Losses Resulting from Stock Becoming Worthless – Deductability Under Federal Income Tax Laws

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LOSSES RESULTING FROM STOCK BECOMING WORTHLESS—DEDUCTIBILITY UNDER FEDERAL INCOME TAX LAWS

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BY WAY of preface, it is suggested that the law student of today would do well to acquire some familiarity with the subject of taxes in general, and with the Federal Revenue Acts in particular. Twenty-five years ago, the subject was of limited interest. Today, the practicing attorney realizes that in many simple and normal transactions he cannot fairly advise a client without first carefully weighing the effect of the transaction upon his client’s tax liability. In the law school days of the writer, the highest rate of Federal individual income tax was 7%, the rate of Federal corporation income tax was a flat 1%, and there were no Federal corporation excess profits taxes, Federal estate taxes or Federal gift taxes. Today, the highest rate of Federal individual income tax is 79%, the highest rates of Federal corporation income and excess profits taxes are 19% and 12%, respectively, the highest rate of Federal estate tax is 70%, and the highest rate of Federal gift tax is 52½%. So it behooves the law student to realize the importance of the subject of taxes in the practice of law.

The Federal Revenue Act provides for various deductions from gross income in the calculation of the net income that is the subject of the income tax. Among these deductions are certain losses. Among the allowable losses are losses resulting from securities becoming worthless, and in this connection the term “securities” is defined to include “shares of stock”. The subject of this article is, therefore, but a narrow strip in an ever widening tax field.

The steadily mounting number of petitions filed with the United States Board of Tax Appeals in income tax cases in which the issue is the deductibility of losses resulting from stock becoming worthless, is evidence that this is a subject on which taxpayers and the Bureau of Internal Revenue frequently are unable to see eye to eye. One would fairly expect that with the aid of over two hundred Board decisions and a formidable array of decisions of the several Circuit Courts of Appeals and other Federal courts, taxpayers and the Bureau would by now find it relatively easy to compose their differences on the point. But the indications are otherwise. Of the total petitions relating to income taxes docketed with the Board in 1938, about seven per cent raised the question of deductibility of worthless stock losses. The subject, therefore, is one which seems to merit study with a view to finding

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if possible the basic reason for the frequency of the disagreements, and
the way to a more prompt and practical disposition of such cases within
the Bureau.

Prior to the enactment of the Revenue Act of 1938, there was no
specific statutory recognition of worthless stock losses, their deducti-

bility being based on the general provisions of the revenue laws which,
in the case of an individual, allowed "losses sustained during the taxable
year . . . (1) if incurred in trade or business; or (2) if incurred in any
transaction entered into for profit, though not connected with the trade
or business", and which, in the case of a corporation, allowed "losses
sustained during the taxable year. . . ."1 The current Revenue Act,
although it leaves unchanged these general provisions, does make ex-
press provision for losses which result from securities (defined for this
purpose as shares of stock and stock rights)2 which "become worthless
during the taxable year and are capital assets",3 and treats such losses
as "from the sale or exchange, on the last day of such taxable year, of
capital assets".4 As in most instances stocks which become worthless
will have been held for more than two years, the new provision, in con-
junction with Section 117 of the Act, will, in the case of an individual,
effect a reduction of the deduction by 50 per centum, and, in the case
of a corporation, limit the deduction to the arbitrary amount of $2,000
plus capital gains.4 But the problem of determining when stock becomes
worthless remains, and resulting litigation promises to continue in sub-
stantial volume.

A taxpayer who claims a deduction for worthless stock must establish
his right thereto to the satisfaction of the Commissioner, and, if he is
unsuccessful and wishes to carry his case further, must be prepared "to
overcome the legal presumption of the correctness of the Commissioner's
determination."5

"The burden of proof to establish a deductible loss and the amount of it,
clearly, was upon the [taxpayer],"
said the Court in Burnet v. Houston,6 and, applying the rule to worthless
stock losses, the Second Circuit has said:

1. Revenue Act of 1936 § 23 (e) and (f), 26 U. S. C. § 23 (e) and (f), and cor-
responding sections of prior acts.
3. Revenue Act of 1938 § 23 (g) (2), 26 U. S. C. A. § 23 (g) (2) (Supp. 1938), in-
cluded in note 18, infra.
4. For the full effect, see Revenue Act of 1938 § 23 (e), (f) and (g), and § 117, 26
U. S. C. A. § 23 (e), (f) and (g), and § 101 (Supp. 1938).
5. Henning Bruhn, 11 B. T. A. 809 (1928). But the presumption "is rebuttable and
will only support a finding in the absence of any substantial evidence to the contrary."
“The burden was upon the executors to establish that the stock, the cost of which they seek to deduct, became worthless during the taxable year.”

and the Sixth Circuit:

“Failing to sustain the burden of showing the Commissioner wrong, the assessment must stand.”

The scope of the taxpayer’s burden of proof was well set forth in Charles O. Middleton:

“The assignment of error is that the Commissioner ‘erred in failing to allow as a loss in 1923, the amount of $20,000 on the White Star Plaster Company stock.’ The Commissioner denied that he had so erred. The issue is plain—Did the Commissioner err in that he has denied the petitioner a loss to which the latter is entitled? The responsibility for having the record contain proof of facts showing the petitioner’s right to the deduction rests upon the petitioner. This proof should disclose the basis for loss in respect to the stock in question and also the circumstances indicating that a loss not compensated for was actually sustained in 1923, as opposed to any other year, in a transaction entered into for profit.”

