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VI

ADVANCE PLANNING FOR CAPITAL GAIN — GENERALLY (cont'd)
CONTROLLING THE CHARACTER OR BASIS OF THE ASSET
TO BE SOLD OR EXCHANGED

Howard M. Kohn

This aspect of the problem of planning in advance to obtain the benefits of capital gain treatment concerns controlling the character or basis of the asset, to attempt to assure that the taxpayer has an asset whose sale or exchange will result in capital gain.

CONTROLLING CHARACTER OF ASSET BY
MANNER OF DISPOSITION

The question of what is a capital asset has already been discussed.¹ For present purposes it is important to bear in mind that the Code defines capital assets in terms of exclusion. The term "capital asset" means all property except that falling in certain excluded categories.² Certain of those exclusions go to the character of the property itself, or the manner in which it was acquired, for example, stock in trade, inventory, copyrights, certain receivables, and also depreciable property used in business. The present discussion is not concerned with those categories.

Frequently, however, property will not fall into any of the above categories, and will qualify as a capital asset if only it is not caught under the *last* category listed in the Code: property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. In such cases, the manner in which it is disposed of may possibly be used to control the character of the asset.

Important examples are: inherited property which the owner wishes to sell;³ property which has been held for a long period as an investment and which now is to be sold; or, as in *Greenspon v. Commissioner*,⁴ property distributed in kind in liquidation of a corporation, which the shareholders wish to sell, and which is unrelated to any trade or business of the shareholders. Moreover, even a dealer may segregate property held by him, and hold such property for investment. In the case of a

1. See discussion pp. 256-66.

2. INT. REV. CODE OF 1954, § 1221. (Hereinafter cited as §).

3. See *Reynolds v. Commissioner*, 155 F.2d 620 (1st Cir. 1946); *Estate of Ferber*, 22 T.C. 261 (1954), *acq.*, 1954-2 CUM. BULL. 4.

4. 229 F.2d 947 (8th Cir. 1956).

dealer in securities, there are specific statutory requirements which must be satisfied.⁵ In other cases, the taxpayer's burden is only the factual one of establishing that the property in question is being held for investment and not primarily for sale to customers.⁶

In every case, the question whether property is held primarily for sale to customers in the ordinary course of trade or business is a factual question. There have been literally hundreds of cases litigated in this area, in which the courts have enumerated various factors considered to be important in resolving that factual determination.⁷ Frequently the dispositions are liquidating sales. When that is the case and the sales activity and other business activity are at a minimum, the fact of liquidation will be given great weight as evidence that the property is not held for sale to customers in the ordinary course of trade or business. When the liquidation is accompanied by extensive development and sales activity, however, the fact of liquidation will not preclude a finding of a trade or business.

Factual Considerations

The factors considered most important are:

- (1) The reason for acquisition of the property.
- (2) Whether any new acquisitions are made during the period when the property is being sold. This can frequently be controlled.
- (3) The length of time the property has been held. A long holding period will generally be favorable to capital gain treatment, but not conclusive.
- (4) The reason for the disposition. A desire to liquidate the investment will be a favorable factor.
- (5) The principal occupation of the seller. If the seller is not regularly in the trade or business of selling such property, that fact will be a favorable factor.
- (6) The amount of development or improvement the seller has made on the property. The less the better.
- (7) The extent of the sales activity or effort, including advertising, employment of real estate agents, the use of signs and other methods of actively soliciting buyers. This is a crucial factor. The greater the amount of such activity, the greater the danger that the property will be classed as property held for sale to customers in the ordinary course of trade or business.

5. § 1236.

6. *E.g.*, see *Williamson v. Bowers*, 120 F. Supp. 704 (E.D.S.C. 1950).

7. See, *e.g.*, *Boomhower v. United States*, 74 F. Supp. 997 (N.D. Iowa 1947), a leading case, in which many of the factors and authorities are discussed.

(8) The number, frequency, continuity and substantiality of sales. Frequent and continuous sales will be an adverse factor.

When the sum total of those factors in a particular case adds up to a minimum of business activity, there is an excellent likelihood that the property will not be regarded as held for sale to customers in the ordinary course of trade or business, and that capital gain will result. Conversely, when those factors add up to substantial business activity, there will be a great danger of the property being classed as held for sale to customers in the ordinary course of trade or business, and the gain as ordinary. Indeed, in one recent case, where the taxpayer was actively engaged in the development and sale of luncheonette sites, the Tax Court held that even though the assets sold by the taxpayer consisted of stock in corporations by which the luncheonette sites were developed, such corporate stock was property held for sale to customers in the ordinary course of trade or business and was a non-capital asset.⁸

CONTROLLING CHARACTER OR BASIS OF ASSET BEFORE ACQUISITION

Another possibility is that of controlling the character or basis of the property by planning before the property is acquired. If the property being acquired is corporate stock, some advance corporate arrangements may be important. If non-stock assets are being acquired, it may be desirable to avoid direct ownership. If improvements are needed it may be highly advisable to have the seller make the improvements.

