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Cover Page Footnote

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TAXATION OF "CAPITAL GAINS" IN THE UNITED STATES, THE UNITED KINGDOM AND CANADA

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IN this day of high tax rates, any system of taxing certain gains at lower rates, or not at all, becomes of monumental significance. It is interesting to compare the laws relating to the taxation of capital gains, because of the difference in the handling of the latter in various countries. No attempt will be made to justify, or argue for or against, special treatment.¹ What is sought to be shown is the similarities and differences in treatment of capital gains in general, and especially in a few common transactions.

I. UNITED STATES

In the United States, the taxation of capital gains, and the preferential treatment thereof, is basically statutory.² The statute³ defining capital assets is essentially a negative one, classifying all assets as capital assets except those which are:

1. Stock in trade, or property held primarily for sale to customers in the ordinary course of trade or business.
2. Land, or depreciable property used in trade or business.
3. A copyright, or a literary, musical or artistic composition in the hands of the creator, or one who acquired by gift from the creator.
4. Certain accounts or notes receivable received in a trade or business.
5. Certain short term governmental obligations.

In addition, the gain on the sale or exchange of land and depreciable property used in a trade or business may have the benefit of capital gain treatment to the extent that the gains on such property, held for more than six months, exceed the losses on such type property.⁴

Capital gains and losses are divided into short-term or long-term depending on whether the property has been held more than six months.⁵ Net capital gains, to the extent that they are long-term, through the application of the net long-term capital gain deduction,⁶ are in effect taxed at one-half the rate that regular income is taxed, with the further

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1. See generally, Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *Taxes* 247 (1957).

2. Int. Rev. Code of 1954, §§ 1201-44.

3. Int. Rev. Code of 1954, § 1221.

4. Int. Rev. Code of 1954, § 1231.

5. Int. Rev. Code of 1954, § 1222.

6. Int. Rev. Code of 1954, § 1202.

provision that the tax shall not exceed twenty-five per cent.⁷ With the tax rates for ordinary income being as high as ninety-one per cent, one can see the great benefit in having gain classified as long-term capital gain. Even for the lowest bracket taxpayer, it means paying ten per cent on the total gains instead of twenty per cent if classified as ordinary income.

II. UNITED KINGDOM AND CANADA

In the United Kingdom and Canada, an item properly classified as capital gain is not taxed at all. Thus, it is even more important in these countries to have an item designated as capital gain than it is in the United States, although, as will be shown later, not as many transactions will be subject to such classification as in the United States.

In these two countries, classification is not found in the statutes per se, but rather by an omission to include the gain in taxable income in the statutes. Thus, the question of whether the profit from a particular transaction is capital gain or not has been dealt with in the cases, each case being determined according to its own facts. The main issue, as shown in the following quotation from the often cited case, *California Copper Syndicate v. Harris*,⁸ is whether the gain is merely an enhancement in the value of an investment, or whether it is a gain made in the operation of a business:

It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. . . . What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in the operation of a business in carrying out a scheme for profit-making?

The rule was expressed slightly differently in the later case of *Collins v. Firth-Brearley Stainless Steel Syndicate, Ltd.*:⁹

Now, the principle I think is very clear and has been established by many cases. The appreciation of an article, the subject of property, whether it is the property of an individual or whether it is the property of a company, is not taxed as such; but it is taxed if the realization of that appreciation forms part of a trade, because

7. Int. Rev. Code of 1954, § 1201.

8. 5 Tax Cas. 159, 165-66 (1904).

9. 9 Tax Cas. 520, 564 (1925).

then the trade is taxed, and this is an item in the trade. That is all there is in the principle.

While each case is decided on its own facts, there are certain factors developed in the cases which are useful in deciding whether the gain in a particular transaction is capital gain, and thus not subject to tax, or is income from a trade or business, and thus subject to tax at ordinary income tax rates. The following are some of the more important factors to be considered.

Isolated Transactions. The fact that the transaction in question is the only one of the type in which the taxpayer has ever engaged is of some significance, the underlying idea being that if there is only one transaction involved, that may not amount to a trade or business. The Canadian cases¹⁰ on this point are more liberal (thus allowing more taxpayers to escape the tax) than are those in the United Kingdom.¹¹ As Lord Russell stated the rule in *Commissioners of Inland Rev. v. Reinhold*.¹² "The profit of an isolated transaction by way of purchase and resale at a profit may be taxable as income under Schedule D if the transaction is to be regarded as 'an adventure in the nature of trade.'"