If, in a worthless stock loss case, a taxpayer is unable to sustain before the Board his burden of proving the Commissioner wrong, his situation is almost hopeless. It is well established that the question of worthlessness of stock, as well as the question of the date when worthlessness occurred, are questions of fact; and the Board’s findings of fact are conclusive upon an appellate court unless there is no substantial evidence to support them. It is not surprising, therefore,

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10. See also Eagleton v. Commissioner, 97 F. (2d) 62 (C. C. A. 8th, 1938); Royal Packing Co. v. Commissioner, 22 F. (2d) 536 (C. C. A. 9th, 1927); Real Estate Trust Co. of Philadelphia v. United States, 20 F. Supp. 20 (E. D. Pa., 1937); Hiram R. Lloyd, 34 B. T. A. 301 (1936); Sterling Morton, 38 B. T. A. 1270 (1938). Where the deduction is placed in issue by the affirmative averments of the Commissioner’s answer, the burden of proof is, however, upon the Commissioner. George L. Richard, 15 B. T. A. 316 (1929), A. VIII-2 C. B. 44.
that of twenty-four worthless stock loss cases appealed from the Board to the Circuit Courts, the appellant prevailed in only four.

That the amount deductible in a worthless stock loss case is the cost of the stock, or other basis for the determination of gain or loss, is elementary. But more than one taxpayer's claim before the Board has been denied for failure to prove his cost.

Until the Revenue Act of 1938 became effective, it was also necessary for an individual claiming a worthless stock loss to establish that the loss arose out of a trade or business, or in a transaction entered into for profit, since such losses, together with losses from fire, other casualty and theft, were the only losses for which the Revenue Acts made provision. Failure to adduce such proof was fatal. But in a proper case, a worthless stock loss is deductible even though the stock was worthless when acquired, and if a stockholder is compelled to make contributions to the capital of a corporation from which no return can be expected, a deductible loss is sustained in the year of payment. However, it may be doubted whether, under the Revenue Act of 1938, it is still necessary for an individual claiming a worthless stock loss to establish that it arose out of a trade or business or in a transaction entered into for profit, since Section 23 (g) of the Act which provides for losses resulting from worthless stock appears to be wholly independent of Section 23 (e), providing generally for losses by individuals.

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13. Art. 23 (e)-4, Reg. 101, and corresponding provisions of prior regulations.


“DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions: . . .

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from
The requirement with respect to bad debts, and, under the Revenue Act of 1938, with respect to securities other than stock and stock rights, that the deduction be taken in the year in which worthlessness is "ascertained" and the item "charged off"\textsuperscript{10} does not apply to worthless stock,\textsuperscript{20} and although the Treasury Regulations once provided for worthless stock deductions "in the taxable year in which the stock was ascertained to be worthless and charged off",\textsuperscript{21} this has long since ceased to be the rule,\textsuperscript{22} and it is well established that the year of deductibility, that is, the year in which the loss was "sustained", is the year in which the stock actually became worthless.\textsuperscript{23} Under the current
Revenue Act, by its express terms the year of deduction is the year in which the shares of stock "become worthless".24

As a corollary to the proposition that the taxpayer must show that the stock claimed to be worthless became so during the taxable year, it has been held that where the Commissioner found that the stock became worthless in another year, the taxpayer had the burden of proving that the stock did not become worthless in such other year. The Board's holding on this point was summarized in Paul Pryibil,25 as follows:

"In William E. Steinback . . . we held that where respondent's determination rests upon a finding of fact that the taxpayer's stock became worthless in a year other than the taxable year for which a loss deduction was sought, and the taxpayer failed to establish that his stock did not become worthless in such other year, the respondent's determination must be approved."

Even in a case in which the Commissioner had disallowed a worthless stock loss on the ground that it was "not substantiated", without specifying the year in which he held the loss occurred, the Board ruled that the taxpayer was obliged to show that the stock had value at the end of the year preceding the taxable year in which the loss was claimed, saying:

"It is material to petitioner's contention to show that the stock in question had some value at the end of the year 1931 to overcome any presumption that the loss was sustained prior to the taxable year, 1932."26

24. Revenue Act of 1938, § 23 (g) (2) 26 U. S. C. A. § 23 (g) (2) (1938 Supp), included in note 18, supra.
25. 31 B. T. A. 164 (1934).
Furthermore, in Charles T. Carlson, the Board held it necessary that a taxpayer prove that the stock claimed to have become worthless during the taxable year had no value at the end of the taxable year. Said the Board:

"Assuming the stock did become worthless during the tax year, it was not worthless at the close of that year. The Bank was not liquidated but resumed business December 31, 1934. If, at that time, petitioner still retained the right to repossess the stock—and we are not convinced that he does not yet have that right—of course he sustained no deductible loss on the stock during that year."

These preliminary observations lead us to the crucial question: When does stock become worthless so that a loss therefrom results? As we shall see, worthlessness connotes not only lack of liquidating value, but lack of potential value as well. How is the absence of these elements of value to be determined? With disarming simplicity, the Treasury Regulations for many years have provided for the allowance of losses from worthless stock in the year in which worthlessness occurs "provided a satisfactory showing is made of its worthlessness."