Avoiding "Hot Stock" Treatment

When corporate stock is being acquired, timely and careful planning may enable the taxpayer to bring preferred stock into the picture while avoiding the taint of the "hot stock" provisions of the law. The Code now provides, to paraphrase very generally, that if a corporation issues preferred stock as a stock dividend or in a recapitalization, and if a distribution of cash instead of the preferred stock would have been taxable as a dividend to the recipients, then the preferred stock will be "tainted stock." When the recipient disposes of such tainted stock, he will have ordinary income tax consequences, unless at the same time he disposes of the common stock on which the preferred was issued.⁹

This is an over-simplified summary of the "hot stock" provision, but it will suffice for present purposes. The point of interest here is that there will be some situations in which the taxpayer may wish to take

8. Herman Katz, P-H TAX CT. REP. & MEM. DEC. (P-H Tax Ct. Mem.) ¶ 60,200 (Sept. 28, 1960). For fuller discussion, see pp. 260-63.

9. § 306. See discussion pp. 319-30.

steps before acquiring stock in a corporation, to insure that the preferred stock will not be hot stock.

For example, the taxpayer might be buying all of the stock of *A Company*, which has exclusively common stock outstanding. He wishes, however, eventually to have a corporate structure which will include both common and preferred. If he were to buy the common, and then create preferred by a stock dividend or recapitalization, the preferred would in all likelihood be tainted stock. In such a situation, he should consider addressing an offer to the sellers to the effect that at such time as the corporation has a capital structure consisting of *X* shares of common stock and *Y* shares of preferred stock, then he will buy all of the sellers' common and preferred stock in the corporation. The sellers could then cause the corporation to issue a stock dividend of preferred stock. That preferred stock may be tainted stock in the sellers' hands; but when sold to the taxpayer along with the common, it will not result in ordinary income treatment under the hot stock provisions, since the sale will terminate the sellers' interest in the corporation.¹⁰ At the same time, the taxpayer has *purchased* the preferred stock, not received it as a distribution from the corporation. Thus it is no longer hot stock. Preferred stock purchased from a prior owner in an arm's length transaction is never tainted stock in the purchaser's hands.

Another feature of the hot stock rules is that preferred stock purchased from the corporation is never tainted stock. Consideration should be given to this rule when a corporation is being formed. Thus, once the amount of money to be invested for stock has been decided upon, it should be remembered that regardless of how much of that stock is preferred stock, such preferred stock purchased from the corporation will be free from the taint of the hot stock provisions. It will frequently be highly desirable, therefore, in a new corporation, to issue only a minimum amount of common stock, and to issue the balance of the stock as preferred. Timing here is extremely important. If only common stock is issued at the time of incorporation and at a later date when the corporation has accumulated earnings it is decided to convert part of the common into preferred, there will be a grave danger that such preferred issued at that later date will be tainted stock.

Another important question to be examined, in considering the problems of the taxpayer who wishes to buy the stock of *A Company*, is whether the corporation has more assets than are needed in the business. If it does, and if the taxpayer were to buy the stock and then withdraw the excess assets, the results might very well be catastrophic. The with-

10. § 306(b)(1).

drawal in all probability would be a dividend (assuming the corporation has earnings and profits), not a tax-free recovery of his basis.

One solution to this problem, requiring careful advance planning, would be for the taxpayer to purchase only a portion of the seller's shares, for an amount which he intends to leave invested in the business, and for the corporation to redeem the balance of the seller's shares in the same transaction.¹¹ Thus, for a reduced investment the purchaser will receive all of the outstanding stock of the corporation; and at the same time the seller's interest in the corporation will be terminated. An important caution for the purchaser in this situation is that he does not agree to buy the shares which the corporation is going to redeem. If he were to obligate himself to purchase those shares, and the corporation were then to buy them from the seller, there would be a danger that the corporate payment relieving the purchaser of his obligation would be treated as a dividend to the purchaser. By agreeing to purchase and then purchasing only the shares which are not to be redeemed, however, the purchaser can avoid that dividend danger and still reduce his investment in the corporation.¹²

Non-Stock Assets

Where the property to be purchased is not stock, but other assets, the taxpayer should consider some other steps before acquisition, looking toward controlling the character of those assets and the character of his gain as capital and not ordinary. One such step is to avoid direct ownership.

An everyday example is the case of an asset which, if acquired individually, would clearly be an ordinary asset, for example, a tract of real estate to be acquired by a real estate developer. If a corporation is formed to acquire and develop the property, the corporation's profit will be ordinary; but the stock in the corporation will be a capital asset, and gain on ultimate liquidation or sale of that stock will be capital gain.¹³

Introduction of a corporation to acquire the property will of course result in a double tax — the ordinary income tax at the corporate level and a capital gain tax at the shareholder level. The overall tax may be less burdensome, however (particularly since the second tax at the

11. See *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), holding that the redemption of the seller's shares does not result in a dividend to him. In Rev. Rul. 54-458, 1954-2 CUM. BULL. 167, and Rev. Rul. 55-745, 1955-2 CUM. BULL. 223, the Commissioner has announced that he will follow the *Zenz* decision.