While this is only one factor to be considered, others may easily outweigh it.

Number of Transactions Involved. This factor is almost the opposite of the preceding one, the idea being that if many transactions are involved, a business is probably being conducted.¹³

Type of Goods Involved. This is one of the most important factors

10. See, e.g., *Whiteside v. Minister of Nat'l Rev.*, 51 D.T.C. 401 (1951) (taxpayer obtained an option to buy timber lands and later sold rights at a substantial profit; held not taxable by Income Tax Appeals Board); *Forget v. Minister of Nat'l Rev.*, 51 D.T.C. 364 (1951) (taxpayer erected an apartment building for home and investment and later sold it; gain held not taxable). But see *Gordon v. Minister of Nat'l Rev.*, 51 D.T.C. 230 (1951) (taxpayer purchased a number of airplane fuselages and sold the scrap aluminum in one transaction; profit held taxable).

11. The leading case is *Commissioners of Inland Rev. v. Livingston*, 11 Tax Cas. 538 (1926), where the taxpayers as a joint venture purchased a cargo vessel with a view to converting it into a steam-drifter and selling it. The taxpayers were not connected in business and had never bought a ship before, but the court held that the profit was received from a venture in the nature of a trade, and, therefore, taxable.

See *Edwards (Inspector of Taxes) v. Bairstow*, [1955] 3 All E.R. 48 (purchase and sale of a spinning plant held to be an adventure in the nature of a trade even though an isolated transaction); *Rutledge v. Commissioners of Inland Rev.*, 14 Tax Cas. 490 (1929) (involving one lot sale of goods).

12. 34 Tax Cas. 389, 394 (1953).

13. See, e.g., *Foulds v. Clayton*, 34 Tax Cas. 382 (1953) (enough sales to designate taxpayer as being in business); *MacMahon and MacMahon v. Commissioners of Inland Rev.*, 32 Tax Cas. 311 (1951). See also *Gairdner Sec., Ltd. v. Minister of Nat'l Rev.*, 54 D.T.C. 1015 (1954) (124 purchases and 200 sales in less than three years held to constitute business as security dealer).

to be considered, since many cases turn on this point alone. If the commodity is one of a type which, from its nature, can give no annual return, and which gives the owner no personal satisfaction or enjoyment, the purchase and later sale at a profit will generally give rise to ordinary income.¹⁴ The reason for this rule is that such a commodity would not generally be held by ordinary persons for investment or for personal use, and therefore must have been purchased with an intent to sell later at a profit in a business type transaction. Thus the purchase and later resale at a profit of such diverse items as whiskey,¹⁵ linen,¹⁶ brandy,¹⁷ a ship,¹⁸ wagons,¹⁹ bathroom tissue,²⁰ and airplane fuselages²¹ have resulted in taxable income even though the taxpayer was not otherwise in the business of selling the type of items involved.

Selling Methods. The method used in producing the sale is sometimes of prime significance. Thus, in *Martin v. Lowry*,²² the taxpayer, a merchant of agricultural machinery, purchased surplus stocks of aircraft linen from the government. Failing to dispose of it in a bulk sale, he set up a skilled organization to dispose of the surplus and realized a large profit which the House of Lords held to be taxable, in spite of the fact that this was a single venture in this type transaction.

The methods utilized to dispose of real estate are often decisive factors in the court's determination as to whether the gain is ordinary income from a business or a capital gain.²³

Intention. The intent of the taxpayer in acquiring property later sold at a gain is considered in some instances and seems to be of more importance in Canada than in the United Kingdom. In *Commissioners of Inland Rev. v. Reinhold*,²⁴ the taxpayer had bought four houses, "with a view to resale," and sold them almost three years later at a profit. The court, holding for the taxpayer, found that the fact the property was purchased with a view to resale did not of itself establish

14. *Commissioners of Inland Rev. v. Reinhold*, 34 Tax Cas. 389 (1953) (dictum).

15. *Commissioners of Inland Rev. v. Fraser*, 24 Tax Cas. 498 (1942).

16. *Martin v. Lowry*, 11 Tax Cas. 297 (1926).

17. *Cape Brandy Syndicate v. Commissioners of Inland Rev.*, 12 Tax Cas. 358 (1921).

18. *Commissioners of Inland Rev. v. Livingston*, 11 Tax Cas. 538 (1926).