In the only income tax case dealing with worthless stock decided by the Supreme Court, United States v. White Dental M'f'g Co., the Court indicated that the test of worthlessness was a practical test, when it said:

"... a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupmens."

The practical rule laid down by the Supreme Court in Lucas v. American Code Co., in relation to losses in general, has been applied to worthless stock losses in particular:

"Practical considerations must govern, for it is as true here as in Lucas v. American Code Co. . . . that: 'No definite legal test is provided by the statute

27. 39 B. T. A. —, No. 29 (1939).
29. See Art. 23 (e)-4, Reg. 101, and the corresponding articles of prior regulations.
for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test."

Since the test of worthlessness is not a legal test nor a theoretical test, but a practical test, since the taxpayer is freed from the obligation of proving no possibility of recovery, and since the Treasury Department requires merely a "satisfactory showing" of worthlessness, it seems all the more remarkable that worthless stock losses should be the subject of so much and such continuous litigation. The answer is to be found in the application of the rule which requires a showing in the year for which the loss is claimed of some fact or circumstance, termed an "identifiable event," which fixes worthlessness.

In United States v. White Dental Mfg Co., the Court stated that the Treasury Regulations properly contemplated losses "which are fixed by identifiable events." 32

In Rosing v. Corwin, 33 the Court phrased the rule:

"Usually it is said that the taxpayer must prove the identifiable event by which the loss is clearly evidenced."

And in Benjamin v. Commissioner, 34 the same Court declared:

"To prevail, the petitioner should be able to establish that . . . some identifiable event occurred by which the loss was clearly evidenced."

In Smith v. United States, 35 the Court said:

". . . the question remains whether this worthlessness became reasonably apparent during that year, or, as sometimes stated, whether it was established directly or indirectly by some identifiable event occurring in 1932."

In Hanna v. Routzahn, 36 the Court observed:

34. 88 F. (2d) 415 (C. C. A. 2d, 1937).
35. 70 F. (2d) 719 (C. C. A. 2d, 1934).
37. 16 F. Supp. 28 (N. D. Ohio, 1936). It is interesting to note in this case that the District Judge mildly chided the Second Circuit for an alleged failure to emphasize the necessity of an "identifiable event" in Squier v. Commissioner, 68 F. (2d) 25 (C. C. A. 2d, 1933), saying: "I cannot be sure that the conclusion reached here is entirely compatible with that decision. The court there seems to lay little stress on the necessity of a definitely identifiable event, which the same court does recognize in other decisions."

The criticism, however, is scarcely justified, because in the Squier case, the court held: "We are satisfied that the stock of such a hopelessly insolvent corporation . . . was
"The cases turn upon the occurrence of the identifiable event by which plaintiffs' losses from these investments were evidenced."

An "identifiable event" has several times been judicially defined. In Industrial Rayon Corporation v. Commissioner, it was defined as:

"... an incident or occurrence that points to or indicates a loss—an evidence of a loss. The evidence need not, though, consist of stereotypic plan or scope. It may vary according to circumstances and conditions."

The same idea was expressed in Rosing v. Corwin, when the Court said:

"The event which identifies a loss by a collapse in the value of securities may be single or may comprise a series of facts."

In John H. Watson, Jr., the Board defined identifiable events as

"... such events as would clearly evidence to the person of average intelligence, under the circumstances, that no probability of realization of anything of value from this investment, by sale, liquidation, or otherwise, thereafter existed."

From the rule which requires the happening of an identifiable event during the taxable year to fix the loss in such year, the further rule follows that an event occurring in a subsequent year will not be recognized as proof, of itself, of worthlessness in the taxable year. In Royal Packing Co. v. Commissioner, the latter rule was set out:

"The taxpayer was not entitled to the deduction merely because the stock may have subsequently become worthless or because, in the light only of subsequent developments, it may appear to have been inherently worthless during the year in question. . . . A loss may be said to be actually sustained in a given year if, within that year, it reasonably appears that such stock has, in fact, become worthless."

That stock was not worthless in a particular year may, however, be shown by subsequent development, and the Courts have not hesitated to fortify their decisions as to worthlessness in the taxable year by reference to subsequent developments.

worthless during the taxable period. But so far as we can see it was worthless some years before", from which it may well be inferred that the "identifiable event" occurred some years before, and not during the taxable year.

38. 94 F. (2d) 383 (C. C. A. 6th, 1938).
39. 38 B. T. A. 1026 (1938), A. 1939-6-9700.
42. Smith v. United States, 16 F. Supp. 393 (D. Mass., 1936); Lyon v. United States,
Now if, normally, the value of theretofore valuable stock was destroyed by a single outstanding occurrence, as, for example, the seizure of stock by the German Government during the World War, United States v. White Dental Mfg Co., the problem of the worthless stock loss case would be simple; but experience is otherwise. In the "run of the mine" worthless stock case, there is a whole series of occurrences overlapping different taxable years, the cumulative effect of which is to render the stock worthless, and the problem is to select from the mass the so-called "identifiable event". In this connection, potential value, as well as liquidating value, must be taken into account, and hence reasonable hope and expectation must be duly appraised. Thus in Deeds v. Commissioner, there "still remained the hope, and possibly the expectation, that the affairs of the corporation could be made to prosper", and the worthless stock loss was disallowed. As was well stated in Sterling Morton:

"The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. . . . If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and cannot be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some 'identifiable event' in the corporation's life which puts an end to such hope and expectation."

