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Federal Income Taxation--Net Losses

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to reduce his income from dividends from eighty thousand dollars in 1919 to three thousand five hundred in 1921. Smith went further. He borrowed about six hundred thousand dollars from the corporation, to provide which the corporation itself went in debt. The net result of these bookkeeping manipulations was to relieve Smith's payment of any income tax as well as to indicate on the corporation books that no money was available for distribution. From these facts the board decided that the intent required by the statute was present and the penalty was imposed.

But should the Government be restricted to such flagrant conduct before revenue can be collected? Should it be deprived of a considerable portion of its income simply because of inadequate statutory enactment? Each day the insufficiency of the current legislation becomes more apparent, and each day suggested remedies are tendered. In a recent article [7] it was proposed to remodel the statute according to that of an English law.[8] This proposition would substitute for "purpose" the fact of evasion. That is, regardless of purpose, if there is an undistributed surplus there is a presumption that it is taxable and the duty of establishing that it is necessary for the business would be on the corporation.

This is but one of the suggestions for the improvement of the law. That modification of some kind is necessary to accomplish justice must be admitted. The loss in revenue to the Government through the accumulation of the undivided profits of one company alone during the four years of 1922-1925 has been estimated at some 186 millions of dollars.[9] Are we to allow those trained in the technicalities of law to impede the accomplishment of equitable distribution of taxes?

WILLIAM H. SMITH.

FEDERAL INCOME TAXATION—NET LOSSES.—The Revenue Act of 1918 provided for determination of "net losses" by definition therein contained.[1] Later revenue acts [2] have incorporated net losses, with a variation, as a deduction. The object and effect of this provision is to provide for equalization of taxes in abnormal cases. Due to changes in economic conditions, such as the period of deflation experienced following the World War, unusual losses occur. In the English statute [3] this situation was provided for by

[7] TAX MAGAZINE (Nov .1932) at 415.
[8] INCOME TAX FINANCE ACT OF 1922, 12-13 Geo. V., c. 17, §21, SCH. 1.
[9] L. H. Parker, NAT. INCOME TAX MAGAZINE (April, 1927) at 125.

[1] REVENUE ACT OF 1918, §204 (a).
[2] REVENUE ACT OF 1921, §204; REVENUE ACT OF 1924, §206; REVENUE ACT OF 1926, §206; REVENUE ACT OF 1928, §206.
[3] See KLEIN, FEDERAL INCOME TAXATION (1929) 533.

using an average of income of three years as the base for the tax rather than the income of one year.

Net losses are of two kinds, net capital loss arising from sale of assets not subject to be inventoried held for a period of two years or longer [4] and net loss arising from trade or business regularly carried on.[5] In determining net losses arising from trade or business a trade or business may be defined as "that which occupies and engages the time, attention and labor of anyone for the purposes of livelihood, profit or improvement." [6] Much litigation has arisen over determination of whether or not a particular "net loss" has been incurred in course of trade or business regularly carried on. A *criteria* to determine whether or not a "net loss" has arisen from a trade or business has been set forth, as amount of capital invested, proportion of time devoted, membership in an exchange and number of transactions.[7]

Considering then the application of "net losses" to particular cases we find that in *Osterberg* v. *Commissioner*,[8] plaintiff was a capitalist and investor on large scales interested in various enterprises and was held to be entitled to establish "net loss." In *Crane* v. *Commissioner* [9] plaintiff was engaged in business of financing and supervising the operation of mining and mining equipment corporations and was held entitled to establish net loss arising from sale of stocks of such corporations and for loans to such corporations which had become worthless. In *Potter* v. *Commissioner* [10] plaintiff was engaged in organizing, incorporating, capitalizing and actively conducting and operating hotel properties and was permitted to establish a net loss arising from sale of stocks of such corporations and certain expenses connected therewith. In *Wyckoff* v. *Commissioner* [11] plaintiff was engaged among other things in promoting and was permitted to establish a net loss arising from loss on stock of company promoted by plaintiff. In *Anthony* v. *Commissioner* [12] plaintiff was engaged in managing, directing and financing corporations in which he was interested. Net loss established arose from loss on stock caused by liquidation of corporation. In *Averill* v. *Commissioner* [13] taxpayer was engaged in many businesses and operating each through a corporation instead of as a personal venture and was permitted to establish a "net loss."

