

# Washington Law Review

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Volume 41 | Number 4

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8-1-1966

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### Recommended Citation

Roland L. Hjorth, *An Introduction to Capital Gain and Losses*, 41 Wash. L. Rev. 764 (1966).

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## AN INTRODUCTION TO CAPITAL GAINS AND LOSSES

ROLAND L. HJORTH\*

*In this article, originally prepared for his class in federal income tax, Professor Hjorth explores the theoretical bases and working principles underlying the taxation of capital gains and losses. Beginning with a review of basic federal income tax concepts and the provisions governing computation and recognition of all gains and losses, he proceeds through a comprehensive discussion of the basic Code provisions governing capital gains and losses. Additional discussion focuses on the specialized treatment afforded quasi-capital assets, copyrights and patents, inventory, discount bonds, short sales, small business stock, and foreign corporations.*

The capital gains tax is imposed on the increase in cash value of certain kinds of property when that increase is "realized" by means of a sale, exchange or other disposition which terminates the owner's interest in the property and marks the success or failure of his investment. Although capital gains are considered "income," within section 61 of the Internal Revenue Code of 1954,<sup>1</sup> they are taxed at rates lower than those applied to ordinary income. For taxpayers other than corporations, the capital gains tax rate is, in effect, about one-half the rate that would apply if the income were not a capital gain, and cannot exceed 25 per cent, even though the maximum rate on ordinary income is 70 per cent. For corporations the capital gains rate is 25 per cent, while the maximum rate imposed on ordinary corporate income is 48 per cent.<sup>2</sup>

Some have argued that this disparity in rates is not justified and that capital gains should be taxed as any other type of income;<sup>3</sup>

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<sup>1</sup> This was expressed as dictum in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (income includes "profit gained through a sale or conversion of capital assets") and was the holding in *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921).

<sup>2</sup> INT. REV. CODE OF 1954, §§ 1, 1201, 1202. The percentages stated are based on rates applicable to income for taxable years beginning after December 31, 1964.

<sup>3</sup> Statement of Merle H. Miller, in 2 *Hearings Before the House Committee on Ways and Means on General Revenue Revision*, 85th Cong. 2d Sess., pt. 2, at 2310 (1958). See Groves, *Taxation of Capital Gains*, House Committee On Ways and Means, 86th Cong. 1st Sess., 2 TAX REVISION COMPENDIUM 1193 (Comm. Print 1959).

others have argued that because of the special nature of capital gains, they should not be taxed at all.<sup>4</sup> It has been said that the capital gains tax is the "greatest source of unfairness in the American tax system."<sup>5</sup> Although the lower rates imposed upon capital gains income may be in part the result of pressures brought by special interest groups,<sup>6</sup> the special treatment afforded capital gains is largely accepted as the result of an attempt to achieve a fair tax structure. Nevertheless, this disparity in rates does give taxpayers a strong incentive to arrange their transactions in such a form that income from the transactions will qualify as capital gains. To combat the ingenuity of taxpayers, provisions of increasing specificity and complexity have been built into the tax structure. But while the capital gains provisions are complex, they are not incomprehensible. Complete comprehension, of course, requires a study of statutes, regulations, cases and rulings. This article is intended to serve as an introduction to such a study.

## I. INTRODUCTORY DEFINITIONS AND DISTINCTIONS

Income, for the purposes of this article, is defined to include (1) earnings from labor, (2) earnings from capital, and (3) gains from the sale, exchange or other disposition of property. Salaries are typical earnings from labor; interest and dividends, typical earnings from capital. The third type of income, gain realized upon the sale of property, may be referred to as "pure" or "casual" profit when it results wholly from inherent appreciation in the property's value. The profit of an investor who buys a share of stock for 100 dollars and sells it two years later for 200 dollars is pure or casual profit.

Frequently income is the product of more than one of the categories listed above. The profits of a shoemaker, for example, may be composed of all three elements of income. Although his profits may be measured in terms of the difference between the price at which he sells the shoes (amount realized) and their cost to him (cost of goods sold), this difference is attributable to the use of labor and capital in producing and distributing the finished product, and in a rising market, to inherent appreciation in the value of the shoes. The gain

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<sup>4</sup> *New York Stock Exchange, Taxes-Equity Capital—And Our Economic Challenges* 38-40 (1953). (Reprinted in BITTKER, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 480-82 (1964).

<sup>5</sup> STERN, *THE GREAT TREASURY RAID* 82 (1964).

<sup>6</sup> See EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 93-105 (1961).

of the shoemaker, a composite of all three types of income listed above, may be referred to as "business" profit.

In general, all earnings, whether attributable to labor or capital, are taxed as ordinary income. The same is true of business profits. There is little reason to tax the business profits of the corner grocer differently from the receipts of the local carpenter whose income consists only of earnings. A distinction must be made, however, between business profits and other types of profits which are often eligible for the special treatment accorded "capital" gains and losses in subchapter P of the Internal Revenue Code of 1954.<sup>7</sup> Profits from the sale, exchange or other disposition of property, other than in the ordinary course of business—that is, profits other than business profits—may represent appreciation in value accrued over several years because mere appreciation in value prior to a taxable event (such as a sale) is not taxed.<sup>8</sup> Thus if a piece of land (1) is purchased for 10,000 dollars, (2) appreciates in value at the rate of 2,000 dollars per year, and (3) is sold after ten years for 30,000 dollars, the taxpayer realizes a 20,000 dollar gain in the tenth year even though the appreciation actually attributable to the tenth year was only 2,000 dollars. Because of the progressive nature of the income tax (under which the 20,000th dollar of income is taxed at a higher rate than the 2,000th dollar) the taxpayer would pay a greater total tax on the 20,000 dollar gain, if it were taxed as ordinary income, than if the annual appreciation had been taxed when it accrued.

The special provisions of the Code relating to the taxation of capital gains were enacted primarily to avoid the inequities caused by this "bunching" of income in the year when the gain is realized. Another reason sometimes advanced to justify the privileged treatment accorded capital gains is that fluidity of investment is encouraged by the lower tax rates. The free flow of investment dollars from unproductive to productive enterprises may be impeded if the investor is required to pay a high tax whenever he changes his investment.<sup>9</sup>

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<sup>7</sup> Subsequent references to "the Code" are to the INTERNAL REVENUE CODE OF 1954, as amended. All "sections" referred to in the text are sections of the Code unless otherwise indicated.

<sup>8</sup> Although it might be constitutionally possible to tax unrealized appreciation, the present Internal Revenue Code does not attempt to do so. Cf. *Helvering v. Griffiths*, 318 U.S. 371 (1943); Brown, *An Approach to Subchapter C*, House Committee on Ways and Means, 86th Cong., 1st Sess., 3 TAX REVISION COMPENDIUM 1619, 1621 (Comm. Print 1959).

<sup>9</sup> These and other arguments are reported in Tax Advisory Staff, Treasury Department, *Federal Income Tax Treatment of Capital Gains and Losses* (1951).

Although this article focuses on the taxation of capital gains and losses, it is necessary to begin with a brief review of the Code provisions relating to computation and recognition of all gains, whether ordinary or capital.

## II. COMPUTATION AND RECOGNITION OF GAINS AND LOSSES IN GENERAL

Section 1001 provides that the amount of "realized" gain or loss shall be the difference between (1) the "adjusted basis" of property and (2) the sum of (a) the cash and (b) the fair market value of other property received in exchange for the property. The "adjusted basis" of property is one of the bases set forth in sections 1012-1015 of the Code, as "adjusted" pursuant to section 1016.

### A. Basis

The most common basis is cost,<sup>10</sup> the price for which the property was acquired, but other bases may apply in particular situations:

(1) The basis of property that should be included in inventory equals its last inventory valuation.<sup>11</sup>

(2) Property acquired as a result of the death of another, whether by will, intestacy, or otherwise, takes a "stepped-up" basis which is the value of the property on the date of the decedent's death, or, if the estate is required to file a federal estate tax return, the value placed on the property for federal estate tax purposes. In order

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They do not convince everyone. See EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 93-105 (1961). See also Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *TAXES* 247 (1957).

The problems created by telescoping income accrued over a long period of time into one taxable year have also been dealt with by means of provisions whose effect is to tax the income as if it had been received over a longer period of time. INT. REV. CODE OF 1954, §§ 1301-05. For a discussion of these "income averaging" provisions, see Goldberg, *Income Averaging Under The Revenue Act of 1964*, 74 *YALE L.J.* 465 (1965).

<sup>10</sup> INT. REV. CODE OF 1954, § 1012. Where property is exchanged for other property in a taxable exchange, "cost" is the fair market value of the property acquired. *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954). Thus, the basis of property acquired by a corporation in return for its stock is the fair market value of the property acquired unless the exchange is nontaxable as far as the shareholder is concerned (*e.g.*, under § 351). This is true even though the corporation recognizes no gain on such acquisition. INT. REV. CODE OF 1954, § 1032. Where property is contributed to a corporation by someone other than a shareholder as such, the corporation's basis in the property is zero.

As a general rule, one who purchases property subject to a liability (*e.g.*, property subject to a mortgage) may include the amount of the assumed liability in his cost basis. The "amount realized" by the seller of mortgaged property includes the amount of any liability assumed by the purchaser. See *Crane v. Commissioner*, 331 U.S. 1 (1947); *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950).

<sup>11</sup> INT. REV. CODE OF 1954, § 1013.

for this "step-up" in basis to apply, the property must be includible in the decedent's gross estate for federal estate tax purposes. Thus, if *A* devises Blackacre to *B* for life with a remainder to *C*, the basis of *C* in the property will depend on its value at *A*'s death since nothing is included in *B*'s gross estate for federal estate tax purposes.<sup>12</sup>

(3) As a general rule, a donee of property takes his donor's adjusted basis in that property. However, if the donor's adjusted basis is higher than the fair market value of the property on the date of gift, the donee takes a bifurcated basis: for purposes of determining gain, his basis is the donor's adjusted basis; to determine loss, his basis is the fair market value of the property on the date of the gift.<sup>13</sup> If the donor paid a gift tax on the transfer, the donee's basis is increased by the amount of the tax paid, up to, but not higher than the fair market value of the property at the time of the gift.<sup>14</sup>

(4) It is said that a donee's basis is a "substituted" basis because it is determined partly by reference to the prior owner's basis in the property. Another common example of a substituted basis is where the basis of property acquired in a non-taxable exchange is determined by reference to the basis of property given up.<sup>15</sup> If a taxpayer trans-

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<sup>12</sup> INT. REV. CODE OF 1954, § 1014. The value placed on property for federal estate tax purposes will be its value on the day of the decedent's death or, at the election of the executor or administrator, its value one year thereafter if not sold in the interval and if sold in the interval, the sales price. INT. REV. CODE OF 1954, § 2032. This "step-up" in basis creates tax-planning possibilities. If a taxpayer owns securities worth \$100 for which he paid \$10, a sale of the securities before his death results in a gain of \$90. If he holds the securities until he dies, his heirs or legatees can sell the securities without realizing any gain. Correspondingly, if securities with a cost basis of \$100 are held until death when they are worth \$10, no deductible loss is realized. Sale of property by older persons should be planned in light of these facts. The Proposed Revenue Act of 1963 would have ended this exemption from income tax of capital gains accrued but not realized at death. See *Statement of Secretary of the Treasury Dillon, President's 1963 Tax Message, HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS* 29, 54-56 (Comm. Print 1963). The proposals were not enacted, but one may reasonably infer that § 1014 will not be a permanent part of the Code.