Accordingly, in each case there exists the problem of determining whether there is "reasonable hope and expectation", and, if so, the year

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5 F. Supp. 138 (Ct. of Cl., 1933); E. D. Belknap, B. T. A. Memo., Docket No. 87244 (1938). See also the statement in Harold K. Bachelder, B. T. A. Memo., Docket No. 82936 (1938), that the evidence of worthlessness was "unrebutted by any evidence of any rise in the value of those assets in a later year . . . ."


44. 47 F. (2d) 695 (C. C. A. 6th, 1931). That "... the situation . . . would lead one to believe that the condition of the mills company was hopeless . . . ." and "... there was the strongest probability at that time that the stock would prove entirely worthless . . . .", was held insufficient to establish worthlessness in Burnet v. Imperial Elevator Co., 66 F. (2d) 643 (C. C. A. 8th, 1933). See also Stewart F. Hancock, B. T. A. Memo., Docket No. 87054 (1938).

45. 38 B. T. A. 1270 (1938). "A showing of undeniable insolvency through the excess of liabilities over actual value of the assets does not justify recognition of worthlessness of the stock where there is prospective value." James L. Byrd, 21 B. T. A. 1183 (1931), A. X-2 C. B. 11, citing Tsivoglou v. United States, 31 F. (2d) 706 (C. C. A. 1st, 1929) and VanDiest v. United States, 67 Ct. of Cl. 655 (1924).
of the "identifiable event" which put "an end to such hope and expectation".

Also, as indicated in *Trowbridge v. United States*,\(^4\) if there is an economic depression, that factor must be considered in appraising potential value. Said the Court:

"Human nature shrinks from accepting as final the drastic losses inherent in an economic depression believed to be of temporary duration. This is not necessarily the quality of incorrigible optimism sometimes seen. . . . It may rather be a reasonable optimism. . . ."\(^3\)

Because worthlessness is "not such a fact as can be fixed with certainty,"\(^47\) and "men may differ as to the proper period within which the loss is established as a deduction,"\(^47\) the door is open to a wide variety of opinions. In this connection, it must be kept in mind that before the Board the taxpayer is handicapped by the presumption that the Commissioner is right until the contrary is proved. The following cases illustrate the difficulties:

**INSOLVENCY**

It is self-evident that stock of a solvent corporation is not worthless. It does not follow, however, that stock of an insolvent corporation is worthless. The cases are numerous in which insolvency has been held insufficient to warrant a finding of worthlessness.\(^48\) Thus, in *Olds & Whipple v. Commissioner*,\(^49\) a corporation had a deficit at the end of 1925 of over $200,000, an operating deficit in 1926 of over $150,000 and an operating profit in 1927 of about $33,000, and it was held that the stock did not become worthless until 1928. The Court explained its finding as follows:

"The fact that the assets were insufficient to meet the operating liabilities may properly be taken as evidence of worthlessness of stock, but it is not conclusive. Actual worthlessness should be the test, and, if those in charge of


\(^{47}\) Paul M. Myers, 7 B. T. A. 1072 (1927). See Jeffery v. Commissioner, 62 F. (2d) 661 (C. C. A. 6th, 1933), and the related case of Stranahan v. Commissioner, 42 F. (2d) 729 (C. C. A. 6th, 1930), *certiorari denied*, 283 U. S. 822 (1931), illustrating the varying weight which may be given to the same evidentiary facts.


\(^{49}\) 75 F. (2d) 272 (C. C. A. 2d, 1935).
the operations of the corporation, acting in good faith, believed that they might work out of their business conditions wherein losses were sustained, and did so, realizing some profits and reducing the deficit, it may not be said that the stock was actually worthless. A real loss is sustained when all chances or possibilities of collection have been effectively destroyed.”

In *J. Harvey Ladew*, the corporation’s balance sheet at the beginning of the year 1923 showed a deficit of approximately $157,000. Commencing in 1923, the operations of the corporation were under the supervision of a creditors’ committee, and at the end of the year the deficit was approximately $300,000. The corporation continued in business until 1926. The Board held that the stock became worthless in the latter year, and concluded:

“However bad the statement of affairs appears from the balance sheet at the beginning of 1923, it is not a basis upon which we think the respondent, in the face of continued operations, would have permitted the petitioner to have taken, in a prior year, the deduction of a loss through worthlessness.”

In *H. Liebes & Co.*, the corporation had a surplus at the beginning of 1920 of approximately $247,000 and a deficit at the end of the year of approximately $747,000. Said the Board:

“However, at the close of the year it was still a going concern; it had cash of over $41,000, receivables of over $264,000, and a merchandise inventory of $454,936 at market. We do not believe that on the evidence it can be said that the Ganss Fur Company stock was worthless at the end of 1920.”

In this case, the liquidation was completed the following year, and the creditors received less than ten per cent.