In these cases the taxpayer claiming privilege of establishing "net loss" under statute was engaged in activities through or with

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[4] REVENUE ACT OF 1918, §204 (a) (1).
[5] *Ibid.* §204 (a) (2).
[6] HOLMES, FEDERAL TAXES (6th. ed. 1925) 969.
[7] MONTGOMERY, FEDERAL TAX HANDBOOK (1932) 398.
[8] 17 B. T. A. 738 (1930).
[9] *Ibid.* 720.
[10] 18 B. T. A. 549 (1931).
[11] 19 B. T. A. 263 (1931).
[12] 20 B. T. A. 5 (1931).
[13] *Ibid.* 1196.

corporations and devoted an appreciable amount of their time and energy to activities which they claim come within meaning of regular business or trade carried on as contemplated by the statute. The net loss occurred through one of a number of similar or partially similar transactions. In deciding the *Averill* case it was said "it is difficult to distinguish the decision in the *Washburn* case from the latter cases. We believe however that the principle upon which these latter cases were decided is sound, that they should be followed and that the *Averill* case falls within them." [14] The *Averill* case was not appealed and apparently the commissioner accepts that case as expressing the correct doctrine.[15]

In two cases recently appealed to the Supreme Court by the Commissioner of Internal Revenue the respective taxpayers were finally denied privilege of establishing a net loss. In *Dalton* v. *Bowers* [16] the taxpayer was an inventor who exploited his inventions through mediums of corporations. Loss claimed arose from loans made to one of these corporations and from loss arising through ownership of stock of said corporation. In *Burnet* v. *Clark* [17] the taxpayer was active in a company and several partnerships engaged in dredging operations and erection of levies. Loss claimed arose from endorsement of obligations of corporation in which taxpayer was interested and also through loss incurred in stocks of company held by taxpayer.

In these cases the question of whether or not the taxpayer was engaged in trade or business regularly carried on as contemplated by the statute would appear to be one of fact. But because of the diversity of decisions concerning cases whose facts are very similar it appears that the previous *criteria* for determining business regularly carried on must be enlarged. In *Dalton* v. *Bowers* [18] the Court said,

> "he was not regularly engaged in business of buying and selling stocks. He treated it as something apart from his ordinary affairs, accepted credits for salary as an officer, claimed losses to himself because of loans to it which had become worthless and caused it to make returns for taxation distinct from his own. Nothing indicates that he regarded the corporation as his agent with authority to contract or act in his behalf. Certainly under the general rule that for tax purposes a corporation is an entity distinct from its stockholders and the circumstances here are not so unusual as to create an exception."

[14] Washburn v. Commissioner, 51 F. (2d) 949, 955 (C. C. A. 8th, 1932), the Court quoting from decision of Board of Tax Appeals in Averill case, 20 B. T. A. 1196 (1931).

[15] *Ibid.*

[16] 286 U. S. —, 53 Sup. Ct. 205, 206 (1932).

[17] *Ibid.* Sup. Ct. 207, 208, rev'g, 59 F. (2d) 1031 (C. C. A., D. C., 1932).

[18] *Supra* note 16.

In *Burnet* v. *Clark*[19] the Court said:

> "The respondent was employed as an officer of the Corporation; the business which he conducted for it was not his own. There were other stockholders and in no sense can the corporation be regarded as his alter ego or agent. He treated it as a separate entity for taxation, made his own personal return and claimed losses through dealings with it. He was not regularly engaged in endorsing notes or buying and selling corporate securities. The unfortunate endorsements were no part of his ordinary business but occasional transactions intended to preserve the value of his investment in capital shares.
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> "A corporation and its stockholders are generally to be treated as separate entities. Only under exceptional circumstances—not present here—can the differences be disregarded."

Therefore it appears that where corporations are used to conduct a business the person claiming net loss through loans made to such corporation or through loss of value of stock must not be an agent of the corporation or an officer therein. In the *Washburn* case the taxpayer was not entitled to any reimbursements from the corporation except expenses actually incurred in connection with the management of the corporations.

ALBERT E. ANDREW.

INCOME TAXATION—CORPORATE BONDS DISTRIBUTED AS DIVIDENDS REPURCHASED AT LESS THAN PAR.—In 1914 the taxpayer, a New York corporation, approved an appraisal of its assets which added $3,000,000 to its surplus account. It then declared a dividend payable in bonds, and issued and distributed among its stockholders its own debenture bonds of a face value of $2,000,000. During the taxable years 1926 and 1927, some of these unmatured bonds were purchased by the corporation at less than their face value. The bonds so purchased were cancelled, and the difference between the purchase price and the face value was credited to surplus. The Board of Tax Appeals ruled that the corporation did not realize a taxable gain in the amount of such difference in the years when the bonds were purchased and retired On appeal to the Supreme Court the respondent relied on *United States* v. *Kirby Lumber Co.*,[1]

[19] *Supra* note 17.

[1] 284 U. S. 1, 52 Sup. Ct. 4 (1931); (1932) 6 ST. JOHN'S L. REV. 415. (A corporation purchased and retired some of its own bonds for less than their par value, which it had received for them when issued. *Held,* the corporation realized within the year an accession to income.)