Under § 1014(b) (6) the interest of the surviving spouse in community property also takes a stepped-up basis on the death of the other. Prior to 1948 the basis of the surviving spouse in his or her share of the community was not changed as a result of the death of the other spouse. *Estate of Waters v. Commissioner*, 3 T.C. 407 (1944).

<sup>13</sup> INT. REV. CODE OF 1954, § 1015(a).

<sup>14</sup> INT. REV. CODE OF 1954, § 1015(d). Prior to 1921, the donee's basis was the fair market value of the property at the time of the gift. By making intra-family gifts of appreciated property, an increased basis could be obtained at a gift tax cost. The present complicated basis provisions were adopted to eliminate this abuse. Under the present statute, if a donee sells appreciated property at a gain, the entire amount of the appreciation (reduced by the amount of gift tax paid) will be realized when the donee sells the property—whether the gain accrued during the donee's ownership, the donor's ownership or both. See *Taft v. Bowers*, 278 U.S. 470 (1929). The reverse, however, is not true. A donor cannot give away a tax loss by making a gift of depreciated property.

<sup>15</sup> INT. REV. CODE OF 1954, § 1016(b).

fers property with a basis of 10 dollars to a controlled corporation for stock worth 50 dollars, he realizes a 40 dollar gain, but if certain requirements are met, the gain will not be recognized.<sup>16</sup> If no gain is recognized, the taxpayer's basis in the stock is 10 dollars, regardless of the value of the stock or of the property he exchanged for it.<sup>17</sup> The corporation, in such a situation, will also have a substituted basis: it takes the taxpayer's basis of 10 dollars in the property.<sup>18</sup> The function of the substituted basis in non-recognition transactions is to insure in most instances that recognition of the gain realized is merely postponed, not ignored for tax purposes. Recognition in this example would normally occur when the taxpayer sells his stock and when the corporation sells the property.<sup>19</sup>

### *B. Adjustments to Basis*

Once the applicable basis has been determined it is "adjusted" up or down in accordance with the provisions of section 1016. Basis is adjusted "upward" for certain expenses incurred by the taxpayer which are attributable to the property, and which qualify as "capital expenditures" (as contrasted to expenses for repair and upkeep).<sup>20</sup> For example, if a taxpayer acquires a building and adds a significant improvement (which is not deductible as a repair expense), the amount spent for the improvement is added on to the cost of the building in arriving at the "adjusted basis" of the building. One of the most common "downward" adjustments is the depreciation allowable to the taxpayer as a business-expense deduction for past taxable years.<sup>21</sup> In the example of the building cited above, all allowable depreciation would be deducted from the sum of original cost and improvement

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<sup>16</sup> INT. REV. CODE OF 1954, § 351.

<sup>17</sup> INT. REV. CODE OF 1954, § 358.

<sup>18</sup> INT. REV. CODE OF 1954, § 362.

<sup>19</sup> This leads to the possibility of a double gain. If a shareholder transfers property with a basis of \$10 in return for corporate stock worth \$100 in a non-taxable exchange, the shareholder realizes a \$90 gain on the subsequent sale of the stock for \$100 and the corporation realizes a \$90 gain on the subsequent sale of the property for \$100.

<sup>20</sup> INT. REV. CODE OF 1954, § 1016(a)(1). *Illinois Merchants Trust Co., Executor*, 4 B.T.A. 103, 106 (1926):

A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operation. It does not add to the value of the property, nor does it appreciably prolong useful life.... Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against earnings.

<sup>21</sup> INT. REV. CODE OF 1954, § 1016(a)(2).

cost in arriving at adjusted basis. The foregoing can be illustrated by an example:

Taxpayer operates a cookie plant as a sole proprietor. On January 1, 1953, he purchased a building for use in his business. The building had an estimated useful life of 20 years, and cost Taxpayer \$1,000,000. On January 1, 1958, Taxpayer paid \$300,000 for a new wing added to the factory and completed on that day. The wing had an estimated useful life of 15 years. Taxpayer depreciated the property under the straight-line method, correctly assuming that there would be no salvage value. On January 1, 1963, Taxpayer sold the building to John Doe for \$1,000,000.

Under section 1001, the amount of gain is the excess of the sales price over the adjusted basis. The basis is the cost—1,000,000 dollars. This basis must be “adjusted” by adding the cost of the new wing, yielding a sum of 1,300,000 dollars. A second adjustment results from deducting the depreciation allowable in respect of the factory and the wing. The annual allowance for the factory was 50,000 dollars; the annual allowance for the wing was 20,000 dollars. Taxpayer could have claimed depreciation on the factory for 10 years and depreciation on the wing for 5 years, yielding an aggregate allowable depreciation deduction of 600,000 dollars. Accordingly, the adjusted basis under section 1016 is 700,000 dollars (costs of 1,000,000 dollars plus 300,000 dollars, less total depreciation of 600,000 dollars).<sup>22</sup> If the adjusted basis is deducted from the sales price of 1,000,000 dollars, the gain realized was 300,000 dollars. Under the facts given, there is no provision of the Code which would result in non-recognition of gain.

The theory behind these basis adjustments is that when a taxpayer receives back part of his property he should not be taxed, but his basis should be reduced, and when he adds something to the property his basis should be increased. A depreciation deduction is in a sense a receipt of property—it is “used up” by the taxpayer and deducted from current income. Similarly, when a taxpayer receives a distribution from a corporation that has no earnings and profits he may realize no income but his basis in the stock is reduced by the amount of the distribution.<sup>23</sup> Conversely, when a taxpayer is taxed directly

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<sup>22</sup> The basis is reduced for amounts actually “allowable” as depreciation deductions even if the maximum amount allowable was not deducted because of a mistake or for some other reason. See *Commissioner v. Superior Yarn Mills, Inc.*, 228 F.2d 736 (4th Cir. 1955).

<sup>23</sup> INT. REV. CODE OF 1954, § 301 (c) (2).



on the income of a partnership or subchapter S corporation his basis is increased by the amount of income attributed to him but not received; for basis purposes he is treated as if he had received the money from the partnership and reinvested it.<sup>24</sup>

### C. Recognition

A "realized" gain is not a taxable event unless it is also "recognized." Section 1002 provides that all gains realized upon a sale or exchange shall be recognized unless the Code specifically provides for non-recognition. Most of the non-recognition provisions of the Code are contained in subchapters O (computation of gains and losses), K (partners and partnerships) and C (corporate distributions and adjustments). The effect of non-recognition is normally to postpone, rather than to eliminate, the taxation of gain.

Most non-recognition provisions apply in two types of situations. The first type involves an exchange where a gain has been realized in form, but where the taxpayer in fact owns essentially the same kind of property after the exchange as before. This would be true, for example, where the taxpayer transfers appreciated property to a corporation in return for all the stock of the corporation. Before the exchange the taxpayer owned particular assets; after the exchange he owns stock. If the stock is worth more than the taxpayer's adjusted basis in the assets, a gain will be realized, but will not be recognized because the taxpayer's interest has changed only in form;<sup>25</sup> the disposition has not terminated his economic interest in the property. Other examples of this type may be found in transfers of property to a partnership in return for an interest in the partner-

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<sup>24</sup> INT. REV. CODE OF 1954, §§ 705, 1376. This is not true where income of a corporation is not taxed directly to shareholders. The shareholder has no "tax cost" in such cases. The Code provides for many other adjustments to basis of a more specialized nature, most of which are set forth or referred to in INT. REV. CODE OF 1954, § 1016. The reason for the basis adjustments might be illustrated by examples:

1. A shareholder receives a tax-free distribution of \$5 from a corporation which has no earnings and profits. Shareholder's basis in the stock is \$10. If the shareholder's basis were not reduced by the amount of the tax-free distribution, he would never be taxed on a real gain of \$5 if he subsequently sold the stock for \$10.

2. A partner's basis in his partnership share is \$10. His distributive share of partnership income is \$5, which is taxed to him but left in the partnership. If his basis were not increased by \$5 he would be subjected to a second tax if he sold the property for \$15.

Accordingly, in the first example, the shareholder's basis is reduced to \$5 and in the second the partner's basis is increased to \$15.

<sup>25</sup> INT. REV. CODE OF 1954, § 351.

ship;<sup>26</sup> exchanges of stock or assets for other stock or assets in connection with certain corporate divisions or reorganizations;<sup>27</sup> and exchanges of investment property for property of a like kind.<sup>28</sup> The reason for granting non-recognition in such instances is that, although a taxpayer may realize gain in a technical sense when he exchanges his property, he does not get the economic benefit of the appreciation in value until the investment is converted to cash or its equivalent.<sup>29</sup>

The second type of situation where non-recognition is granted involves an involuntary conversion of property followed by reinvestment of the proceeds in similar property.<sup>30</sup> Non-recognition here is granted as a kind of relief measure since the taxpayer is usually forced to realize his gain because of circumstances beyond his control. Although the sale of a residence is not technically an involuntary conversion, here, too, the taxpayer is often forced to realize his gain (if any) by reason of a change of employment or because of other circumstances beyond his control. Thus, if the taxpayer reinvests the proceeds in another residence within one year, he is allowed to postpone recognition of the gain.<sup>31</sup>

<sup>26</sup> INT. REV. CODE OF 1954, § 721.

<sup>27</sup> INT. REV. CODE OF 1954, §§ 354, 355, 356, 361, 368.

<sup>28</sup> INT. REV. CODE OF 1954, § 1031.

<sup>29</sup> The economic reasons for non-recognition of gain or loss where an exchange does not materially affect a taxpayer's financial or economic position have been considered most thoroughly in connection with corporate reorganizations and adjustments. See, e.g., Brown, *An Approach to Subchapter C*, HOUSE COMMITTEE ON WAYS AND MEANS, 86th Cong., 1st Sess., 3 TAX REVISION COMPENDIUM 1619, 1621 (Comm. Print 1959); PAUL, *STUDIES IN FEDERAL TAXATION* 1, 4-8 (3d ser. 1940).

<sup>30</sup> INT. REV. CODE OF 1954, § 1033.

<sup>31</sup> INT. REV. CODE OF 1954, § 1034. Care must be taken to follow the literal requirements of the section in order to qualify for non-recognition treatment. The property sold must have been used as the taxpayer's principal residence and the new property must be purchased and used as the new principal residence within one year from the original sale. See Arthur M. Rosenthal, 24 CCH TAX CT. MEM. DEC. 1373 (1965).