19. *T. Benyon & Co. v. Ogg*, 7 Tax Cas. 125 (1918).

20. *Rutledge v. Commissioners of Inland Rev.*, 14 Tax Cas. 490 (1929).

21. *Gordon v. Minister of Nat'l Rev.*, 51 D.T.C. 230 (1951).

22. 11 Tax Cas. 297 (1926).

23. See, e.g., *Taylor Estates, Ltd. v. Minister of Nat'l Rev.*, 52 D.T.C. 250 (1952) (Income Tax Appeals Board found that operations savoured of a well organized real estate development rather than a normal disposal of land); *No. 257 v. Minister of Nat'l Rev.*, 55 D.T.C. 269 (1955) (subdividing); *MacMahon and MacMahon v. Commissioners of Inland Rev.*, 32 Tax Cas. 311 (1951); *Hudson's Bay Co. v. Stevens*, 5 Tax Cas. 424 (1909).

24. 34 Tax Cas. 389 (1953).

that the transaction was an adventure in the nature of trade. It did indicate, however, that this holding would not apply to the similar purchase of a commodity which, from its nature, can give no annual return. In Canada intent has been considered in such cases as the purchase of army camps,²⁵ airplane fuselages,²⁶ and real estate.²⁷ It is perhaps more important in the case of real estate as the holding in the other cases could also be explained on other factors.

Holding Period. The holding period in the United Kingdom and Canada is not critical as is in the United States. The disposal of property within a relatively short period of time after its acquisition may be of some importance in determining whether the property was acquired for investment or for later resale at a profit in a trade or business transaction,²⁸ but this factor is certainly not conclusive.

III. COMPARISON OF COMMON TRANSACTIONS

A comparison of some common transactions will illustrate the similarities and differences in the taxation of capital gains in the three countries.

Securities. Probably the most important items concerning classification as a capital asset are stocks and other securities. In the United States, securities are classed as capital assets since they do not fall within any of the statutory exceptions.²⁹ A dealer in securities is not entitled to the benefits of capital gain treatment unless he meets the two conditions set forth in the statute, viz., that (1) the security is identified in the dealer's records as a security held for investment within thirty days after its acquisition, and (2) the security was not, after the thirtieth day, held primarily for sale to customers in the ordinary course of business.³⁰ For the ordinary taxpayer the gain is given special treatment as set forth earlier in this article.

25. *Larouche v. Minister of Nat'l Rev.*, 52 D.T.C. 12 (1952), where the taxpayer purchased army camps allegedly for the purpose of salvaging lumber, but which in fact were sold at a profit. The Income Tax Appeals Board held that the taxpayer intended to resell at profit.

26. *Gordon v. Minister of Nat'l Rev.*, 51 D.T.C. 230 (1951). See note 10 supra.

27. *Bryk v. Minister of Nat'l Rev.*, 51 D.T.C. 278 (1951), where the taxpayer, a retail grocer and butcher, made some purchases and sales of real estate over the years. The Income Tax Appeals Board found that there was no buying for the express purpose of reselling at a profit.

28. See, e.g., *No. 236 v. Minister of Nat'l Rev.*, 55 D.T.C. 132 (1955) (purchase of eighty acres and later resale within same year held not taxable); *Commissioners of Inland Rev. v. Reinhold*, 34 Tax Cas. 389 (1953) (sale of four houses almost three years after acquisition held capital gain); *Pickford v. Quirke*, 13 Tax Cas. 251 (1927) (purchase and sale of four cotton mills within one year held taxable income).

29. Int. Rev. Code of 1954, § 1221.

30. Int. Rev. Code of 1954, § 1236.

In the United Kingdom, securities are classed as capital assets, and the gain thereon is not taxable unless the taxpayer is a dealer,³¹ and even a dealer can have a private investment in shares.³²

Likewise in Canada, securities are classified as capital assets, and the gain on the disposition thereof is not taxable unless the transaction is one in the business of the taxpayer as a security dealer.³³

Residences (Referring to the taxpayer's own residence, and not to the sale of houses in general). A residence in the United States is a capital asset, and if sold at a profit, capital gain results. By statute, however, provision is made generally for the non-recognition of gain if another residence is purchased either within a year before or after the sale of the old one; or if construction of a new home, started either within a year before or after the sale of the old one, is completed within eighteen months after the sale of the old one. Furthermore, the taxpayer must spend as much or more on the new home than he received on the sale of the old.³⁴ While this is merely a postponement of the payment of the tax on the gain, in many instances it is eliminated entirely.³⁵ A loss on the sale of a residence is not deductible.

