

1950

THE CASE OF THE FORGOTTEN BASIS: AN ADMONITION TO VICTIMS OF INTERNAL REVENUE CODE SECTION 115(g)

Richard Katcher

Michigan, New York and Ohio bars

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Tax Law Commons](#)

Recommended Citation

Richard Katcher, *THE CASE OF THE FORGOTTEN BASIS: AN ADMONITION TO VICTIMS OF INTERNAL REVENUE CODE SECTION 115(g)*, 48 MICH. L. REV. 465 ().

Available at: <https://repository.law.umich.edu/mlr/vol48/iss4/5>

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

THE CASE OF THE FORGOTTEN BASIS:
AN ADMONITION TO VICTIMS OF INTERNAL REVENUE
CODE SECTION 115(g)

*Richard Katcher**

WHAT happens to the basis of corporate stock which is cancelled under circumstances requiring the treatment of the amount distributed as "essentially equivalent" to a taxable dividend under the provisions of section 115(g)?¹ Is the basis to be ignored completely, thus preventing the shareholder from recouping his capital investment tax-free?² Or, if the shareholder retains other stock, does the basis of the cancelled stock jump to the retained stock, and if so, how is it allocated? Or, is the shareholder entitled to a loss deduction? If a loss deduction is allowed, is it for an amount equal to the basis of the cancelled stock, regardless of the portion of the stock cancelled, or is it for an amount equal to the difference, if any, between the amount distributed and the basis? Finally, is the loss ordinary or capital?

These inquiries take on significance in every section 115(g) situation where the cancelled stock was issued for money or other valuable

* LL.B., University of Michigan; member, Michigan, New York and Ohio bars; practicing attorney, Cleveland, Ohio.—Ed.

¹ "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend." (All section references are to the Internal Revenue Code, unless otherwise noted.)

² See *Parker v. United States*, (C.C.A. 7th, 1937) 88 F. (2d) 907, where the court reached the "somewhat paradoxical" result that a cancellation might be a dividend as against the original recipient of stock and not a dividend "as against a holder who acquired it for full value from the original recipient," the rationale being that if a stockholder acquires cancelled stock for cash he should be allowed to recoup his capital investment. *Randolph v. Comr.*, (C.C.A. 8th, 1935) 76 F. (2d) 472, cert. den. 296 U.S. 599, 56 S.Ct. 116 (1935). *De Nobli Cigar Co.*, 1 T.C. 673 (1943), affd., (C.C.A. 2d, 1944) 143 F. (2d) 436. In *Comr. v. Snite*, (7th Cir. 1949) 1949 P-H Fed. Tax Serv., vol. 5, ¶72664, the court held that §115(g) did not apply to a sale of stock where the stock sold was held as treasury stock for resale to employees, and stated: "The lack of force of the Commissioner's reasoning is apparent, we think, when we consider the position of the taxpayers. They had acquired this stock for a certain cost. When they sold it they accounted for their profit. If all they received is to be treated as ordinary income, what becomes of their original investment and original cost of the stock sold to the corporation?" Cf. example in *Committee on Ways and Means Rep. No. 1, 69th Cong., 1st sess., p. 5 (1926)*.

consideration.³ To illustrate the problems involved, we may take as a typical case, *Bertram Meyer*,⁴ where preferred shares were issued for property of a value equal to the par value of those shares. The Tax Court held that the distributions in retirement of the preferred stock were essentially equivalent to a taxable dividend under section 115(g). The petitioner, however, failed to raise any question with respect to his basis of \$100 per share for the cancelled stock. He might well have inquired whether his basis vanished into thin air, never to be recouped, or whether it should be recouped in a manner comparable to that in which an ordinary dividend recipient recoups basis upon later sale or other disposition of his stock.

It is the purpose of this article to explore the various means available to a victim of section 115(g)⁵ for recovering the basis of his cancelled stock and to examine the reasons that may be advanced in support of the conclusion that the victim should be allowed a capital loss deduction measured by the amount of the basis.

³ The question of recouping basis might also arise where the cancelled stock was issued as a stock dividend. Cf. *Randolph v. Comr.*, (C.C.A. 8th, 1935) 76 F. (2d) 472, where the commissioner unsuccessfully argued that the basis of old common stock should be allocated between new common stock and new preferred stock subsequently redeemed, the redemption being treated as an ordinary dividend.

⁴ 5 T.C. 165 (1945), remanded, (C.C.A. 3d, 1946) 154 F. (2d) 55, on remand, 7 T.C. 1381 (1946).