In a non-recognition transaction a taxpayer may receive, in addition to property permitted to be received tax-free, certain other property "to boot." The general pattern of the Code is (a) to recognize gain in such instances in an amount not exceeding the fair market value of the "boot" and (b) to make appropriate basis adjustments. Thus, if a taxpayer transfers property with a basis of \$10 to a corporation in return for stock worth \$80 and \$20 in cash, and if gain would not be recognized if no cash had been received, only \$20 of the \$90 gain will be recognized. Basis in the stock will be reduced by the value of "recognition" property received and increased by the amount of gain recognized. See e.g., INT. REV. CODE OF 1954 §§ 351(b), 358. In cases where property is sold or converted and non-recognition depends upon reinvestment in similar property, gain will be recognized to the extent proceeds are not in fact reinvested. If a taxpayer's commercial building, with an adjusted basis of \$10,000, is condemned and proceeds in the amount of \$100,000 are paid to the taxpayer, he may avoid recognition by investing the entire \$100,000 in a similar commercial building. If the taxpayer only invests \$80,000 of this amount in the new building, however, he will recognize \$20,000 of his \$90,000 realized gain. See INT. REV. CODE OF 1954, § 1033.

## III. CAPITAL GAINS AND LOSSES—DEFINITIONS

*A. Sale or Exchange*

A capital gain or loss arises upon the sale or exchange of a capital asset.<sup>32</sup> Although section 1221 defines "capital asset," there is no definition of "sale or exchange" in the Code.<sup>33</sup> A preliminary distinction must be noted between the language of section 1001 which governs computation of gain or loss realized on the "sale or other disposition" of property, and the language of section 1222, which defines capital gains and losses solely in terms of "sale or exchange." Although it should usually be clear whether a transaction involves a sale or exchange, in difficult cases this distinction may be used by a court to deny capital gains treatment to a transaction which is clearly a disposition, but which it finds to be neither a sale nor exchange. For example, the collection of a debt at a gain or loss is a disposition but not a sale or exchange, and thus entails "ordinary" tax consequences.<sup>34</sup> As a general rule, however, "sale or exchange" is broadly interpreted to include involuntary conversions and most other dispositions of property.<sup>35</sup>

<sup>32</sup> INT. REV. CODE OF 1954, § 1222.

<sup>33</sup> INT. REV. CODE OF 1954, § 1001. While a detailed discussion of whether borderline transactions constitute "sales or exchanges" is outside the scope of this article, it may be noted that the term includes certain property transfers incident to a separation or divorce in non-community property states, e.g., *United States v. Davis*, 370 U.S. 65 (1962), but does not necessarily include the division of community property. See Rev. Rul. 56-437, 1956-2 CUM. BULL. 507. A taxpayer having rights to income under a contract may "sell" that contract in return for an annuity, or he may re-negotiate the contract to modify the manner in which he will receive the later income. The first transaction is probably a "sale or exchange," while the latter novation is probably not a taxable event. See *Commissioner v. Olmstead Inc. Life Agency*, 304 F.2d 16 (8th Cir. 1962).

<sup>34</sup> See *Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub. nom.*, *Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954) (gain realized on settlement of judgment). Abandonment of property does not amount to a sale or exchange. *Jamison v. Commissioner*, 8 T.C. 173 (1947). The result of finding no "sale or exchange" means that even though there may be gain or loss realized on the disposition of a capital asset, the gain or loss will be ordinary. Although § 1001(a) & (b) refers to the computation of gain or loss on a sale or disposition, §§ 1001(c) and 1002, referring to recognition of gains or losses apply only on sales or exchanges. Section 1002 provides that all gains or losses from sales or exchanges shall be recognized unless a specific non-recognition provision applies. The taxpayer in *Ogilvie* might thus have argued that if the disposition was not a sale or exchange, § 1002 would not apply and no gain or loss should be recognized. However, the fact that § 1002 refers only to gains or losses from sales or exchanges does not prevent gains from other dispositions from being included in gross income because it does not exclude such gains from gross income; they are included within the general definition of gross income, which includes "gains derived from dealings in property." INT. REV. CODE OF 1954, § 61(a)(3).

<sup>35</sup> See, e.g., *Helvering v. Hammel*, 311 U.S. 504 (1941) (foreclosure sale of

### B. Capital Asset

More difficult problems arise in determining whether the sale or exchange has involved a "capital asset." Although section 1221 defines capital asset to include *all* property<sup>36</sup> except the specific types therein enumerated, the term "property" has been judicially narrowed to exclude certain "property rights" which are merely substitutes for ordinary income.

As a general rule, a right to receive income is not property for purposes of section 1221, and a sale of that right cannot give rise to a capital gain or loss. Thus, the right of a landlord to receive rent under a short-term lease is not property under section 1221.<sup>37</sup> If the landlord cancels the lease, receiving a payment from the tenant in return for forgiving the tenant's lease obligations, the payment is not received in exchange for a capital asset. Similarly, amounts paid to a former employee in return for his rights under an ordinary employment contract are not amounts paid for property.<sup>38</sup> What the landlord and the employee gave up were in reality rights to receive income in the future.

It is sometimes difficult, however, to distinguish a right to receive income from a property right which is a capital asset. Although a life tenant has only a right to income, it has been held that a life estate is property whose sale can give rise to capital gain or loss.<sup>39</sup> The problems involved in determining whether the subject of a sale or exchange is a capital asset are the same as those faced by taxpayers

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interest in property); *Hummel v. United States*, 227 F. Supp. 30 (N.D. Calif. 1963) (retirement of depreciable property used in the business). INT. REV. CODE OF 1954, §1231 now provides that gains arising from involuntary conversions of capital assets held more than 6 months shall be treated as long-term capital gains, but that losses from such conversions under certain circumstances may be treated as ordinary losses. The term "involuntary conversion" includes destruction, theft or seizure and condemnation or the threat thereof. INT. REV. CODE OF 1954, § 1231 (a).

<sup>36</sup> A gain or loss from the sale or exchange of an option to buy or sell property is treated in the same fashion as a gain or sale of the property to which the option relates. INT. REV. CODE OF 1954, §1234. The section does not apply to options to buy or sell inventory property or to employee stock options.

<sup>37</sup> *Hort v. Commissioner*, 313 U.S. 28 (1941). The converse, however, is not true. A lessee who surrenders his lease to a lessor may be treated as having sold or exchanged a capital asset. The same is true of a distributor who has a substantial investment in a distributorship and who cancels the distributorship agreement for consideration. INT. REV. CODE OF 1954, §1241.

<sup>38</sup> *McFall v. Commissioner*, 34 B.T.A. 108 (1936). An exception to this rule is contained in the infamous "Mayer amendment," INT. REV. CODE OF 1954, §1240, but it is unlikely that anyone other than the intended beneficiary of that amendment could meet its requirements.

<sup>39</sup> *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

seeking to assign property for income-splitting purposes. In both cases, the taxpayer must ascertain whether the subject of his sale or assignment is property or merely a right to receive income.

If the subject of a sale or exchange is in fact property, it qualifies as a capital asset unless *specifically excluded* by section 1221. Types of property specifically excluded are: (1) inventory and property held for sale to customers in the ordinary course of the taxpayer's trade or business; (2) real or depreciable property used in the taxpayer's trade or business; (3) copyrights and other literary property in the hands of authors; (4) accounts receivable acquired in the ordinary course of business; and (5) certain government bonds. The exclusion of inventory and ordinary accounts receivable from the definition of capital asset takes most business profits out of the capital gains category.<sup>40</sup>

If one remembers that a principal purpose of the capital gains provisions is to ameliorate the bunching problem, it is easy to see why inventory and other property held for sale to customers are not considered capital assets. Because inventory is seldom held for more than one year, profits from its sale do not create bunching problems. Moreover, this kind of profit is usually due to the taxpayer's services and the use of his capital, rather than to value-appreciation. The same reasoning applies to accounts receivable acquired in the ordinary course of business.

The reasons for excluding the other items specified in section 1221 are less obvious. A copyright in the hands of the author is excluded for historical reasons—many authors were, under former law, treating their work product as “property” and selling it at capital gains rates.<sup>41</sup> Certain government bonds are excluded from the definition of capital asset because they are redeemable at a “gain” which is actually a substitute for interest.<sup>42</sup> Real or depreciable personal property used in the taxpayer's business is also excluded from the definition of capital asset under section 1221, but assets falling within this category are given special treatment under section 1231: If they are sold at a net gain in the taxable year, the gain is treated as a capital gain; if such assets are sold at a net loss, the loss is treated as an

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<sup>40</sup> It has been stated that “in these deceptively few words Congress is attempting to exclude from ‘capital gain’ all of those profits which it regards as the everyday profits of the business and commercial world.” SURREY & WARREN, FEDERAL INCOME TAXATION 681 (1960).

<sup>41</sup> See notes 70-75 *infra* and accompanying text.

<sup>42</sup> INT. REV. CODE OF 1954, § 1221(5).

ordinary loss.<sup>43</sup> Problems relating to property used in the trade or business and copyrights are discussed in more detail below.

### C. Holding Period

The holding period—how long the taxpayer has held the property before selling or exchanging it—determines whether the gain or loss arising on a transaction is long- or short-term. A short-term gain or loss results when the property has been held for six months or less prior to sale. If the property has been held for more than six months, the gain or loss is long-term.<sup>44</sup>

The holding period provisions of section 1223 are connected with the non-recognition and substituted basis provisions considered above.<sup>45</sup> If the taxpayer has received a gift, he not only takes a substituted basis in the gift property, but his holding period includes that of his donor. In a non-taxable exchange of property for stock in a corporation, the taxpayer's basis in the stock is the same as his basis in the property exchanged for it, and his holding period in the stock includes the period for which he held the property prior to the exchange.<sup>46</sup> Although there are other particularized provisions in section 1223, these are the most important for understanding the basic structure of the capital gains tax.

Once it has been determined whether a gain or loss is long- or short-term, it is necessary to determine "net" short- and long-term gains or losses. A net short-term gain or loss is the excess of short-term gains over short-term losses (or of losses over gains) realized and recognized in the taxable year. Net long-term gain or loss is found in the same manner.<sup>47</sup> These net figures are used to compute the capital gains tax.

## IV. COMPUTATION OF TAX

It may be noted preliminarily that net short-term gains, to the

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<sup>43</sup> See note 63 *infra* and accompanying text.

<sup>44</sup> INT. REV. CODE OF 1954, § 1222.

<sup>45</sup> INT. REV. CODE OF 1954, § 1223(1). See notes 25-31 *supra*, and accompanying text.

<sup>46</sup> One reason for "tacking on" prior holding periods where the property held has a substituted basis is that the gain or loss realized on sale would include gain or loss accrued during a prior holding period. Assume, for example, that a donor pays \$1000 for stock, holds it for 10 years when it is worth \$10,000 and gives it to his nephew, paying no gift tax. If the nephew sells the stock the next day he will realize a \$9,000 gain even though that gain accrued during the donor's ownership. If a long-term gain is more advantageous than a short-term gain, the nephew should have that advantage if he is to be taxed on the appreciation.