There are, however, other cases in which the insolvency was so extreme that in view of the corporation’s cessation of business, or the nature of its assets, or of other conditions, the situation was regarded as so utterly hopeless as to remove all probability of potential value, and insolvency was held to be an identifiable event fixing worthlessness. Such a case was *Gimbel v. Rothensies*, where a securities corpo-

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ration which had pledged all its assets with a bank was insolvent by approximately $475,000 at December 31, 1930, and unable to meet calls for further collateral. In that case, the Court, after referring to the necessity of an identifiable event, said:

"In my opinion the insolvency of a corporation is such an event, particularly where the insolvency follows the pledge of all the free assets of the corporation so that it is unable to meet any of its unsecured obligations."

**Receivership**

The cases consistently recognize that the mere fact of a corporation being in receivership is alone not enough to establish the worthlessness of its stock, and it has even been held in one case that receivership, coupled with a statement of the receiver that the company’s complete holdings could be purchased for “roughly $100,000 less than its outstanding indebtedness”, and that “the stock is totally of no worth”, is not acceptable proof of worthlessness, and in another case that the appointment of a receiver, followed by a court order that the company’s plant be shut down, was not an “identifiable event” establishing worthlessness of the stock. There are other cases in which, among elements indicating worthlessness, the fact of receivership has been included.

Likewise, the constituting of a creditors’ committee to manage a corporation’s business, or even to liquidate its affairs, is insufficient to establish worthlessness. Also insufficient is the fact that the corporation’s property has been transferred to liquidating trustees, and the corporation’s charter surrendered.

**Bankruptcy**

Similarly, it has been held that a mere showing of bankruptcy is alone not an “identifiable event” establishing worthlessness of stock.

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59. Jarvis v. Heiner, 39 F. (2d) 361 (C. C. A. 3d, 1930), the court holding that the
although bankruptcy has been considered as tending, along with other elements, to prove worthlessness. In the case of a railroad, however, the Board has held:

"The filing of the petition in bankruptcy under section 77 of the Bankruptcy Act . . . and the appointment of trustees for its property by the court in such proceedings in 1933, constituted an 'identifiable event' by reason of which the worthlessness of stock in that company might be determined in that year."

But it should be noted that, as pointed out by the Board, the value of the bankrupt's assets, as assessed for tax purposes, was only about twenty-five per cent of the amount of its long-term indebtedness, and that the company was in default in the payment of its bond interest.

**FAILURE OF BANKS**

The difficulty in determining the "identifiable event" fixing worthlessness of stock is well illustrated in cases of failed banks. There are two lines of thought, of which *In re Hoffman*, represents one view, and

adjudication of insolvency inherent in the adjudication of bankruptcy was not binding upon the taxpayer; Lyon v. United States, 5 F. Supp. 138 (Ct. of Cl., 1933); Peter Doelger Brewing Co., 22 B. T. A. 1176 (1931), A. X-2 C. B. 19; William E. Metzger, 21 B. T. A. 1271 (1931), A. X-1 C. B. 43; Oscar K. Eysenbach, 10 B. T. A. 716 (1928), A. VII-2 C. B. 12.

60. Real Estate Trust Co. of Philadelphia v. United States, 20 F. Supp. 20 (E. D. Pa., 1937) in which the court held: "The bankruptcy, the sale of the assets at a sum insufficient to pay preferred claims, the acquisition of those assets by the Committee at less than half the amount of the bond claims, followed by the creation of a mortgage of $350,000, are sufficient identifiable events and circumstances to warrant the finding that the stock in the Cherokee Company was worthless prior to the year 1932."


61. William L. Taylor, 37 B. T. A. 1055 (1938). It is interesting to note that the Board based its decision largely on the nature of the business of the railroad, saying that: "... the nature of a railroad as a public utility has precluded, except in extraordinary cases, any procedure other than reorganization in cases of overcapitalized and non-profitable railroads in financial distress. There is seldom any real liquidation of railroad properties or cessation in the conduct of their operation comparable to a liquidation or cessation from doing business which is usually the 'identifiable event' fixing the worthlessness of stock in private corporations." See also Claude D. Cass, 32 B. T. A. 713 (1935), aff'd, 83 F. (2d) 841 (C. C. A. 8th, 1936); Hanna v. Routzahn, 16 F. Supp. 28 (N. D. Ohio, 1936), emphasizing the speculative character of the enterprise; Sterling Morton, 38 B. T. A. 1270 (1938).

John H. Watson, Jr., the other. In the Hoffman case, the fact that a bank was closed and ordered liquidated was accepted as proof of the worthlessness of the bank’s stock. Judge Kirkpatrick stated:

“To say that stockholders of a bank which has been closed by order of the authorities and ordered liquidated do not sustain a loss upon their stock until some subsequent date when liquidation finally takes place, or until the official appraisement of the bank’s assets, seems to me to be losing touch with reality.”

On the other hand, in the Watson case, the Board rejected as proof of worthlessness in 1933 of the stock of the largest bank in Cleveland the fact that in that year it was closed, a conservator and liquidator successively appointed, and an interim report released by the liquidator indicating that the bank was insolvent. The Board held that the stock became worthless in 1934 when the liquidator’s final report was issued and enforcement of stockholders’ double liability recommended.

