Sections 267 And 707: Are Related Party Transactions Leaving You At A Loss?

Except for the simplest transactions, the results under the rules are still unpredictable.

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**IN 1934**, Congress enacted section 24(a)(6) of the Revenue Act of 1934, the precursor to section 267, in response to situations in which taxpayers entered into transactions with their family members and closely held corporations in order to recognize losses. Over time, taxpayers and their advisors devised different transactions to accomplish the same result. In 1954, Congress responded by enacting sections 267 and 707(b), covering much more than just the two relationships originally addressed by former section 24(a)(6).

As a result of the economic collapse that began in 2008, many taxpayers own assets with unrealized built-in losses. Although taxpayers are free to harvest these losses through bona fide transactions with third parties, taxpayers entering into “loss harvesting” transactions often encounter unanticipated
results because of the application of the loss disallowance and deferral provisions of section 267 and section 707(b). (Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect on the date of this article (“Code”), the Internal Revenue Code of 1954 (“1954 Code”), and the Internal Revenue Code of 1939 (“1939 Code”), in each case as the context requires. Similarly, unless otherwise indicated, all “Treas. Reg. §” references are to the Treasury Regulations promulgated under the Code as in effect on the date of this article.)

This article discusses the development of sections 267 and 707(b) from 1934 to the present as well as certain transactions with related partnerships in which a loss is allowed, disallowed, or deferred, as well as issues associated with those transactions.

**BACKGROUND**

Before the enactment of section 24(a)(6) in 1934, courts addressed transactions between family members, between individuals and their closely-held corporations, and between two closely held corporations entered into with the intent to accelerate losses. In general, whether the loss was allowed depended on whether the court determined the loss resulted from a bona fide sale, even if the intent of the taxpayer in entering into the transaction was to claim a loss. See *Johnson v. Commissioner*, 37 B.T.A. 155 (1938), aff’d, 104 F.2d 140 (8th Cir. 1939), aff’d, 308 U.S. 523 (1939) (loss from sale between individual and related corporation allowed because sale was bona fide).

For example, in *Cole v. Helburn*, 4 F. Supp. 230 (1933) the taxpayer, through a broker, sold stock at a loss on the stock market and immediately lent money to his son who, through a broker, bought the same amount of the same stock, which served as collateral for the loan. The taxpayer acknowledged that he sold the stock in order to establish a loss for tax purposes. Nevertheless, the court held the taxpayer could claim a deduction for the loss because the loss resulted from a bona fide sale.

In contrast, in *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), cert. denied, 296 U.S. 586 (1935) the court disallowed the loss claimed by the taxpayer because, in the court’s opinion, the taxpayer did not in substance dispose of the loss property. In *Shoenberg*, the taxpayer sold stock through his broker and, at the same time, instructed his broker to purchase — for the account of a related corporation — the same number of shares in the same companies. Later, the taxpayer purchased the shares from the related corporation. The court denied the loss, stating that “it is clear that this sale by taxpayer was merely part of a plan by which he hoped to create a tax deductible loss without any real change in his position” and that the taxpayer “was no poorer when the plan was executed than he had been before the sales by him.”

Similarly, in *Mitchell v. Commissioner*, 89 F.2d 873 (2d Cir. 1937), rev’d, 303 U.S. 391 (1938) the taxpayer purportedly sold securities to his wife at a loss. Significantly, the taxpayer was not paid in cash, nor did he receive a promissory note or any type of security. Moreover, neither the taxpayer nor his wife notified the husband’s broker, who was holding the securities, of the transfer; and, although the wife made interest payments to the taxpayer, the taxpayer had provided the wife with numerous cash gifts throughout the year (which presumably the court believed effectively funded the interest payments). In light of these facts, the court held that the arrangement was not a bona fide sale and disallowed the loss.

**Section 24(a)(6)**

In 1934, Congress, referring to the *Cole, Shoenberg*, and *Mitchell* cases, stated that “many instances have been brought to light where transactions [directly or indirectly, between members of a family, or between an individual and a corporation] have taken place for the sole purpose of avoiding pay-
ment of taxes.” See H. Rep. 704, 73d Cong., 2d Sess. (1934) and S. Rep. 558, 73d Cong., 2d Sess. (1934) (providing that the proposed change would operate to close a perceived loophole of tax avoidance). To “effectively close this loophole,” id., Congress enacted section 24(a)(6), which provided that:

“in computing net income no deduction shall in any case be allowed in respect of loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purposes of this paragraph – (C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.”

Congress believed that the enactment of section 24(a)(6) eliminated the temptation from “tax dodgers who transferred securities or other property from one member of a family to another in order to deduct a capital loss against ordinary income.” Id.