<sup>47</sup> INT. REV. CODE OF 1954, § 1222.

extent they are *not* offset by net long-term losses, are taxed in the same manner as ordinary income. Net long-term gains, however, (to the extent they are not offset by net short-term losses) are eligible for special tax treatment.<sup>48</sup> Both net short-term and net long-term losses are first offset against gains in the other category.<sup>49</sup> To the extent that losses in one category exceed gains in the other category, they may be deducted from ordinary income only by taxpayers other than corporations and then only to the extent of 1,000 dollars per year.<sup>50</sup> This is discussed in more detail below.

The separate computation of net short-term gain or loss and net long-term gain or loss creates four possibilities:

- (1) A net short-term *gain* and a net long-term *gain*;
- (2) A net short-term *loss* and a net long-term *gain*;
- (3) A net short-term *gain* and a net long-term *loss*; *and*
- (4) A net short-term *loss* and a net long-term *loss*.

In item (1), the net short-term gain is taxed in the same manner as ordinary income, but the taxation of the net long-term gain is subject to the special rules described below. In item (2), the net short-term loss is offset against the net long-term gain: If the remainder is a loss, the loss is subject to the special rules set forth below relating to the limited deductibility of capital losses; if the remainder is a gain, the remainder is subject to the special rules set forth below relating to taxation of long-term capital gains. In item (3), the net long-term capital loss is offset against short-term capital gain: If the remainder is a loss, the loss is subject to the special rules set forth below relating to the limited deductibility of capital losses; if the remainder is a gain, the gain is taxed as any other item of ordinary income. In item (4), both categories of losses are subject to the special rules set forth below relating to the limited deductibility of capital losses.

#### *A. Taxation of Long-Term Capital Gains*

The taxation of the excess of net long-term capital gains over net short-term capital losses varies, depending upon whether the taxpayer is an individual or a corporation. As to individuals, there is no "special" tax unless the "alternative" tax described below applies; however, the taxpayer may deduct from his gross income one-half of

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<sup>48</sup> See text accompanying notes 51-55 *infra*.

<sup>49</sup> INT. REV. CODE OF 1954, § 1222(5)-(9).

<sup>50</sup> See notes 56-60 *infra* and accompanying text.

the excess of net long-term capital gain over net short-term capital loss.<sup>51</sup> This may be illustrated by the following example:

Taxpayer is a salaried employee who has no business expenses. His salary for the taxable year was \$10,000. He also sold a house and a lot for \$20,000, realizing a long-term capital gain of \$10,000. Since Taxpayer had no other capital transactions, this \$10,000 is the "excess of his long-term capital gain over his short-term capital loss."

As a result of the above transaction, taxpayer's gross income is \$20,000 (\$10,000 salary and \$10,000 long-term capital gain). He is permitted to deduct one-half the gain from gross income. His adjusted gross income is therefore \$15,000.

Unless taxpayer pays the "alternative tax," he goes on to compute his taxable income and tax without further adjustment in respect of the capital gain. Because of the capital gains deduction, tax on the capital gain will be somewhat less than one-half the amount he would have paid had the gain been ordinary income. It should be remembered that this deduction for capital gains is available only to taxpayers other than corporations. Corporations must always pay either the alternative tax or the tax imposed by other sections without benefit of the capital gains deduction.

In computing the alternative tax, a corporation must segregate its ordinary income from its excess of net long-term capital gain over short-term capital loss. It then pays a tax on its ordinary income at normal rates and pays a tax on its net capital gain at the rate of 25 per cent.<sup>52</sup> In taxable years beginning before January 1, 1964, the alternative tax was always advantageous to corporations because the lowest corporate tax rate was 30 per cent. For taxable years beginning on or after January 1, 1964, however, capital gain income could actually be taxed to corporations at a higher rate than ordinary income, because the effective rate on a corporation's first 25,000 dollars of ordinary taxable income is only 22 per cent. A corporation in the 22 per cent bracket will now treat its capital gains as ordinary income.<sup>53</sup> Capital gains rates continue to be favorable to corporations whose marginal rate on ordinary income is 48 per cent, but the net tax advantages of capital gains are far less significant to corporations than to other taxpayers.

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<sup>51</sup> INT. REV. CODE OF 1954, § 1202.

<sup>52</sup> INT. REV. CODE OF 1954, § 1201(a).

<sup>53</sup> See INT. REV. CODE OF 1954, §§ 11, 1201(a). The alternative tax applies only if it results in a lower tax than rates imposed elsewhere.



The alternative capital gains tax imposed on non-corporate taxpayers is similar to that imposed on corporations, differing only in method of computation. It is computed by subtracting one-half the applicable long-term gain from *taxable income* otherwise computed, computing the tax on the remainder and computing a separate capital gains tax at the rate of 25 per cent of the excess of net long-term capital gain over net short-term capital loss.<sup>54</sup> Since one-half of such excess was deducted from gross income *before* computing taxable income, adoption of the alternative tax simply means that *all* long-term capital gain is deducted in computing the ordinary taxable income and the tax thereon. A separate capital gains tax is then imposed upon the excess of net long-term capital gain over net short-term capital loss. The net result of these complicated procedures is that where the alternative tax does not apply, the taxpayer in effect includes only one-half the excess of net long-term gain over short-term loss in his income; where the alternative tax applies he computes one tax on his ordinary income and a separate tax on his capital gains. The more complicated procedures described in the Code should be followed, however, for purposes not related to capital gains taxation.<sup>55</sup>

Rules relating to the application of the alternative tax to non-corporate taxpayers may be summarized as follows:

(1) If the tax rate on the last dollar of taxpayer's taxable income, *exclusive* of capital gains, is 50 per cent or higher, the alternative tax will be applied. In such a case, the effective tax rate on capital gains will be at least 25 per cent, even after the deduction for long-term capital gains is taken into consideration; as a result of the long-term capital gain deduction, only half the gain is taxed, but, if the applicable rate on this half is 50 per cent or more, the tax on the entire amount is 25 per cent or more.

(2) If the tax rate on the last dollar of taxpayer's income *including* capital gains, after the capital gains deduction, is 50 per cent or less, the alternative tax will not be applied. In this case the effective tax on long-term capital gains would always be less than the 25 per cent alternative tax rate.

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<sup>54</sup> INT. REV. CODE OF 1954, § 1201(b).

<sup>55</sup> The procedure described in INT. REV. CODE OF 1954, §§ 1202 and 1201 is necessary to find "adjusted gross income," which must often be ascertained for such purposes as computing the allowable medical expense deduction and charitable contributions deduction. See generally INT. REV. CODE OF 1954, §§ 170(b)(1)(A)&(B), 213(a)&(b).

(3) If the tax rate on the last dollar of taxable income, exclusive of capital gains, is less than 50 per cent but the tax rate on the last dollar of taxable income including capital gains after the capital gains deduction is more than 50 per cent, both the regular tax, with the capital gains deduction, and the alternative tax must be computed. The taxpayer pays the smaller of the two taxes.

### B. Limitations on Losses

The limitations upon ordinary losses are also imposed upon capital losses. These limitations will not be discussed in detail, but it may be stated generally that losses may be deducted only if the property is used in the taxpayer's trade or business or held for the production of income.<sup>56</sup> Moreover, only this type of loss may be offset against capital gains. Thus, even though a gain realized on the sale of a residence is (subject to certain exceptions) includible in gross income, a loss suffered on such a sale is not deductible. Such a loss may not even be offset against gains realized, for example, from the sale of securities.<sup>57</sup>

If an ordinary loss is deductible at all, it may be offset against ordinary income without limitation.<sup>58</sup> The deductibility of a capital loss, however, is limited in several ways. A deductible capital loss is used first to offset a capital gain. A capital loss of one type (*e.g.* short-term) is first applied against gains of the same type. To the extent this type of loss exceeds the gain of the same type, it is used as an offset against gains of the other type (*e.g.*, long-term). If losses exceed gains of both types (*i.e.*, long-term and short-term), the excess loss may be deducted from ordinary income only if the taxpayer is *not* a corporation, and then only to the extent of 1,000 dollars.<sup>59</sup> These limitations

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<sup>56</sup> INT. REV. CODE OF 1954, § 165(c). Losses suffered as a result of a casualty need not meet these requirements. All ordinary losses of corporations are deductible. If a security which is a capital asset becomes worthless during the taxpayer's taxable year, the loss is deemed to be one incurred on a "sale or exchange" of the asset on the last day of that taxable year. INT. REV. CODE OF 1954, § 165(g).

<sup>57</sup> Assume that a taxpayer suffers a \$10,000 loss on the sale of his residence and realizes a \$10,000 gain on the sale of securities. His net gain is probably \$10,000 although the statute is not explicit on this point. INT. REV. CODE OF 1954, § 165(f) allows capital losses to be deducted "to the extent allowed in section 1211 and 1212." These sections allow losses to be deducted "to the extent of gains" without incorporating the requirements of § 165(c). It would seem unreasonable, however, to allow taxpayers deductions for losses merely because they are "capital" losses. INT. REV. CODE OF 1954, § 1211 is a *limitation* upon deductibility of losses and would probably not be construed as creating a deduction not provided in § 165.

<sup>58</sup> Wagering losses, however, may be deducted only to the extent of wagering gains. INT. REV. CODE OF 1954, § 165(d).

<sup>59</sup> INT. REV. CODE OF 1954, § 1211. The reason why capital losses must *first* be offset against capital gains may be illustrated by an example. If an individual taxpayer with

lead to situations where a taxpayer has excess capital losses which may not be deducted from current ordinary income. To ameliorate this situation, the Code provides that capital losses may be carried over by taxpayers other than corporations for an indefinite number of years and by corporations for a maximum of five years.<sup>60</sup>

The limitations on deductibility of capital losses are designed to prevent taxpayers from "timing" their losses by selling depreciated property in high-income years and deducting the losses against high-bracket ordinary income.

#### V. QUASI-CAPITAL OR "SECTION 1231" ASSETS

As noted above, section 1221 specifically excludes depreciable property used in the trade or business and real property used in the trade or business from the definition of capital asset. Because this type of asset is subject to the special rules set forth in section 1231, the assets are usually called "section 1231" assets. Because section 1231 provides for capital gain treatment if these assets are sold at a net gain, but allows ordinary loss treatment if these assets are sold at a net loss, these assets are also called "quasi-capital" assets. Before turning to the special provisions of section 1231, some special problems created by sales and exchanges of this kind of property will be considered.

On the one hand, the sale of quasi-capital assets presents a bunching problem. If a shoemaker purchases a small lot and building for 10,000 dollars for use in his business, and sells that lot and building for 100,000 dollars ten years later, he would have a bunching problem if the assets were not afforded capital gains treatment. On the other hand, it can be argued that a loss on the sale of property used in the trade or business should not be subjected to the limitations placed on capital losses because such a loss is in reality a part of the cost of doing business. It would be inequitable to limit the deductibility of the loss merely because the asset is a capital asset.

Moreover, much of section 1231 property is depreciable, and depreciation deductions may be offset against ordinary income. Treating depreciable property as a capital asset would permit the taxpayer

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a marginal tax rate on ordinary income of 60% has a \$1,000 capital loss and a \$1,000 capital gain, deduction of the loss from ordinary income would create a "tax benefit" of \$600 and inclusion of the gain at capital gains rates would lead to a "tax cost" of \$250, resulting in an after-tax gain of \$350. For this reason the loss must be set off against any includible capital gains first.

