THE ARROWSMITH DOCTRINE AND CONTINUITY OF CHARACTER

The character of a transaction is a function of the transaction as a whole, even if it transcends multiple years.

Under the Arrowsmith Doctrine - enunciated in 1952 - the tax characterization of a transaction occurring in one year may control the tax characterization of a second transaction in a subsequent year. For the Doctrine to apply, however, a sufficient relationship must exist between the two transactions such as to justify treating the transactions are parts of a unified whole.

Thus, the doctrine does not seriously breach the principle of the annual accounting period because it makes no attempt to reopen and readjust the treatment of the original transaction. This is an important exception to the general rule that each year stands alone, as established by the Burnet v Sanford & Brooks, 282 U.S. 359 (1931), North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932) and U.S. v. Lewis, 340 U.S. 590 (1951) cases. Significantly, Arrowsmith affects neither whether an amount is deductible (or includible) nor when it would be so: the decision affects only the character of the item. Also, the case dealt with losses; whether it applies to gains or other income items is unclear. Significantly, two dissenting Justices speculated that the Doctrine would also apply to gain, probably to the detriment of the government.

SUMMARY OF ARROWSMITH

In Arrowsmith, two individual shareholders liquidated their corporation in 1937-1940 and divided the proceeds equally. The shareholders reported the resulting gains as capital gain; as a result, they paid less tax than they would have paid on ordinary income. Four years later, a judgment rendered against the liquidated corporation bound the two shareholders as transferees of the old corporation. The shareholders each paid one-half of the judgment as and deducted their payments as ordinary losses. They claimed ordinary loss treatment because the payments did not result from a "sale or exchange."

According to the Commissioner, however, the loss claimed by the stockholders was part of the corporate liquidation – statutorily treated as a sale or exchange; thus, the loss, too was properly capital. Agreeing with the Commissioner, the Supreme Court agreed with the Commissioner, stated:
[T]heir liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceeding."

Id. at 8. The Court considered the judgment as simply the last event in the liquidation begun four years later. The stockholders, in effect, had to return a portion of the assets received in the liquidation. Because the original distribution of assets was a capital transaction, the return of assets resulted in a capital loss.

Three Justices dissenting, arguing the importance of the North American Oil/Sanford & Brooks Doctrine:

We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year's losses as if they diminished last year's gains.

Douglass, J., dissenting.

WHY IS THE DOCTRINE IMPORTANT?

The main rationale behind the Arrowsmith Doctrine is evident: if money was taxed at a special lower rate when received (capital gain rates), the taxpayer would be accorded an unfair tax windfall if the repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. In 2008 terms, the relevant rates are 15% for capital gain versus 35% for ordinary income. At the time of Arrowsmith, the rates were 25% versus 87%. The Court in Arrowsmith was unwilling to infer that Congress intended such a result; in contrast, the dissents argued that if Congress had intended this result, it should have said so explicitly.

The case foreshadows the Skelly Oil Doctrine, which also applies a continuity of character analysis. In Skelly, the taxpayer essentially paid tax on only a portion of revenues because of the oil depletion allowance. It later returned the amounts and claimed a full deduction (which the Court denied):

We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received.

Skelly Oil, 394 U.S. at 685.

Courts generally cite the Arrowsmith Doctrine for the following principle:

Two transactions, one occurring subsequent to the other, and each integrally related, should be treated as parts of the same transaction, so that the subsequent event should relate back and be given the same effect and treatment as the prior.
Under this relation-back doctrine, the tax consequences should be as if the prior and the subsequent transactions occurred during the same year. *Seagate Technology, Inc. v. Commissioner*, 80 T.C.M. (CCH) 759, 763 (2000). Commonly, Courts employ the **Arrowsmith Doctrine** employed to distinguish between capital and ordinary treatment.

In 1957, The United States Tax Court applied the **Arrowsmith Doctrine** to a renegotiation of a prior sale in *Wener v. Commissioner*, 24 T.C. 529 (1955), aff’d, 242 F.2d 938 (9th Cir. 1957). In Wener, the taxpayers were partners in a partnership and conveyed their partnership interests to other partners, receiving a cash down payment and an agreement to receive the remainder of the purchase price over three installments. In the year following the sale, due to a pressing need for funds, the taxpayers negotiated a settlement of the remaining installment obligations. The taxpayers settled for an immediate cash payment that was less than the amount remaining under the installment agreement, and treated the difference as an ordinary loss. The court rejected the taxpayer's argument that the sale and the settlement were two separate transactions.

> [P]rior to the dates the remainder of the purchase price was to become due, there was a renegotiation, adjustment, or revamping of the sale itself both as to price and the terms of payment. . . . [T]here was . . . a renegotiation and revision of the unexecuted provisions of the sales contract itself and the substitution of new provisions thereof.

*Id.* at 532-33. Arguably, Wener differs substantially from Arrowsmith: while Arrowsmith involved pre-existing, but otherwise not-yet-characterized items, Wener involved subsequent events. Typically, under the principles of *North American Oil* and *Sanford & Brooks*, such subsequent events would result in treatment characterized on its own merits, rather than by reference to prior events.

Moreover, the courts also use the **Arrowsmith Doctrine** to determine the capital or ordinary character of damages paid by a party to a sale transaction in settlement of a claim relating to the sale. For example, in *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974), the taxpayer sold his interest in two oil and gas leases and reported a long-term capital gain. Later evidence showed the wells to be illegally slanted; as a result, production stopped. A bank that held a security interest in the leases threatened to sue the taxpayer. Subsequently, the taxpayer settled the claim based upon fraud and deducted the payment as a section 162 ordinary expense. The court concluded, however, that *Arrowsmith* was controlling and characterized the settlement proceeds as an adjustment to the purchase price of the oil and gas leases.