9 T.C. 314 (1947)

The character of a loss (capital or ordinary) is determined by the tax law in effect during the year the loss was sustained, not the year in which a net operating loss deduction is claimed.

Summary

Reo Motors, Inc. sought to deduct a 1941 loss from the worthlessness of its subsidiary's stock as a net operating loss in 1942. In 1941, the loss was treated as a capital loss. However, a 1942 amendment to the tax code would have classified the same loss as an ordinary loss. The Tax Court addressed whether the 1941 or 1942 tax law governed the characterization of the loss for purposes of a net operating loss deduction in 1942. The court held that the law in effect when the loss was sustained (1941) controlled, classifying the loss as a capital loss, which was not deductible for net operating loss purposes.

Facts

- Reo Motors, Inc. acquired all stock of Reo Sales Corporation in January 1940.
- Reo Sales acted as a sales agent for Reo Motors.
- In February 1941, Reo Sales was dissolved, and its assets and liabilities were transferred to Reo Motors.
- Reo Motors sustained a loss of $1,551,902.79 due to the stock's worthlessness.
- Reo Motors claimed the loss as a long-term capital loss in 1941, which was allowed by the Commissioner.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Reo Motors' 1942 income and excess profits tax. The Commissioner disallowed Reo Motors' net operating loss deduction claimed for 1942, which stemmed from the 1941 stock loss. Reo Motors petitioned the Tax Court, arguing that the 1942 tax code should govern the characterization of the 1941 loss. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the character of the stock loss sustained in 1941 should be determined under the tax law as it existed in 1941 or as amended in 1942 for purposes of computing a net operating loss deduction in 1942.

Holding

No, because the character of a loss is determined by the tax law in effect during the year the loss was sustained. Therefore, the 1941 stock loss was a capital loss under the 1941 tax code, and it must be excluded from the net operating loss computation

© 2025 SCOTUSreports.com. All rights reserved.

under Section 122(d)(4).

Court's Reasoning

The court reasoned that Section 122(d), which addresses exceptions and limitations for net operating loss deductions, does not define or change the character of a gain or loss retroactively. The court stated, "Whether an item of gain or loss arising in 1941 is capital or ordinary depends on the law of 1941." It emphasized that the amendment to Section 23(g) in 1942, which would have classified the stock loss as ordinary, was explicitly applicable only to taxable years beginning after December 31, 1941. The court distinguished its prior decision in *Moore, Inc.*, stating that case only addressed the treatment of gains and losses from sales or exchanges of capital assets under Section 122(d)(4) of the 1942 Act, and did not involve the retroactive recharacterization of assets from capital to non-capital assets.

The court emphasized that the 1942 amendments were "applicable only with respect to taxable years beginning after December 31, 1941." This meant the character of the 1941 loss remained a capital loss. Because Section 122(d)(4) excludes capital losses in excess of capital gains from the net operating loss computation, Reo Motors could not include the 1941 stock loss in its 1942 net operating loss deduction. Judge Leech dissented, arguing that the majority opinion was inconsistent with the court's prior holding in *Moore, Inc*.

Practical Implications

This case establishes the principle that the tax law in effect during the year a gain or loss is realized governs its characterization (capital or ordinary). This principle is crucial for determining the tax treatment of items affecting net operating losses, capital gains, and other tax calculations. Practitioners must consult the relevant tax code and regulations applicable to the year the underlying transaction occurred, even when the tax consequences are realized in a later year. Later cases would cite *Reo Motors* as foundational in establishing the proper year for applying relevant tax law, especially when legislative changes occur between the event creating tax consequences and the realization of those consequences.

© 2025 SCOTUSreports.com. All rights reserved.