<sup>60</sup> INT. REV. CODE OF 1954, § 1212.

to offset his depreciation deductions against ordinary income and later to recapture that depreciation at capital gains rates if he sold at a profit.<sup>61</sup> This can be illustrated by the following example:

Taxpayer's top income tax bracket is 60%. In 1955, he purchases depreciable property for \$100,000. He properly depreciates the property at the rate of \$10,000 per year. Because the depreciation is fully deductible against ordinary income, each deduction allows Taxpayer to retain \$6,000 from his other income that he would have had to pay to the government if he had not been able to claim the depreciation deduction. If Taxpayer depreciates the property for five years, the total depreciation deduction is \$50,000. Taxpayer has saved \$30,000 in taxes and his adjusted basis in the property is \$50,000.

Taxpayer sells the property on January 1, 1960, for \$100,000 realizing a \$50,000 gain. At capital gain rates, the tax on this income will be \$12,500.

Taxpayer's tax *benefit* from the depreciation was \$30,000. He has "recaptured" the depreciation at a tax *cost* of only \$12,500.

Thus if quasi-capital assets are treated as capital assets, the result is often unjust to the taxpayer who sells at a loss, but may be a windfall to the taxpayer who sells at a gain. For these reasons, gains or losses from the sale or exchange of quasi-capital assets were originally treated as ordinary gains or losses.

Section 1231 was adopted during the Second World War when many businessmen were forced to sell business property to the government at substantial gains. Such sales often resulted in hardship because, even though depreciation deductions taken on the property had earlier been offset against ordinary income, taxpayers were often in higher tax brackets in the year of condemnation, and the gain on the sales often greatly exceeded a recapture of the prior depreciation deductions.<sup>62</sup> Even if this had not been the case, the old system had

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<sup>61</sup>The disparity is illustrated most dramatically when a taxpayer claims a depreciation deduction for the very year during which the depreciated asset is sold at a gain. In *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272 (1966), taxpayer claimed a depreciation deduction of over \$135,000 in a year during which a capital gain of over \$500,000 resulted from the sale of the depreciated asset. Taxpayer paid no tax on the gain (because taxpayer was dissolved and liquidated in a transaction qualifying under INT. REV. CODE OF 1954, § 337), but even if it had, allowance of the deduction would have allowed it to offset \$135,000 against ordinary income and to "recapture" the amount deducted at favorable capital gains rates. Since 1962 the Commissioner had sought to disallow depreciation in the year of sale to the extent it was "recaptured" by sale at a gain. The Court in *Fribourg* allowed the deduction. INT. REV. CODE OF 1954, § 1245 requires a recapture of depreciation allowed after 1961 to be taxed as ordinary income. For more on this problem see McNERNEY, *Disallowance of Depreciation in Year of Sale at a Gain*, 20 TAX L. REV. 615 (1965).

<sup>62</sup>"The enactment of [the predecessor of] section 1231, was in large part a wartime

built-in inequities. In the example cited above, a gain of 50,000 dollars might elevate taxpayer's top tax bracket above 60 per cent so that, while the depreciation was offset against income in the 60 per cent bracket, the gain would put taxpayer in a higher bracket.

Section 1231 provides that the gains and losses from the sale, exchange or involuntary conversion of section 1231 assets are to be separately computed. If gains exceed losses, each individual gain and loss is treated as a gain or loss arising from the sale of a capital asset held for more than six months. If losses exceed gains, each individual gain and loss is treated as an ordinary gain or loss.<sup>63</sup> This solution protects the businessman who sells business property at a loss and ameliorates the "bunching" problem of the businessman who sells business property at a gain. But, it also creates the occasional windfall described above for the businessman who recaptures his prior depreciation deductions by selling at a gain. The windfall problem is aggravated by the fact that accelerated depreciation methods may now be utilized, under which the proportionate depreciation deductions for the first years of useful life are higher than the allowable deductions for the last years of useful life. In the example cited above, taxpayer purchased depreciable property for 100,000 dollars which he depreciated at the rate of 10,000 dollars per year. From these facts it can be inferred that the property had a useful life of 10 years, would have no salvage value, and was depreciated under the "straight-line" method. However, if the taxpayer, pursuant to section 167, had adopted an accelerated method of depreciation, such as the sum-of-the-years-digits method, 44/55 of the value of the building could have been depreciated during the first five of the ten years of useful life.<sup>64</sup> Taxpayer would have been able, in five years, to offset 80,000 dollars against ordinary income taxed in the 60 per cent bracket, obtaining a tax benefit of 48,000 dollars. If the property were sold for 100,000 dollars, the tax cost of the 80,000 dollars gain (depreciation deductions would have reduced his adjusted basis to 20,000 dollars) would be 20,000 dollars.<sup>65</sup> If taxpayer de-

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relief measure." *Statement of Fred C. Schribner, Under Secretary of the Treasury, HEARINGS ON REVISING TAX ON GAINS FROM SALES OF DEPRECIABLE PERSONAL PROPERTY 4-9, HOUSE COMMITTEE ON WAYS AND MEANS, 86th Cong., 2d Sess. (1960).*

<sup>63</sup> The benefits of § 1231 apply not only to sales or exchanges of § 1231 assets but also to proceeds from the involuntary conversion of § 1231 assets and capital assets held more than six months. Section 1231 assets include only assets held for more than six months. INT. REV. CODE OF 1954, § 1231 (a), (b) (1).

<sup>64</sup> INT. REV. CODE OF 1954, § 167 (b) (3). Application of the sum-of-the-years-digits method is illustrated in Treas. Reg. § 1.167 (b)-3.

<sup>65</sup> Possibilities of abuse in connection with transactions between family mem-

preciates the building on the straight-line method, his windfall is 17,500 dollars; if he depreciates it on the sum-of-the-years-digits method, his windfall is 24,000 dollars.

Sections 1245 and 1250 were adopted to prevent these windfalls. Section 1245, where applicable, prevents any windfall occurring when depreciation previously deducted from ordinary income is "recaptured" by means of sale at a gain. Section 1250 which applies to a different category of property, is designed principally to prevent only that portion of the windfall resulting from the use of accelerated depreciation methods rather than the straight-line method.

Section 1245 applies to depreciable personal property and other types of tangible property (other than buildings) which are eligible for annual depreciation allowances. It provides that the gain on the sale of such property, to the extent it is a recapture of depreciation *allowed after December 31, 1961*, shall be taxed as ordinary income. The section may be illustrated by the following example:

On January 1, 1960, Taxpayer purchased machinery used in his trade and business, paying \$20,000. The property had a useful life of eight years and would have no salvage value. Taxpayer depreciated the property under the straight-line method, taking a \$2,500 depreciation deduction for each of the years 1960, 1961, 1962 and 1963. On January 1, 1964, Taxpayer sold the property for \$22,000. Taxpayer's adjusted basis is his cost less allowable depreciation deductions of \$10,000. Since this results in an adjusted basis of \$10,000, Taxpayer's gain is \$12,000. Of this amount, \$10,000 represents a full recapture of his 1960-63 (inclusive) depreciation deductions. The post-1961 depreciation which has been "recaptured" (\$5,000) is taxed as ordinary income. The pre-1962 recaptured depreciation (\$5,000) and the extra \$2,000 gain are taxed in the same manner as gains from the sale of capital assets held for more than six months.

Section 1245 may result in hardship to some taxpayers. Although depreciation deductions are offset against ordinary income and recaptured depreciation is taxed as ordinary income, the recapture is bunched, while the annual depreciation deductions are not.

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bers or between shareholders and controlled corporations are obvious. A taxpayer who has obtained the benefit of depreciation deductions might sell the appreciated property for cash to a corporation controlled by him, paying a capital gains tax. The corporation, his alter-ego, would then claim depreciation deductions based on the new cost basis, and the cycle would be repeated. To avoid this result, § 1239 provides that gain realized on sales or exchanges of depreciable property between (a) a husband and wife or (b) a shareholder and a corporation 80% of whose stock is owned by the shareholder or his family, shall be treated as gain from the sale of property which is not a capital asset or a § 1231 asset.

As noted above, section 1245 applies only to certain classes of depreciable property used in the trade or business and applies only to the recapture of depreciation deductions allowed after December 31, 1961. Section 1245 applies to elevators, but does not otherwise apply to depreciable real property such as buildings and their structural components.<sup>66</sup> Section 1250, effective as of January 1, 1964, was enacted to fill this gap. But whereas section 1245 subjects all post-1961 recaptured depreciation to ordinary income treatment, section 1250, which applies only to post-1963 depreciation deductions, is more limited.

(1) The entire amount of recaptured depreciation is subjected to ordinary income treatment only in the case of property held for one year or less. If the property is held for more than one year, only a portion of the recaptured depreciation is taxed as ordinary income.

(2) If the property is held for more than one year but not for twenty-one months, recaptured depreciation is taxed as ordinary income only to the extent that the depreciation actually allowed exceeds the depreciation that would have been allowed under the straight-line method of depreciation. For example, if taxpayer purchases a building having a useful life of four years for 10,000 dollars (with no salvage value) and depreciates the building under the sum-of-the-years-digits method, his depreciation for the first year would be 4,000 dollars. His depreciation under the straight-line method would be 2,500 dollars. If he sells the property twelve months and one day after the day of purchase for 10,000 dollars only 1,500 dollars of the 4,000 dollars recaptured depreciation will be taxed as ordinary income. The remaining 2,500 dollars will be taxed as if it were long-term capital gain. In summary, only the recaptured "excess" depreciation is treated as ordinary income.<sup>67</sup>

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<sup>66</sup> INT. REV. CODE OF 1954, § 1245(a)(2)&(3). Only post-June 30, 1963 depreciation of elevators and escalators is covered by section 1245. INT. REV. CODE OF 1954, § 1245(a)(2)(B).

<sup>67</sup> A similar procedure is adopted in INT. REV. CODE OF 1954, § 1238, relating to amortization deductions exceeding allowable depreciation deductions. Under INT. REV. CODE OF 1954, § 168, the cost of certain "emergency facilities" (facilities used for defense purposes) may at the option of the taxpayer be amortized over a five-year period. If a facility has a long useful life, the deductions allowed under § 168 might be considerably larger than the depreciation deductions allowable under § 167. Deducting these greater amounts reduces adjusted basis below the adjusted basis computed by deducting depreciation allowable under § 167. Section 1238 provides that in such event gain from the sale or exchange of property "shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168." Treas. Reg. § 1.1238-1(a).

(3) If the property is held for twenty-one months or more, only a specified percentage of the recaptured "excess" depreciation is treated as ordinary income. The applicable percentage is 100 less one percentage point for each full month the property is held in excess of twenty months. Thus, if the property is held for ten years or more, section 1250 becomes inapplicable.<sup>68</sup>

## VI. SPECIAL RULES—STATUTORY

The discussion thus far has dealt with the general statutory rules of capital gains taxation. But no statute can contemplate all the transactions that will be affected by it and courts have been "obliged to lend a hand even to highly articulate statutes."<sup>69</sup> The definition of such terms as "property," "capital asset" and "sale and exchange," and the question whether certain items fall within those categories of property specifically excluded from the definition of "capital asset" are to a large degree dependent upon judicial gloss. This judicial gloss has prompted statutory rules dealing with specific problems of capital gains taxation. Sometimes the gloss has been codified; at other times it has been overruled; and sometimes Congress has preceded the courts in filling gaps in the statute. These special statutory rules appear in sections 1232-1249 of the Code.

