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CAPITAL GAINS AND LOSSES
SUBSEQUENT TO CORPORATE LIQUIDATION

E. McGRUDER FARIS, JR.*

A distinct set of tax problems arise upon the dissolution of a corporation. First, the distribution of the corporate assets in the form of liquidating dividends presents the question whether, by nature, they are true dividends at all or merely a return of invested capital. To the extent that the distribution represents a return of capital, it is non-taxable, not being "income" within the meaning of the tax statutes.¹ Since it rarely happens that a shareholder receives upon distribution the exact amount that he has invested, at nearly every corporate dissolution a second problem presents itself of how to treat his gain or loss—as an ordinary gain or loss, or as a capital gain or loss.

A capital gain or loss results from the sale or exchange of a capital asset, which is defined in general as any property held by the taxpayer, whether or not connected with his trade or business, with certain enumerated exceptions.² The sale or exchange of a capital asset held for more than six months results in a long-term capital gain or loss; if held for six months or less there is a short-term capital gain or loss.³ Section 115 (c) of the Internal Revenue Code classifies a distribution in complete liquidation as a capital transaction, producing capital gain or loss.⁴

The tax advantage or disadvantage of having a gain or loss classified as a capital one is apparent when the method of computing the amount to be included on the individual's return is observed. Several steps are required for such computation. All short-term capital gains and losses are taken together to determine *net* short-term capital gain or loss. All long-term capital gains and losses are taken together to determine *net* long-term capital gain or loss. Then the net of the long and short term transactions are taken together to determine net gain or loss from the sale or exchange of all capital assets.⁵

Net *gain* so computed is included as gross income for the year it

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¹Henderson, *Introduction To Income Taxation* (1943) § 48.

²Int. Rev. Code § 117 (a).

³Int. Rev. Code § 117 (b).

⁴Int. Rev. Code § 115 (c). "Amounts distributed in complete liquidation of a corporation shall be treated in full payment in exchange for stock...."

⁵Int. Rev. Code § 117 (a).

is incurred. However, certain tax advantages are obtained under the Code. For tax years beginning before October 20, 1951, only 50 per cent of long-term capital gains and losses were taken into account in determining long-term gain or loss.⁶ A tax advantage resulted when dealing with long-term capital gains, because only 50 per cent of them were included. A disadvantage resulted when dealing with long-term capital losses, because only 50 per cent of them were deductible. Short-term transactions were taken into account 100 per cent.

By the Revenue Act of 1951, this law was changed so that for tax years beginning after October 20, 1951, all capital gains and losses are taken into account 100 per cent. However, relief is now granted by allowing a deduction from gross income equal to 50 per cent of the *excess of net* long-term capital gain over net short-term loss.⁷ In some cases the new is more advantageous to the taxpayer, in others less advantageous, and in still others the result is the same under both the old and new law.⁸

⁶Int. Rev. Code § 117 (b).

⁷Int. Rev. Code § 23 (ee), 117 (b).

⁸Under the old law, \$1 of short-term capital loss offset \$2 of long-term capital gain, as only 50 percent of long-term gains were taken into account. Under the new law, a short-term capital loss will offset a long-term capital gain dollar for dollar, as 100 per cent of long-term capital gain is taken into account. Under the old law, \$1 of short-term capital gain offset \$2 of long-term capital loss, while under the new law, a short-term capital gain offsets a long-term capital loss dollar for dollar.

EXAMPLE ONE

	OLD LAW	NEW LAW
Long-term gain....\$10,000	\$5,000 (50% recognized)	\$10,000 (100% recognized)
Short-term loss.... 5,000	5,000 (100% recognized)	5,000 (100% recognized)
Net gain from capital transactions	\$0	\$ 5,000
Deduction from gross income—(50% of excess of net long-term gain over short-term loss)	0	2,500
Capital gains subject to tax	\$0	\$2,500

EXAMPLE TWO

	OLD LAW	NEW LAW
Short-term gain ..\$10,000	\$10,000 (100% recognized)	\$10,000 (100% recognized)
Long-term loss .. 10,000	5,000 (50% recognized)	10,000 (100% recognized)
Net Gain from capital transactions	\$5,000	\$0
Deduction from gross income. 0	0	0
Capital gains subject to tax	\$ 5,000	\$0

When dealing with a net capital gain, other advantages are found in the alternative method of tax liability computation, which in effect places a maximum rate of 26 per cent on long-term capital gains,⁹ in contrast with individual rates up to 88 per cent of net income. From the above it can be seen that in many instances a capital gain is preferable to an ordinary gain.

