6-1-1969

Income Tax -- Deductibility of Losses Suffered in Intra-Family Transfers

Stephen Mason Thomas

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/nclr/vol47/iss4/18

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
congressional intent, it is submitted that Congress should act to restate
the amount of avoidance motive it feels should be present before imposi-
tion of the surtax.

JAMES R. CARPENTER

Income Tax—Deductibility of Losses Suffered in Intra-Family
Transfers

In Merritt v. Commissioner,¹ the Court of Appeals for the Fifth Cir-
cuit held that section 267 of the Internal Revenue Code of 1954 precluded
deduction of a loss suffered by a husband when his stock in a family
corporation was sold to his wife in an involuntary sale. The sale had been
forced by the Internal Revenue Service to obtain funds for the payment
of taxes from previous years, and the wife's 25,000 dollar bid was in
sharp contrast to the 135,000 dollar basis at which the husband had been
carrying the property. But the court of appeals affirmed the decision of
the Tax Court² and disallowed the 110,000 dollar deduction.

The broad terms of section 267 disallow any deduction claimed for
losses suffered in transactions between certain related taxpayers, gen-
erally family members.³ The provisions of this present section originated
in section 24(a)(6)(A) and (B) of the Revenue Act of 1934.⁴ Prior to
1934, the rule was that the deductibility of all sales, regardless of the
identity of the vendor and vendee, depended on the presence of a bona

¹ 400 F.2d 417 (5th Cir. 1968).
² James H. Merritt, Sr., 47 T.C. 519 (1967).
³ Section 267 provides:
(a) Deductions Disallowed.—No deduction shall be allowed—
(1) Losses.—In respect of loses 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...

INT. REV. CODE of 1954, § 267 (emphasis added).
fide sale as evidenced by the seller's divesting himself of title or control.\textsuperscript{5} Allegations that a sale was a bona fide one in cases involving transactions between related taxpayers were often difficult to overcome,\textsuperscript{6} and section 24(a) was enacted to counter widespread use of these transfers as a means of tax avoidance.\textsuperscript{7} Its provisions were held not applicable to bona fide transfers.\textsuperscript{8}

This history led the Supreme Court to conclude in the classic case of McWilliams v. Commissioner,\textsuperscript{9} relied on in Merritt, that section 267 precluded deduction of losses suffered by a taxpayer from sales of stock on the open market when the same number of shares were purchased by the same broker for the taxpayer's wife, and of losses suffered by the wife when the process was reversed.\textsuperscript{10} The Court stated:

The difficulty of determining the finality of an intrafamily transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of § 24(b) \textsuperscript{[now § 267].} It is clear, however, that this difficulty is one which arises out of the close relationship of the parties, and would be met whenever, by prearrangement, one spouse sells and another buys the same property at a common price, regardless of the mechanics of the transaction. . . .

Moreover, we think the evidentiary problem was not the only one which Congress intended to meet. Section 24(b) states an absolute prohibition—not a presumption—against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic in-

\textsuperscript{5} Criteria of "good faith" are discussed in John E. Zimmermann, 36 B.T.A. 279, 284-86 (1937). See also Note, Nondeductible Capital Losses and Bona Fide Sales under the Federal Income Tax, 49 YALE L.J. 75 (1939).


\textsuperscript{7} H.R. REP. No. 704, 73d Cong., 2d Sess. 23 (1934); S. REP. No. 588, 73d Cong., 2d Sess. 27 (1934). The bona fide sale standard still applies to transfers not covered by § 267. Treas. Reg. § 1.267(a)-1(c) (1958). See Jesse Johnson, 24 T.C. 107 (1955), aff'd, 233 F.2d 752 (4th Cir.), cert. denied, 352 U.S. 841 (1956); Mintz, Tax Disallowance of Loss on Sales between Related Companies or Individuals, 4 MIAMI L.Q. 277, 294-300 (1950).

\textsuperscript{8} Frank C. Engelhart, 30 T.C. 1013 (1958); Nathan Blum, 5 T.C. 702 (1945); W.A. Drake, Inc., 3 T.C. 33, aff'd, 145 F.2d 365 (10th Cir. 1944). See also Treas. Reg. § 1.267(a)-1(c) (1958).

\textsuperscript{9} See also Robert Boehm, 28 T.C. 407 (1957), aff'd per curiam, 255 F.2d 684 (2d Cir. 1958), where taxpayer's loss was disallowed when third parties who bought his securities shortly thereafter sold them to a corporation he controlled. Cf. Charles E. Cooney, P-H Tax. Ct. Mem. ¶ 42,589 (1942).
It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.\textsuperscript{11}

Inferior courts, in applying section 267 and \textit{McWilliams} to varied factual situations involving involuntary transfers, have reached different, and seemingly inconsistent, results. Courts have rationalized these results by stressing certain factors such as the lack of exceptions to the statute, the taxpayer’s ability (or lack of it) to determine the time of transfer, the formalities of title, and the facts surrounding the judicial sale.