⁵ For purposes of this article it will be assumed that §115(g) applies. Generally no question will arise as to its application to a partial cancellation of stock pro rata among stockholders. *Treas. Reg. 111, §29.115-9* (1943); *Kirschenbaum v. Comr.*, (C.C.A. 2d, 1946) 155 F. (2d) 23, cert. den., 329 U.S. 726, 67 S.Ct. 75 (1946); cf. *Joseph W. Imler*, 11 T.C. 836 (1948), acqd. 1949 P-H Fed. Tax Serv., vol. 5, ¶76208; *Int. Rev. Bul.*, p. 1 (March 7, 1949). The statement in the Regulations, (*Treas. Reg. 111, §29.115-9*), that the section does not apply to a cancellation of *all* the stock of a particular shareholder where "the shareholder ceases to be interested in the affairs of the corporation," cannot be taken at its face value. If the purpose of the cancellation is to distribute accumulated earnings, the mere fact that the cancellation separates the stockholder from the corporation is not sufficient reason to defeat the application of the section. *Leopold Adler*, 30 B.T.A. 897 (1934), *affd.* on other grounds, (C.C.A. 5th, 1935) 77 F. (2d) 733; *Shelby H. Curlee, Trustee*, 28 B.T.A. 773 (1933). The same result was implied in *William A. Grimditch*, 37 B.T.A. 402 (1938); cf. *Clara Louise Flinn*, 37 B.T.A. 1085 (1938). Serious and difficult problems are latent in those situations where there is a familial relationship between the stockholders. The question then is whether there is the requisite cessation of interest in the affairs of the corporation upon cancellation of all of the stock; e.g., (1) in an estate where the remaining stockholder after cancellation is also the sole beneficiary of the estate; (2) where all of the stock of a shareholder is cancelled and the remaining shareholder is his wife who acquired her stock by gift from her husband. For an excellent discussion of these problems see *Miller, Stock Redemptions*, in *PROCEEDINGS OF SIXTH ANNUAL NEW YORK UNIVERSITY INSTITUTE ON FEDERAL TAXATION* 307 at 319-326 (1948); *Cohen, Estate Planning: The Case of Mr. Burch*, in *PROCEEDINGS OF SEVENTH ANNUAL NEW YORK UNIVERSITY INSTITUTE ON FEDERAL TAXATION* 659 at 669-670 (1949).

I

RECOVERY OF BASIS THROUGH ALLOWANCE OF A LOSS DEDUCTION

A. *Section 23(e)*. Conceding that deductions are permitted solely as a matter of legislative grace, and that the stockholder victim of section 115(g) who seeks a loss deduction equal to the basis of his cancelled stock must not only point to an appropriate statute but must bring himself squarely within its provisions,⁶ it is submitted that such a stockholder can pigeonhole his deduction within the provisions of section 23(e)(2). Under those provisions an individual is allowed to deduct a loss incurred in a transaction entered into for profit and actually sustained during the taxable year. The basis for determining the amount of the deduction for the loss is the same as is provided in section 113 for determining loss from the sale or other disposition of property;⁷ that is, its cost or other basis. If such loss is not compensated for by insurance or otherwise, the entire loss is allowed as a deduction in computing net income.

Has a shareholder, whose shares have been cancelled under section 115(g) circumstances, leaving him with an unrecouped basis, sustained a loss? If the shares were purchased for value, their cost represents the shareholder's investment. Upon their cancellation, the shareholder is forever divested of his shares. At that moment he has irrevocably lost his investment in the shares. This loss would appear to be deductible, since the loss of one's investment in property is the very thing that section 23(e) contemplates as a deduction.⁸ Accordingly, if the shareholder can satisfy the requirements of section 23(e), he probably will be able to obtain a loss deduction equal to his basis.

No difficulty would be encountered in satisfying the section 23(e) requirement that the loss be sustained in a transaction entered into for profit, since, ordinarily, a shareholder who receives a distribution that falls within the sweep of section 115(g) has purchased his stock with an eye to the profit to be realized therefrom.⁹

Another requirement to be satisfied before a loss is allowed is that some identifiable event must fix the actual sustaining of the loss and

⁶ *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 54 S.Ct. 778 (1934).

⁷ Sec. 23(i).

⁸ *Commonwealth, Inc.*, 36 B.T.A. 850 (1937); 5 MERTENS, *LAW OF FEDERAL INCOME TAXATION* §28.12 (1942).

⁹ *Weir v. Comr.*, (C.C.A. 3d, 1940) 109 F. (2d) 996; PAUL, *STUDIES IN FEDERAL TAXATION*, 2d ser., 280 (1938).

the amount thereof. Generally, no loss is sustained until there is a sale or other disposition of property,¹⁰ the rationale of this rule being that until such sale or other disposition occurs the possibility remains that the taxpayer may recover or recoup the basis of the property. Upon cancellation of his shares, our victim, however, has effectively disposed of his shares, and no possibility remains that he will recoup the basis of those cancelled shares, inasmuch as he has received from them "all that it is possible for him to receive."¹¹ Accordingly, it appears that a section 115(g) victim may recoup the basis of his cancelled stock through the allowance of a loss deduction.

B. *Jumping the Basis.* Militating against the conclusion that a deductible loss is sustained by a section 115(g) victim is the argument that the basis of stock cancelled under section 115(g) jumps to the basis of other stock retained by the section's victim and is considered an additional cost of the retained stock.¹² Under this argument the basis of the cancelled stock is recouped upon later disposition of the retained stock. Let us examine the validity of such an argument. In the first place, we can quickly dispense with its application where *all* the shares of a stockholder are cancelled. Obviously, in such a situation the basis cannot jump, there being no other stock remaining to absorb that basis. Accordingly, this proposed method of recouping a victim's capital investment would not inure to the benefit of all victims, but only to those who have less than all their stock cancelled. Even as to this latter category of victims, however, the argument is not valid for the reason that no statutory justification exists for jumping basis.