FORECLOSURE

Like the holders of stock of closed banks, the holders of stock of corporations whose properties were lost through judgments of foreclosure and sale, or other judgments, subject to redemption within a specified period, have found it difficult to fix the identifiable event determining the worthlessness of their stock. The Board held in Alexander A. Altschuler, that where the properties of a corporation were sold to satisfy a tax lien in 1931, but the right of redemption was not foreclosed until 1933, the taxpayer sustained a loss by reason of

The same result was reached but apparently on different grounds, in B. Warfield Co. v United States, — F. Supp. — (N. D. Ill., 1938); Walter W. Moyer, 35 B. T. A. 1155 (1937), A. 1937-2 C. B. 19; H. V. Foster, B. T. A. Memo., Docket No. 83397 (1938); Irving S. Olds, B. T. A. Memo., Docket No. 84875 (1938); Harold K. Bachelder, B. T. A. Memo., Docket No. 82936 (1938); L. Howard Jenkins, B. T. A. Memo., Docket Nos. 82905, 82906 (1937); The United States National Bank of Portland, B. T. A. Memo., Docket No. 77725 (1935). See also Robert Barbour, 39 B. T. A. —, No. 71 (1939), in which the loss was allowed even though the bank reopened and the taxpayer exchanged his stock for new stock in the reopened bank.


64. B. T. A. Memo., Docket No. 84368 (1938).
the stock having become worthless in 1933. Similarly, in *Ambassador Commercial Co.*\(^{65}\) where properties of a corporation were sold at foreclosure in 1933, but the period of redemption did not expire until 1934, the stock was held to have become worthless in the latter year.

But, in *Hiram R. Lloyd*,\(^{66}\) where the sheriff “sold all of the property of the corporation”, the property sold being “subject to redemption at any time within twelve months from date of said sale, pursuant to the statute in such cases made and provided”, it was held that the stock became worthless in the year of sale. It could be inferred that the equity of redemption was worthless, since the judgment was for an amount greatly in excess of the sales price of the property. Also, in *Clara B. Parker*,\(^{67}\) it was held that where “substantially all the corporate assets” were sold and it was apparent that “the equity of redemption in the property . . . was worth nothing,” the worthless stock loss occurred in the year of sale.

The rule of the *Altschuler* and *Ambassador Commercial Co.* cases appears wholly arbitrary, while the rule of the *Lloyd* and *Parker* cases appears to require a practical test.

**Cessation of Business**

In deciding the question of worthlessness of stock, proper weight must be given to the factor of cessation or continuance of business. Cessation of business has been held determinative of worthlessness in one line of cases relating to bank stock;\(^{68}\) when coupled with insolvency, bankruptcy or other similar factors, it has also been considered as establishing worthlessness of stock of certain other types of corporations.\(^{69}\)

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66. 34 B. T. A. 301 (1936).

67. 31 B. T. A. 644 (1934). The reasonable view is that taken by Member Arundell in The Nicolai Corporation, B. T. A. Memo., Docket No. 85243 (1938), when he said: “So in each case the matter of foreclosure and the right of redemption are but single elements of several that go into a determination of the value or lack of value of stock in a particular year and all of the facts affecting value must be examined.” See also Fred Grittman, 11 B. T. A. 122 (1928), A. VII-2 C. B. 16; I. T. 3235, 1939-9-9732. And see the following cases in which the fact of foreclosure is considered without reference to the effect of the right of redemption, if any existed: James F. Curtis, 39 B. T. A. —, No. 44 (1939); Charles Heiss, 36 B. T. A. 833 (1937), A. 1938-1 C. B. 14; William E. Steinback, 30 B. T. A. 1252 (1934); Ward W. Kelley, B. T. A. Memo., Docket Nos. 91046, 91049 (1938); Thomas Coughlin, B. T. A. Memo., Docket No. 78207 (1937); Burnette F. Stephenson, B. T. A. Memo., Docket No. 77653 (1937); Isidor Leviton, B. T. A. Memo., Docket No. 59800 (1934).

68. See pp. 212-213, *supra*.

69. Eagleton v. Commissioner, 97 F. (2d) 62 (C. C. A. 8th, 1938); Peters v. United
On the other hand, continuance of business has been considered persuasive proof that the stock of a corporation had not lost its value, even where other factors pointed to worthlessness. But cessation of business is not conclusive of worthlessness, nor is continuance of business conclusive of value.

**Liquidation**

While it is said that the general rule is that the determination of the worthlessness of stock need not be deferred until the final liquidation of the corporation and the disposal of all of its assets, and the courts and the Board in certain cases involving insolvent corporations have looked rather to the decision to liquidate or the commencement of liquidation, other cases have held that a worthless stock loss will not be recognized until completion of the liquidation of the corporation.


73. John Crosby Brown, 27 B. T. A. 176 (1932); Floyd E. Poston, 17 B. T. A. 921 (1929), A. IX-1 C. B. 44. See also E. S. Lee, 15 B. T. A. 1213 (1929).


The cases involving worthless stock losses where the corporation was later reorganized hold that where the stockholders of the old corporation do not participate on a preferred basis, the fact of reorganization does not destroy the right to a worthless stock loss, and where other evidence indicates that the stock became worthless in the taxable year, and the reorganization did not take place until a subsequent year, a worthless stock loss is not precluded in the taxable year, even though the stockholders are given valuable rights in the subsequent year. But where a company is reorganized within the taxable year and the stockholders participate on a preferred basis, that fact alone has been held sufficient to show that the stock was not worthless although a contrary result was reached where it was found that the rights had no value. The fact that a reorganization is contemplated does not preclude a finding of worthless.


