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**Income Tax--Transactional Entered Into For Profit--Proper Basis For Computing Deductible Loss**

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edies available in the federal courts but did not extend their jur-
isdiction.” Skelly Oil Co. v. Phillips Petroleum Co., 339 U.S. 667, 671 (1950). “(J)urisdiction must exist either because a federal question is involved or because of diversity of citizenship, since jurisdiction does not exist merely because a declaratory judgment is sought.” 26 C.J.S. Declaratory Judgments § 114 (1956). However, a basic area of misunderstanding remains concerning the manner in which remedies have been broadened through the Declaratory Judgment Act. Simply stated, the act provides a remedy for a person threatened with liability who could not otherwise have his status adjudicated until his adversary asserted his claim in court. See 16 Am. Jur. Declaratory Judgments § 6 (Supp. 1960).

In the instant case, the trustees relied on subsection (e) of the Labor Management Relations Act, supra, 29 U.S.C. § 186, permitting injunctive relief of unlawfully administered funds, in an attempt to obtain federal jurisdiction. When reading the statement of purpose of the Declaratory Judgment Act, it appears that perhaps the trustees were entitled to a determination of the validity of the transfer of funds; but combine a reading of the statement of purpose of the Labor Management Act, supra, 29 U.S.C. § 186, and the holding in this case appears. If the state must decide the issue of what constitutes the proper administration of the trust (the validity of the transfer of funds), how then may the federal courts enjoin such a determination by the state? One doesn’t eat toadstools to see if they are mushrooms. Why then should the federal court be empowered to enjoin the improper administration of a trust, and yet be incapable of determining what is improper?

James William Sarver

Income Tax—Transaction Entered Into For Profit—Proper Basis For Computing Deductible Loss

Decedent taxpayer, for whose estate this action was instituted, was president of the Phoenix Hosiery Company as well as its controlling stockholder. In October, 1944, decedent personally granted, as an incentive, written options to key executives and employees of the company to purchase from him a stipulated number of shares of Phoenix common stock at a price well below the current market and below his cost basis. In 1945, two of the company’s
vice presidents exercised their options by purchasing a total of 300 shares of common from decedent at $5.00 per share, which was approximately $23.50 below the market price at the time. Decedent deducted $6993, the difference between the market price and the amount realized for the stock, as a deductible loss for 1945. The Commissioner of Internal Revenue disallowed the deduction. *Held,* reversed. Such transaction is one entered into for profit, and the stockholder is entitled to deduct as a loss for personal income tax purposes the difference between market price at the time of the sale and the amount realized. *Berner v. United States,* 282 F.2d 720 (1960).

The court, in relying upon *Kress v. Stanton,* 196 F.2d 499 (3d Cir. 1951), and *Scherman v. Helvering,* 74 F.2d 743 (2d Cir. 1935), as a basis for interpreting INT. REV. CODE OF 1939, § 23 (e) (2), correctly determined that the principal case involved a transaction entered into for profit, and therefore a loss incurred in such a transaction would be deductible from gross income in the year in which such loss was incurred. The courts in the *Kress* and *Scherman* cases, *supra,* both found transactions entered into for profit in factual situations analogous to that of the present one, thereby furnishing substantial support for the court's finding of such a transaction in the principal case.

That a deduction for the loss incurred in the transaction in the principal case may be taken by the taxpayer is not in contention, but the amount of such a loss, reflected by the manner in which it is computed, is one whose correctness needs to be questioned and one whose computations need necessarily to be precisely discerned.