Net loss from the sale or exchange of capital assets can be used to offset an individual's ordinary income, but only to the extent of \$1,000 in the year of loss.¹⁰ However, under Code Section 117 (e) (1), an individual sustaining a net capital loss may carry over such loss to each of the five succeeding years as a short-term capital loss. Since the loss carry-over is treated as a short-term loss, it can be used only to offset capital gains, plus \$1,000 of ordinary income in each of the later years.

For example, if T had sustained a net capital loss of \$20,000 in 1952, only \$1,000 could be used to offset his ordinary income for that year. If in 1953, T has a capital gain of \$2,000, the \$19,00 loss balance from the previous year can be used to offset this gain, and another \$1,000 used to offset ordinary income for 1953. If during the next four succeeding years T has no capital gains against which to apply his loss carry-over, the maximum \$1,000 deduction against ordinary income would be the only one to which he is entitled. The tax disadvantage of having a loss classified as a capital one is apparent from this example, where only \$8,000 in deductions were allowed over a six year period (\$1,000 in each year except 1953 when \$3,000 was allowed), although the economic loss to the taxpayer was \$20,000.

The tax treatment of other types of losses is too varied to discuss here. Suffice it to say that other losses can usually be used to offset ordinary income in the year of loss, with no \$1,000 limitation. Special carry-over provisions apply in certain instances.¹¹

Subsequent Repayments by Distributee-Shareholders

The problem of classifying a transaction as an ordinary or capital one takes on added complications when in a year subsequent to what purports to be a final liquidation it is discovered that the corporation

⁹The 26 per cent rate is applicable for the calendar year 1952 and for other tax years beginning after October 31, 1951, and before November 1, 1953. The method of computing the alternative tax is effective for taxable years beginning on or after October 20, 1951. Sec. 322 (d), Revenue Act of 1951.

¹⁰Int. Rev. Code § 117 (d) (2).

¹¹Int. Rev. Code § 122 (b) (1, 2).

has hidden assets or liabilities. It is not unusual to discover at a later time that the corporation has hidden assets which require distribution, or hidden liabilities which must be satisfied. An obvious example is the situation in which after the apparently final distribution the corporation becomes entitled to a tax refund, or is obliged to pay an additional tax assessment. Under general corporation law doctrines, a distributee-shareholder is entitled to his pro rata share of any assets collected by the corporation after liquidation and in turn is liable for the debts of the corporation.¹² While Section 115 (c) treats distributions in complete liquidation as capital transactions, no Code provision prescribes how the shareholder should treat his subsequent payments in discharge of his transferee liability for the corporation's debts. The Commissioner's position in regard to such payments is that they are capital losses, while the taxpayer's position has usually been that the later payments are ordinary losses, not subject to the limitations found in the case of capital losses.

At one time the difference in the two positions was less important than it is today, as the taxpayer could have had his returns for previous years reopened and adjusted,¹³ provided the statute of limitations had not run.¹⁴ Accordingly, in the case of a distributee later paying a liability of the dissolved corporation, the taxpayer-distributee could reopen his return which had reported the receipt of the liquidating dividend, adjust downward the original capital transactions to reflect the loss from the subsequent repayment, and collect a refund. This practice of treating stockholder-distributee repayment as a reduction of the liquidating dividend originally received was repudiated by dictum of the Supreme Court in 1932. In the *North American Oil* case¹⁵ the Court declared: "If a taxpayer receives earnings *under a*

¹²The liability of stockholder-distributees is joint and several, each being liable to the full extent of amounts received by him. *Phillips v. Commissioner*, 283 U. S. 589, 51 S. Ct. 608, 75 L. ed. 1289 (1930).

