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TAXATION-FEDERAL INCOME TAX-STATUS OF PAYMENT OF CORPORATE LIABILITY BY STOCKHOLDER SUBSEQUENT TO LIQUIDATION

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TAXATION—FEDERAL INCOME TAX—STATUS OF PAYMENT OF CORPORATE LIABILITY BY STOCKHOLDER SUBSEQUENT TO LIQUIDATION—Petitioners, from 1937 to 1940, received distributions from the liquidation of a corporation of which they were stockholders and reported the profits thus obtained, classifying them as capital gains pursuant to I.R.C., §115. In 1944, a judgment was rendered against the corporation. Petitioners, as transferees, paid the judgment and took a deduction of 100 per cent, classifying the amount paid as an ordinary business loss.[1] The Commissioner took a contrary position, and held the payment a capital loss.[2] The Tax Court upheld the petitioners' contention[3] but the court of appeals reversed.[4] On appeal, *held,* affirmed, three Justices dissenting. The payment should be viewed as a part of the original liquidation transaction requiring classification as a capital loss. *Arrowsmith and Bauer v. Commissioner of Internal Revenue,* (U.S. 1952) 73 S.Ct. 71.

Prior to the judicial introduction of the taxable year concept into the tax law of the United States, when a taxpayer received distributions from the liquidation of a corporation in one year and in a subsequent year had to pay a liability of that corporation, the proper treatment was to reopen his earlier return and adjust the gain there reported.[5] However, in 1932, as a corollary to the

[1] Under I.R.C., §23(a).

[2] Applying I.R.C., §§117(b), (d)(2), and (e).

[3] Bauer v. Commisioner, 15 T.C. 876 (1950).

[4] Commissioner v. Arrowsmith, (2d Cir. 1952) 193 F. (2d) 734.

[5] Appeal of Barker, 3 B.T.A. 1180 (1926); O'Neal v. Commissioner, 18 B.T.A. 1036 (1930).

development of the "claim of right" doctrine,[6] the Supreme Court developed the taxable year concept under which subsequent payment of a contingent liability was treated as a loss in the year it was paid, and not as reducing income for the year in which the liability accrued.[7] The justification for the rule was found in administrative necessity in the levying and collection of taxes,[8] and, since its adoption, it has become well established that each year should stand alone for tax accounting purposes in these cases.[9] In 1941 the Tax Court determined that the taxable year concept applied to situations like the principal case and overruled the earlier decisions by holding that the loss should be reported in the year it was paid.[10] In the principal case it was argued on behalf of petitioners that the taxable year concept should be applied to foreclose consideration of the past liquidation transaction as was done in an earlier Third Circuit decision.[11] The majority, in declining to follow the Third Circuit decision, rests on a sound logical distinction in that the question in the principal case is not in what accounting period the loss should be returned—the question to which the taxable year doctrine is directed—but whether the loss should be characterized as ordinary or capital. The application of the taxable year concept to foreclose consideration of past events to determine the nature of a loss or gain would be a considerable extension of the concept. That the court will consider past transactions to determine the nature of a loss or gain despite the taxable year concept was indicated in the case of *Commissioner v. Dobson*.[12] Despite the distinction drawn by the majority, the question still remains whether it would not have been better to extend the tax year doctrine to cover this type of case. The majority argue that petitioners' position should be no different from what it would be if they had paid the obligation in the earlier year, in which case it would have been a capital loss. This argument, however, ignores the fact that had they paid it in that year, they would have had a capital gain

[6] North American Oil Co. v. Burnet, 286 U.S. 417, 52 S.Ct. 613 (1932), where the Court held that earnings received under a claim of right in one year should be treated as income earned in that year (regardless of any contingent liability to return all or part at some time in the future).

[7] North American Oil Co. v. Burnet, note 6 supra; Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S.Ct. 150 (1931).

[8] Burnet v. Sanford & Brooks Co., note 7 supra.

[9] United States v. Lewis, 340 U.S. 590, 71 S.Ct. 522 (1951); Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 64 S.Ct. 596 (1944). See also annotation, 154 A.L.R. 1276 (1945).

[10] Furlong v. Commissioner, 45 B.T.A. 362 (1941); Estate of Mills v. Commissioner, 4 T.C. 820 (1945).

[11] Commissioner v. Switlik, (3d Cir. 1950) 184 F. (2d) 299.

[12] 320 U.S. 489, 64 S.Ct. 239 (1943). For other cases in which the courts have looked to past transactions to determine the nature of a loss or gain, see Westover v. Smith, (9th Cir. 1949) 173 F. (2d) 90; and Commissioner v. Carter, (2d Cir. 1948) 170 F. (2d) 911. In these cases distributions made to taxpayers upon liquidation included contract rights to royalties, to which no value was assigned in the returns for the year of liquidation. Payments received in subsequent years were held to be capital gains and not ordinary income, being treated as a part of the earlier liquidation transaction.

against which they could set off the entire loss. If, however, they have no capital gain in the year they pay the loss or in the ensuing four years, they would be able to deduct only $5,000.[13] In support of the majority, however, it may be argued that to hold otherwise would be to place a premium on miscalculating the corporate obligations upon liquidation. To decide the case either way on the basis of equities is a difficult proposition, either alternative yielding some undesirable consequences. Perhaps it should be noted that the inequity in deciding against petitioners is not so much caused by the failure to apply the taxable year concept as it is by the application of that concept to foreclose readjustment of the prior years' returns. The conclusion of the majority in the principal case, while not completely satisfactory, is at least based on a sound distinction, and is as just as any result could be as long as the single accounting year principle is accepted.

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[13] Under I.R.C., §117(d)(2), loss from sales or exchanges of capital assets are allowed only to the extent of capital gains plus $1000. Sec. 117(e) provides that there shall be a capital loss carry-over into the five succeeding years.