

RECENT DEVELOPMENTS

WIFE'S PURCHASE OF HUSBAND'S STOCK IN FAMILY CORPORATION AT INVOLUNTARY SALE HELD AN INTRA- FAMILY TRANSFER

In *Merritt v. Commissioner*¹ the Court of Appeals for the Fifth Circuit, relying upon section 267 of the Internal Revenue Code of 1954,² disallowed the deduction of a loss sustained by a taxpayer following an involuntary sale of stock in a family-owned corporation to the taxpayer's wife. James H. Merritt, Sr., had accumulated uncontested tax liabilities during 1944, 1945, and 1946 totaling \$191,812.98 which were still outstanding in 1960. After receipt of a notice of levy, he delivered his shares of the family-owned wholesale plumbing corporation, having a basis of \$135,000, to the Internal Revenue Service. Merritt's "right, title, and interest" in the seized stock was sold at public auction for \$25,000 to the only bidder, his wife, Amanda Merritt. On their joint return for 1960 the Merritts reported a long-term capital loss amounting to \$110,000 and applied \$10,187.49 thereof to offset capital gains and other income for 1960. The Commissioner disallowed all deductions, ruling that the loss resulted from an intrafamily transfer and consequently was not deductible under section 267. The Tax Court found for the Commissioner,³ and the Fifth Circuit affirmed.

¹ 400 F.2d 417 (5th Cir. 1968).

² INT. REV. CODE OF 1954, § 267:

"(a) Deductions disallowed. --No deduction shall be allowed--(1) Losses. --In respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b). . . .

"(b) Relationships.--The persons referred to in subsection (a) are: (1) Members of a family, as defined in subsection (c)(4); . . .

"(c) Constructive Ownership of Stock.--For purposes of determining, in applying subsection (b), the ownership of stock--

. . . .
(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;"

³ *Merritt v. Commissioner*, 47 T.C. 519 (1967).

Section 267 is the expanded successor of section 24 of the 1934 Internal Revenue Act,⁴ which represented Congress' initial attempt to eliminate a Depression-born wave of tax evasion resulting from deductions created by transactions between related parties which did not give rise to an actual economic loss.⁵ Prior to 1934 deductions were allowed for all losses incurred during *bona fide* property transfers, regardless of the relationship between vendor and vendee.⁶ However, the difficulty of distinguishing good faith sales from sham transactions when related parties were involved led to the enactment of section 24 whereby deductions for any loss resulting from a direct or indirect transfer between clearly-defined related parties were disallowed.⁷ Originally this restriction covered sales or exchanges of property between the taxpayer and his family or between the taxpayer and a corporation in which he or his family owned more than 50 percent of the stock; "family" was defined as brothers, sisters, spouse, ancestors and lineal descendants.⁸ The 1936 revenue legislation extended the ban to certain transfers among grantors, fiduciaries, and beneficiaries, and beneficiaries of the same trust.⁹ Despite the limited scope of the restrictions¹⁰ and the freedom to make evasive joint-tenancy grants,¹¹ the legislation was fairly effective because the courts

⁴ See Act of May 10, 1934, ch. 277, § 24, 48 Stat. 680 (now INT. REV. CODE OF 1954, § 267).

⁵ See Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 TAX L. REV. 253 (1960); 78 CONG. REC. 2662 (1934) (remarks of Rep. Hill, Chairman of House Subcomm. on income tax laws).

⁶ See *Commissioner v. Behan*, 90 F.2d 609 (2d Cir. 1937) (seller must divest himself of all title and control); *Zimmermann v. Commissioner*, 36 B.T.A. 279 (1937), *rev'd on other grounds*, 100 F.2d 1023 (3d Cir. 1939) (securities losses in interspousal sales through broker at market prices held deductible); *Twining v. Commissioner*, 32 B.T.A. 600 (1935) (sale must be for a fair market price).

⁷ See Hertz, *Dealing with Related Persons: Salaries and Other Compensation; Sales of Property; Interest Accruals and Other Deductions*, 23 INSTITUTE ON FED. TAXATION 577, 579 (1965); 33 VA. L. REV. 95, 96 (1947).

⁸ See note 4 *supra*.

⁹ Act of June 22, 1936, ch. 690, § 24(b)(1)(D)(E)(F), 49 Stat. 1648 (now INT. REV. CODE OF 1954, § 267).

¹⁰ See *Hanna's Estate v. Commissioner*, 320 F.2d 54 (6th Cir. 1963) (loss allowed on sale of stock by estate to corporation it controlled); Reilly, *supra* note 5, at 280, 281.