In the United Kingdom, a residence is considered as a capital asset, and gain on the sale thereof is not taxable, nor is a loss deductible. The only case to question this rule was based on peculiar facts. A taxpayer resigned his job and shortly afterwards bought a plot of land. He started building a bungalow and completed it in about two years, using it as his home. About five months later, he sold the bungalow and purchased another plot of land. Another bungalow was completed in about two years. The taxpayer moved in, and about five months later, sold it to accept a job in another city. Both bungalows were built without any hired labor. The commissioner attempted to assess the profit on both houses, but the court held only the profit on the last bungalow taxable.³⁶

The rule in Canada pertaining to residences would seem to be the same as the English rule. A residence is a capital asset and any profit on the sale thereof is capital gain and not taxable,³⁷ nor would any loss be deductible.

Depreciable Property. In the United States, a reasonable allowance

31. *Lomax v. Peter Dixon & Sons, Ltd.*, 25 Tax Cas. 353 (1943). See also *Scottish Investment Trust Co. v. Forbes*, 3 Tax Cas. 231 (1893).

32. *Harvey v. Caulcott*, 33 Tax Cas. 159 (1952).

33. *Gulf Sec. Co. v. Minister of Nat'l Rev.*, 54 D.T.C. 231 (1954).

34. *Int. Rev. Code of 1954*, § 1034.

35. For example, if the owner died, his heirs would pick up a new basis at his death.

36. *Page v. Pogson*, 35 Tax Cas. 545 (1954).

37. *Forget v. Minister of Nat'l Rev.*, 51 D.T.C. 364 (1951).

for depreciation may be deducted on property used in a trade or business or on property held for the production of income.³⁸ On the subsequent sale of the property, any amount received over the adjusted basis (cost less depreciation generally) is capital gain in the case of property held for the production of income,³⁹ or, in the case of property used in a trade or business, may generally receive capital gain treatment if the requirements of section 1231 of the Internal Revenue Code of 1954 are met. In the case of loss, the loss is either a capital loss where property is held for the production of income,⁴⁰ or an ordinary business loss expense for property used in a trade or business.⁴¹

In the United Kingdom, an allowance is likewise made for depreciation on certain types of property,⁴² although the allowance is not as broad in coverage as in the United States. On the subsequent sale of the property, a "balancing charge"⁴³ comes into play, and any excess that is received between the depreciated cost and the original cost is taxable as ordinary income. The excess received over the original cost is tax-free. In case a loss occurs, no deduction is allowed.

In this respect, Canada is very similar to the United Kingdom, in that a capital cost allowance is made,⁴⁴ and on the subsequent sale any profit is taxed in an amount equal to the smaller of the actual profit or the difference between the original cost and the undepreciated cost, the excess over original cost being tax-free.⁴⁵ Any loss would not be deductible, as is illustrated by the case where a funeral director who, purchasing a hearse for use in his business, found it unsuitable for his needs and resold it the same year at a loss. The Income Tax Appeals Board held this loss was not deductible.⁴⁶

Real Property. In the United States, the sale or exchange of real property at a profit may give rise to capital gains treatment if the transaction does not involve real property used in a trade or business,⁴⁷ or even if the realty is used in a trade or business (through the application of section 1231 of the Internal Revenue Code of 1954). However,

38. Int. Rev. Code of 1954, § 167.

39. Int. Rev. Code of 1954, § 1221.

40. Int. Rev. Code of 1954, § 1221.

41. Int. Rev. Code of 1954, § 1231.

42. Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, § 277.

43. Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, §§ 292-97.

44. Can. Rev. Stat. c. 148, § 11(1)(a) (1952).

45. Can. Rev. Stat. c. 148, § 20(1) (1952). See *Minister of Nat'l Rev. v. British & Am. Motors Toronto, Ltd.*, 53 D.T.C. 1113 (1953) (sale of a service car at a profit not taxable); *Hollick v. Minister of Nat'l Rev.*, 50 D.T.C. 469 (1950) (sale by farmer of farm equipment at a profit not taxable).

46. *McLaughlin v. Minister of Nat'l Rev.*, 50 D.T.C. 114 (1950).