¹³E.g., *E. F. Cremin*, 5 B. T. A. 1164 (1927); *O. B. Baker*, 3 B. T. A. 1180 (1926).

¹⁴Reg. 111, Sec. 29.322-7. Unless a claim for creditor refund of an overpayment is filed within three years from the time the return was filed by the taxpayer, or within two years from the time the tax was paid, the commissioner is prohibited from allowing or making a credit or refund.

¹⁵*North American Oil Co. v. Burnett*, 286 U. S. 417, 52 S. Ct. 613, 76 L. ed. 1197 (1932). The taxpayer had received money in 1917 as the result of winning a dispute with the government. The government took an immediate appeal, but settled with the taxpayer in 1922. The Supreme Court held the income was realized in 1917, not in 1922, the year in which the litigation with the government was finally terminated.

claim of right and without restriction as to its disposition, he has received income which he is required to return [on his tax form], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged to restore its equivalent."¹⁶

Since this decision the courts and the Commissioner have considered that the stockholder-distributee payment of a corporation liability no longer could be used to reduce the liquidating dividend. It is suggested by a well considered note in the Yale Law Journal¹⁷ that the stockholder-distributee liability payments might well be specifically excepted from the rule barring reopening of prior returns, since it is the only significant situation in which the original "claim of right" receipt is a capital event.

The taxpayer's position that the subsequent payment should be treated as an ordinary loss was upheld in the 1950 decision of *Commissioner v. Switlik*.¹⁸ In that case the shareholders of a corporation received final distribution in complete liquidation in 1941, each reporting his profit on the distribution as long-term capital gain. In 1942 the Commissioner assessed tax deficiencies against the corporation for the years 1940 and 1941. There being no corporate funds with which to pay the deficiencies, the shareholder-distributees themselves paid the assessments in 1944. The Court of Appeals for the Third Circuit upheld the Tax Court's decision that, as the 1944 payments did not represent losses from the sale or exchange of capital assets, they were fully deductible in that year as ordinary losses.¹⁹ The holding is based on the well-established annual accounting concept that each year is a separate unit for tax purposes.²⁰

Doubt was cast upon the *Switlik* case rule last year when the Commissioner's position that a subsequent payment by a shareholder-distributee is a capital loss was upheld in *Commissioner v. Bauer*.²¹ In that case the two shareholder-officers of a corporation received liquidating dividends pursuant to a plan of total liquidation during the years 1937 through 1940, and reported their profits as long-term capital gains in those years. At the time of the final liquidating dividend in 1940, a tort suit was pending against the corporation and

¹⁶286 U. S. 417, 424, 52 S. Ct. 613, 615, 77 L. ed. 1197, 1200 (1932) [italics supplied].

¹⁷Note (1952) 61 Yale L. J. 1081, 1089.

¹⁸184 F. (2d) 299 (C. A. 3d, 1950).

¹⁹The taxpayers had claimed as deductions the losses they incurred as "losses incurred in a transaction entered into for profit." Int. Rev. Code 23 (e) (2).

²⁰Henderson, Introduction To Income Taxation (1934) § 3.

²¹193 F. (2d) 734 (C. A. 2d, 1942).

against one of the shareholder-officers, Frederick R. Bauer, individually. In 1944, the two taxpayers were required to, and did, pay the judgment against the corporation, of whose assets they were transferees. The Court of Appeals for the Second Circuit, reversing the Tax Court's decision based on the *Switlik* case, held that since the liabilities which the taxpayers incurred under the judgment would not have existed except for the distribution, the two transactions should be tied together.²² Therefore, the 1944 payments on the judgment were treated as capital losses, even though one of the taxpayers incurred liability under the judgment as an officer as well as a distributee. This adoption of the Commissioner's position is to the disadvantage of the taxpayer, for under the law before October 20, 1951 discussed earlier, only 50 per cent of the long term loss was deductible.²³ Even under the law today, which takes into account 100 per cent of all losses, the limitation that a capital loss can be used only to offset capital gains, plus \$1,000 of ordinary income, would be to the individual's detriment in many cases.²⁴