After its enactment, section 24(a)(6) was applied in Lakeside Irrigation Co., Inc. v. Commissioner, 41 B.T.A. 892 (1940) aff’d, 128 F.2d 418 (5th Cir. 1942), cert. denied, 317 U.S. 666 (1942), to disallow a loss between a corporation and an individual. In Lakeside Irrigation, the taxpayer, a corporation, sold stock in other corporations to a shareholder who owned more than 50 percent in value of the stock of the taxpayer. Some of the stock sold was built-in loss stock; other was built-in gain stock. The taxpayer argued that it should have been able to use the losses recognized upon the transaction to offset any gains recognized upon the transactions. The court rejected this position and disallowed the losses under section 24(a)(6), stating that the losses “constitute unallowable deductions, and, as such, are not to be applied to reduce the gains from the sales or exchanges of other assets.” Thus, even though the sale was a bona fide sale, the loss was disallowed because the relationship between the corporation and shareholder was described in section 24(a)(6). (Lakeside Irrigation is also important because it made clear that the loss disallowance rules of section 24(a)(6) applied to the gross losses recognized on a transaction, not the net loss.)

Section 24(b)

Notwithstanding Congress’s attempt to remove the temptation from “tax dodgers,” taxpayers continued to enter into similar transactions in which the relationship between the transferor and transferee was not covered by section 24(a)(6). See Shelden Land Company v. Commissioner, 42 B.T.A. 498 (1940) (loss from sale between a corporation owned by family members and a corporation owned by a trust for the benefit of some of those family members allowed because relationship not described in section 24(a)(6) and sale was bona fide); Ickelheimer v. Commissioner, 45 B.T.A. 478 (1941), aff’d, 132 F.2d 660 (2d Cir. 1943) (loss from indirect sale between individual and trust allowed because relationship not described in section 24(a)(6) and sale was bona fide). As a result, in 1937, section 24(a)(6) was repealed and replaced by section 24(b) of the Revenue Act of 1937. Section 24(b)(1) expanded section 24(a)(6) to address, among other things, transactions between two related corporations “more than 50 per centum in value of the outstanding stock of each of which is owned by or for the same individual.”

Although section 24(b) disallowed losses between two related corporations, it did not address sales between partnerships and related corporations. As a result, courts were faced with the question of whether sales and exchanges between partnerships and related corporations were subject to the loss disallowance rules of section 24(b), essen-
tially tackling the issue of whether a partnership should be treated as an aggregate of its partners for purposes of section 24(b). In Whitney v. Commissioner, 8 T.C. 1019 (1947), aff’d in part, rev’d in part, 169 F.2d 562 (2d Cir. 1948), cert. denied, 335 U.S. 892 (1948), the partners of J. P. Morgan & Co. organized a trust company, J. P. Morgan & Co. Incorporated, in which they acquired more than 72 percent of the trust company’s outstanding stock. J. P. Morgan & Co. then sold certain loss assets to the trust company. In concluding that the sale between the partnership and the related trust company was not subject to section 24(b), the Tax Court stated:

“We do not find in these amendments any evidence of an intent to embrace a partnership within the term “individual.” To so hold, we think, would enlarge the statute by judicial construction. Since section 24(b) is expressly restrictive in character, we should not arbitrarily extend the boundary of the prohibited classes to include those not specifically mentioned or within the natural and ordinary meaning of the terms used.”

8 T.C. at 1035.

The Commissioner appealed to the Second Circuit, and, on appeal, the Second Circuit reversed the Tax Court’s decision. The Second Circuit stated that the Tax Court and the taxpayer inappropriately relied on the concept of a partnership as an entity. In concluding that a loss resulting from a transfer between a partnership and a related corporation should be disallowed, the court concluded that Congress could not have intended to leave a large loophole for these transactions, stating that:

“When these detailed statutory provisions are read against the background of the legislative history and the problem as it was presented to the Congress in 1934, we cannot feel that there can be any serious doubt as to the legislative intent or any substantial ground for believing that Congress intended to leave so large a loophole — almost as large as the one it was trying to close — from its prohibition against deductible losses upon transfers between closely related persons or groups…. The circumstances under which a jural aggregate — admittedly the status of a partnership under the federal revenue laws and the Uniform Partnership Act — may become a jural entity are fascinating in their possibilities for semantic dispute. But this should not be allowed to go so far as to draw all teeth from a statute carefully directed at what the legislative body viewed as the evil of “tax evasion.” Whitney, supra, 169 F.2d at 565. “There can be little reason for a transfer in substantial amount of firm assets to a corporation except the substitution of the corporate way of doing business for the former partnership one; and the prohibition of section 24(b)(1)(B), unless it is to be meaningless, must be held to apply then equally or especially.”

Id. at 562. See also Liflans Corporation v. United States, 390 F.2d 965 (Ct. Cl. 1968) (concluding that a partnership is a collection of individuals for purposes of section 267(b)).

Following the decision of the Second Circuit, the Tax Court in Busche v. Commissioner 23 T.C. 709 (1955), aff’d per curiam, 229 F.2d 437 (5th Cir. 1956) stated that, “in keeping with the purpose of section 24 and the treatment generally accorded partnerships for purposes of Federal taxation, we consider the sale of partnership assets to have been made by the individual partners and not by the partnership entity.” In Busche, a taxpayer indirectly owned more than 50 percent of the interests in a partnership and 50 percent of the stock in a corporation, and the partnership sold property at a loss to the corporation. The court, addressing only the taxpayer’s share of the partnership’s loss, held that the sale was deemed to be a sale between the taxpayer and a corporation rather than a sale between a partner-