of the loss on the sale of this particular stock to his wholly owned corporation. The deduction was not allowed. The taxpayer, after paying the full tax, brought suit in the federal district court, where judgment went against him.

The circuit court of appeals reversed and on appeal to the Supreme Court, *held,* deduction not allowed since the sale was not an actual sale within the meaning of the taxing statute. Two justices dissented. *Higgins v. Smith,* 308 U. S. 473, 60 S. Ct. 355 (1940).

To suffer a loss under § 23(e) of the Revenue Act of 1932,[1] the loss must be actual and real as the result of a completed transaction.[2] The principal case deals with the question whether the sale to a wholly owned corporation comes within this definition. The answer depends on whether for the purposes of the taxing statute the corporation should be considered as a separate and distinct entity from its sole stockholder who is also the taxpayer, or whether the corporation and the stockholder should be considered as one identity. Generally, the corporate entity is respected in the field of taxation.[3] However, it will be disregarded in unusual cases where the statute was intended to tax the substance of the transaction.[4] It is frequently said that mere intent to reduce tax liability is not to be condemned and the taxpayer may resort to any lawful means to minimize taxes.[5] Applying this principle the lower federal courts and the board of tax appeals have consistently held that a transfer from a taxpayer to his corporate self with the intent of creating a deductible loss is a perfectly legitimate means of reducing tax liability.[6] It is well settled that there must be a bona fide sale and the taxpayer's interest in the securities must be terminated before an actual loss will result.[7] Several cases have disallowed the loss because of the existence of an agreement to resell to the taxpayer. However, it would seem that in the case of a sale to a wholly owned corporation the agreement to resell would be immaterial, and since the taxpayer has full control over the stock he should not be allowed a deductible loss. The principal case conforms to the present tendency of the Court to regard control over the securities as the essential factor [8] and the result can be justified on that basis. However, the argument was made by the dissenting justices that in cases where a corporation was used by the taxpayer in a transaction that resulted in a taxable gain, the corporate entity was respected and the gain was held includable as taxable income.[9] The theory in these cases is that the taxpayer must take the disadvantages of the

[1] 47 Stat. L. 180, 26 U. S. C. (Supp. 1939), § 23(e). The same provision was reenacted by the Internal Revenue Code of 1939, § 23(e), 53 Stat. L. 13.

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

[3] See infra, p. 1359, discussion of Griffiths v. Helvering, at note 1.

[4] Ibid., at note 4.

[5] Ibid., at note 5.

[6] Commissioner v. Eldridge, (C. C. A. 9th, 1935) 79 F. (2d) 629; Jones v. Helvering, 63 App. D. C. 204, 71 F. (2d) 214 (1934); Commissioner v. McCreery, (C. C. A. 9th, 1936) 83 F. (2d) 817; Helvering v. Johnson, (C. C. A. 8th, 1939) 104 F. (2d) 140; Hardwick v. Commissioner, 33 B. T. A. 249 (1935); Hochstetter v. Commissioner, 34 B. T. A. 791 (1936). The cases are collected in 102 A. L. R. 505 (1936).

[7] Shoenberg v. Commissioner, (C. C. A. 8th, 1935) 77 F. (2d) 446; Commissioner v. Dyer, (C. C. A. 2d, 1935) 74 F. (2d) 685.

[8] Corliss v. Bowers, 281 U. S. 376, 50 S. Ct. 336 (1930).

[9] Burnet v. Commonwealth Imp. Co., 287 U. S. 415, 53 S. Ct. 198 (1932); Dalton v. Bowers, 287 U. S. 404, 53 S. Ct. 205 (1932), where the taxpayer tried to claim individual losses for the losses of his wholly owned corporation.

corporate form of doing business along with the advantages. The dissenting justices regarded it as inconsistent to recognize the corporate entity when a capital gain can be found, and at the same time disregard it when a capital loss may be avoided. This may seem like a logically inconsistent position, but it must be remembered that normally the corporate entity is given due recognition for tax purposes. It is in exceptional cases where it may be disregarded. Consequently there is nothing incongruous about the decision in the principal case even though it is recognized that normally transfers between a sole stockholder and his corporation are not ignored under the income tax law. It should be pointed out that when the corporation sells to its stockholder it has divested itself of control of the securities, while the stockholder still has complete control when he sells to his wholly owned corporation. In 1934 Congress enacted an amendment[10] which refused deductions for losses upon transfers between a corporation and its controlling stockholder. This would now cover the fact situation in the principal case, but it leaves open the interesting problem of determining at what time the loss is sustained if the corporation later sells the securities. It is thought that the first sale to the corporation will be regarded as a nullity so that the loss or gain is taxable to the stockholder whenever it is finally disposed of by the corporation.[11]

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[10] 48 Stat. L. 691, § 24(a) (6), substantially reenacted by the Internal Revenue Code of 1939, § 24(b) (1).

[11] The principal case has also been noted in 8 GEO. WASH. L. REV. 996 (1940).