Federal Taxation: Family Sales

James Parmelee

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Federal Taxation—Family Sales—A taxpayer managed his wife’s independent estate as well as his own, and ordered his broker to sell certain stocks of one of the estates, and to buy for the account of the other the same number of shares of the same stock. Held: that the losses sustained on the sale were not deductible. Brooks B. McWilliams v. Commissioner, 67 S. Ct. 1477 (1947).

This conclusion was reached even though the identity of the persons buying or selling the stocks was unknown, and the buying spouse invariably received certificates different from those which the other had sold. The Supreme Court reasoned that such sales were sales made “indirectly” between members of a family within the meaning of Sec. 24(b), Internal Revenue Code, which prohibits deductions for losses from “sales or exchanges of property, directly or indirectly, between members of a family, and between certain other closely related individuals and corporations.” The court by this decision, in effect, overrules Ickelheimer v. Commissioner¹, thus adopting the dissenting opinion of Judge L. Hand in that case. It was held there, that Sec. 24 (b) was not applicable where the taxpayer’s husband sold her bonds at a loss through a brokerage firm of which he was a member, and the next day repurchased the same amount of bonds for a trust of which he was trustee, and the taxpayer was life beneficiary and donee of a special power of appointment.

The Supreme Court based its opinion mainly upon the legislative history back of the enactment of Sec. 24 (b). The Congressional Committees, in reporting the provision enacted in 1934, merely stated that “the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax,” and that these provisions were proposed to “deny losses to be taken in the case of such sales” and “to close this loophole of tax avoidance.”² Similar language was used in reporting the 1937 provisions. Chairman Doughton of the Ways and Means Committee, in explaining the 1937 provisions to the House spoke of “the artificial taking and establishment of losses where property was shuffled back and forth between various legal entities owned by the same person or persons,” and stated that “these transactions seem to occur at moments remarkably opportune to the real party in interest an reducing his tax liability but, at the same time allowing him to keep substantial control of the assets being traded or exchanged.”³ The court concluded that Congress, with such a purpose in mind could not have intended to include within the scope of Sec. 24 (b) only simple

¹ 45 B.T.A. 478 (1941) ; affirmed, 132 Fed. (2d) 660 (1943).
³ 81 Cong. Rec. 9019 (1937).
transfers made directly or through a dummy, or to exclude transfers of securities effected through the medium of the Stock Exchange, unless it wanted to leave a loophole almost as large as the one it set out to close.

Congress, in enacting the present statutes, has departed from the pre-1934 rule, which applied to all sales regardless of the relationship of seller and buyer, and made the deductibility of the resultant loss turn on the "good faith" of the sale, i.e., whether the seller actually parted with title and control.\textsuperscript{4} The Statute also has been interpreted recently to include involuntary sales as well.\textsuperscript{5} The Tax Court has disallowed a loss to a taxpayer who was a part owner of a farm mortgaged to his brother. The mortgage was foreclosed and the farm was sold at a sheriff's sale where it was bought by the mortgagee-brother. The taxpayer sustained a loss, but the court held that the language used by Congress in Sec. 24 (b) is so broad that it covers involuntary sales as well as bona fide transactions, without regard to hardship in specific cases. There were three dissenting judges, however, and whether the Supreme Court will go as far as to include bona fide involuntary sales, remains to be determined upon appeal. Upon examination of the statute, which states, "In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly ...\textsuperscript{6}" it appears that a strict interpretation can do no more than uphold the Tax Court decision. While it is true that hardships may be worked in specific cases, it will obviate the necessity of the court's resorting again to the "good faith" rule.

Another interesting aspect of the provision and its present interpretation is its relationship to the "wash sales" provisions.\textsuperscript{7} Under those provisions a taxpayer is assured of the right to deduct losses incurred on a sale of securities, even though he himself buys similar securities thirty-one days later. Certainly it would seem that he should not be precluded from claiming a similar loss if the taxpayer's spouse, instead of the taxpayer, makes the purchase under the same circumstances. Such a suggestion was noted in the McWilliams case but not considered since the problem did not exist under the facts of that case. It does appear to be an apt subject for future legislation before such a situation in fact does arise.

At least one more phase to be considered is the case of a taxpayer who is blessed with cooperative "in-laws." The Statute refers only

\textsuperscript{4} Com'r v. Hale, 67 F(2d) 561 (1933); Zimmerman v. Com'r, 36 B.T.A. 279 (1937) reversed on other grounds, 100 F(2d) 1023 (1939); Uihlein v. Com'r, 30 B.T.A. 399 (1934), affirmed, 82 F(2d) 944 (1936).
\textsuperscript{5} Thomas Zacek v. Com'r, 8 T.C. 1056 (1947).
\textsuperscript{6} Sec. 24 (b) (1), Internal Revenue Code.
\textsuperscript{7} Sec. 118, Internal Revenue Code—Loss from wash sales of stock or securities.
to sales and exchanges between members of a family as defined in Sec. 24 (b) (2) (D)\(^8\). There are many friendly "in-laws" (comic strips to the contrary, notwithstanding), who would not be covered by this provision. Certainly, Congress in its efforts to close a tax-avoidance loophole should not hesitate to include them as members of a family.

—JAMES PARMELEE

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\(^8\) Section 24 (b) (2) (D) defines the family of an individual to include "only brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants: . . ."