For instance, the Tax Court in \textit{Thomas Zacek}\textsuperscript{12} looked to the literal language of the statute. The case involved a sheriff’s sale of real property. The purchasers, who were also the foreclosing mortgagees, had been cotenants of the parties (their brothers and sisters) claiming the deduction. The sale price covered only the mortgage, principal, interest, back taxes, and costs. Although these facts indicated that the sale was in good faith, the court reasoned that “the language chosen by Congress is so broad that it includes bona fide transactions, without regard to hardship in particular cases,”\textsuperscript{13} and disallowed any deduction for the loss.

In \textit{McCarty v. Cripe},\textsuperscript{14} however, the Seventh Circuit concluded that an involuntary sale was not one between persons or groups designated by section 267. The case involved a foreclosure sale of real property to satisfy liens for taxes and assessments for public improvements at a loss of 19,000 dollars. The property was bought after “spirited bidding” by a trustee for a corporation. But the former owner of the land owned over fifty per cent of the corporation’s stock, and hence the sale was arguably covered by section 267(b)(2). Nevertheless, the court held that a tax title had nothing to do with any previous title, and rejected an argument that \textit{McWilliams} looks to identity of economic interest. It concluded that the purpose of that decision was to “put an end to the right of taxpayers to choose, by intra-family transfers . . . their own time for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted.”\textsuperscript{15}

\begin{itemize}
  \item[12] 8 T.C. 1056 (1947).
  \item[13] \textit{Id.} at 1057.
  \item[14] 201 F.2d 679 (7th Cir. 1953).
\end{itemize}

The next paragraph of the latter decision, however, begins: “We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished.” 331 U.S. at 700.
The Fourth Circuit's decision in *McNeill v. Commissioner,*\(^16\) emphasized the taxpayer's lack of control over the authorities' disposition of his property. The case is even more difficult to distinguish from *Merritt.* Real estate, purchased by McNeill for 20,000 dollars, had been seized by county commissioners for taxes due, but when they were unable to find a purchaser, they offered to resell to McNeill for 750 dollars. McNeill arranged a purchase by Royal Village Corporation, which was owned by him and his family. The court reasoned that the 19,250 dollar loss was brought about not by the transfer to Royal Village, but by the seizure and sale two and one-half years earlier. "[T]he true nature of the transfer rather than the form" was controlling, and nothing was found to "warrant the inference that McNeill controlled the . . . authorities so that in effect the seizure and sale for taxes were his actions and not theirs. . ."\(^17\)

The Fifth Circuit in *Merritt* took issue with *McCarty* and *McNeill.* It challenged their assertion that any break in the string of ownership occurring when the taxing authority seizes the property has significance.\(^18\) The court pointed out that the Supreme Court in *McWilliams* had faced a situation where title had passed through an intermediate party (in fact, the identical property had not been the subject of both the sale and re-purchase) and had looked to substance showing the same economic interest had been retained. The court in *Merritt* also stated that while preventing taxpayers from choosing their own time to realize a benefit might have been one of Congress' goals, that alone could not explain the broad sweep of the statute. The court emphasized that continuity of control and identity of interest were the controlling factors under *McWilliams.*

Stock, especially stock in a close corporation as in *Merritt,* is particularly likely to be the subject of the kind of transaction that inspired section 267. It is less attractive to outside bidders and more amenable to family control, and its purchase by prearrangement at a judicial sale more likely. The statute, however, says nothing to justify treating stock any differently from other types of property. While the presence of "spirited bidding" arguably indicates good faith, or at least

\(^{16}\) 251 F.2d 863 (4th Cir.), cert. denied, 358 U.S. 825 (1958).

\(^{17}\) Id. at 865-66.

\(^{18}\) 400 F.2d at 420. But see United States v. Norton, 250 F.2d 902 (5th Cir. 1958), aff'd in part and rev'd in part, 144 F. Supp. 425 (W.D. La. 1956) (sale of stock by the son and an identical purchase by the mother twenty-eight days later, held, the passage of time signified a complete break in control, making it impossible that the sale was between son and mother).
a lack of collusion between seller and purchaser, it is difficult to see its relevance to a statute that purports to reject the good faith standard. Because such distinctions seem meaningless or inappropriate it is hard to avoid the conclusion, which the Merritt court reached, that Merritt is irreconcilable with McNeill, and probably McCarty.

The Fifth Circuit's refusal to treat involuntary sales differently from voluntary sales under section 267 can have a drastic affect on the tax liability of taxpayers in the Merritt situation. An important question will arise if Mrs. Merritt at some future time sells her stock to an outsider. In that case her sale, unlike her husband's, would mark the loss with finality. Since her bid was 25,000 dollars, however, that would presumably be her basis for tax purposes unless the same statute that denied her husband his loss makes some provision for her. Section 267(d) of the Code only provides:

(d) **AMOUNT OF GAIN WHERE LOSS PREVIOUSLY DISALLOWED—If—**

(1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a) (1) . . . then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. . . .