### *A. Copyrights and Patents*

#### Copyrights and music, artistic and other literary property are

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<sup>68</sup> INT. REV. CODE OF 1954, §§ 1245 and 1250 override any other non-recognition provisions of the Code. INT. REV. CODE OF 1954, §§ 1245(d) and 1250(h). See also Treas. Reg. § 1.1245-6. Sections 1245 and 1250 contain their own non-recognition provisions, covering some of the more common tax-free transfers, such as transfers by gift, transfers at death, transfers to certain controlled corporations and partnerships, like-kind exchanges, involuntary conversions, etc. INT. REV. CODE OF 1954, §§ 1245(b), 1250(d). These non-recognition provisions are not, however, co-extensive with non-recognition provisions generally and it should never be assumed that non-recognition provisions apply to § 1245 and § 1250 assets without prior reference to those sections. For example, a corporation generally recognizes no income upon the distribution of appreciated property to its shareholders, but gain might nevertheless be realized upon the distribution of § 1245 assets. See Treas. Reg. § 1.1245-1(c). Example 1. The non-recognition of gain permitted by INT. REV. CODE OF 1954, §§ 1245 and 1250 raises the question whether the assets acquired for § 1245 assets become § 1245 assets, or whether they lose their taint. If a taxpayer who has been allowed \$50 in post-1961 depreciation deductions transfers the depreciated property (with an adjusted basis of \$50) to a controlled corporation for stock (worth \$100), the transfer may qualify for non-recognition treatment under INT. REV. CODE OF 1954, §§ 351 and 1245(b) (3). Taxpayer's basis in the stock will be \$50 and the corporation's basis in the asset will also be \$50. It would appear that the stock would not be a § 1245 asset in taxpayer's hands, but that the asset transferred to the corporation would keep its taint. The burden of INT. REV. CODE OF 1954, § 1245 has in effect been transferred from one taxpayer to another. The question of the degree to which the burden of § 1245 can be transferred from one taxpayer is largely unsettled.

<sup>69</sup> PAUL, *STUDIES IN FEDERAL TAXATION* 1 (3d ser. 1940).



specifically excluded from the definition of capital assets by section 1221(3) if held by the author, composer or artist or by someone in a similar position.<sup>70</sup> It is easy to understand why this should be so in the case of the professional, where proceeds from the sale of copyrights may be the equivalent of payments for services rendered. In one sense, a professional author's copyrights are his inventory. These arguments apply with less force in the case of the amateur author, who is not in the "trade or business" of producing and selling literary or artistic property. But even in the case of the amateur, a copyright is usually obtained as the result of labor performed. If he performed the labor for direct compensation, the payments would constitute ordinary income. There would be something artificial about affording capital gains treatment to the author merely because he has obtained a copyright and cast the transaction in the form of a sale of the copyright. The determination whether a copyright or similar literary property is a capital asset was originally handled on a case-by-case basis. The answer often depended upon whether the author was an amateur or a professional.<sup>71</sup> Section 1221(3) now provides that this kind of property, when held by the author or a person in a similar situation, is *never* to be treated as a capital asset.

The rationale for excluding copyrights and other artistic or literary property from the definition of "capital asset" would appear to apply also to the sale of patents by professional inventors. An inventor who sells his patent has also turned the sale of his services into the sale of his "work product." However, under section 1235 a domestic patent obtained by an individual inventor is almost always treated as a capital asset. Few convincing reasons can be offered in justification of the distinction between patents and copyrights for capital gains taxation purposes, but the differences do exist. An inventor is favored first on the original sale in that the proceeds are taxed at capital

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<sup>70</sup> INT. REV. CODE OF 1954, § 1221(3)(B). "Someone in a similar position" is a taxpayer whose basis in literary property is determined in whole or in part by reference to its basis in the hands of the author. If an author makes a gift of a copyright the copyright will not be a capital asset in the hands of the donee. The copyright could be a capital asset to someone who purchased it from the donee.

<sup>71</sup> See *Stern v. United States*, 164 F. Supp. 847 (E.D. La. 1958); S. REP. NO. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 CUM. BULL. 483, 515. Generally, a person in the profession of writing books was required to treat income from the sale of copyrights as ordinary income, either on the theory that proceeds from sales of copyrights were the equivalent of income for services rendered or were sales of property held for sale to customers in the ordinary course of business and thus excludable from the definition of capital asset under § 1221(1).

gains rates.<sup>72</sup> An inventor is also favored in that he can take his proceeds over the life of the patent in a manner similar to that of a licensor or lessor and still qualify for capital gains treatment. If an owner of appreciated land sells the land outright at a gain, the capital gains provisions apply, but if the same owner transfers mineral rights in the land in return for annual royalties based upon mineral profits, the royalties are considered to be ordinary income.<sup>73</sup> An inventor, on the other hand, may obtain capital gains treatment on the "sale" of a patent even if (1) the payments for the patent are to be made periodically over a long period of time, (2) the payments depend upon the purchaser's profits from the use of the patent and/or (3) the inventor retains a security interest in the patent. However, the inventor cannot retain a remainder interest in the patent, and he must sell "substantially all" rights granted by the patent.<sup>74</sup> Thus an inventor can sell his patent under an arrangement which would of itself avoid any bunching problem and, in addition, may obtain capital gains treatment on the periodic payments as they are received. The reason expressed for these tax benefits to inventors is that industrial progress requires encouragement to inventors.<sup>75</sup> A comparison of the treatment accorded patents with that accorded copyrights leads inescapably to the conclusion that our tax policy is designed to foster progress in industry, but not in the arts.

### *B. Special Problems Relating to Inventory*

Section 1221(1) excludes from the definition of capital asset "stock in trade of the taxpayer," inventory, or property "held by the taxpayer primarily for sale to customers in the ordinary course of [taxpayer's] trade or business."<sup>76</sup> The determination whether or not property is inventory usually is not difficult: A baker's wares are inventory. But there are many cases where it is difficult to determine

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<sup>72</sup> INT. REV. CODE OF 1954, § 1235 applies to individual inventors and certain individual purchasers from inventors. Other persons (including corporate inventors) are governed by the general rules of INT. REV. CODE OF 1954, §§ 1221 & 1231. This means that a professional inventor's patents are capital assets, but patents developed by a corporation in the trade or business of selling patents are not. Patents used by a corporation in its trade or business are § 1231 assets.

<sup>73</sup> See *Burnet v. Harmel*, 287 U.S. 103 (1932).

<sup>74</sup> INT. REV. CODE OF 1954, § 1235(a). The inventor must transfer "all substantial rights . . . or an undivided interest" to all rights in the patent.

<sup>75</sup> See S. REP. NO. 2375, 81st Cong., 2d Sess., cited *supra* note 71. Proceeds from sales of patents to controlled foreign corporations are ordinary income, whether the transferor is the inventor or not. INT. REV. CODE OF 1954, § 1249.

<sup>76</sup> For purposes of convenience, stock in trade, inventory, and property held for sale to customers in the ordinary course of a taxpayer's trade or business, are all included in the general category of "inventory property" in this article.

whether property is held primarily for investment, or primarily for sale to customers in the ordinary course of business.

Where the increase in value of goods is attributable to value added or services rendered by the owner, as in the case of manufacturers and retailers, the goods are clearly inventory. But where the property involved is a kind which may be held for long periods of time (even when held by dealers), and where the profit depends as much upon inherent value appreciation as upon value added by the owner's capital or services, it is not always easy to decide at what point in time a person who buys and sells such property ceases being a mere investor or casual speculator and has gone into the "business" of trading in such property.

Difficulties arise very frequently when land is subdivided for resale and when securities are held by securities "dealers." The difficulties may be illustrated by an example:

Taxpayer owned a large tract of land which became exceedingly valuable as a residential site. Taxpayer was not in the business of buying and selling land and could have sold the tract in one unit as a capital asset, but in order to maximize his profit, Taxpayer subdivided the property into lots and spent a considerable amount of time over the course of two years in selling the lots to individual purchasers.

In the example cited, it can be claimed that the property has become inventory property—or property held for sale to customers in the ordinary course of business—because of the subdivision of the property and of the time devoted to sales activity. Determining when a taxpayer ceases being an investor in land and becomes a dealer in land is largely a factual question, and some courts have regarded activities involved in subdividing, developing, and selling blocks of land in small lots as strong evidence that a taxpayer is in the trade or business of selling real estate.<sup>77</sup> Taxpayers who hold appreciated land in the vicinity of growing cities, however, may be forced to subdivide the land to maximize their profit. If the acts of subdividing and selling turn that profit into ordinary income, these owners may be forced to sell the land in one sale to developers and forego some of the profit. Section 1237 was adopted to enable true investors to engage in the active subdivision and sale of real property without thereby turning the profit into ordinary income. The section provides that if the land was inherited or held for at least five years, was not substantially

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<sup>77</sup> See, *e.g.*, *Mauldin v. Commissioner*, 195 F.2d 714 (10th Cir. 1952).

improved by the taxpayer directly or indirectly, and was not previously held for sale to customers in the ordinary course of business, then the mere subdivision and sale of the property and activities incidental thereto shall not be deemed to put a taxpayer in the trade or business of selling such property.

Where a taxpayer is allowed to treat land as a capital asset by virtue of section 1237, he is bound by its special limitations. One of the most important limitations of the section is that all gain from the sale of lots in the taxable year in which the sixth lot is sold will be taxed as ordinary income to the extent of 5 per cent of the sales price. This limitation may not be as restrictive as it seems, however, because ordinary expenses of sale can be deducted as ordinary expenses to the extent that the proceeds are treated as ordinary income. This can be illustrated by the following example:

Taxpayer subdivides Blackacre into ten lots. The adjusted basis of Blackacre is \$10,000, or \$1,000 per lot. In year one Taxpayer sells five lots at a price of \$3,000 per lot. Taxpayer incurred no expenses. His gain of \$10,000 (\$2,000 per lot) is treated as a gain from the sale of a capital asset.

In year two, Taxpayer employs a realtor to sell the lots for a commission of 7% of the gross sales price. Realtor sells the property for \$3,000 per lot. Since there are five lots, realtor obtains \$15,000. Since this is the year in which the sixth lot is sold, 5% of the selling price is treated as ordinary income (about \$750). However, of the total commissions of \$1,050 paid to the realtor, \$750 may be deducted from Taxpayer's ordinary income. The remaining \$300 may be treated as a reduction of the amount realized from the sale.

