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ADVANCE PLANNING FOR CAPITAL GAIN — GENERALLY MAKING THE DISPOSITION A SALE OR EXCHANGE

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No matter how long an asset has been held, and regardless of the fact that it is a capital asset, long term capital gain will not result from its disposition unless that disposition qualifies as a sale or exchange.[1] The payment of a debt obligation is a common example of a disposition which fails to qualify. Although the retirement of certain obligations is treated as an exchange under the express provisions of section 1232(a)-(1),[2] many obligations, including all those in which the obligor is an individual, do not come within the terms of that section. Accordingly, the holder of such a debt obligation with a basis less than its face amount incurs ordinary income upon payment of the obligation at maturity. Ordinary income may be avoided in this situation, however, by a sale of the obligation prior to maturity. The few cases in this area have been liberal in allowing the creation of sales or exchanges by a taxpayer faced with an imminent disposition which would not qualify as a sale or exchange.[3]

As in all instances where a taxpayer seeks to avoid ordinary income by creating a capital gain transaction, caution is required. The cases have clearly stated that a tax-avoidance motivation alone will not destroy the intended capital gain result, but the sale must be bona fide.

As a first requirement, of course, the transaction must not fall within the anticipation or assignment of income principles.[4]

Second, the sale must have reality. The cases in the area have not gone deeply into this point; under the circumstances present in each case, the courts were able to conclude that the sale was real. However, a few suggestions may be offered. The property together with the benefits and, if any, the burdens of its ownership should actually be transferred to the third party. Following the sale, any gain or loss on the later disposition

1. See INT. REV. CODE OF 1954, § 1222(3). Certain dispositions, by special statutory provisions, are treated as sales or exchanges. See, *e.g.*, §§ 1231(a), 1232(a)(1).

2. See discussion pp. 351-52.

3. Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960) (dictum), *reversing* 30 T.C. 866 (1958); Arnfeld v. United States, 163 F. Supp. 865 (Ct. Cl. 1958) (dictum), *cert. denied*, 359 U.S. 943 (1959); Paine v. Commissioner, 236 F.2d 398 (8th Cir. 1956), *reversing* 23 T.C. 391 (1954); Conrad N. Hilton, 13 T.C. 623 (1949); Stanley D. Beard, 4 T.C. 756 (1945), *acq.*, 1944-1 CUM. BULL. 13; W. P. Hobby, 2 T.C. 980 (1943); Clara M. Tully Trust, 1 T.C. 611 (1943); Rose M. Everett, 4 CCH Tax Ct. Mem. 454 (1945).

4. See discussion p. 265. As to discount obligations, see discussion pp. 351-59.

must fall to the purchaser. In the debt situation, for instance, the seller should not guarantee the buyer against loss in the event the obligation is not paid in full at maturity. The purchaser should not be restricted in his use of the asset or in the manner of its disposition.[5]

Third, there should be, if possible, a substantial time interval between the sale and any later non-qualifying disposition. Where possible, too, the later disposition should not be certain of occurrence at the time of the sale or exchange.[6] Great latitude has been afforded by the courts on this point, upholding sales where a later disposition was virtually certain to occur in only two or three days' time.[7] But it is safer to avoid such circumstances.

Fourth, the sale should be to a third person completely unrelated to the taxpayer. The cases have provided some latitude here. Sales have been upheld when made to friends and business associates,[8] including law partners,[9] under circumstances indicating that the purchaser entered into the transaction simply as an accommodation to the seller.[10] But where possible this should be avoided. This is not an area where sharp lines can be drawn which a taxpayer can skirt with safety. All of the circumstances of the transaction will come under the court's scrutiny, and even a slight weakness in any of them may have some effect in determining the result.

The courts have shown a greater liberality toward the taxpayer's attempts to engineer a sale or exchange than in most areas of tax law. The step transaction doctrine, in particular, has not been applied with rigor. This is perhaps due to the technical nature of the sale or exchange requirement itself. That requirement in most circumstances has little relation to the reasons for allowing long term capital gain treatment. Accordingly the courts seem willing to accept a technical compliance with it.[11]

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5. See Leona Kurth Moore, 5 CCH Tax Ct. Mem. 133 (1946) (disregarding a "sale" of stock when the purchaser was under a binding commitment to sell to the issuing corporation within a few months after the "sale" occurred).

6. *Ibid.*

7. Arnfeld v. United States, 163 F. Supp. 865 (Ct. Cl. 1958) (dictum), *cert. denied,* 359 U.S. 943 (1959); John D. McKee, 35 B.T.A. 239 (1937), *acq.,* 1937-1 CUM. BULL. 10.

8. W. P. Hobby, 2 T.C. 980 (1943).

9. Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960) (dictum).

10. Arnfeld v. United States, 163 F. Supp. 865 (Ct. Cl. 1958) (dictum), *cert. denied,* 359 U.S. 943 (1959); W. P. Hobby, 2 T.C. 980 (1943).

11. Where the sale is designed to do more than simply meet the requirement of a sale or exchange the courts have usually been less lenient. *E.g.,* Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958). *But see* Zenz v. Quinliven, 213 F.2d 914 (6th Cir. 1954), *reversing* 706 F. Supp. 57 (N.D. Ohio 1952); Chamberlain v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *reversing* 18 T.C. 164 (1952).