The problem confronting the court, hypothetically illustrated, is as follows: A, a taxpayer, is president and a controlling stockholder of C Corporation. As an incentive he sells 100 shares of C Corporation stock, personally owned by him, to B, a key executive of C Corporation. The fair market value of the stock at the time of the sale by A to B is $100 per share. A's cost basis for the stock is $20 per share. The sales price from A to B is $10 per share. The basic problem, granting that the sale constitutes a transaction entered into for profit, is determining the amount of the loss that A can deduct in computing his income tax. An additional problem in computing the amount of deductible loss is determining the amount that shall be used as A's basis in computing such a loss.
From the ruling in the principal case, the court has adopted the following procedure for computing A's deductible loss: Deductible loss equals the difference between the fair market value of the stock at the time of the sale and the amount realized. Hence in our hypothetical situation, the deductible loss would be $9000, computed as follows: $10,000 \times [100 \text{ (number of shares sold)} \times 100 \text{ (fair market value of each share at the time of sale)}] \text{ minus } $1000 \times [100 \text{ (number of shares sold)} \times 10 \text{ (sales price per share received by taxpayer)}]. If such deductible loss were properly computed it would be limited to $1000, computed as follows: $2000 \times [100 \text{ (number of shares sold)} \times 20 \text{ (taxpayer's cost basis per share)}] \text{ minus } $1000 \times [100 \text{ (number of shares sold)} \times 10 \text{ (sales price per share received by taxpayer)}]. The fundamental difference in the amounts of the deductible losses is attributed to the different amounts used as the bases for computing the losses, the fair market value of the stock at the time of the sale being used in the first instance, the seller's cost being used in the second instance.

The method used in computing losses incurred in transactions entered into for profit by taxpayers is enumerated in the Internal Revenue Code of 1954. Section 1001(a) of the Internal Revenue Code of 1954, substantially the same as section 111(a) of the Internal Revenue Code of 1939, provides that the loss from the sale or other disposition of property shall be the excess of the adjusted basis, provided in section 1011 for determining loss, over the amount realized. Reading sections 1011 and 1012 of the Internal Revenue Code of 1954, substantially the same as sections 113(b) and 113(a) of the Internal Revenue Code of 1939, together, the adjusted basis for determining loss from the sale or other disposition of property shall be the cost of the property adjusted upwards or downwards for events subsequent to the acquisition of the assets. The fundamental rule derived from these sections is that the seller's basis for computing loss on the sale of corporate stock is his cost. Neither case nor statutory authority is available which allows the use of the present market price of corporate stock as a basis for computation of any deductible loss on its sale.

In the Kress case, supra, where a transaction was found to be one entered into for profit, the deductible loss was limited to the extent that the amount realized, which was in fact the book value of the stock, was less than the seller's cost. In the Scherman case, supra, where the finding of a transaction entered into for profit was
also sustained, the court held that the loss on sale of the stock was limited to the difference between the amount realized, which was the cash received, and the seller's basis for loss, which was the cost of the shares to him. At the time of the sale by the stockholder, the market value of the shares was greater than his cost.

Both the Kress and Scherman cases find a transaction entered into for profit in factual situations analogous to that of the principal case, but in both cases the deductible loss was limited to the differences in the amount realized and the seller's cost, not the difference between the amount realized and the market price of the stock at the time of the sale.

To allow one's basis in computing deductible losses to be the present market value of the stock sold rather than the seller's cost of such stock, and to permit the deductible loss to be the difference between the market value and the amount realized when such market value exceeds the seller's cost basis, creates a situation which is fraught with uncertainties and ambiguities. When that particular situation exists, wherein the market price of the stock vastly exceeds the seller's cost and the seller sells such stock at an amount closely approximating, but nevertheless below his cost basis, the dangerous manipulations certain to occur can readily be foreseen. Countless devices and innumerable schemes to simultaneously avoid the payment of income taxes and substantially reward deserving executives and employees by sale to them of individually owned corporate stock as incentives will beset the courts.

It clearly appears, from reading the applicable sections of both the 1939 and 1954 Internal Revenue Codes, that the seller's cost is the proper basis for computing deductible loss in any transaction entered into for profit. If such is to be changed to allow the market value to be used as the basis for computing deductible loss, the change should be made legislatively by enacting additional provisions to our present Internal Revenue Code. Until such enactments are promulgated, the decision in the principal case appears to be contra to the general rule for computing deductible loss and therefore should be further reviewed to allow only the difference between the seller's cost and the amount realized to be taken as the amount of such loss.

Aaron David Trub