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TAXATION--INCOME TAX--NONDEDUCTIBLE LOSSES--INTRA-FAMILY TRANSACTIONS

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TAXATION—INCOME TAX—NONDEDUCTIBLE LOSSES—INTRA-FAMILY TRANSACTIONS—Petitioner managed his wife's as well as his own estate. On several occasions, to establish tax losses, he ordered his broker to sell certain stock on the Stock Exchange for his account, and then to buy the same number of shares of the same stock for his wife's account. Petitioner claimed losses derived from these sales when filing his income tax return, but the commissioner disallowed these deductions on the authority of section 24 (b) of the Internal Revenue Code.[1] On the taxpayer's application to the Tax Court, it held section 24 (b) inapplicable. The circuit court of appeals reversed the Tax Court, and the Supreme Court granted certiorari. *Held,* affirmed. The purpose of 24 (b) was to put an end to the privilege of taxpayers, by intra-family transfer, to choose their own time for realizing tax losses on investments which for most practical purposes they continue to own. *McWilliams v. Commissioner of Internal Revenue,* (U.S. 1947) 67 S. Ct. 1477.

Prior to the Revenue Act of 1934, a loss such as the one alleged in the principal case was deductible because the courts felt that such a transaction constituted a "bona fide sale." As long as the taxpayer divested himself of all title and control over the property sold, purchases by his spouse did not constitute a reacquisition of the securities either by the taxpayer or by the marital community.[2]

[1] 26 U.S.C. (1940) § 24 (b); the relevant portion of this statute is as follows:
"(b) Losses from sales or exchanges of property.
"(1) Losses disallowed. 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—
(A) Between members of a family, as defined in paragraph (2) (D); . . . ."
Section 24 (b) (2) (D) reads: "The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

[2] Commissioner of Internal Revenue v. Behan, (C.C.A. 2d, 1937) 90 F. (2d) 609; Porter v. Commissioner of Internal Revenue, 36 B.T.A. 475 (1937); Hyman

In fact, a husband could sell directly to his wife for the avowed purpose of taking a loss if the transaction were bona fide; that is, if full value were paid from the separate property of the wife.[3] Congress, in an effort to stop these methods of tax avoidance, enacted appropriate legislation in the Revenue Act of 1934.[4] Keeping in mind the parade of tax avoidance transactions before 1934, and looking at the language of the section, it would seem clear that Congress intended to disallow a loss effected as was the one in the principal case.[5] But in 1943 the Second Circuit Court of Appeals, Judge Learned Hand dissenting, held that a transaction analogous to the one in the principal case was not covered by the indirect sale prohibition of the section, and permitted the loss to be deducted.[6] It would seem that the court closed its eyes to economic realities, and rendered the indirect sale prohibition a nullity; its decision merely echoed the holdings of courts prior to the enactment of the section. In 1946 the Fourth Circuit Court of Appeals, presented with a fact situation similar to that of the principal case, rejected the second circuit's reasoning and reached the opposite result.[7] The court stated that, since husband and wife are but one economic unit, when one sold stock and the other purchased the same amount no actual loss had been suffered by the selling spouse. The Supreme Court in the principal case, by overlooking legal niceties, has now resolved the conflict and has given

v. Commissioner of Internal Revenue, 36 B.T.A. 202 (1937); Gummey v. Commissioner of Internal Revenue, 31 B.T.A. 139 (1934).

[3] Commissioner of Internal Revenue v. Hale, (C.C.A. 1st, 1933) 67 F. (2d) 561.

[4] Revenue Act of 1934, § 24 (a), (b), 48 Stat. L. 680, 691 (1934). The language used in 24 (a) (b) has since been incorporated into 24 (b), supra, note 1.

[5] Mr. Doughton, of the Committee on Ways and Means, in a report to the House of Representatives explained why § 24 (a) (b) had been incorporated into the Revenue Act of 1934: "Experience shows that the practice of creating losses through transactions between members of a family and close corporation has been frequently utilized for avoiding the income tax. It is believed that the proposed change will operate to close this loophole of tax avoidance." H. Rep. 704, 73d Cong., 2d sess., p. 23.

Mr. Harrison of the Committee on Finance used the same language in his report to the Senate. S. Rep. 558, 73d Cong., 2d sess., p. 27.

Representative Hill, in the debate on the floor of the House, stated: "We have endeavored in this bill to absolutely close the gap through which these people have escaped paying taxes, and we feel that we have accomplished our purpose under the provisions of this bill. We do not claim that we have stopped every hole, but we do claim that we have plugged the big holes." 78 CONG. REC. 2662 (1934).

[6] Commissioner of Internal Revenue v. Ickelheimer, (C.C.A. 2d, 1943) 132 F. (2d) 660. A wife had given her husband a power of attorney, to deal with her property as he saw fit. The husband was also one of three trustees of a trust which gave the wife the income for life with a testamentary power of appointment. The husband acting under the power of attorney sold some of his wife's bonds through the stock exchange and the next day in his capacity as trustee purchased the same number of bonds as those sold.

[7] Commissioner of Internal Revenue v. Kohn, (C.C.A. 4th, 1946) 158 F. (2d) 32; the husband and wife each had separate brokerage accounts and the husband, acting for himself and as agent for his wife sold stock for his account and purchased (through a broker) the same number of shares of the particular stock for his wife's account.

an effective meaning to the section's indirect sale prohibition. A question unanswered by the Court is whether the indirect sale provision will be applied in every case, as is the direct sale prohibition. In certain family transfers, application of the direct sale provision prevents a deduction although the vendor has suffered real economic loss.[8] But it would seem that such injustice can be avoided under the indirect sale proviso.[9] It is submitted that in the principal case the court looked at whether or not the husband was poorer in an economic sense after the transaction. It might appear, therefore, that before the court would attach the label "indirect sale" to any transaction, it would first conclude that in an economic sense, no loss had occurred. This approach gives the indirect sale prohibition the necessary flexibility which the direct sale prohibition lacks; and should this analysis be used, the indirect sale proviso, while just as effective to prevent fictitious losses, would be free from the accompanying injustice.

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[8] MONTGOMERY, FEDERAL INCOME TAX HANDBOOK 461 (1938-1939); in criticizing section 24 (b) Mr. Montgomery said: "There can be no quarrel with an attempt to disallow colorable losses, but it is decidedly unjust to disallow losses actually sustained on *bona fide* transactions merely because a member of the family is the purchaser. In many closed corporations it is impossible to effect a sale of the stock except to members of the family. Because of disagreement, or any one of a number of other good reasons, a stockholder in a family corporation may find it expedient to sell his stock. Although he is unable to find a purchaser other than a member of his family or the corporation itself, his loss will be disallowed no matter how obvious his good faith may be in making the transaction.

"Similarly, it is not an infrequent occurrence for the holder of the majority of the stock in a corporation to provide in his will that one of his children shall have the option to purchase within a specified period after the testator's death the stock bequeathed to his other children. Any loss sustained by other children on such a transaction will be disallowed, although obviously no bad faith is involved."

[9] Conceivably the question could arise in the following hypothetical case. *A* and *B*, although brothers, are bitter enemies. *A* sells some of his stock through the stock exchange and sustains a loss. *B*, two days later, by coincidence, purchases the same amount of this particular stock through a broker. Obviously, *A* and *B* are not in collusion and *A* has actually suffered an economic loss for *B*'s purchase of the stock will not give *A* any economic benefit.