47. Int. Rev. Code of 1954, § 1221.

this latter result does not follow if the property is held primarily for sale to customers in the ordinary course of a trade or business.⁴⁸ Many taxpayers have litigated the question of whether the property they sold or exchanged was "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,"⁴⁹ some successfully, others not. To alleviate part of the confusion relating to the subdivision of land by the owner thereof, section 1237 of the Internal Revenue Code was added in 1954.⁵⁰ This rather complicated provision provides that if the requirements of section 1237 are met (which include, among others, that the taxpayer must not otherwise have been a real estate dealer in the year in question; must have held the property for at least five years, unless inherited or received by will; and must not have made substantial improvements of the tract), the property in question shall not be deemed primarily held for sale to customers in the ordinary course of trade or business.

In the United Kingdom, real property is ordinarily a capital asset, and therefore gain is not taxed, but if it is found that the transaction was one where the taxpayer was carrying on a trade or business on such property, then the profits are subject to tax. A case often quoted on this point is *Hudson's Bay Co. v. Stevens*,⁵¹ wherein it was stated:

The real question is whether this money can be regarded as profits or gains derived by the Company from carrying on a trade or business. In my opinion it cannot. The Company are doing no more than an ordinary land owner does who is minded to sell from time to time, as purchasers offer, portions suitable for building of an estate which has devolved upon him from his ancestors. I am unable to attach any weight to the circumstances that large sales are made every year. This is not a case where land is from time to time purchased with a view to resale; the Company are only getting rid by sale as fast as they reasonably can of land which they acquired as part of a consideration for the surrender of their Charter.⁵²

The later cases vary in their holding, as might be expected, because whether one is carrying on a trade or business constitutes a question of fact.⁵³ One of the most interesting cases, both for its holding and its

48. Int. Rev. Code of 1954, § 1221.

49. See, e.g., *Philbin v. Commissioner*, 26 T.C. 1159 (1956) (holding that lots were held for sale to customers in the ordinary course of business); *Farley v. Commissioner*, 7 T.C. 198 (1946) (holding that lots were not held for sale to customers).

50. Int. Rev. Code of 1954, § 1237.

51. 5 Tax Cas. 424 (1904).

52. *Id.* at 436.

53. See, e.g., *Glasgow Heritable Trust, Ltd. v. Commissioners of Inland Rev.*, 35 Tax Cas. 196 (1954) (under facts of case sales were not made in the course of a trade); *Commissioners of Inland Rev. v. Reinhold*, 34 Tax Cas. 389 (1953) (not a trade or business where taxpayer bought four houses with view to resale and sold them at a profit almost three years later); *MacMahon and MacMahon v. Commissioners of Inland Rev.*, 32 Tax Cas. 311 (1951) (profits made in carrying on an adventure or concern in the nature of trade).

facts, is *Commissioners of Inland Rev. v. Toll Property Co.*,⁵⁴ where the taxpayer company, formed in 1942, purchased property consisting of shops and tenements for the price of £20. Repairs were made, and the company received an annual rent of £50 to £100. In 1946 part of this property was sold at a profit which was assessed to income tax. In 1949, the remainder of the property was sold for £3,000, and in 1950 the company went into liquidation. On appeal, a majority of the general commissioners considered the profit in 1949 as an appreciation of a capital asset. On further appeal, the court of sessions held that the purchase and sale of the property was an adventure in the nature of trade, profit on which was assessable to income tax.

In Canada, real estate is normally a capital asset, the gain thereon not being taxed, although, as in the United Kingdom, one encounters the problem of whether the taxpayer is in the business of selling real estate. Two illustrations perhaps may help to explain the scope of this problem. In *No. 257 v. Minister of Nat'l Rev.*,⁵⁵ the taxpayer bought thirty-two acres of land with the alleged purpose of building a home on part of it. He built roads, subdivided the property, and sold all but two lots, which were retained for himself. The Income Tax Appeals Board held that the taxpayer had engaged in transactions in the nature of trade for the purpose of making a profit, and therefore, the gain was taxable. In *No. 236 v. Minister of Nat'l Rev.*,⁵⁶ a taxpayer had farmed his 200 acres for nine years and decided to sell. He sold five parcels, retaining twenty-four acres. Shortly thereafter, he bought forty acres from a neighbor, and later in the same year, purchased forty more. Being offered a substantial profit, he sold the eighty acres. The Minister sought to tax the gain as a gain from a business, but the Income Tax Appeals Board held otherwise.

