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CASE-COMMENT

ARROWSMITH NEEDS A DOCTOR: SUGGESTIONS FOR A CONGRESSIONAL CURE

by

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On November 10, 1952, the United States Supreme Court decided the case of *Arrowsmith v. Commissioner.*[1] The problem involved was of general interest and application, and the final decision was long awaited. The writers agree with the holding of the Court, and with the reasoning involved. It does, however, give rise to a general class of inequities for which relief should be provided. The writers believe that this relief is up to Congress, and should be brought to the attention of the appropriate Congressional tax committees.

NATURE OF THE DECISION

In the *Arrowsmith* case the taxpayers, in 1937, liquidated and divided the proceeds of a corporation which they owned. Partial distributions were made in 1937, 1938, and 1939, and a final distribution was made in 1940. Taxpayers reported the profits obtained from this transaction as capital gain. In 1944, a judgment was rendered against the old corporation. Taxpayers, as transferees, paid the judgment. On their tax return they deducted the loss as an ordinary loss rather than as a capital loss. The Commissioner viewed the 1944 payment as part of the original liquidation transaction and required its classification as a capital loss, consistent with the treatment of the original transaction as a capital gain. The Supreme Court resolved the problem in favor of the Commissioner. Its position may be summed up in the following quotation:

> It is contended, however, that this payment which would have been a capital transaction in 1940 was transformed into an ordinary business transaction in 1944 because of the well-established principle that each taxable year is a separate unit for tax accounting purposes. *United States v. Lewis,* 340 U.S. 590; *North American Oil Co. v. Burnet,* 286 U.S. 417. But this principle is

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[1] 344 U. S. 6 (1952).

not breached by considering all the 1937-1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

As stated previously, the writers agree with the reasoning of the Court. In fact, in an article entitled "Not a Gain Again, Again and Again", published in Taxes—The Tax Magazine, in June 1952, by one of the present writers, the same reasoning was set forth. In that article the *Switlik*[2] case was criticized and the *Arrowsmith* case (also called the *Bauer* case) was urged as the correct decision and, in view of the conflict, it was anticipated "that the problem will eventually be referred to the United States Supreme Court for decision." Now it is decided, but the decision creates further disturbances.

IMPLICATIONS OF THE DECISION—INEQUITIES

Although the decision is correct in principle, the *Arrowsmith* rule will lead to inequities in a great variety of situations.

The first case involves the factual situation of the *Arrowsmith* case itself. Taxpayer reported and paid taxes on capital gains in 1938, 1939 and 1940. In 1944 it had to make a repayment which, for tax purposes, is regarded as a capital loss. Under present rules the taxpayer may apply that loss against capital gains in 1944, and carry any unused balance to be similarly applied for the next five years. Further, if taxpayer is an individual, he may also apply the capital loss against ordinary income to the extent of $1,000 a year for each of the six year period just described. However, what may he do where he has no capital gains during the six year period, and where the loss may be too large to be substantially satisfied at the rate of $1,000 a year for six years. For example, suppose that Arrowsmith reported a capital gain in the liquidation of $500,000. Further, suppose that in 1944 he was required to repay $100,000, and that he had no capital gains during the next six years or, perhaps, more capital losses. Under such circumstances he would have paid a capital gains tax on profits of $100,000 that he never really made.

In the *Arrowsmith* case the capital gain arose from liquidation which, for tax purposes, is treated under I. R. C. section 115 (c) as a sale of stock. Suppose, in fact, that the gain was from an actual sale of stock. For example, taxpayer is retiring from business and sells the entire capital stock of his company. He makes a profit of $500,000 and reports it for tax purposes as a long-term capital gain. In subsequent years he must repay, for one reason or another (e.g., fraud, misrepresentation, breach of warranty, etc.), $100,000 of the proceeds of the sale

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

of the stock. Since he then has a capital loss of $100,000, he is in the unhappy position of having no capital gains against which to take the deduction. Again he has lost the tax on $100,000. This very situation may have arisen in the case of *Duveen Brothers.*[3] The petitioner, in order to sell a large block of stock which was callable at $11 per share, agreed to pay purchasers of the stock the difference between the purchase price and the $11 redemption price. The stock was sold during the years 1943 and 1944 at prices in excess of the redemption price. The stock was called, and the petitioner, in 1945, paid the purchasers the amount guaranteed to them. The Court held that the 1945 payment was a long-term capital loss.

Since the taxpayer may not deduct the loss against the prior gain, he must hope for future gains to get the deduction. Thus he paid tax on profits that he didn't really make. The type of situations in which this inequity may arise are endless. They involve just a few variables. First, there must be a transaction from which a capital gain results.