The Internal Revenue Code¹³ defines the gain from "the sale or other disposition of property" as "the excess of the amount realized therefrom over the adjusted basis provided in Sec. 113(b). . . ." Section 113(b) states that the "adjusted basis for determining the gain or loss from the sale or other disposition of property" is "the basis under

¹⁰ Sec. 111; Treas. Reg. 111, §29.111-1.

¹¹ See *Dresser v. United States*, (Ct. Cl. 1932) 55 F. (2d) 499 at 512, cert. den. 287 U.S. 635, 53 S.Ct. 85 (1932).

¹² Maloney, *Outline of Points to Be Considered in Stock Redemptions*, in *PROCEEDINGS OF FIFTH ANNUAL NEW YORK UNIVERSITY INSTITUTE ON FEDERAL TAXATION* 837 at 842, n. 15 (1947). Cf. §113(a)(10) (the wash sale loss which is not allowed under §118 is added to the basis of the stock the purchase of which resulted in the disallowance); *Kistler v. Burnett*, (App. D.C. 1932) 58 F. (2d) 687 (upon surrender by a stockholder of a ratable portion of his stock to the corporation under circumstances that do not change his proportionate interest in the corporation, the basis of the stock contributed may be considered an additional cost to the stockholder of the stock retained).

¹³ Sec. 111(a).

subsection (a)," which declares that "the basis of property shall be the cost of such property."¹⁴ A rule that would jump the basis of cancelled stock to the stock retained would patently contravene this statutory scheme for determining gain or loss. Thus, if our victim were the owner of 100 shares of stock represented by one certificate for which he paid \$10,000 and 50 shares were cancelled, the basis of the remaining 50 shares, for purposes of determining gain or loss, is \$5,000, not \$10,000 which would be the result reached if the basis of the cancelled stock were to jump.¹⁵ The determination of the "cost" of the retained stock would involve more serious complications if the shares were purchased at different dates and at different prices and the identity of the lots could not be determined.¹⁶ In addition, the manner of determining the holding period of stock which has absorbed the basis of cancelled stock would present problems upon disposition of the retained stock.¹⁷

Consequently, it may be concluded that jumping the basis offers no solution to the problem of how a section 115(g) victim may recoup basis, because where all of the shares are cancelled, there are no other shares to which the basis of the cancelled stock can jump and where a part of the victim's shares are cancelled jumping the basis contravenes the statutory rule that gain or loss is determined by comparing the amount realized from the sale or other disposition of the property with the adjusted basis of the property provided in section 113(b).

¹⁴ The twenty-two exceptions to the rule that basis is cost are of no relevance here.

¹⁵ Cf. the rule that upon purchase of realty with a view to dividing it into lots for sale, cost or other basis must be equitably apportioned to several lots, with gain or loss determined on the sale of each lot rather than awaiting recovery of capital in the entire tract before returning taxable income. *Frederika Skinner*, 20 B.T.A. 491 (1930); *Treas. Reg.* 111, §29.22(a)-11.

¹⁶ Suppose 100 shares were purchased in 1940 for \$100 per share; 200 shares in 1943 for \$75 per share; and 100 shares in 1946 for \$50 per share. If the 100 shares purchased in 1940 were cancelled in 1949 under §115(g) circumstances and subsequently 50 shares were sold, what is basis of the 50 shares? Does the \$10,000 basis of the cancelled stock jump to the 1943 lot, to the 1946 lot? Does it jump equally to the remaining two lots, or pro rata? Will the victim be permitted to jump the basis to that lot where he can secure the greatest tax advantages? Suppose the victim was unable to identify the shares cancelled, how would the basis be allocated? Problems also might arise where the stock retained is of a class other than that cancelled.

¹⁷ Suppose the shares of the cancelled stock were purchased on June 10, 1946 and cancelled on September 1, 1946. The retained stock which was purchased in October, 1943 is sold on November 1, 1946. Is the entire gain on the November, 1946 sale long-term, or part long-term and part short-term? Suppose the situation were reversed and the cancelled stock held for more than six months, and the retained stock sold within six months of its purchase, how would the holding period be determined?

II

THE AMOUNT OF THE LOSS DEDUCTION

Having concluded that the basis of shares cancelled under section 115(g) circumstances can be recouped through a loss deduction, our next inquiry is as to the *amount* of the loss sustained. We can best point up this phase of our problem by way of an example. Let us assume that a corporation cancels 50 shares of stock having a basis of \$5,000 and distributes \$4,000 to the stockholder. The amount distributed is taxed as essentially equivalent to a taxable dividend. What is the amount of the victim's loss—\$1,000, the difference between the amount distributed and the basis—or \$5,000, the entire basis?

By looking solely to the language of section 115(g), it is possible to conclude that the section's victim has sustained a loss of only \$1,000. The section provides that upon cancellation of stock at such time and in such manner as to make the distribution and cancellation essentially equivalent to a taxable dividend, the amount so distributed shall be treated as a taxable dividend. In other words—to continue to use our example—\$4,000 is taxed as an ordinary dividend, but under section 115(g) the \$5,000 basis of the cancelled stock cannot be used as an offset against the amount distributed. However, since the amount distributed is less than the basis, obviously a \$1,000 loss has been suffered and should be allowed to that extent. Under this theory if the amount distributed equalled or exceeded basis, no loss would be allowed, inasmuch as the victim could not be said to have sustained a loss when he receives an amount equal to or in excess of his basis. Thus, if \$5,000 were the amount of the distribution and basis \$5,000, no loss deduction would be allowed.