12. An alternative method would be to form a new corporation having the desired capital structure, and have the new corporation, with interim debt-financing, purchase all the seller's stock and then liquidate the old corporation. See Colborn, Katcher, Fleming & Merritt, *Buying and Selling a Corporate Business: A Survey of Tax and Non-tax Implications*, 10 WEST. RES. L. REV. 123, 130 (1959).

13. *But see* § 341, relating to collapsible corporations.

shareholder level is deferred until the stock is disposed of), than if the income were all realized by the individual as ordinary income taxable in his individual income tax bracket.

Another means of avoiding direct ownership is the use of negotiable warehouse receipts. Warehouse receipts for whiskey have been involved in a number of litigated cases.¹⁴ In some of the cases the taxpayer was a dealer or processor of whiskey; in others, the whiskey was unrelated to any trade or business of the taxpayer. In none, however, was the taxpayer a dealer in warehouse receipts. The courts took the view that warehouse receipts are in the nature of a security, and held them to be capital assets. It would appear that the capital asset treatment accorded whiskey warehouse receipts in those cases should, in an appropriate case, be equally applicable to receipts relating to other property, such as lumber or steel.

Another alternative which should be considered before the property is acquired is the advisability of its acquisition by the taxpayer's wife or children, or a trust for them, rather than the taxpayer, if he might be held a dealer in such property. Whether the property will be a capital asset in the hands of such related persons will depend upon whether the property is held by them for sale to customers in the ordinary course of their trade or business.¹⁵ The fact that the husband or father is a dealer in the property, and that such property if held by him would probably be classed as an ordinary asset, although calling for close scrutiny, will not stamp the property in the hands of a related person as an ordinary asset.

If no funds of the wife or children or any trust are available to acquire the property, and the taxpayer is not prepared to make a gift, he may wish to place the property in a trust for his own benefit, as a means of segregating and identifying the property which the trust is to hold, for investment and not for sale in his trade or business.¹⁶

Finally, and regardless of who is going to acquire the property, if improvements will be required it must be recognized that if the taxpayer makes those improvements himself there will be a greater danger that gain on disposition will be held to be ordinary.¹⁷ The possibility should be considered of having the seller make such improvements before the taxpayer acquires the property.

14. Thomas E. Wood, 16 T.C. 213 (1951), *acq.*, 1951-2 CUM. BULL. 4; Continental Distrib. Co. v. United States, 143 F. Supp. 652 (N.D. Ill. 1956); Cedar Valley Distillery, Inc., 16 T.C. 870 (1951), *acq.*, 1955-1 CUM. BULL. 4; Greenbros, Inc., 23 T.C. 226 (1954), *acq.*, 1955-1 CUM. BULL. 4.

15. Weaver v. Henslee, 120 F. Supp. 707 (M.D. Tenn. 1954).

16. See Williamson v. Bowers, 120 F. Supp. 704 (E.D.S.C. 1960).

17. See Rev. Rul. 59-91, 1959-1 CUM. BULL. 15.

CHANGING THE CHARACTER OF AN ASSET ALREADY OWNED

Where property already owned is a non-capital asset, it may still be possible to change its character. A copyright, literary, musical or artistic composition is an ordinary asset if held by the person whose personal efforts created it, or if held by one whose basis is determined by reference to the creator's basis.¹⁸ Such a copyright or composition, however, could be sold for its fair market value, even to a related person. It might then be a capital asset in the hands of the purchaser.

Again, there may be inventory or other trade or business property which has appreciated or is expected to appreciate in value. If such property were given to another who was not in the same business, and the property were removed from inventory and held not for sale to customers but for investment, character of such property could thereby be changed to a capital asset.¹⁹ Again, the transfer could be to one or more individuals; or it could be to a trust for them. In either case, the test will be whether in the transferee's hands the property is inventory, or stock in trade, or property held primarily for sale to customers in the ordinary course of his trade or business.

Even if the transfer is to a trust for the benefit of the grantor, it may still be effective. As previously stated, if an individual owns inventory property, or property held for sale to customers, and he wishes to remove it from the market, segregate it, and hold it for investment, he can do so and thereby remove it from the ordinary asset classification. His principal problem will be proof of segregation, and proof of intention to hold not for sale but for investment. The trust could be extremely helpful in this connection, in establishing the removal from inventory, the segregation, the holding for investment, and the resulting capital asset classification.

Finally, it should be noted that property owned by a decedent at his death which was a non-capital asset in his hands, for example, inventory, will not for that reason be a non-capital asset in the hands of his successor in interest.²⁰ The character of such assets will be redetermined in the hands of the successor in interest. Assets in the hands of the executor will normally be capital assets, unless the executor continues a business in which the decedent was engaged. In any case, the executor or the successor will have a basis for the assets equal to their value at the date of the decedent's death (or the optional valuation date).²¹

18. § 1221(3).

19. *Cf. Weaver v. Henslee*, 120 F. Supp. 707 (M.D. Tenn. 1954).

20. See *Estate of Ferber*, 22 T.C. 261 (1954), *acq.*, 1954-2 CUM. BULL. 4.

21. § 1014.