The facts of the *Arrowsmith* and *Duveen*[4] cases are only illustrative. There may be a public issue by the insiders of a closely held corporation, or one stockholder may sell all or part of his interest to another, or any other facts which give rise to a capital gain. Second, circumstances must exist which give rise to a repayment in a future year, which repayment is a capital loss (per the doctrine of the *Arrowsmith* case). In addition to the situations previously discussed, there may be innumerable other cases leading to the same result. For example, the repayment may be occasioned by fraudulent misrepresentations involved in the sale, and subsequent suit and recovery thereon. This occurred in the cases of *Margery K. Megargel*[5] and *Harwick v. Commissioner.*[6] Or, the misrepresentations may exist in the absence of fraud, and yet require repayment. Or, there may have been a mistake which later requires the seller to reimburse the buyer. Third, the party who later sustains the capital loss must *not* be in a position to obtain a tax deduction or other benefit from the loss.

OTHER IMPLICATIONS OF THE DECISION

Not every situation involving the doctrine of the *Arrowsmith* case will result in harm or inequity. As a general rule, inequity results only when the three factors mentioned in the preceding paragraph are present. For example, if the original transaction resulted in a loss and the seller subsequently recovers additional funds, no harm is apt to result. Or, if the original transaction is a gain transaction and the seller subsequently

[3] *Duveen Brothers v. Commissioner,* 17 T. C. 124 (1951), *aff'd,* 197 F. 2d 118 (2d Cir. 1952), *cert. denied,* 244 U. S. 884 (1952).

[4] *Ibid.*

[5] 3 T. C. 238 (1944).

[6] 133 F. 2d 732 (8th Cir. 1943).

collects more monies, no harm is done. Or, if the original transaction is a loss transaction and the seller later must pay additional funds to the buyer, the seller has not been hurt. Finally, if the basic transaction is a gain deal, and seller later sustains a loss through repayment, there is still little harm to be done, if any, where the seller has capital gains in the year of loss or subsequent years which to offset the loss.

This article will not attempt to analyze the possible effects of the *Arrowsmith* reasoning on the tax law in general. In other words, as a general proposition it may be interesting to explore the extent to which a transaction in one year may be colored by facts which occurred in a prior or later year, particularly in view of the "annual accounting concept" which has become fairly well fixed in our tax law. In the *Arrowsmith* case the conclusion of the Court was regarded by it as consistent with the "annual accounting concept", but there may be situations where resort to circumstances of another year to determine the character of a transaction in the taxable year may violate or threaten the "annual accounting concept".

SUGGESTED METHODS OF RELIEF

There are several possible ways in which the aforementioned inequities may be relieved.

An obvious answer is to permit the taxpayer to carry back the loss to the year in which the profit from the basic transaction was reported, and obtain a refund. This is objectionable for several reasons. First, it will require a longer period of limitations for the right to file refund claims. This is inconsistent with the desired policy of closing tax returns once and for all, as manifested by the present period of limitations. Further, the Government would undoubtedly be given the right to find offsets against the refund. Thus a tax return could be opened many years after it would normally be closed by the statute of limitations. Another objection is that the legislation would be of a patchwork character, and would apply to only a narrow group of cases.

A second, and broader approach to the solution of this type of inequity, as well as of other inequities, is to permit the carryback, as well as the carryforward, of capital losses. The period of the carryback is, of course, to be decided by Congress. A simple approach might be to have the carryback for one year, as with net operating losses, since capital losses have the same five year carryforward as net operating losses. Thus the capital loss carryback and carryforward provisions would cover exactly the same period as do the net operating loss carryback and carryforward provisions. This may not solve the problem completely, since the gain transaction may have occurred more than one year prior to the year of the loss arising therefrom. However, it will be of some help and time will tell us whether a longer carryback period is in order.

This change will not merely relieve the problem discussed herein. It may also relieve a more generally disturbing situation. That is, the case of the market trader or other businessman who makes a large capital gain one year and then, to his surprise, loses it right back in later years. At that point he has paid taxes, and lost the use of tax dollars, on profits that he didn't really make. Further, if he doesn't continue his operations, his opportunity to utilize the later capital loss may be gone forever. To that extent he may, for tax reasons, be encouraged to continue a business operation against his better judgment, or to otherwise engage in speculative operations, since he is in a position to make a capital gain at no tax cost. As indicated previously, the one year capital loss carryback may not relieve all inequitable cases, but it should do a lot of good. Experience will teach us whether equity dictates extending the period of the carryback for more than one year.