This conflict between the Courts of the Second and Third Circuits in cases involving similar fact situations caused the Supreme Court of the United States to grant certiorari in the *Bauer* case, now under the title of *Arrowsmith v. Commissioner*.²⁵ Adopting the view of the court below that the two transactions should be treated as one, the Supreme Court, speaking through Justice Black declared: "The losses here fall squarely within the definition of 'capital losses' contained in these sections [Int. Rev. Code Section 23, Section 115]. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains received during the year."²⁶

Continuing, the Court observed: "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

²²Commissioner v. Bauer, 193 F. (2d) 734, 735 (C. A. 2d, 1952).

²³Int. Rev. Code § 117 (b).

²⁴Int. Rev. Code § 122 (d) (2).

²⁵344 U. S. 6, 73 S. Ct. 71, 97 L. ed. 19 (1952).

²⁶73 S. Ct. 71, 73, 97 L. ed. 19, 21 (1952).

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. Burnett*, 286 U. S. 417. But this principle is not breached by considering all the 1937-1944 liquidation events *in order 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."²⁷

In view of the *Arrowsmith* decision, taxpayer-distributees will ask whether they can do anything to minimize their income taxes. Where it appears that subsequent to the termination of corporate activity, liability may still arise, tax advantages could possibly be obtained by leaving with the corporation sufficient funds to cover such contingent liability. There would be in effect a partial final distribution with the reservation of a contingency fund. Any future payment of corporate liability would then be made directly from this fund. By this means, the distributee would avoid being taxed on the part of the liquidating dividends which he received only to pay back later. Such a device could have prevented the difficulty in the *Bauer* case, where the suit resulting in ultimate liability was in litigation at the time of the final liquidating dividend. For individuals on a cash accounting basis, this retention would have an added advantage even if the fund were not actually used, as its distribution in a later year would allow the taxpayer to spread his gains over more than one year, thus taking advantage of lower surtax brackets.

There are three capacities in which a shareholder of a corporation may be liable directly or indirectly for the debts of the corporation. First, the shareholder indirectly pays when the corporation itself satisfies liability, as would be the case where a reserve fund is retained. Second, the shareholder may be liable in his capacity as distributee of the corporate assets. Third, he may be individually liable as an officer or agent of the corporation. The last liability would arise as the result of a tort action against the individual, in which case the corporation would also be subject to suit under the doctrine of respondeat superior. The capacity in which one is sued or pays is apparently an important factor in determining the classification of the subsequent payment as a capital or an ordinary loss.

The decision in the *Arrowsmith* case appears to be limited to the situation in which the shareholder makes payment in his capacity as

²⁷73 S. Ct. 71, 73, 97 L. ed. 19, 21 (1952) [italics supplied].

distributee. The language of the Court is: "While there was liability against him [Bauer] in both capacities [as an officer and as a transferee], the individual judgment against him was for the whole amount. His payment of only half the judgment indicates that both he and the other transferee were paying in their capacities as such. We see no reason for giving Bauer a preferred tax position."²⁸ The implication is that by paying in a personal capacity, rather than as a distributee, the transaction would be classified as an ordinary loss with the usual tax advantages. As an illustration, consider a small corporation where the officers are the only stockholders. After complete liquidation, a tort suit is threatened, and the tort is one for which the officers individually, as well as the corporation, are liable. A tax advantage could apparently be obtained by requesting the plaintiff to sue the officers in that capacity, rather than as distributees. Possibly a promise to place funds in the hands of the court pending the outcome of the litigation would be inducement even to the most hostile plaintiffs. Under these circumstances the same persons would be paying the same amount, but if the distributees made payment in the capacity of individual officers, the loss would be an ordinary one, whereas if they paid as distributee-shareholders, the loss would be considered a capital one.