This line of reasoning, however, fails completely to take into consideration the apparent purpose of section 115(g).¹⁸ Basically, that purpose was to prevent the distribution of accumulated earnings, cloaked as a liquidating distribution, from escaping taxation as ordinary dividends. Thus, Congress apparently intended to *equalize* for tax purposes all recipients of an ordinary dividend regardless of the manner in which distribution of earnings was effected. If, however, a section 115(g) victim is deprived of the opportunity to recoup the basis of his cancelled stock through a loss deduction, he no longer is on a parity with a recipient of an ordinary dividend. On the contrary,

¹⁸ Committee on Ways and Means Rep. No. 1, 69th Cong., 1st sess., p. 5 (1926); 61 CONG. REC. 7507.

he is placed in a more unfavorable tax position with the result that section 115(g) is converted into a penalty statute—a result which is nowhere indicated in the legislative history of the section. That inequality would result is quickly demonstrated by comparing the tax position of a recipient of a section 115(a) dividend with that of a recipient of a section 115(g) distribution.

If \$4,000 is distributed as an ordinary dividend under section 115(a), the recipient retains the stock upon which the dividend is paid. If we assume that his stock subsequently becomes worthless, he will be entitled to a loss deduction of \$5,000 (assuming a basis of \$5,000); thus, he has effectively recouped his entire \$5,000 basis. On the other hand, in a section 115(g) distribution not only is the \$4,000 taxed as an ordinary dividend, but the recipient no longer retains the stock which has been cancelled, so that he is not at liberty to obtain a loss deduction equal to basis upon later sale or disposition. Accordingly, to place the section 115(g) victim on a parity with a recipient of a 115(a) dividend, the former, upon cancellation of his stock, should be allowed a loss deduction measured by his \$5,000 basis.

If the entire basis cannot be recouped through a loss deduction, the moral may well be never to effect a distribution in cancellation of stock that may fall within the sweep of section 115(g); rather, make a distribution of earnings under section 115(a). The latter course will probably assure a tax-free recovery of basis.

III

CHARACTER OF THE LOSS

A. *Interrelationship between Sections 115(c) and 115(g)*. There remains for consideration the question as to the *character* of the loss deduction; that is, whether capital or ordinary. Section 23(g)(1) provides that losses from the sale or exchange of a capital asset are deductible only to the extent provided in section 117. It is patent, in view of the limitation on the deduction of capital losses,¹⁹ that the section 115(g) victim should expend every effort to avoid the application of section 117.

¹⁹ If, after applying the statutory percentages to the capital gains and losses of an individual taxpayer, losses exceed gains, only \$1000 of such net losses may be deducted from the individual taxpayer's net income, or if his net income is less than \$1000, then to the extent of his net income, §117(d)(2). Any such net capital losses, however, may be carried over for the five succeeding years but only to offset the net capital gain in each of the five succeeding years, plus other net income to the extent of \$1000. §117(e)(1).

A loss can be subject to the limiting provisions of section 117 if, and only if, these two prerequisites are met: (1) the property which is the subject of the loss is a capital asset, and (2) the loss results from a transaction which is, or is treated as, a "sale or exchange."²⁰ Generally, there can be no dispute as to the classification of stock as a capital asset.²¹ A dispute may well arise, however, as to whether the loss with respect to the unrecouped basis results from a sale or exchange, or from what is regarded as a sale or exchange. If the loss should fall within the sale or exchange category, the loss would be subject to the limiting provisions of section 117; otherwise, the loss would be an ordinary one.

Section 115(c) provides that the amount distributed in partial liquidation shall be treated as a payment made in exchange for the stock. Inasmuch as the transaction is treated as an exchange, any gain or loss, as determined by section 111, will be subject to the capital gain and loss provisions of section 117. If section 115(g) supersedes section 115(c) solely for the purpose of determining how the distribution is to be taxed, the argument can be advanced that the loss with respect to the unrecouped basis of the cancelled stock is capital.

Congress realized that section 115(c), standing alone, required the taxation of all distributions in cancellation of stock as a sale²² of the stock. Accordingly, section 115(g) was enacted to prevent the distribution of accumulated earnings, in the guise of a liquidating distribution, free from the tax upon the ordinary dividend. It would appear, therefore, that section 115(g) presents the exception to the general treatment of a liquidating distribution²³ so that if a liquidating distribution is essentially equivalent to an ordinary dividend, it is taxed as such.

It could be argued that the treatment of the distribution as essentially equivalent to a taxable dividend does not disturb its essential

²⁰ Sec. 117(d)(2).

²¹ Generally, stock would not fall within any one of the following statutory exceptions to a capital asset: (1) stock in trade or other property of a kind which would be properly included in inventory; (2) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; (3) depreciable property used in trade or business. Sec. 117(a)(1).