Thus, it can be seen that in the United Kingdom and Canada, if all the facts taken together indicate that the property was sold in a transaction in the nature of a trade for the purpose of making a profit, the gain will be assessable to income tax at ordinary rates. If the sale or exchange is not determined to be a business profit, then the gain is capital gain, and the profit is nontaxable, except to the extent of any depreciation recovered as discussed in the preceding section on depreciable assets.⁵⁷

Depletable Property. In the United States an allowance is made for depletion of wasting natural assets, the taxpayer having his choice of

54. 34 Tax Cas. 13 (1952).

55. 55 D.T.C. 269 (1955).

56. 55 D.T.C. 132 (1955).

57. See pp. 440-41.

using the cost method, or in most cases, percentage depletion.⁵⁸ The percentages run from a high of 27½% of gross income in respect of the property in the case of oil and gas, to a low of 5% in such properties as brick and tile clay, provided that the amount of the deduction cannot exceed 50% of the taxable income from the property before any allowance for depletion.⁵⁹ The percentage depletion allowance is allowable even though the taxpayer has recovered back his full cost tax free,⁶⁰ although his basis (for purpose of later sale) will never be reduced below zero. On a subsequent sale of the property, any amount in excess of the basis will be entitled to capital gain treatment.⁶¹

In the United Kingdom, no allowance is made for depletion of wasting assets except for overseas operations,⁶² and that only since 1952. The idea is that the amount paid is a capital charge, and it is not paid for the particular units extracted. This rule was early established in the case of *Alianza Co. v. Bell*,⁶³ which involved a company extracting ore in Chile from which nitrates and iodine were produced. This case, while a landmark decision, was apparently merely declaratory of existing law.⁶⁴

Canada has a scheme of allowing depletion on wasting natural assets somewhat similar to that of the United States. The allowance ranges from ten cents a ton for coal to four dollars per ounce of gold, and up to 33⅓% of the profits attributable to the production of the property in the case of metalliferous mines and oil wells.⁶⁵ Here, however, the similarity to the United States system ends. Upon a subsequent sale of the property, any amount that is recovered in excess of the depleted capital cost is treated as ordinary income to the lesser of the excess, or what the excess would have been if the property had been sold for the capital cost.⁶⁶ The idea is that depletion has been taken when it was not in fact justified, and to the extent thereof it is taxable, but any excess over the taxable cost would be capital gain and not taxable.

58. Int. Rev. Code of 1954, §§ 611-14.

59. Int. Rev. Code of 1954, § 613.

60. *Commissioner v. Elliott Petroleum Corp.*, 82 F.2d 193 (9th Cir. 1936).

61. Either as a capital asset under § 1221, or as an asset under § 1231 of the Int. Rev. Code of 1954.

62. Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, § 310.

63. [1906] A.C. 18.

64. The closest distinction that has been made is *Mohanlal Hargovind of Jubbulpore v. Commissioner of Income Tax*, [1949] 2 All E.R. 652, where a firm of cigarette manufacturers entered into short term contracts with proprietors of forests in India to remove and collect the leaves of tendu trees, which are used, instead of paper, in making cigarettes. It was held that this granted no interest in land and was not a capital expenditure but an ordinary business expense.

65. Can. Rev. Stat. c. 148, § 11(1)(a)-(b) (1952); Income Tax Regulations §§ 11201-05.

66. Can. Rev. Stat. c. 148, § 20(1) (1952).

Sale of Business as a Whole. In the United States, a business under a sole proprietorship is not considered as a capital asset, but rather each asset of the business must be considered individually, such as fixtures, inventory, trucks, goodwill and other items, some assets giving rise to ordinary income or loss and others giving rise to capital gain or loss.⁶⁷

In the United Kingdom, on the other hand, the sale of a business is considered as a single asset,⁶⁸ except that upon the sale of the business any amount allocated or allocable to assets subject to depreciation, if in excess of the depreciated cost, will be subject to tax on an amount equal to the excess, or the difference between the original cost and the depreciated cost, whichever is smaller.⁶⁹ Moreover, the inventory must be revalued at its value on the date of termination of the business, any profit as a result of the revaluation of the inventory showing up in the regular income of the business for the year of termination.⁷⁰

Likewise, in Canada, the general rule is that no income tax consequences arise upon the sale of a business,⁷¹ except that for sales after April 5, 1955, the profit or loss on trade inventory is considered business income or loss.⁷² Any amount allocated to depreciable property in excess of the depreciated cost will be taxable, but not in an amount greater than the difference between original cost and the depreciated cost.⁷³

Stock Dividends. In the United States, by statute,⁷⁴ stock dividends are taxable only in two instances: (1) to the extent that the distribution is made in discharge of preference dividends for the current or preceding year; or (2) if the shareholders have an option to take cash or other property in lieu thereof. It makes no difference whether the option is exercised before or after the declaration of the dividend or whether the shareholder exercises the option or not. It is taxable.