Subsequent Receipts by Distributee-Shareholders

The *Arrowsmith* decision that subsequent payments by distributee-shareholders in satisfaction of corporate debts should be treated as capital losses presumably strengthens the rule that if property received in exchange for stock has no market value the transaction is not closed and later receipts or collections can result in capital gains.²⁹

It may, however, weaken the decision in *Osenbach v. Commis-*

²⁸73 S. Ct. 71, 73, 97 L. ed. 19, 21 (1952).

²⁹*Westover v. Smith*, 173 F. (2d) 90 (C.A. 9th, 1949). Where the owner of all the stock of a corporation, on the dissolution of the corporation, received an assignment of a valuable royalty contract, the fair market value of which could not be ascertained, royalty payments thereunder in later years were treated as payments in exchange for stock and taxed as capital gain rather than as ordinary income. The decision is based on the rule that where the assets received in exchange for stock have no market value at that time, the transaction remains open until all payments are completed. *Burnet v. Logan*, 283 U. S. 404, 51 S. Ct. 550, 75 L. ed. 1143 (1930).

sioner³⁰ that collections on notes received by taxpayers in a Code Section 112 (B) (7)³¹ liquidation are ordinary income. That ruling was based on the ground that the distribution in kind in exchange for their stock was a closed transaction. Under the *Arrowsmith* case it is possible that a court might find that though there was no subsequent sale or exchange of the capital assets so received, yet the earlier liquidation distribution could be looked to *in order to classify the nature of the later gain*, as a capital gain.

The *Arrowsmith* decision will be of further significance when subsequent to apparent final liquidation it is discovered that the corporation has further assets to which the shareholders are entitled. If under appropriate state law the corporation is still in existence for the purpose of collecting these assets, no particular problem will arise.³² In such case the corporation will collect the assets, and distribute them to the shareholders in further liquidation, a capital transaction.

If under state law, the shareholders themselves can bring the action to collect the assets, a more complicated problem may arise, for then the taxpayer would again be presented the question of whether his recovery is a capital gain or an ordinary gain. Such a possibility is foreseen in Justice Jackson's dissent in *Arrowsmith*. "Suppose that subsequent to liquidation it is found that a corporation has undisclosed claims instead of liabilities, and that under applicable state law they may be prosecuted for the benefit of the stockholders. The logic of the Court's decision here, if adhered to, would result in a lesser return to the government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss [transaction] if the shoe were on the other foot?"³³

³⁰198 F. (2d) 235 (C. A. 4th, 1952) affirming 17 T. C. 797. Taxpayer, as a stockholder in a corporation liquidation under the provisions of Code § 112 (b) (7), received in kind, certain loans, discounts, mortgages and other claims. Collections were later made thereon. *Held*, the amounts received on collections were ordinary income and not capital gain, on the ground that the subsequent dealings with the loans, etc., did not involve sale or exchange, but collection, and hence could not qualify as capital transactions, even though the assets had originated in the closed, completed liquidation.

³¹Code § 112 (b) (7) provides relief in the form of an election as to the recognition of gain in certain corporate liquidations occurring within one calendar month in 1951 or 1952. See Eaton, Liquidation Under Section 112 (b) (7), (1952), 38 Va. L. Rev. 1.

³²When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in place of the corporation for such purposes.

³³73 S. Ct. 71, 74, 97 L. ed. 19, 22 (1952).

This writer has been able to find no cases directly on the point. However, it is doubtful if mere "prosecution for the benefit of the stockholders" by the corporation would be sufficient to raise a doubt of whether the recovery is a capital or ordinary gain. If the funds pass through the hands of the corporation to the shareholders, it would appear that this would be a corporate distribution resulting in capital gain to the shareholder. If, however, the recovery is made directly by the shareholder for his own benefit, then the nature of the transaction is doubtful. Applying the *Arrowsmith* decision, the gain would be a capital gain.

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