Buffalo Law Review

Volume 2 | Number 2 Article 23

4-1-1953

Taxation—Stockholder-Transferee Liability: Ordinary or Capital Loss?

Jerome D. Adner

TAXATION—STOCKHOLDER-TRANSFEREE LIABILITY: ORDINARY OR CAPITAL LOSS?

On dissolution of a corporation, the stockholders received liquidating dividends, upon which they properly paid capital gains tax. In a later year a judgment was rendered against the corporation which was paid by the stockholders as transferees of the corporate assets. *Held* (6-3): Such payments must be treated as capital losses, not ordinary losses, in the year of payment. *Arrowsmith v. Commissioner,* 73 S. Ct. 71 (1952).

Each stockholder-transferee of the assets of a liquidated corporation is severally liable for the unpaid debts of the corporation, as if he were a trustee, but this liability is limited in amount to the liquidation dividends he receives. *Phillips-Jones Corp. v. Parmley,* 302 U. S. 233, 235 (1937); *Koch v. United States,* 138 F. 2d 850, 852 (10th Cir. 1943). The Code provides that liquidation dividends are to be treated as capital gains or losses. INT. REV. CODE §§ 115(c), 117(a). However, there is no provision which expressly prescribes how a payment of a corporate debt by a stockholder-transferee is to be treated.

Early decisions of the Board of Tax Appeals permitted such payments to be treated as reductions of the previously received liquidation dividends, so that the taxpayer could reopen his earlier tax return, recompute his tax liability for that earlier year, and collect a refund if one were due. *O. B. Barker,* 3 B. T. A. 1180 (1926); *Benjamin Paschal O'Neal,* 18 B. T. A. 1036 (1930). But this practice was expressly changed in *John T. Furlong,* 45 B. T. A. 362 (1941), on the ground of a Supreme Court dictum stating that income received under a "claim of right" is fully taxable in the year of receipt, and if the taxpayer must later repay all or part of this income, the loss must be treated as a deduction in the year of repayment. *North American Oil v. Burnet,* 286 U. S. 417, 424 (1932); see also *United States v. Lewis,* 340 U. S. 590 (1951). This alone, however, does not determine whether such deduction is a capital or an ordinary loss.

Commissioner v. Switlik, 184 F. 2d 299 (3d Cir. 1950), differing from the principal case only in that a corporate tax deficiency was involved rather than a judgment, held that such a payment results in an ordinary loss under Int. Rev. Code § 23(e) (2). The court strictly adhered to the theory which treats the single year as a separate unit for tax purposes, and would not consider the nature of the liquidation distributions in determining the character of the loss. It then concluded that the loss did not fall within the statutory definition of a "loss from the sale or exchange of a capital asset." INT. REV. CODE § 117(a).

In the principal case, the second circuit expressly disagreed with the *Switlik* case, *supra,* holding the loss to be a capital one. *Commissioner v. Arrowsmith,* 193 F. 2d 734 (2d Cir. 1952). The court stated simply that the loss was "directly related to and would not have existed except for" the previous capital distributions, so by considering the two transactions as "tied together," the losses "show up as arising out of a 'sale or exchange'." *Supra* at 735. In affirming, the Supreme Court stated that the principle of treating a single year as a separate tax unit is not violated by considering the events of previous years in determining the nature of the current year's loss. 73 S. Ct. 71, 73. Both courts in the instant case broadly construed "sale or exchange," the Supreme Court concluding with little explanation that the loss in question fell "squarely within" the statutory definition of capital losses.

The dissenters in the Supreme Court took the position that the single year concept should be strictly applied, the result being no capital transaction since there was no sale or exchange of any capital asset within the taxable year.

It has been stated that a fundamental reason for the "single year rule" is its capacity to "produce revenue ascertainable, and payable to the government, at regular intervals." *Burnet v. Sanford & Brooks Co.,* 282 U. S. 359, 365 (1931). Considering this purpose, it does not appear to be a violation of the rule to allow a court to examine an earlier related transaction in order to help to determine the nature of a subsequent payment, since it would not entail a reopening or recomputation of the taxpayer's previous return.

Admittedly, the instant case may be said to reach an equitable result. The loss, if viewed realistically from a transactional approach, does appear to be in effect a reduction of the prior capital gain. However, the equities involved ought not to obscure the fact that taxation is essentially a matter of statute. It has been stated that "not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains from 'the sale or exchange' of capital assets." *Dobson v. Commissioner,* 321 U. S. 231 (1944). The taxable year in the instant case contains neither a sale nor an exchange of any capital asset.

Thus, an examination of the prior returns shows only that the loss in question was sustained *because of* a previous capital transaction. This alone does not seem to require the conclusion that the payment of the judgment is itself a "loss from the sale or exchange of a capital asset" in the present taxable year. Although the instant case appears to reach an equitable result, it does not seem to be fully justified under the present statutory language.

Jerome D. Adner