In the United Kingdom, the matter is controlled by case law, rather than by statute. In the early case of *Commissioners of Inland Rev. v. Blott*,⁷⁵ the House of Lords held that where there was no option to

67. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), aff'd, 218 F.2d 603 (2d Cir. 1955).

68. *Doughty v. Commissioners of Taxes*, [1927] A.C. 327, concerned a sale by two partners of their merchandising business to a limited company which they had formed, and in which they became the only stockholders. The court held that there was no separate sale of the stock of goods apart from the business, and therefore, no taxable gain resulted.

69. Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, §§ 292-97.

70. Income Tax Act of 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, § 143.

71. *Empire Mfg. Co. v. Minister of Nat'l Rev.*, 51 D.T.C. 217 (1951).

72. Can. Rev. Stat. c. 148, § 85E (1952).

73. Can. Rev. Stat. c. 148, § 20(1) (1952). See *Woods v. Minister of Nat'l Rev.*, 55 D.T.C. 53 (1955).

74. Int. Rev. Code of 1954, § 305.

75. [1921] A.C. 171.

receive cash or other property, a stock dividend was not income. In *Commissioners of Inland Rev. v. Coke*,⁷⁶ it was held that when a taxpayer has an option to take cash or stock, and in fact does take some cash and some stock, he has realized income to the extent of the cash and value of the stock received. A companion case involving the same corporation, but a different shareholder, was *Commissioners of Inland Rev. v. Wright*.⁷⁷ It was held that when a taxpayer had an option to take cash or stock, and in fact took only stock, this constituted a taxable dividend. On appeal,⁷⁸ however, the court of appeals held that this was not income. While *Commissioners of Inland Rev. v. Coke*⁷⁹ was not appealed, it would seem to have doubtful validity in view of the decision in *Wright*.⁸⁰

In the United Kingdom, as in the other countries being considered, a dividend in stock of another corporation,⁸¹ or in other property, would be fully taxable, as this is a dividend in property and not a stock dividend.

In Canada, the matter is controlled by statute,⁸² and, contrary to the rule in the United States, a stock dividend is taxable. The limit of taxability is the shareholder's proportionate share of the undistributed income of the corporation then on hand, which would be similar to the taxability of cash dividends in the United States.

Capital Losses. In the United States capital losses may be utilized to offset capital gains in the year in question, but if capital losses exceed capital gains, serious restrictions are placed on their deductibility. In the year in which such excess capital loss occurs, the amount deductible from other income, in the case of individuals, cannot exceed \$1,000,⁸³ and any amount not so deducted may be carried forward for as many as five years. In the succeeding years, the capital loss carried forward may be used to offset any net capital gains, and, in addition, an amount not in excess of \$1,000 may be deducted from other income in a year.⁸⁴ In the case of corporations, net capital losses may never be used to offset other income,⁸⁵ but may be carried forward to offset net capital gain in

76. [1926] 2 K.B. 246.

77. [1926] 2 K.B. 246.

78. [1927] 1 K.B. 333.

79. [1926] 2 K.B. 246.

80. [1927] 1 K.B. 333.

81. *Poole v. Guardian Inv. Trust Co.*, [1922] 1 K.B. 347; *Peabody v. Eisner*, 247 U.S. 347 (1918); *Cheley v. Commissioner*, 131 F.2d 1018 (10th Cir. 1942).

82. *Can. Rev. Stat. c. 148*, §§ 81(3), (6) (1952).

83. *Int. Rev. Code of 1954*, § 1211(b).

84. *Int. Rev. Code of 1954*, § 1212.

