1 T.C. 640 (1943)

A retroactive tax law amendment is constitutional unless it is so arbitrary as to be a confiscation of property rather than a valid exercise of the taxing power.

Summary

The case examines the retroactive application of Section 501(a) of the Second Revenue Act of 1940, which altered the calculation of corporate earnings and profits for tax purposes. The Wheeler Co. liquidated in 1938 under Section 112(b)(7) of the Revenue Act of 1938. The IRS applied the 1940 amendment to calculate the taxable gains from the liquidation, resulting in higher taxes for the shareholders. The taxpayers argued that the retroactive application was unconstitutional. The Tax Court upheld the IRS's determination, finding the retroactive application constitutional because it was not an arbitrary confiscation of property.

Facts

John H. Wheeler and his wife formed the Wheeler Co. and transferred securities in exchange for its stock. For tax purposes, the company used the transferors' cost basis when selling these securities, but for its own books, it used the securities' fair market value at the time of transfer. In 1938, the Wheeler Co. liquidated under Section 112(b)(7) of the Revenue Act of 1938, distributing its assets to shareholders. The shareholders elected to have their gains taxed according to Section 112(b)(7), reporting only the gains from assets acquired after April 9, 1938.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies in the shareholders' 1938 income tax, applying Section 501(a) of the Second Revenue Act of 1940 to recalculate the company's earnings and profits. The taxpayers petitioned the Tax Court, arguing that the retroactive application of the 1940 Act was unconstitutional and that a 1936 surtax should be deducted from earnings and profits. The Tax Court consolidated the cases and ruled in favor of the Commissioner, with an adjustment for the 1936 surtax.

Issue(s)

1. Whether the Commissioner erred in applying Section 501(a) of the Second Revenue Act of 1940 in computing the earnings and profits distributed in liquidation by the Wheeler Co. to its stockholders under Section 112(b)(7) of the Revenue Act of 1938.
2. Whether Section 501(a) of the Second Revenue Act of 1940, as applied, is unconstitutional.
3. Whether the Commissioner erred in failing to reduce the amount of earnings and profits by the amount of a 1936 surtax on undistributed profits.

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Holding

1. Yes, because Congress clearly intended Section 501(a) to apply retroactively, and the language of the statute must be given effect.
2. No, because retroactivity alone is not sufficient to make a taxing statute unconstitutional, and the statute is not so arbitrary as to be a confiscation of property.
3. Yes, because accrued but unpaid taxes must be taken into account when determining earnings and profits available for distribution as dividends, even if the corporation used the cash basis for computing taxable income.

Court's Reasoning

The court reasoned that Section 501(c) of the Second Revenue Act of 1940 explicitly states that the amendments made by subsection (a) are effective as if they were part of prior revenue acts. The court noted that retroactivity alone does not render a tax statute unconstitutional unless it is so arbitrary as to be confiscatory. Citing *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, the court stated that the due process clause does not limit Congress's taxing power unless the statute is a confiscation of property or lacks a basis for classification leading to gross inequality. The court distinguished cases cited by the taxpayers, such as *Nichols v. Coolidge*, 274 U.S. 531, as involving gifts made before the enactment of the taxing statute. The court found the liquidation of Wheeler Co. was driven by tax considerations and not generosity, making the retroactive application permissible. The court followed *M. H. Alworth Trust, 46 B.T.A. 1045*, in holding that accrued but unpaid taxes reduce earnings and profits, even for cash-basis taxpayers.

Practical Implications

Wheeler v. Commissioner reinforces the principle that Congress can retroactively amend tax laws, subject to constitutional limitations. It clarifies that such amendments are permissible as long as they are not arbitrary or confiscatory. This case is relevant when assessing the impact of tax law changes on prior transactions, particularly in corporate liquidations and reorganizations. It underscores the importance of considering the underlying motives and potential tax avoidance strategies when evaluating the fairness and constitutionality of retroactive tax legislation. It also highlights that "earnings and profits" is not always equivalent to "taxable income."

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