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Commissioner Vs. Wheeler

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Court : US Supreme Court

Decided On : Mar-26-1945

Appeal No. : 324 U.S. 542

Appellant : Commissioner

Respondent : Wheeler

Judgement :

Commissioner v. Wheeler - 324 U.S. 542 (1945)
U.S. Supreme Court Commissioner v. Wheeler, 324 U.S. 542 (1945)

Commissioner v. Wheeler

Nos. 510 and 511

Argued February 26, 1945

Decided March 26, 1945

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APPEALS FROM THE SUPREME COURT OF CALIFORNIA

SYLLABUS

Article 115-3 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, requires that, for computing under 112(b)(7)(E) the amount of "earnings and profits" distributed by a corporation as liquidating dividends with respect to securities which the corporation had acquired by tax-free exchanges for its own stock and had later sold, the basis be the transferor's cost, rather than the value of the securities at the time of their acquisition by the corporation.

HELD

1. The regulation was reasonable, and a valid exercise of the rulemaking power. P. 324 U. S. 546 .

2. Though the Tax Court relied on 501 of the Second Revenue Act of 1940, it is unnecessary here to determine the constitutionality of applying that section retroactively. P. 324 U. S. 547 .

143 F.2d 162 reversed.

Certiorari, 323 U.S. 694, to review the reversal of a decision of the Tax Court, 1 T.C. 640, which sustained the Commissioner's determination of deficiencies in income tax.

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MR. JUSTICE JACKSON delivered the opinion of the Court.

The Circuit Court of Appeals for the Ninth Circuit has held Section 501(a) of the Second Revenue Act of 1940 to be unconstitutional. [Footnote 1] This, of course, called for grant of certiorari. [Footnote 2]

Since our problem is not computation of a tax, the facts relevant to the issues in the five cases, consolidated on appeal may be shortly stated. In 1925, John H. Wheeler and his wife, Frances, organized under the laws of California the John H. Wheeler Company. Then and thereafter, they transferred an assortment of securities to it in exchange for shares of its common stock. The securities had cost

them $304,683.49, and, at transfer, had a fair market value of $491,800. In exchange, the Wheelers received 4,918 shares with a par value of $100 each. No gain by them was recognized for income tax purposes by reason of the exchange. *Cf.* Internal Revenue Code, 112(b)(5).

For purposes of determining its income tax liability on subsequent disposition of the securities, the corporation was obliged to and did use as a cost base the cost of the securities to the transferors, $304,684.49. *Cf.* Internal Revenue Code, 113(a)(8). But, for its corporate accounting, the corporation set up a cost of $491,800, market value at the

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time of acquisition in exchange for common stock of equal par value. The whole question in this case is which of these bases is to be used to compute, pursuant to 112(b)(7)(E) of the Revenue Act of 1938, 52 Stat. 447, 488, the amount of "earnings and profits" distributed as liquidating dividends. The Act in 1938, to induce corporate liquidations, permitted a qualified stockholder to elect postponement of a portion of the gain realized on a December, 1938, liquidation, and to be taxed, as for a dividend, on "so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation. . . ." If the market value basis is used for the securities acquired from the Wheelers and later sold, the operations of the Company showed a deficit on November 30, 1938, when the books were closed. If the "cost to transferors" basis is used, "earnings and profits" were distributed to respondents, the stockholders, in the amount of $132,813.48, as computed by the Commissioner. [Footnote 3]

After considering the applicability of 112(b)(7), the stockholders duly dissolved the corporation and distributed its assets during December, 1938. They elected to be taxed on the gains on their shares pursuant to 112(b)(7), and they reported, of course, according to the higher or market value basis for the securities acquired and disposed of by the Company. The Commissioner asserted a deficiency based on the lower cost to the transferors. In explaining his determination, he relied on 501(a) of the Second Revenue Act of 1940, 54 Stat. 974, 1004, which provides

that earnings and profits on the sale or other disposition of property shall be determined by using the adjusted basis for determining gains and by recognizing such gains to the extent that they are recognized for computing net income, and on 501(c), which makes the provisions of 501(a) applicable to prior years.

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The Tax Court sustained the Commissioner. [Footnote 4] It held 501(a) of the Act of 1940 a "complete answer" to taxpayers' contention, and it overruled their claim that, if the section was applicable to increase their 1938 liability, it was retroactive in contravention of the Fifth Amendment to the Constitution. The Circuit Court of Appeals agreed that the section was applicable, but held that such retroactivity rendered it unconstitutional.

Although the term "earnings and profits" has long been in the revenue acts in connection with the definition of dividends, it has never been defined by the statutes [Footnote 5] (except insofar as 501(a) of the Second Act of 1940 has now done so). But, under the Revenue Act of 1934 and succeeding acts, the Commissioner dealt by regulation with that portion of the problem of definition relevant here. Article 115-3 of Treasury Regulations 101, promulgated under the 1938 Act, provided in part as follows;

"Gains and losses within the purview of Section 112 or corresponding provision of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. [Footnote 6]"

This regulation, if valid, disposes of the controversy, for, when the corporation sold its securities acquired from the Wheelers, it realized gain, based on transferor's cost, which was fully recognized under 112.