77. Mary S. Peabody, 37 B. T. A. 1086 (1938), A. 1939-5-9692. It has been indicated by one tax commentator that one in the position of the taxpayer in the companion case of George H. Horning, 35 B. T. A. 897 (1937), who was denied a deduction claimed on the ground that the Middle West Utilities Co. stock became worthless in 1932 could, in certain circumstances, invoke Section 820 of the Revenue Act of 1938 [26 U. S. C. A. § 346 (Supp. 1938)], but the language of the section, as interpreted and illustrated in T. D. 4856, I. R. B. 1938-35, 3, makes this position questionable. See also Henry C. Holt, B. T. A. Memo., Docket No. 87049 (1938), where it was found the rights issued were valueless. Cf. J. Harold Frantz, B. T. A. Memo., Docket No. 82426 (1938); Montgomery v. United States, 23 F. Supp. 130 (Ct. of Cl., 1938). And see Robert Starr, B. T. A. Memo., Docket No. 82894 (1937), where the taxpayer did not participate in the reorganization.

78. "The parties themselves bargained on the basis of a value in the common stock. . . When parties ascribed a value to the stock, by trading it in on stock of conceded value, it is substantial evidence that it had some value." Coleman v. Commissioner, 81 F. (2d) 455 (C. C. A. 10th, 1936). Cf. A. J. Wallace, 25 B. T. A. 858 (1931), aff'd, 62 F. (2d) 826 (C. C. A. 9th, 1933), certiorari denied, 289 U. S. 752. If the reorganization does not qualify as a "reorganization" under the applicable Revenue Act, the allowance of a loss on the exchange is, of course, not precluded. A. C. Gwynne, 22 B. T. A. 164 (1931), A. X-2 C. B. 28.

79. "Owing to the fact that under certain conditions a part of the stock of the new corporation might eventually be given to the holders of stock in the old corporation, there was a possibility that in the future the stock of the old corporation might have some exchange value. . . This is not a sufficient basis upon which to determine a value in 1932." Charles Heiss, 36 B. T. A. 833 (1937), A. 1938-1 C. B. 14. See also Union C. DeFord, 19 B. T. A. 339 (1930), A. IX-2 C. B. 15.

Although there are cases in which worthless stock losses have been disallowed by reason of the fact that at or after the end of the taxable year the stock was dealt in on stock exchanges, even at nominal prices, the weight of authority is that such sales will not preclude a finding of worthlessness. The latter seems to be the better view. The following cases illustrate the conflict:

In Peter Doelger Brewing Co., stock of a corporation in bankruptcy was sold on the New York Stock Exchange in 1922, and there were large sales in December of that year. For the last two weeks of December, the common stock "fluctuated between 12½ cents and about 40 cents a share." The Board held that the loss occurred in 1923, and referred to the December sales on the Exchange as follows:

"When a stock has a ready market value on the New York Stock Exchange, although that value is low, and is freely traded on the exchange, it cannot be said that the stock is altogether worthless."

So, also, in B. B. Blair, where a trustees' report stated that holders of common stock of the Studebaker Corporation would receive nothing on liquidation, but despite the report the stock was actively traded in on the New York Stock Exchange in 1934, the loss was not allowed in that year.

On the other hand, in Wesch v. Helburn, it appeared that a corporation was placed in the hands of a receiver on November 24, 1930, that between that date and January 8, 1931, the stock, which until the latter date had been listed on the Chicago Stock Exchange, was "daily sold on the Exchange in considerable blocks", and that sales made on and off the Exchange during practically the remainder of the year 1930 "ranged from 12½ cents to 62½ cents." The District Judge, however, held that the stock became worthless in 1930, and dismissed such sales on the Exchange as

"in large part, prearranged for the purpose of establishing income tax losses,

32. B. T. A. Memo., Docket No. 8833 (1938). See also Robert Starr, B. T. A. Memo., Docket No. 82384 (1937); J. Harold Frantz, B. T. A. Memo., Docket No., 82426 (1938). In Trowbridge v. United States, — F. Supp. — (D. Conn., 1938), it was said that over-the-counter quotations were "obviously of slight weight" but "constituted competent evidence."
or else represented purchases made by incorrigible optimists, in defiance of
common sense and the generally known and accepted facts."

In George H. Horning, the Board, dealing among other things with
common stock of Middle West Utilities Co., claimed by the taxpayer to
have become worthless in 1932, after referring to the fact that the
common stock sold on the New York Curb at prices which were as low
as $\frac{1}{2}$ in 1932 and from $\frac{3}{4}$ to $\frac{1}{2}$ in 1933, found such trading as "some
indication of value", and that the shares were "not absolutely or
practically worthless", and disallowed the loss. But when the question of
worthlessness of the same stock in the same year again came before the
Board in Mary S. Peabody, quotations of the stock were dismissed as
"so low that they would scarcely justify or support a sale of an interest
as large as that of this petitioner."