²² While §115(c) expressly refers to the term "exchange" rather than to the more generally used term "sale or exchange," the Supreme Court has attached no significance to this fact. *White v. United States*, 305 U.S. 281, 59 S.Ct. 179 (1938). The relevant Committee Reports also show that the terms "sale" and "exchange" were used interchangeably, and there seems to have been no intention on the part of Congress to spell out a distinction between these two terms as they are used in the section. Committee on Ways and Means Rep. No. 179, 68th Cong., 1st sess., p. 11 (1925).

²³ *De Nobili Cigar Co.*, 1 T.C. 673 (1943), *affd.* (C.C.A. 2d, 1944) 143 F. (2d) 436.

character, that of a liquidating distribution, inasmuch as it is a "distribution by a corporation in complete cancellation or redemption of a part of its stock. . . ." ²⁴ In other words, "but for" the intervention of section 115(g) which, under certain circumstances, characterizes a liquidating distribution as an ordinary dividend, that distribution would be regarded as a payment in exchange for the stock.

Under an argument that regards section 115(g) as operating only to determine whether the distribution is to be taxed as an ordinary dividend, but leaves undisturbed its legal character as a distribution in liquidation, it may be concluded that section 115(c) controls any question, other than that relating to the taxation of the amounts distributed, that may arise with respect to the cancellation of stock in connection with a distribution of accumulated earnings. In short, in determining the character of the loss, we ascribe to it the same character as that from which it arose; namely, the capital transaction in the exchange of a capital asset, stock, for the amounts received upon distribution.

This position appears substantiated by the provisions of section 115(g) which state merely that amounts distributed in cancellation of stock must be treated as a taxable dividend if essentially equivalent thereto. The fact remains, however, that stock has been cancelled, and that such cancellation constitutes a partial liquidation which section 115(c) states must be treated as an exchange. Accordingly, if there is a loss on that stock by reason of the stockholder having an unrecouped basis, the exchange provision of section 115(c) would dictate that the loss deduction be subject to the limiting provisions of section 117.

Granting for the present that the loss is capital, we again direct our attention to the problem of how much of a loss is sustained; that is, \$1,000, the difference between the \$4,000 distribution and the \$5,000 basis; or \$5,000, the entire basis. To reach the conclusion that the loss is \$1,000 requires, in effect, a double tax consideration of the distribution. Thus, the \$4,000 is first treated under section 115(g) as essentially equivalent to an ordinary dividend, and then the same \$4,000 distribution is treated under section 115(c) as a payment in exchange for the cancelled stock, at least for the purpose of determining the amount of the loss claimed by reason of the unrecouped basis.

A loss limited to the difference, if any, between the amount of the distribution and the basis of the cancelled stock might appear to be

²⁴ Sec. 115(i). This section defines the term "amounts distributed in partial liquidation."

the natural consequence of the premise that section 115(g) supersedes section 115(c) only for the purpose of determining how to tax the amount distributed. Conceding that section 115(g) operates only in this limited field, nevertheless it might be argued that the loss is one equal to the entire basis of the cancelled stock. Such an argument, as pointed out above, is more consistent with the purpose of section 115(g) to equalize the tax position of its victim with that of a recipient of a section 115(a) dividend. Since the \$4,000 distribution is taxed as a dividend under section 115(g), it should not also be regarded as the amount distributed under section 115(c) when we return to that section to determine the character of the loss. Under this view, the amount distributed in cancellation of stock under section 115(c) is zero, and the entire basis of the cancelled stock may be deducted as a capital loss.

It is recognized that to regard the amount distributed under section 115(c) as zero necessitates the employment of a fiction, for it is difficult to say that "zero" is an "amount distributed." To employ such a fiction, however, to reach a result in harmony with the apparent purpose of section 115(g) would appear amply justified. Certainly, the result obtained is more just than the one which considers the amount distributed and taxed under section 115(g) as the amount distributed under section 115(c), since this latter result would operate to deprive the section 115(g) victim of all opportunity to recoup his basis if the amount distributed equalled or exceeded basis.

The discussion above indicates that the determination of whether the loss deduction will be ordinary or capital depends upon whether section 115(c) applies even though section 115(g) is applicable. If, as suggested above, section 115(c) is applicable, the loss is capital. On the other hand, it may seriously be questioned whether the application of section 115(g) to a particular distribution does not remove the transaction entirely from the operation of section 115(c).

As already noted, the conditions and limitations of section 117 can apply to the loss deduction only if there has been a "sale or exchange." The words "sale or exchange" are defined neither in the Code nor in the Regulations. The cases, however, indicate that the words are to be accorded their conventional meaning.²⁵ When so accorded, it will be appreciated that there must be a transfer of property for money

²⁵ *Hale v. Helvering*, (App. D.C. 1936) 85 F. (2d) 819; *Gruver v. Comr.*, (C.C.A. 4th, 1944) 142 F. (2d) 363.

or its equivalent.²⁶ What money or its equivalent does our section 115(g) victim receive when his stock is cancelled?