¹¹ See Stapleton, *Losses Between Related Taxpayers Under Section 24(b)*, 31 TAXES 902 (1953). See also, e.g., *Stern v. Commissioner*, 215 F.2d 701 (3d Cir. 1954) (where taxpayer sold realty to his son-in-law and taxpayer's daughter supplied no part of consideration but

retained the flexibility of their pre-1934 approach and continued to look to the economic realities of an entire transaction. Thus, a loss deduction was disallowed whenever "control" was maintained by the transferor despite a clearly legal sale to a party not statutorily classified as related.¹²

With the statute disallowing the loss on sales among particular parties and the courts requiring a cessation of economic control in each sale before a loss could be deducted, it was inevitable that the legal discussion should focus on what constitutes a "sale," direct or indirect.¹³ In *Commissioner v. Ickelheimer*,¹⁴ where a husband acting under a power of attorney sold his wife's bonds on a public exchange and subsequently, without prearrangement, repurchased a like number of the same bonds as trustee of a trust in which his wife was beneficiary, the transfer was held to be an arms-length transaction rather than an "indirect sale" between fiduciary and beneficiary, and the loss deduction was allowed. Yet, in *Commissioner v. Kohn*¹⁵ and *Commissioner v. McWilliams*,¹⁶ interspousal stock transfers made for the avowed purpose of establishing tax benefits, although likewise passing through public brokers, were held to be indirect sales not giving rise to loss deductions. In each of the three cases the taxpayer had sold securities on the open market, and the spouse had made roughly similar purchases at approximately the same time, but in only two of the cases was the transaction held to constitute an "indirect sale." In *McWilliams v. Commissioner*¹⁷ the Supreme Court resolved this conflict by characterizing section 24 as an "absolute

became tenant by the entirety under Pennsylvania law as result of direction of taxpayer's son-in-law that she be included in deed of conveyance, taxpayer's daughter did not become purchaser of such realty so as to bring taxpayer within provision of Code prohibiting deduction in respect to losses between members of family, so that loss was deductible).

¹² See *Higgins v. Smith*, 308 U.S. 473 (1940); *Boehm v. Commissioner*, 255 F.2d 684 (2d Cir. 1958) (sale and repurchase between wife and father-in-law); *Bank of America Nat'l Trust and Savings Ass'n v. Commissioner*, 15 T.C. 544 (1950), *aff'd per curiam*, 193 F.2d 178 (9th Cir. 1951) (reacquisition agreement); *Crown Cork Int'l Corp. v. Commissioner*, 4 T.C. 19 (1944), *aff'd per curiam*, 149 F.2d 968 (3d Cir. 1945) (no substantial economic effect).

¹³ See *National Metropolitan Bank v. United States*, 111 F. Supp. 422 (Ct. Cl. 1953); Moore, *When Is a Sale Not a Sale?* 25 TAXES 326 (1947).

¹⁴ 132 F.2d 660 (2d Cir. 1943).

¹⁵ 158 F.2d 32 (4th Cir. 1946).

¹⁶ 158 F.2d 637 (6th Cir. 1946), *aff'd*, 331 U.S. 694 (1947).

¹⁷ 331 U.S. 694 (1947).

prohibition—not a presumption¹⁸—against allowing losses for sales within certain groups and by deciding that indirect sales should not be interpreted so narrowly as to leave a loophole almost as large as section 24 had set out to close.¹⁹ After *McWilliams* had been argued in the Supreme Court, but before the opinion was promulgated, the Tax Court decided in *Zacek v. Commissioner*²⁰ that the attempted deduction by a mortgagor for his *bona fide* loss on a foreclosure sale of the mortgaged property to relatives should be disallowed because the concept of indirect sale was comprehensive enough to include even an *involuntary* sale.²¹ Although *McWilliams* called for a broad interpretation of “indirect sale,”²² it made no specific reference to the issue of involuntary action. The Court merely identified section 24 as an attempt to block those who “choose . . . their own time for realizing tax losses,”²³ as the petitioner in *McWilliams* had so patently done. Some courts therefore limited *McWilliams* to voluntary sales, direct or indirect, where the parties had attempted to “choose their own time,” and allowed deductions for losses resulting from *involuntary* transfers of property where possible tax benefits were clearly not the impetus. In *McCarty v. Cripe*,²⁴ where the taxpayer’s farm was sold for taxes at a public sale to a trustee using funds supplied by the taxpayer himself, and the trustee immediately conveyed the farm to a corporation in which the taxpayer owned more than fifty percent of the stock, it was held that the transaction was not a sale directly or indirectly between the taxpayer and his controlled corporation because he had not been able to choose his own time for realizing the tax loss. Therefore, the deduction was allowed.²⁵ In *McNeill v. Commissioner*,²⁶ where the taxpayer’s property was sold for taxes directly to a corporation in which the taxpayer and his family owned all the stock, the taxpayer was not precluded from deducting the loss since the sale was occasioned by the separate and

¹⁸ *Id.* at 699.

¹⁹ *Id.* at 700, 701.

²⁰ 8 T.C. 1056 (1947).

²¹ *Id.* at 1057.

²² See note 17 *supra*.

²³ 331 U.S. at 700.

²⁴ 201 F.2d 679 (7th Cir. 1953).

²⁵ *Id.* at 682.