Thus, this limitation is of little consequence to the seller who retains a realtor to make the sales.<sup>78</sup>

The principal problem raised by section 1237 is to determine whether it applies at all. The following examples demonstrate three of the possibilities:

- (1) Assume that subdividing and selling property are the only evidence that the property was held for sale to customers in the ordinary course of business, but that a court would, absent section 1237, hold that the

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<sup>78</sup> The section does not apply if the taxpayer installs "substantial" improvements on the property, but if the taxpayer can show that the property without improvements would sell for less than similar unimproved property in the vicinity, the improvements made by him to make the land marketable would not be deemed "substantial" if he has held the property for 10 years or more. INT. REV. CODE OF 1954, § 1237(b) (3).

property was not a capital asset because of this evidence.<sup>79</sup>

In this case section 1237 applies, together with its conditions and limitations.

(2) Assume that there is substantial evidence that the property was held for sale to customers in the ordinary course of business in addition to the evidence created by subdividing and selling.

In this case section 1237 does not apply, so that absent other circumstances, the gain from the sale or exchange will be ordinary income.

(3) Assume that the owner engages in activities of subdivision and sale, but that these activities are not substantial enough, even disregarding section 1237, to put the owner in the trade or business of selling real property.

In this case section 1237 does not apply. Therefore, no part of the selling price will be treated as ordinary income, even in the year the sixth lot is sold.

The difficulty posed by the statute is that its force is negative; it gives no indication of what factors will cause a taxpayer to be in the business of selling land. It is of significance only in very limited number of situations, as the examples demonstrate. In effect, it leaves unsolved the basic question: whether or not property is held for sale in the ordinary course of business. This section demonstrates that legal problems created by factual questions cannot easily be legislated away.<sup>80</sup>

The question whether property is investment property or business property also arises where securities are held by securities dealers.<sup>81</sup> A so-called "securities dealer" may in fact be a broker or agent in that he arranges sales but does not buy or sell on his own account (*i.e.*, the dealer is a "broker"). Income arising from this activity clearly does not qualify for capital gains treatment. The same securities dealer may purchase issues of securities from the issuing corporation or from a primary underwriter for re-sale to his customers and in doing so act as a wholesaler or retailer of securities (*i.e.* the

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<sup>79</sup> Such an assumption would not seem to be warranted, although the courts seem to be in some disagreement. Compare *Curtis Co. v. Commissioner*, 232 F.2d 167, 169 (3d Cir. 1956), with *Home Co. v. Commissioner*, 212 F.2d 637 (10th Cir. 1954).

<sup>80</sup> See *Bynum v. Commissioner*, 46 T.C.—(1966).

<sup>81</sup> See, *e.g.*, *Van Suetendael v. Commissioner*, ¶ 44,305 P-H TAX CT. MEM. (1944).

dealer is a "merchant"). In these cases the securities involved would appear to constitute inventory or its equivalent. Finally, the same dealer may purchase securities (whether on the market, from primary underwriters or directly from the issuer) with a view toward investment and possible re-sale when the market improves (*i.e.* the dealer is a "trader"). In this last case, the dealer acts as any other trader or investor might and should be eligible for capital gain treatment—at least under the policy of the present statute. Because a dealer can act both as a "trader" and as a "merchant," there is a danger that such a person will claim to have acted as a "trader" in respect of his gains and as a "merchant" in respect of his losses, so that all his gains will be capital gains and all his losses will be ordinary losses. To cope with this problem, section 1236 provides that a securities dealer may claim capital gain treatment only on the sale of those securities which he has designated in his accounts as being held for investment *and* only if the securities were *in fact* held for investment. If the securities are so designated, the dealer may under no circumstances treat a loss on the sale of such securities as an ordinary loss. In order to obtain capital gain treatment, therefore, the dealer must meet two tests: First, he must designate the securities as "investment" securities; and second, he must in fact hold the securities for investment and not for resale to customers. On the other hand, the mere designation of the securities as investment securities will prevent the dealer from claiming an ordinary loss, whether or not the securities were in fact held for investment.<sup>82</sup>

### *C. Other Special Rules: Discount Bonds*

If a corporation wishes to borrow money, it can issue bonds at a discount or at "par." This may be illustrated by an example:

Corporation wishes to borrow money at a time when the going interest rate is 4% to 6%. Corporation may issue a \$100 bond redeemable in three years at "par" (*i.e.*, \$100), agreeing to pay interest at the rate of 5% per annum. Or, if it so desired, Corporation might issue the same bond at a \$15 "discount" for \$85, agreeing to redeem the bond in three years for \$100, but to pay no interest in the same interval. In the first case, the lender's interest is clearly ordinary income. In the second case, however, the lender may claim that he purchased a "capital asset" for \$85 and sold or exchanged that same asset three years later realizing a long-term capital gain.

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<sup>82</sup> INT. REV. CODE OF 1954 § 1236(b).

In practice, an investor who purchases a bond at a discount might also receive interest: The issuer may attempt to sell the bonds at par but be forced to accept something less than par because the stated interest rate does not conform to the market interest rate. (Conversely, if the interest rate is higher than the market rate the issuer may be able to sell its bonds at a premium.) Since a discount is in fact a substitute for interest, it constitutes "earnings" on capital rather than a "gain" and should be taxed as ordinary income. Section 1232 provides that the amount of the discount, when received by the owner of a security upon the redemption of the bond, is to be treated as ordinary income and not as a capital gain. If the issuing corporation does not intend to redeem the bond prior to its maturity date and the bondholder sells or redeems the bond prior to such date, only a ratable portion of the amount received will be treated as a return of the original issue discount:<sup>83</sup>

Taxpayer purchases bonds issued by X Corporation in the face amount of \$100,000, paying only \$90,000. The bonds mature in 15 years, or 180 months. After holding the bonds for 90 months, Taxpayer sells them to a third party for \$100,000. Only half the original issue discount is deemed received by the Taxpayer on the sale. Thus, of the \$10,000 gain, \$5,000 may be treated as long-term capital gain and \$5,000 (the amount of the discount deemed received by the Taxpayer on the sale) will be treated as ordinary income.

If Taxpayer holds the bonds until the maturity date, when they are redeemed for \$100,000, his entire gain of \$10,000 will be treated as ordinary income.

A premium paid on the purchase of a bond may be amortized over the life of the bond. If an investor purchases a \$100 bond for \$110, and if the bond matures in ten years, taxpayer may deduct \$1 from his ordinary income each year. If he does not amortize the premium, loss suffered when the bond is redeemed at par is treated as a capital loss.<sup>84</sup>

#### *D. Short Sales*

In the securities markets, it is possible to sell "short." To sell "short" means to sell securities now for delivery at a later date. Short sales can be used either as a means of speculation or as a hedge against price changes. This may be illustrated by the following examples:

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<sup>83</sup> See Treas. Reg. § 1.1232-3(c), examples 1 & 2.

<sup>84</sup> INT. REV. CODE OF 1954, § 171. The premium amortization is in effect an offset against the interest received.

(1) Taxpayer is a speculator who believes that the price of X Corporation stock will fall. The current price of the securities is \$100 per share. Taxpayer therefore sells one share of X Corporation stock to buyer for \$100, promising delivery three months from the day of sale. If Taxpayer was correct in his belief concerning the future price level of X Corporation stock, he may be able, on the day of delivery to purchase one share of X Corporation stock for \$80 on the market. Taxpayer purchases the stock for \$80 and delivers it to the short sale buyer. Taxpayer has realized a gain of \$20. Assuming the share is a capital asset, Taxpayer will have realized a short-term capital gain.

(2) Taxpayer has purchased one share of X Corporation stock for \$60. Since the day of purchase, the stock has risen to a price of \$100 per share. Taxpayer believes the market will decline and would like to realize his gain but has pledged his stock as security for a loan and is unable to sell it. Taxpayer therefore sells one share of X Corporation stock "short" (promising delivery on the day when he gets back the share he pledged), realizing a \$40 gain. If the stock declines or falls in market value between the dates of sale and delivery, Taxpayer will nevertheless realize a gain of \$40. He has protected himself against a subsequent rise or decline in the market by "selling short."

If a taxpayer buys a security for 50 dollars which rises in value to 100 dollars three months later, he might wish to sell and realize his profit at that time. If he does so, however, his gain will be short-term gain (the capital gains deduction and alternative tax are only available for long-term gains), and, unless it is offset by other losses, will be taxed at ordinary rates. In order to guarantee his profit, therefore, taxpayer might sell one share of the same stock "short" with delivery to be made four months after the date of sale, or seven months after acquisition of the stock. If taxpayer delivers his one share of stock on the delivery date he may claim to have held the stock for more than six months. While such a claim would be plausible in form, it is clear that taxpayer's economic position is the same as if he had sold the stock outright on the earlier date. Section 1233 meets this problem by providing that:

(1) A gain on a short sale is a capital gain if the security sold short was a capital asset.<sup>85</sup>

(2) The holding period of the property sold short ends on the day of delivery ("closing date") rather than on the day the sale was agreed upon ("contract date").<sup>86</sup>

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<sup>85</sup> INT. REV. CODE OF 1954, § 1233(a).

<sup>86</sup> Treas. Reg. § 1.1233-1(a).



(3) Any gain realized upon a short sale is treated as a short term capital gain if the property delivered on the closing date is the same or substantially identical to property held by the taxpayer for six months or less before the contract date.<sup>87</sup>

(4) If property delivered upon the closing date is "substantially identical" but not the same property originally purchased by the taxpayer, the holding period of the property originally purchased by the taxpayer, to the extent that it is replaced by property sold short, begins to run anew from the closing date.<sup>88</sup> These provisions may be illustrated by the following examples:

(a) Taxpayer buys one share of stock for \$100 on January 1. On April 1 the stock is worth \$200 and Taxpayer sells one share of stock short to buyer for \$200, delivery to be made on August 1. On August 1, Taxpayer delivers the stock purchased by him on January 1 to buyer. Taxpayer's gain is short term.

(b) Same as (a) except that the stock is worth \$180 on the delivery date. Taxpayer therefore does not deliver the stock purchased by him on January 1, but buys another share for \$180 and delivers the share to buyer, all on August 1. Taxpayer's gain of \$20 is short term. On September 1, Taxpayer sells the share purchased by him in January for \$210. Taxpayer's \$110 gain on the second sale is short term, because the holding period of the stock originally purchased began to run anew on August 1.

### *E. Small Business Stock*

Corporate stock is generally considered to be a capital asset unless held by a securities dealer. Accordingly, loss realized upon the sale of stock (or when the stock becomes worthless)<sup>89</sup> is ordinarily subjected to the limitations on deductibility placed upon capital losses. A loss sustained in conducting the business of a sole proprietorship or partnership, on the other hand, is often treated as an ordinary loss, except to the extent that the losses of the business itself were capital losses. Because of limitations placed on the deductibility of capital losses, one who contemplates forming an enterprise whose ultimate success is in doubt may choose to operate the business by means of a sole proprietorship or partnership in order to take full advantage of the loss if the enterprise should fail.<sup>90</sup> Shareholders of

<sup>87</sup> INT. REV. CODE OF 1954 § 1233(b).

<sup>88</sup> INT. REV. CODE OF 1954, § 1233(b)(2).

<sup>89</sup> See INT. REV. CODE OF 1954, § 165(g).