Other Factors

Other factors to which more or less weight has been given on the
issue of worthless stock include contemporary statements with respect
to value; dual relationship of taxpayer to corporation, as creditor and
stockholder; additional investments by the taxpayer; the taxpayer's
refusal to make additional investments; the possibility of procuring
additional financing; the unreliability of book values; evidence con-
tained in tax returns of the corporation and the taxpayer; resignation

84. 35 B. T. A. 897 (1937).
85. 38 B. T. A. 1086 (1938), A. 1939-5-9692.
86. Burnet v. Imperial Elevator Co., 66 F. (2d) 643 (C. C. A. 8th, 1933); John
Crosby Brown, 27 B. T. A. 176 (1932); Union C. DeFord, 19 B. T. A. 339 (1930),
87. Alfred K. Nippert, 32 B. T. A. 892 (1935), A. XIV-2 C. B. 16; Homer M.
88. Gimbel v. Rothensies, 24 F. Supp. 117 (E. D. Pa., 1938); Hanna v. Routzhahn,
16 F. Supp. 28 (N. D. Ohio, 1936); Walter E. Templeman, 20 B. T. A. 493 (1930), A.
X-1 C. B. 64; Homer M. Preston, 7 B. T. A. 414 (1927), A. VII-1 C. B. 26; Ward W.
Kelley, B. T. A. Memo., Docket Nos. 91046, 91049 (1938); E. D. Belknap, B. T. A.
Memo., Docket No. 87244 (1938); L. Howard Jenkins, B. T. A. Memo., Docket Nos.
82905, 82906 (1937).
89. Kirby v. Commissioner, — F. (2d) — (C. C. A. 5th, 1938); G. E. Cotton, 25
90. Trowbridge v. United States, — F. Supp. — (D. Conn., 1938); P. J. Quealy, 6
B. T. A. 419 (1927), A. VI-2 C. B. 6; Green Bay Lumber Company, B. T. A. Memo.,
Docket No. 70514 (1935).
91. Hobby v. Commissioner, 97 F. (2d) 731 (C. C. A. 5th, 1938); Smith v. United
States, 16 F. Supp. 393 (D. Mass., 1936); John J. Flynn, 35 B. T. A. 1064 (1937); T. F.
Bush, B. T. A. Memo., Docket Nos. 86013, 86012 (1938); Harold K. Bachelder, B. T. A.
Memo., Docket No. 82936 (1938).
92. Benjamin v. Commissioner, 70 F. (2d) 719 (C. C. A. 2d, 1934); Forbes v. Com-
mitioner, 62 F. (2d) 571 (C. C. A. 4th, 1933); Darling v. Commissioner, 49 F. (2d)
of important employee; and the fact that creditors are friendly.

**Conclusion**

It will be apparent from the foregoing that the task of determining the worthlessness of stock by the selection of an identifiable event is fraught with difficulties. With reference to the rule as to the year in which stock losses are deductible, it has been said by the Board that there was "enough flexibility . . . to prevent its harsh application," and by a Circuit Court that the "taxpayer is not required to ascertain at his peril the year in which such value may become extinct," but the worthless stock loss cases hardly reflect these views.

The test of worthlessness of stock is said to be a practical test. But was a practical test applied in the foreclosure cases which laid down the rule that a loss on stock of a corporation all of whose properties were foreclosed was not sustained until the redemption period had expired? Was a practical test applied in the bank stock cases where stock was held not to have become worthless in the year when the bank was closed and liquidation ordered? Was a practical test applied in the receivership case where a receiver reported that the corporate assets could be purchased for far less than the outstanding indebtedness and that the stock was totally of no worth, but the Board held the stock loss was not sustained until a subsequent year? Was not the tendency in all these cases, rather, to take a legalistic approach to the problem?

The test of worthlessness of stock should be a practical one, but a wider latitude must be allowed taxpayers in the application of the test, if there is to be more general agreement on the subject between taxpayers and the Bureau.

Where one is dealing with such factors as potential value, or "reasonable hope and expectation", it is too much to expect that reasonable


97. See pp. 213-214, supra. See also Falls City Ice & Beverage Company, 27 B. T. A. 1346 (1933), A. XII-1 C. B. 5, where the purely legalistic concept, the passage of title, is involved.

98. See p. 213, supra.

men will not differ in fixing the event which destroyed such potential value and put an end to such "reasonable hope and expectation." In the complex situations which surround corporations in financial and business difficulties, it is in many cases almost impossible, without the benefit of some prima facie presumption, to fix that event which will be mutually acceptable as the "identifiable event". The problem is administrative; it requires neither statutory amendment nor change in the principles laid down by the courts and the Board. Its solution lies in a more liberal interpretation by the Commissioner of a "satisfactory showing" of worthlessness. The Treasury Regulations now provide that if certain banking institutions, pursuant to the requirement of Federal or State authorities, charge off stock as worthless, such charge-off will be considered prima facie evidence of worthlessness for income tax purposes. An extension of the Bureau rule would seem feasible. If a taxpayer claims a worthless stock loss in any year between that in which the corporation became insolvent and that in which its liquidation was completed, and shows the occurrence of some event within the taxable year which could reasonably be considered as indicating the stock then lost its potential value, such showing should be considered by the Bureau as prima facie evidence that the stock became worthless in that year. The volume of litigation involving worthless stock losses should then be materially reduced, and the taxpayer would not so often be required to "ascertain at his peril the year" in which the value of his stock became extinct. As the Commissioner, even with the benefit of a presumption in his favor, lost approximately 44% of the worthless stock loss cases coming before the Board and the courts (and this is the record of 238 worthless stock loss cases examined), it would seem that the Bureau could afford to be more liberal in its acceptance of evidence of worthlessness without serious effect upon the revenues.

100. Art. 23 (e)-4, Reg. 101.
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