²⁶ 251 F.2d 863 (4th Cir. 1958), *cert. denied*, 358 U.S. 825 (1958).

independent action of the public authorities which eliminated any choice in selecting the time for realizing the loss.²⁷ *Merritt* represents an attempt to revitalize *McWilliams* and proposes that *all* transactions between the parties specified in section 267 be denied the privilege of loss deductions without regard to volition.

In *Merritt v. Commissioner* the Tax Court divided sharply on the meaning of section 267.²⁸ The majority rejected any consideration of the absence of sham or prearrangement, looking only to the fact that the wife was the ultimate recipient of the property. The concurring opinion disallowed the loss because of the near identity of the economic interests before and after the transfer. The dissent stoutly maintained that section 267 was intended to reach only wilful manipulators. On appeal the Fifth Circuit, disregarding such distinctions, concluded that the only consideration is whether property has been received by one who satisfied the statutory definition of "related party," regardless of whether there has been an active attempt at tax evasion.²⁹ Quoting extensively from *McWilliams'* discussion of section 24, the court indicated that section 267 is likewise an absolute prohibition against the allowance of losses on *all* sales between parties in certain designated groups and that its purpose should not be aborted by introducing the "niceties of either sequence of title or voluntary versus involuntary sales."³⁰ The purpose of the legislation was and is "to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses. . . ."³¹ The court did note the more traditional issues of identity of interest and continuous control of the stock³² but concluded that, for the sake of simplicity, section 267 should result in denial of *all* deductions for losses incurred during transfers between forbidden parties whether voluntary or not.³³

Two circuits have allowed deductions for losses resulting from forced sales to related parties, when it was clear that the sale was

²⁷ *Id.* at 866.

²⁸ 47 T.C. 519 (1967).

²⁹ 400 F.2d 417 (5th Cir. 1968).

³⁰ *Id.* at 420.

³¹ *Id.*, quoting *McWilliams v. Commissioner*, 331 U.S. 694, 700 (1946).

³² *Id.* at 421.

³³ *Id.*

not prearranged for tax purposes³⁴ and when an actual economic loss was suffered.³⁵ The *Merritt* case now holds that deductions for losses from sales among related parties should be disallowed without exception whether voluntary or not. Yet that court felt compelled to buttress its categorical announcement by reference to the "continuous control" and "identity of interest"³⁶ which characterized and vitiated the earlier *McWilliams* opinion. The extensive reliance on *McWilliams* seemed more to emphasize the need to block scheming tax dodgers who "choose their own time"—in the instant case perhaps by a conscious decision to ignore taxes and force a foreclosure³⁷—than to ground the decision upon an absolute rule that the deduction is to be disallowed whenever a related party obtains the property regardless of surrounding circumstances. Thus, it is arguable that the thrust of the Fifth Circuit opinion disallowed Merritt his deduction not because of the existence of an "absolute rule," but because of a manifest continuity of control and identity of interest which precluded his suffering a real loss to the extent of \$110,000. Indeed, it is this very situation which the statute was designed to cover.³⁸ Thus, the articulated rule of *Merritt* in its absolute form would seem an unnecessarily broad basis for the holding, and its indiscriminate application to transfers among related parties where there is complete transfer of control accompanied by actual economic loss would be unwarranted. While the *Merritt* rule offers uniformity and ease of application, it completely ignores the fact that sales to related parties are often made for reasons other than tax evasion.³⁹ Where an involuntary sale involves several competitive bidders or results in a fair market price, the loss should be allowed.⁴⁰ The decisions of the Fourth and Seventh Circuits have always looked to the substance rather than the form of intrafamily

³⁴ See note 17 *supra*.

³⁵ See note 23 *supra*.

³⁶ See note 28 *supra*.

³⁷ See Stapleton, *supra* note 11, at 904-05. *But cf.* Hamovit, *Disallowance of Losses and Deductions and Characterization of Gains Between Related Persons*, 15 W. RES. L. REV. 270, 275 (1964).

³⁸ See note 5 *supra*.

³⁹ Comment, *Nondeductible Capital Losses and Bona Fide Sales Under the Federal Income Tax*, 49 YALE L.J. 75, 78 (1939).

⁴⁰ R. MONTGOMERY, *FEDERAL INCOME TAX HANDBOOK 1938-39*, at 461 (1938); Anthoine, *Transactions Between Related Taxpayers*, 1956 TULANE TAX INSTITUTE 269, 277.

transactions when allowing loss deductions under section 267. The flexibility offered by those circuits should not be eliminated. The *Merritt* transaction would not qualify for a deduction under the *McNeill* and *McCarty* theory, but it should not become the vehicle for precluding such relief in future cases arising under more compelling factual circumstances. The position of the *McNeill* and *McCarty* courts has a significant equitable basis; in effect, they treat section 267 as a rebuttable presumption.⁴¹ A blanket elimination of the flexible concept of "involuntary sale" by any explicit affirmation of *Merritt* would be unfortunate; legislative intent and justice would be lost in the rush to replace adaptability with simplicity.

⁴¹ See Gilliam, *Some Effects of Nonrecognized Losses on Corporations and Their Shareholders*, 35 N.C.L. REV. 31, 59-60 (1956).