<sup>90</sup> INT. REV. CODE OF 1954 §§ 1371-1377 now permits certain corporations to elect to have their profits taxed directly to their shareholders and, in turn, to

small business corporations, however, may avoid capital loss limitations to the extent provided in section 1244 where the conditions of that section are met.

Section 1244 provides that if certain formal requirements are met, losses sustained upon the sale or other disposition, or upon the worthlessness, of so-called "small business" stock or "section 1244" stock may be treated as ordinary losses to the extent of 25,000 dollars per year (or 50,000 dollars in the case of married taxpayers filing joint returns). In order for any stock to qualify under this section, it must be issued over a two-year period *pursuant to a plan*. The stock must be issued for money or other property (not for services) and no prior offering of stock may be outstanding. The corporation itself must be a "small business corporation," which means that (1) the aggregate amount of securities offered under the plan plus any property received by the corporation after June 30, 1958, may not exceed 500,000 dollars and (2) the aggregate equity capital of the corporation may not exceed 1,000,000 dollars. In addition, the corporation must be an "operating" company as opposed to an "investing" or "holding" company: More than 50 per cent of its gross receipts must come from sources other than royalties, rents, dividends, annuities and capital gains. Section 1244 also contains other special rules relating to limitations upon the amount of losses allowable. For example, if a shareholder contributes property to a corporation at a time when the property's adjusted basis exceeds its market value and if his basis in the stock is equal to his basis in the contributed property, the amount of loss may not exceed the fair market value of the property at the time it was contributed to the corporation.<sup>91</sup>

It may be noted that section 1244 refers only to *losses* on the sale of small business stock. Since gains from the sale of this stock may presumably be treated as capital gains, investors may derive advan-

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have their losses deductible directly by shareholders. Since "subchapter S" corporations may, however, have only one class of stock and a maximum of 10 shareholders (all individuals), these provisions are of little benefit to enterprises which need equity financing from a larger number of individuals. For this reason speculative enterprises needing outside capital are often carried out in the form of limited partnerships. The limited partners have the advantage of limited liability, but need not treat the loss on their investments as capital losses. See, *e.g.*, *Junior Miss Company v. Commissioner*, 14 T.C. 1 (1950), where such an organization was held not to be taxable as an "association" under the predecessor of INT. REV. CODE OF 1954, § 7701(a)(3).

<sup>91</sup> Only individual shareholders may take advantage of INT. REV. CODE OF 1954, § 1244; a corporation, trust or estate is not entitled to an ordinary loss under this section. It is probable that many small business corporations that could qualify under § 1244 do not adopt a qualifying plan, either because of optimism or oversight.

tages from section 1244 similar to the benefits afforded by section 1231 to real property and depreciable personal property used in the trade or business.

#### *F. Small Business Investment Companies*

In 1958, a federal law was enacted relating to the formation of companies, known as "small business investment companies," whose purpose is to help finance small businesses.<sup>92</sup> Among the inducements offered citizens to participate in such enterprises are the tax benefits set forth in sections 1242 and 1243. Section 1242 provides that losses from the sale or exchange of small business investment company stock may be treated as ordinary losses. Section 1243 relates to the losses of the small business investment company itself (as opposed to its shareholders) by providing that losses upon the sale or exchange of certain convertible debentures acquired by the SBIC may be treated as ordinary losses.

#### *G. Foreign Corporations*

Domestic corporations are subject to a tax on income from both domestic and foreign sources.<sup>93</sup> Earnings and profits (1) remaining after payment of taxes and (2) subsequently distributed to shareholders, are taxed to shareholders at ordinary income rates.<sup>94</sup> However, if the shareholder sells stock, or if the shareholder's stock is redeemed by the corporation in a redemption qualifying under section 302 or in a distribution in complete or partial liquidation of the corporation qualifying under section 331, the gain on the sale or redemption may be treated as a capital gain even though the increased value of the stock is attributable to earnings retained by the corporation and which, if distributed to the shareholder as dividends, would be treated as ordinary income and taxed accordingly. Sales or qualified redemptions might thus be used as means of converting what would otherwise be ordinary income into capital gain.<sup>95</sup> Where domestic corporations are involved, an unexpressed reason for giving this advantage to taxpayers may be that the corporation itself has already paid one tax on the income. Foreign corporations not having

<sup>92</sup> 15 U.S.C. § 681-687.

<sup>93</sup> INT. REV. CODE OF 1954, § 11.

<sup>94</sup> INT. REV. CODE OF 1954, §§ 61, 301.

<sup>95</sup> For a discussion of present taxation of corporate distributions and proposed changes, see Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, House Committee on Ways and Means, 86th Cong., 1st Sess., 3 TAX REVISION COMPENDIUM 1643 (Comm. Print 1959).

income from sources within the United States pay no federal income taxes and may well pay no taxes at all. If special rules did not apply to sales or redemptions of stock in such foreign corporations, untaxed corporate earnings might be repatriated at capital gains rates by liquidating the foreign corporation or by selling its stock.<sup>96</sup> These advantages are no longer available to taxpayers. Under section 1248, gain realized from the sale or exchange of stock in foreign corporations (10 per cent or more of whose stock is owned by the taxpayer or related persons) is to be treated as a dividend to the extent of earnings and profits attributable to the stock and accumulated after December 31, 1962. In the case of individual stockholders the amount of tax imposed is not to exceed the aggregate tax that would have been paid by the shareholder and corporation if the corporation had been taxed as a domestic corporation and the shareholder had paid a capital gains tax on the gain arising from the sale or exchange.<sup>97</sup>

#### VII. THE LIMITATION OF STATUTES

In dealing with capital gains and losses, Congress might have adopted a statute expressing in general terms the fundamental principles governing the taxation of capital gains and losses, leaving to the Treasury Department and the courts the power to formulate specific rules within the framework of expressed statutory principles. A second possibility would have been to attempt to adopt statutes minutely articulated, designed to cover every conceivable situation. Congress appears to have started with a fairly general statute, but as years have passed, it has reacted to specific problems arising in the courts and elsewhere by tacking detailed rules onto the basic statutory framework.

Whatever the original intent, the statute has become specific. But the student should realize that no statute, however articulate, can be sufficiently detailed to cover all transactions arising in modern commercial life. One must also remember that while "the room for [judicial] interpretation must contract" to the extent that "the artic-

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<sup>96</sup> Possibilities of avoiding United States tax by use of "tax haven" corporations were severely limited by the Revenue Act of 1962. See generally INT. REV. CODE OF 1954, §§ 951-964. Under these provisions some income of certain controlled foreign corporations is taxed directly to United States shareholders whether or not the earnings are distributed. See Friedman & Silbert, *Doing Business Abroad: Effects of the Revenue Act of 1962: An Introduction*, 23 N.Y.U. INST. FED. TAXATION 945 (1965).

<sup>97</sup> Similar rules apply to sales or exchanges of foreign investment company stock. See INT. REV. CODE OF 1954, §§ 1246, 1247.

ulation of a statute increases,<sup>98</sup> the courts may still deny capital gain treatment to an item of income on the grounds that Congress did not intend to cover the transaction "even though the facts answer the dictionary definitions of each term used in the statutory definition."<sup>99</sup> A court may conclude as it did in *Corn Products Refining Co. v. Commissioner*,<sup>100</sup> that Congress intended something more than it made explicit in the statute. In *Corn Products*, the court held that even though every literal statutory condition to long-term capital gain had been met, the gain was ordinary income because the purchase and sale of the assets involved were an integral part of the taxpayer's manufacturing operations. The income was "business income" as described in the beginning of this article even though in *form* it was a capital gain.<sup>101</sup> The decision in *Corn Products* is a dramatic illustration of the need to know the policy behind the capital gains provisions, and serves as a warning that literal compliance with the statutes may not be enough.

Even where the courts do not override the literal terms of the capital gain statutes, problems of interpretation remain, and where a taxpayer attempts to use legal forms to cast the receipt of ordinary income into a technical gain from the sale of a capital asset, he is bound to encounter difficulty. As noted above, this frequently occurs when a taxpayer attempts to "sell" or "assign" as property something that is in fact nothing more than a right to future income for the past, present or future use of the taxpayer's services or capital. Thus, proceeds from the sale of one's rights under an executory employment contract,<sup>102</sup> from the sale of rights to income under a lease<sup>103</sup> or interest from bonds,<sup>104</sup> from the sale of dividends to be paid in the future,<sup>105</sup> and from the sale of rights to royalties or to payments under oil contracts,<sup>106</sup> are all treated as ordinary income. But even here it is difficult to draw a line. It is easy enough to say that the proceeds from the sale of the right to income for one year under a trust con-

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<sup>98</sup> L. Hand, J., in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

<sup>99</sup> *Ibid.*

<sup>100</sup> 350 U.S. 46 (1955).

<sup>101</sup> For discussions of the meaning and effect of the *Corn Products* case, see Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 990-96 (1956); Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion*, 65 YALE L.J. 401 (1956).

<sup>102</sup> O'Neill v. Commissioner, ¶ 64,003 P-H TAX CT. MEM. DEC. (1964).

<sup>103</sup> *Hort v. Commissioner*, 313 U.S. 28 (1941).

<sup>104</sup> See *Helvering v. Horst*, 311 U.S. 112 (1940).

<sup>105</sup> See *Smith's Estate v. Commissioner*, 292 F.2d 478 (3d Cir. 1961).

<sup>106</sup> *Commissioner v. Lake*, 356 U.S. 260 (1958).

stitute ordinary income, but the sale of a life estate, which is merely extension of the same right, is another matter.<sup>107</sup> And while the proceeds given to an employee for "buying" his contract are ordinary income, a different result might obtain where the employee or agent has developed a business out of his employment which can be sold to others.<sup>108</sup> The distinction between ordinary income and capital gain is a troubled one, and for thorough analyses the reader is referred elsewhere.<sup>109</sup> The only point that is intended to be made here is that while a study and knowledge of statutes relating to the taxation of capital gains is a necessary beginning to an understanding of this area, it is only a beginning.

The statutory framework for the taxation of capital gains and losses reminds one of a fruit salad in which there are many lemons. The basic premises are debatable; the six-month holding period bears little relation to the "bunching problem"; the inconsistent treatment of patents and copyrights cannot be justified; special advantages afforded "quasi-capital" assets do not do equity, nor do sections 1245 and 1250, which modify those special advantages in different ways, depending whether the property is real or personal; a "dealer" in securities can get capital gains treatment on securities sales, while an amateur seller of land often cannot. These are only a few aberrations evident in the statute itself, which begs for critical examination.

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<sup>107</sup> In *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947), the beneficiary of a life interest in a trust was allowed to deduct the present value of the interest from the proceeds received for its surrender and to report the difference as a capital gain or loss.

<sup>108</sup> See INT. REV. CODE OF 1954, § 1241.

<sup>109</sup> See Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964). The problem is especially difficult in transactions involving the sale of contractual rights. The cases are reviewed in *Commissioner v. Ferrer*, 304 F.2d 125, 130-36 (1962). See also Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 MINN. L. REV. 1 (1964); Eustice, *Contract Rights, Capital Gain and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964).