Although it may appear that the amount distributed is the amount received for the stock, the argument can be advanced that, when a section 115(g) distribution is taxed as an ordinary dividend, nothing is received for the cancellation of the stock. It is to be observed that section 115(g) does not state that the amount distributed is, or is to be regarded as, the consideration for the cancellation of the stock. The section merely states that if stock is cancelled at a particular "time" and in a particular "manner," the amount distributed will be treated as essentially equivalent to an ordinary dividend. This argument may well lead to the conclusion that no sale has taken place, inasmuch as the section 115(g) victim receives nothing for his cancelled stock. There being no sale, an ordinary loss would ensue.

The proposition that a loss is ordinary if it is not the result of a sale or exchange—that is, if property is surrendered without consideration—is supported by the reported cases. In *Commonwealth Inc.*,²⁷ a mortgagor deeded his property to the mortgagee without consideration. Inasmuch as there was "in fact no consideration" passing to the mortgagor, the transfer of title was held not to be a sale or exchange; accordingly, the loss sustained by the mortgagor was an ordinary loss deductible in full.²⁸

In *Budd International Corporation*,²⁹ petitioner surrendered part of its shares to the corporation to enable it to transfer them to creditors for their acquiescence in another transaction. Petitioner received nothing for such transfer, and the Board of Tax Appeals, holding that there was no sale or exchange, allowed petitioner to deduct as an ordinary loss the cost to it of the shares surrendered. The Board stated:

²⁶ ". . . a sale in the ordinary sense of the word is a transfer of property for a fixed price in money or its equivalent." *Gruver v. Comr.*, (C.C.A. 4th, 1944) 142 F. (2d) 363 at 366.

²⁷ 38 B.T.A. 850 (1937).

²⁸ Accord: *James B. Lapsley*, 44 B.T.A. 1105 (1941), acqd., 1941-2 Cum. Bul. 8; *William H. Jamison*, 8 T.C. 173 (1947), acqd., 1947-1 Cum. Bul. 2. Cf. *Helvering v. Hammel*, 311 U.S. 504, 61 S.Ct. 368 (1941); *Helvering v. Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666, 61 S.Ct. 827 (1941). In these last two cited cases the Supreme Court held that the word "sale" in §117(d) was comprehensive enough to cover a "forced sale" as well as a voluntary sale. The loss with respect to the unrecouped basis, however, arises from neither a forced or a voluntary sale; the cancellation of the stock has no aspect of a sale or exchange.

²⁹ 45 B.T.A. 737 (1941), reversed on other grounds, (C.C.A. 3d, 1943), 143 F. (2d) 784, cert. den., 323 U.S. 802, 65 S.Ct. 562 (1945).

"There is nothing in the disposition of petitioner's shares to give color to the idea that there was a sale or exchange. Petitioner received nothing unless it be the possible effect upon its remaining shares. What the effect was does not appear; but there was nothing more tangible. It merely gave up its shares to the issuing corporation and received nothing . . . it is impossible consistently to say that a shareholder who surrenders his shares for no money, property or rights is making a sale or exchange."³⁰

The principle of the foregoing cases might well be extended to the determination of the character of the loss of an unrecouped basis resulting from a section 115(g) cancellation of stock. The stock in such a situation is not sold; it is cancelled, extinguished. The victim receives nothing for the stock and acquires no exchangeable asset. What in form is a sale or a liquidating distribution is in actuality a distribution of an ordinary dividend. If our victim had retained the stock, no question would arise with respect to the character of the amount distributed; it would be an ordinary dividend. The mere fact that the stockholder turns in stock for cancellation in connection with a distribution taxed as a dividend should not be the reason for using the distribution twice—as a dividend and as the proceeds of a sale.

By way of summary, therefore, if the distribution is a dividend, it may be argued that the stockholder receives no consideration for the cancellation on the theory that the distribution should not at one and the same time be considered a dividend and the consideration for the stock. Accordingly, if no sale or exchange has occurred when stock is cancelled under section 115(g) circumstances, the loss, measured by the basis of the cancelled stock, would be deductible as an ordinary loss.

The ready answer to this argument is that the amount distributed is, in fact, the consideration received for the cancelled stock. Section 115(g) intervenes to tax the distribution as an ordinary dividend, but such treatment of the distribution does not detract from the fact that the shareholder receives the distribution in consideration of the surrender of the stock. In addition, the argument that the loss is ordinary runs afoul of a practical difficulty; that is, to allow an ordinary loss equal to the basis of the cancelled stock would completely or to a large extent, depending upon the amount distributed, nullify the effect of section 115(g). If basis equalled or exceeded the amount dis-

³⁰ *Id.* at 756. See *Comr. v. Wright*, (C.C.A. 7th, 1931) 47 F. (2d) 871; *Comr. v. Burdick*, (C.C.A. 3d, 1932) 59 F. (2d) 395; *Peabody Coal Co. v. United States*, (Ct. Cl. 1934) 8 F. Supp. 845, involving relinquishment by a stockholder of part of his shares for the purpose of procuring benefits for the corporation from third parties.

tributed, the amount taxed as a dividend would be offset by an ordinary loss deduction. If basis were less than the amount distributed, the sting of section 115(g) would be severely lessened. Obviously, taxpayers could effectively avoid the force of the section by making a distribution equal to basis.³¹ It cannot be seriously thought that a court would lend a ready hand to a result that would make a nullity of a section that was intended to close a tax loophole existing in section 115(c).