The only reason to doubt the validity of the regulation is found in certain decisions of the Board of Tax Appeals and lower courts mentioned in the Tax Court's opinion. Despite these adverse decisions, however, the Commissioner

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persisted in applying the regulation. The question was never reviewed here. Before it was finally judicially considered, Congress enacted 501 of the Second Revenue Act of 1940, as the committee reports show, [Footnote 7] to "clarify the law" by enacting the substance of the regulation. But, if the regulation itself was valid and effective, the clarifying amendment of 1940 added nothing to the liability of these taxpayers, and even though the Tax Court relied on it, rather than on the regulation, no question of retroactivity is presented.

We think the regulation is reasonable, and a valid exercise of the rulemaking power. The taxpayers are insisting on using as a base for tax purposes a figure that, in itself, had no relation to taxation. It was no doubt permissible, and perhaps the correct accounting for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either. [Footnote 8] Congress has determined that, in certain types of transaction, the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability, but shall be taken account of later. 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. *Compare Commissioner v. Sansome,* 60 F.2d 931, *and see* Sen.Rep. No. 2156, 74th Cong., 2d Sess., p. 19; H.R.Rep. No. 2894, 76th Cong., 3d Sess., p. 41. Indeed, Congress appears to have provided for this result in the statute

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itself, 111(c) of the 1938 Act, which declares:

"In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this title* shall be determined under the provisions of section 112. [Footnote 9]"

In this case, to be sure, there was no question of recognition of gain or loss to the corporation at the time of the exchange with the Wheelers, because it was issuing its own stock, and so realized no gain or loss. But to recognize the increment in value as affecting earnings and profits would no more harmonize with the taxless character of the transaction than to treat a realized gain as doing so. The same policy which carries over the transferor's basis for purposes of the corporation's income tax, 113(a)(8), requires carrying it over for determining the taxability of its distributions as the Commissioner's regulation directs: gains and losses are to be brought into earnings and profits at the time and "to the extent" that they are recognized under 112. Finally, no doubt of the reasonableness of the rule can linger in the presence of 501(a), by which Congress has indicated its express approval of the principle that the basis for determining earnings and profits shall be the basis for determining gain.

We therefore think that, on principles often reiterated, [Footnote 10] the regulation is valid and decisive of this issue. There is no necessity to predicate the determination of deficiency on the 1940 amendment. The 1940 amendment consequently

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has no retroactive effect on the liability of these taxpayers, and the conclusion of the Court of Appeals that it is unconstitutional is not warranted. The judgment of the Court of Appeals is reversed. and that of the Tax Court is affirmed.

Reversed.

MR. JUSTICE ROBERTS is of opinion the judgment should be affirmed for the reasons stated by the Circuit Court of Appeals, 143 F.2d 162.

[Footnote 1]

143 F.2d 162.

[Footnote 2]

323 U.S. 694.

[Footnote 3]

This was slightly modified by the Tax Court in an aspect not material here.

[Footnote 4]

1 T.C. 640.

[Footnote 5]

See Paul, Selected Studies in Federal Taxation, Second Series, 1938, 149, 155 *et seq.*

[Footnote 6]

The provision appears in Reg. 94, Art. 115-3, under the Act of 1936; Reg. 86, Art. 115-1, under the Act of 1934, and in Reg. 103, Sec.19.115-3, and Reg. 111, Sec. 29.115-3, under the Internal Revenue Code.

[Footnote 7]

See H.R. Rep. No. 2894, 76th Cong., 3d Sess., p. 41; Sen.Rep. No. 2114, 76th Cong., 3d Sess., p. 22.

[Footnote 8]

See 1 Mertens, Law of Federal Income Taxation (1942) 9.33.

[Footnote 9]

(Italics supplied.) *See* Paul, Selected Studies in Federal Taxation (Second Series, 1938) 193-95.

[Footnote 10]

Boske v. Comingore, 177 U. S. 459 , 177 U. S. 470 ; *Brewster v. Gage,* 280 U. S. 327 , 280 U. S. 336 ; *United States v. Kirby Lumber Co.,* 284 U. S. 1 , 284 U. S. 3 ; *Fawcus Machine Co. v. United States,* 282 U. S. 375 , 282 U. S. 378 . It may also be noted that the regulation has the support of the doctrine that reenactment of the statute without disapproval of regulations thereunder gives them added sanction. *United States v. Dakota-Montana Oil Co.,* 288 U. S. 459 , 288 U. S. 466 ; *Helvering v. Winmill,* 305 U. S. 79 , 305 U. S. 83 ; *Helvering v. Griffiths,* 318 U. S. 371 , 318 U. S. 395 -397.

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