Hence, if the wife is able to obtain more than 135,000 dollars for the stock, only the excess over 135,000 dollars will be taxable. What will be the situation if the price she is able to obtain is between 25,000 dollars and 135,000 dollars? It might be argued that a transfer between persons having "an identity of economic interests" is no transfer at all in the eyes of the taxing authority, and thus her basis should be 135,000 dollars. The Senate report on the bill,20 the Income Tax Regulations,21 and commentators' opinions,22 however, reject this view. Therefore, if the second

---

19 INT. REV. CODE of 1954, § 267(d).
20 Any gain to the taxpayer on the disposition of the property will be recognized only to the extent that it exceeds the amount of the loss not previously allowable. This rule does not affect the basis of the property for determining gain, and consequently depreciation and other items which depend upon that basis are also unaffected.

21 Treas. Reg. § 1.267-1(c)1 (1958).
23 Herberich, Hall, Harter Agency, P-H Tax Ct. Mem. ¶ 44,146 (1944), held
sale is for 50,000 dollars, for example, the husband-wife "unit" has been deprived of 85,000 dollars (the original purchase price of 135,000 dollars minus the ultimate sale price of 50,000 dollars) in tax deductions merely because an intra-family transfer occurred, which was not only involuntary but, worse, forced by the Internal Revenue Service. If the second sale is for less than 25,000 dollars, 10,000 dollars for example, the wife's deduction apparently will be 15,000 dollars, the difference between the 25,000 dollars and the sale price.

Such a result is harsh when section 267 is applied to voluntary transfers, but when, as in Merritt, the rule is extended to those who were forced to part with their property, its application is severe indeed. There is little evidence that involuntary sales of any nature were in the contemplation of Congress when section 267(a)'s predecessors were being considered. However, there is also little evidence that Congress intended them to be excluded. Section 267(d) apparently was intended to keep the purchasing party's basis at the purchase figure, and again, apparently, no separate consideration was given to the forced sale situation. The question is obviously a difficult one. If the formal passing of title or the removal from taxpayer control is relied on to give relief in the forced sale context, taxpayers may be able to avoid taxes by making intra-family transfers through a third party. It is difficult, moreover, to determine just how far the ruling in McWilliams is binding on the lower courts in the related Merritt situation, or even how it applies.

It has been suggested that section 267 be amended to create a mere presumption of continued control, with the possibility of the taxpayer's proving good faith left open. It has been further recommended that a taxpayer be allowed to establish a "potential loss" after a section 267 transaction, based on the difference between the transferor's adjusted basis and the section 267 transfer price or the fair market value, whichever is smaller. This "potential loss" would be deductible if the property thereafter passes out of his sphere of economic control.

---

24 In McWilliams it was said: "[i]t is a fair inference . . . that Congress did not deem . . . [legally genuine intra-family transfers] to be appropriate occasions for the allowance of deductions." 331 U.S. at 699. If so, would not the transfer of the property out of the "unit" be a proper "occasion" for the allowance of the entire deduction?

The question of substituting a presumption for section 267's prohibition is not one for the courts. The fact that Congress has enacted 267(d) seems to imply that no other relief should be granted to intra-family transferors, especially if such transfer is willful. When a transfer within the economic "unit" has been *forced*, however, the equities of the situation, especially in the absence of a specific Congressional pronouncement, would suggest retention by that "unit" of the original basis.

**STEPHEN MASON THOMAS**

**Labor Law—The Legality of Co-ordinated Bargaining**

Co-ordinated or coalition bargaining is a new technique in the power struggle between labor and management. This approach to collective bargaining consists of forming a multi-union negotiating committee for the purpose of cooperation and communication among several unions that represent employees of a common employer. Through this process the cooperating unions hope to achieve common contract terms.\(^1\) Management has not welcomed this union practice. When co-ordinated union bargaining extends to the bargaining table, resistance by management has taken the form of refusing to negotiate with joint-union committees.

The legality of union insistence on management's negotiating with a union coalition was considered by the National Labor Relations Board in *General Electric Co.*\(^2\) In that case the union whose contract was to be negotiated insisted on including members of other unions on its negotiating committee. The Board held that by refusing to bargain with this committee, General Electric was guilty of unfair labor practices.

Eight of the unions\(^3\) with which G.E. had contracts were dissatisfied with a lack of progress in previous negotiations with that company and therefore formed the Committee on Collective Bargaining (CCB).\(^4\) The objective of the CCB was to gain the cooperation in collective bargaining of unions representing employees of a single employer in order to negotiate major economic items on a company-wide, national level. G.E.'s labor

---


\(^3\) These eight unions became dissatisfied with the lack of union progress under G.E.'s purported "whipsawing" tactics. Under this practice G.E. convinced the weaker unions to accept its contract offers and then used the acceptances to bring pressure on the stronger unions.

\(^4\) 69 L.R.R.M. at 1305.