The allowance of an ordinary loss deduction is also at odds with this purpose of section 115(g), namely, to equalize the tax positions of the recipients of a section 115(a) and a section 115(g) distribution. If a section 115(a) recipient were to sell his stock after receipt of the distribution, his loss (assuming he received less than his basis) would be capital. There is no more reason to favor a section 115(g) victim by allowing him to recoup his entire basis through an ordinary loss deduction than there is reason to penalize him by depriving him of all opportunity to recoup his basis.

Even assuming, however, that nothing is received for the cancelled stock, the loss may nevertheless be capital. This conclusion would follow if the exchange provision of section 115(c) supersedes or is unaffected by the line of cases requiring that some consideration pass if there is to be a sale or exchange. Under section 115(c) amounts distributed in partial liquidation are treated as payment "in exchange for the stock," and the loss resulting from such exchange is subject to the limitations of section 117. Consequently, if a transaction falls within the provisions of section 115(c), it is treated as an exchange.

If it is so treated, it is not unreasonable to say that the transaction is an exchange and thus subject to the limitations of section 117, regardless of the amount distributed. Under this view, even if nothing passed to the stockholder for his cancelled stock, the transaction would be regarded as an exchange, although absent the exchange provision of section 115(c) the transaction would not be a sale because of the lack of consideration.

The argument that the loss with respect to the unrecouped basis of a section 115(g) victim is capital because section 115(c) treats the liquidating dividend as the payment in exchange for the stock, has vitality if section 115(c) is superseded by section 115(g) solely for the purpose of taxing the distribution as an ordinary dividend.

³¹ See *Pullman Inc.*, 8 T.C. 292 (1947).

If, however, sections 115(a), 115(c) and 115(g) operate independently of one another so that if section 115(g) applies to a particular distribution, that section supersedes section 115(c) for all purposes, the loss may be ordinary. In other words, once a distribution is taxed under section 115(g), the character of the loss as well as the manner of taxing the distribution is to be determined by the provisions of section 115(g) without any reference to section 115(c). Under the provisions of section 115(g), there is no fiction that regards the distribution as the payment in exchange for the cancelled stock. Accordingly, if we were to conclude that nothing was received for the stock, the rationale of the *Budd* and *Commonwealth* cases would compel the conclusion that no sale or exchange occurred, and the loss resulting from the cancellation would be ordinary. This conclusion, however, would be subject to the very same criticisms voiced above with regard to allowance of an ordinary loss deduction equal to the unrecovered basis.

B. Possibility of a Worthless Stock Deduction. Regardless of whether we consider section 115(c) as superseded by section 115(g) for the limited purpose of taxing the distribution as an ordinary dividend, or whether we consider sections 115(c) and 115(g) independent of one another, the loss would nevertheless be capital if governed by section 23(g)(2). That section provides that losses sustained by reason of stock becoming worthless are subject to the limitations provided in section 117 with respect to sales or exchanges. The losses resulting from worthless stock are considered as being sustained from the sale or exchange of the stock on the last day of the taxable year.

If zero is the amount received for the cancelled stock, the stock, at least from the stockholder's viewpoint, is worthless. Obviously, the stock has no potential or possible future liquidating value, inasmuch as it has been cancelled. It is, admittedly, somewhat paradoxical to conclude that stock upon which a dividend has been paid is worthless, for had the dividend distribution been made without the cancellation of stock there would be little doubt that an effort to take at that time a worthless stock deduction would prove unsuccessful.

If the purpose of section 115(g) is to equalize the tax positions of all ordinary dividend recipients, regardless of the form which such dividends take, then the argument that the section 115(g) victim should get a worthless stock deduction for his cancelled stock is not entirely without reason. The section 115(a) dividend recipient retains the stock upon which the dividend has been paid as his capital investment and recoups his basis either upon later sale of the stock or upon

its becoming worthless. Since the section 115(g) victim must recoup his basis upon cancellation of the stock or probably be forever deprived of this opportunity, the allowance of a capital loss deduction in the amount of the entire basis of his cancelled stock on the theory that the stock is worthless, should serve effectively to equalize his tax position with that of an ordinary dividend recipient. Moreover, such a loss deduction would not have the effect of nullifying the force of section 115(g) as would an ordinary loss deduction.

C. *Possibility of an Abandonment Loss.* If our section 115(g) victim could recoup his basis of the cancelled stock by an abandonment loss, an ordinary loss would ensue, inasmuch as the limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to abandonment losses.³² In order to obtain an abandonment loss, the property involved must be permanently discarded and whether such property has been abandoned depends upon the intention of the owner coupled with the act of abandonment—both to be gleaned from the attending facts and circumstances.³³

It would not be difficult to fit the loss deduction sought by our section 115(g) victim within the framework of these general principles, because the very act of surrendering the stock to the corporation for cancellation would constitute the overt act indicating abandonment. An additional requirement for an abandonment loss, however, is that the property abandoned must be worthless.³⁴ Even if we assume that the cancelled section 115(g) stock is worthless because nothing is received for it and that, therefore, an ordinary loss ensues; how do we reconcile this conclusion with the provisions of section 23(g)(2)? That section provides that a loss resulting from the worthlessness of stock is considered as resulting from a sale or exchange and, therefore, a capital loss. In view of this express statutory provision, it appears extremely doubtful that worthless stock can ever be the subject of an abandonment loss.³⁵

³² This is probably premised upon the fact that upon abandonment, no consideration is received, and hence no sale or exchange has occurred. William H. Jamison, 8 T.C. 173 (1943) acqd., 1947-1 Cum. Bul. 2.