85. *Int. Rev. Code of 1954*, § 1211(a).

the succeeding year. A net capital loss may be carried forward for a period of five years.⁸⁶

In the United Kingdom, an item properly labeled capital loss is not deductible against other income.⁸⁷ The test is whether, if there had been a gain rather than a loss, the gain would have been taxable. Likewise, in Canada, capital losses are not deductible.⁸⁸

A serious problem is raised when it is necessary to purchase what would normally be considered a capital asset in order to secure goods for sale or to obtain a contract. In the United States, if it can be affirmatively shown that this was necessary, the loss will be classified as a business loss, rather than a capital loss. The leading case is *Western Wine & Liquor Co. v. Commissioner*,⁸⁹ wherein the taxpayer, a wholesale liquor dealer, bought stock in a distillery corporation in order to secure liquor for sale. After obtaining the liquor for sale, the stock was sold at a loss. The court allowed the loss as an additional cost of the liquor, and it was therefore deductible from ordinary income.

The English courts have not been so favorably inclined toward the taxpayer in these situations. They have denied a deduction to a taxpayer who purchased stock in order to get contracts,⁹⁰ and have also denied a deduction with respect to loss on capital invested in a subsidiary company.⁹¹

The Canadian cases appear somewhat more lenient to the taxpayer in this area than do the English, deduction for losses having been allowed to a lumber wholesaler who, following a practice common to the trade, made advances to small operators in order to get supplies for resale,⁹² to a company which purported to make money through the increase in the market value of the securities purchased and resold, but which in the year in question had suffered losses on the sale of certain securities.⁹³ However, where a taxpayer company had on hand a large

86. Int. Rev. Code of 1954, § 1212.

87. *Stott v. Hoddinott*, 7 Tax Cas. 85 (1918).

88. *McLaughlin v. Minister of Nat'l Rev.*, 50 D.T.C. 114 (1950) (sale of hearse by funeral director at a loss); *Gorfinkel v. Minister of Nat'l Rev.*, 53 D.T.C. 93 (1953) (short sales of stock). But compare *Gulf Sec. Co. v. Minister of Nat'l Rev.*, 54 D.T.C. 231 (1954) (loss on sale of securities allowed as an ordinary loss on ground that purchase and sale made in ordinary course of business as authorized by the company's memorandum of association).

89. 18 T.C. 1090 (1952). See also *Bagley & Sewall Co. v. Commissioner*, 221 F.2d 944 (2d Cir. 1955), where a taxpayer had to purchase bonds to place in escrow in order to secure a contract. The bonds were later sold at a loss which the court allowed as an ordinary business expense.

90. *Stott v. Hoddinott*, 7 Tax Cas. 85 (1918).

91. *M. Jacobs Young & Co. v. Harris*, 11 Tax Cas. 221 (1926).

92. *Maritime Lumber Distribs., Ltd. v. Minister of Nat'l Rev.*, 53 D.T.C. 296 (1953).

93. *Economic Trust Co. v. Minister of Nat'l Rev.*, 2 D.T.C. 830 (1946).

number of oil burners which were difficult to sell because of a prospective shortage of fuel oil, and in order to secure fuel oil and thus be able to sell its burners the company purchased stock in a fuel company, which was later sold at a loss, the loss was disallowed.⁹⁴

CONCLUSION

Before one could recommend a change from one system of taxing (or not taxing) capital gains, a further study of the political and economic effects, as well as a consideration of the revenue gain or loss involved, would of course be required. Individual taxpayers in the various countries may well look at the taxing structure in other countries and think that there "the grass is greener." As an example, an American businessman may look with envy at the United Kingdom's method of allowing the gain on the sale or exchange of land used in a business to go untaxed, but he would shudder at the thought of not being allowed to deduct a loss on the sale of such land or of equipment used in his business.

At first blush, the method that the United Kingdom and Canada have of taxing as ordinary income any depreciation recovered appears to be most reasonable, but upon closer examination, it is only a method of reducing the income that escapes taxation when capital gains are not taxed. If one assumes that depreciation is an allowance for wear and tear on an asset, when an asset is sold for more than its depreciated cost, the excess must be from the appreciation in value of the asset, assuming the allowance for depreciation to have been reasonable. Thus, these countries tax as ordinary income what in reality is capital gain in this instance.

Finally, other taxes in each country would have to be considered before one could make definite recommendations for change. As an example, the transfer taxes on the sales of securities in the United States are nominal, whereas in the United Kingdom, they are relatively high. Thus, in part at least, the advantage of the taxpayer in the United Kingdom in not paying tax on the capital gains on securities is offset by the disadvantage of a high transfer tax.

94. *Robert Dixon Co. v. Minister of Nat'l Rev.*, 53 D.T.C. 25 (1953). The taxpayer's position was characterized as unfortunate.