³³ 5 MERTENS, LAW OF FEDERAL INCOME TAXATION, §28.18 (1942).

³⁴ Mack v. Comr., (C.C.A. 2d, 1942) 129 F. (2d) 598; William H. Jamison, 8 T.C. 173 (1943) acqd., 1947-1 Cum. Bul. 2.

³⁵ A distinction, albeit a shadowy one, between an abandonment loss and a worthless stock deduction is that in the former case the stock is surrendered, whereas in the latter case the stockholder generally retains the stock. It is not believed that an argument based on this distinction could successfully avoid the application of §23(g)(2). Technically, this distinction does not exist, inasmuch as §23(g)(2) treats the worthless stock as having been sold or exchanged.

D. *The Danger of Section 24(b)*. At first blush, section 24(b)³⁶ might be thought to offer a real obstacle to the allowance of a loss deduction with regard to the basis of the cancelled stock, but on closer analysis this obstacle disappears. Under the provisions of that section, a loss will be disallowed if it results from a "sale or exchange," directly or indirectly, between a stockholder and his controlled corporation—that is, if there be owned, directly or indirectly, by or for the individual involved more than 50% of the value of the stock of the corporation on the date of the sale or exchange. It will be appreciated that if the claimed loss with respect to the unrecouped basis can be said to result from a sale or exchange, section 24(b) would probably preclude the allowance of the loss in most section 115(g) situations, because the section generally hits close family corporations.

Two reasons can be advanced, however, to overcome the application of section 24(b). The first one concerns itself with the "sale or exchange" requirement. If there is no sale or exchange upon the receipt of a section 115(g) dividend and the cancellation of stock because the stockholder receives nothing for the stock, the necessary prerequisite for the application of section 24(b)—a sale or exchange—is lacking. We have, however, concluded that in all probability the exchange provision of section 115(c) will control the character of the loss. In such event, the "sale or exchange" requirement of section 24(b) would be satisfied.

Even if it be assumed that the loss with respect to the unrecouped basis results from a sale or exchange, the express statutory exception to losses resulting from distributions in liquidation would preclude the disallowance of the loss under section 24(b), provided, however, that the determination that section 115(g) applies to a given distribution does not rule out a conclusion that the same distribution is also one in liquidation. The answer to this problem would appear to hinge upon whether Congress, by the use of the phrase "except in the case of distributions in liquidation," intended to confine this exception to those distributions which are taxed as liquidating dividends under section 115(c), and did not intend to include those distributions which

³⁶ Sec. 24(b)(1)(B): "In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly. . . .

"(B) *Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.*" (Emphasis supplied).

are liquidating dividends in form but not in effect; that is, section 115(g) distributions.

If section 115(g) operates as the exception to section 115(c) only in so far as the manner of taxing the distribution is concerned, it would not do violence to the statutory language of section 24(b) to conclude that the exception applies to all distributions which are liquidating in nature, regardless of how they are taxed. That is, if the distribution results in a partial liquidating distribution, as defined in the statute³⁷—a cancellation or redemption of a portion of corporate stock—the exception in section 24(b) would compel recognition of the loss even if it arose from a sale or exchange.

It is believed, therefore, that while section 24(b) presents a possible obstacle to the allowance of the loss,³⁸ this obstacle can be hurdled on the ground that the distribution in cancellation of stock, although taxed as an ordinary dividend, is one in liquidation within the intentment of the statutory exception.

IV

CONCLUSION

Admittedly, numerous obstacles face the section 115(g) victim in his attempt to recoup the basis of his cancelled stock through a loss deduction. That he is entitled to recoup basis would appear to follow if the purpose of section 115(g) is to place its victim on an equal tax footing with the recipient of an ordinary dividend. In order to achieve this equality, the section 115(g) victim should be allowed a capital loss deduction equal to the entire basis of his cancelled stock. If no tax consideration is to be accorded basis, taxpayers would indeed be foolhardy to risk the dangers of section 115(g) when they could be in a better position taxwise if they simply declared an ordinary dividend without cancelling stock.

³⁷ Sec. 115(i).

³⁸ If it be concluded that the exception applies solely to true liquidating distributions under §115(c) as defined by §115(i), the basis of the cancelled stock might never be recouped. The failure to return the victim's basis tax-free is not tantamount to taxing a return of capital and hence would not appear to offer any constitutional objections under the 16th amendment. See statement in *Virginian Hotel Corporation v. Helvering*, 319 U.S. 523, 63 S.Ct. 1260 (1943), that "Congress has made no such guarantee" that taxpayers will recover their investment tax-free. Cf. §§112(b)(6) and 113(a)(15).

Unfortunately, because this article deals with a judicially unchartered area, the section 115(g) victim may have to resort to the uncertainties of litigation to secure tax recoupment of his basis. A well-advised victim, however, may find it worth his while, inasmuch as he may discover tax benefits lurking in a section that to date has been a one-way street in the Commissioner's favor.