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Advance Planning for Capital Gain--Generally (cont'd) Controlling the Amount of Gain

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IX

ADVANCE PLANNING FOR CAPITAL GAIN — GENERALLY (cont'd)
CONTROLLING THE AMOUNT OF GAIN

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MINIMIZING GAIN BY SELECTION OF ASSET TO BE SOLD

Control of the *amount* of gain by selection of the particular asset which is to be the subject of the sale or exchange may be as important as casting the transaction so as to qualify it for capital gain rather than ordinary income treatment. The need for careful selection exists in at least two general situations: one, where the asset to be sold is one of a group of many similar assets; the other, where the asset to be sold may be converted into another form prior to its sale or exchange.

Tracing Assets and Allocation of Basis

At the outset, where similar assets are held, some for sale in the course of the taxpayer's business and others for investment, care must be exercised to assure that the property selected as the subject of the sale or exchange qualifies as a capital asset. Thus, a dealer in securities should select for sale stock from his investment account rather than from his inventory account.[1]

Once a capital asset has been selected for the sale or exchange, a further inquiry may be required to determine which of several similar capital assets should be sold or exchanged. This may be important for two reasons. First, selection of a high-basis asset will minimize the amount of the taxable capital gain. Second, the particular asset must have been held for more than six months in order for the gain to qualify as long term capital gain.

Generally, the basis used to measure the gain upon the sale or exchange of an asset is the cost, as adjusted, of that particular asset.[2] It is thus necessary, in order to assign a cost basis to the asset which is to be sold or exchanged, to *identify* the particular asset which is the subject

1. Carl Marks & Co., 12 T.C. 1196 (1949), *acq.*, 1949-2 CUM. BULL. 3. For special rules in the Internal Revenue Code relating to dealers in securities, see INT. REV. CODE OF 1954, § 1236. (Hereinafter cited as §). If these rules are not followed, the dealer cannot treat the gain from sale of securities as capital gain. Generally, the security must be clearly identified on his records within thirty days of its acquisition as held for investment and thereafter must not be held primarily for sale to customers in the ordinary course of his trade or business. As to what constitutes clear identification, see Treas. Reg. § 1.1236-1(d)(1). (Hereinafter cited as Reg.).

2. Reg. § 1.1012-1.

of the sale or exchange. This poses a problem most frequently in the case of securities. The taxpayer may hold corporate stock acquired in lots at different prices or on different dates, some more than six months prior, and some six months or less prior to the sale or exchange. Identification of the particular lot from which the stock is taken will determine both the amount of the gain and whether it is short term or long term gain. But the lot from which the stock has been sold or transferred must be "adequately identified" before the stock is considered as having come from that particular lot.[3]

The Regulations explain what constitutes adequate identification. Generally, the stock covered by certificates delivered to the transferee is considered to be the stock sold or transferred, and a showing that certificates of shares from a given lot were so delivered constitutes an adequate identification.[4] This general rule applies, with certain limited exceptions, although the taxpayer intends to sell or transfer stock from a different lot or instructs his broker or agent to do so. The limited exceptions to this general rule apply and the stock designated by the taxpayer is considered to have been sold:

(1) where the taxpayer specifies to his broker or agent at the time of the sale or transfer (or when the certificate is delivered to the agent or broker) the particular stock to be sold or transferred, and written confirmation from the broker of such specification is set forth within a reasonable time (although certificates from a different lot are delivered to the transferee);

(2) if the stock is sold or transferred directly without a broker, where the taxpayer maintains a written record of the particular stock which he intended to sell or transfer.[5]

If the wrong stock is actually tranferred, and one of these exceptions applies, the sale, transfer or distribution deemed to have taken place will be considered in identifying the taxpayer's remaining stock for purposes of subsequent transactions.[6]

Where the lot from which the shares were sold *cannot* be adequately identified, the cost basis and holding period are determined by reference to that lot which was acquired the earliest,[7] and this rule applies despite

3. Reg. § 1.1012-1(c)(1). For special rule as to basis of securities received from a profit-sharing trust, see Rev. Rul. 57-514, 1957-2 CUM. BULL. 261.

4. Reg. § 1.1012-1(c)(2).

5. Reg. § 1.1012-1(c)(3). There is also an exception where the sale, transfer or distribution is made by an executor, administrator or trustee who holds the stock, if written specification is made in his books and, in the case of a distribution, the distributee is given a written documentation of the particular stock distributed. Reg. § 1.1012-1(c)(4).

6. Reg. § 1.1012-1(c)(5).

7. Reg. § 1.1012-1(c)(1).

the taxpayer's intention and even though his designation is not followed.[8] However, there is an exception to this "first-in, first-out" rule where the securities sold or transferred were acquired earlier in certain tax-free exchanges. In that event, generally the cost of each class of the old stock or securities is allocated to the stock or securities held after the tax-free exchange in proportion to the fair market value of the stock or securities of each class held after the exchange.[9]

Sale of Assets v. Sale of Stock

Counsel for the seller of business assets which are being held and operated in corporate form should consider carefully and balance the alternative methods available for effecting the sale, with a view to minimizing the gain to the seller. There are three basic alternative methods to be considered in selling an incorporated business: (1) sale of stock; (2) sale of assets by corporation; and (3) sale of assets by shareholders, following liquidation of the corporation.

Sale of Stock

Sale of stock is probably the simplest way of disposing of an incorporated business and may have advantages apart from tax considerations, such as insulating the seller from any unknown or unforeseen liabilities of the corporation.

From the tax viewpoint, the main advantage to the seller is that the sale of stock avoids the tax to the corporation which might result if it sold the assets.[10] Of course, if the assets are sold at a loss, there may be an advantage in having the corporation effect the sale so as to realize a tax benefit from the loss. If it is decided to sell stock, care must be taken that the gain on the sale is capital gain and not ordinary income under the collapsible corporation provisions.[11]

A possible advantage to the seller from the sale of stock rather than

8. Davidson v. Commissioner, 305 U.S. 44 (1938) (intention to sell particular stock, even though coupled with direction to the bank, is not enough where that particular stock is not in fact sold).

9. Reg. §§ 1.358-2(a)(2), (a)(3); Commissioner v. Von Gunten, 76 F.2d 670 (6th Cir. 1935). However, where the tax-free exchange is a recapitalization under § 368(a)(1)(E), no change is made in the basis of retained seccurities where the taxpayer has an option to surrender some or none of his stock or securities and he exchanges an identifiable part of his stock or securities. Reg. § 1.358-2(a)(5).

10. Counsel for the seller may wish to point out in the course of the negotiations several possible advantages to the purchaser in buying stock instead of the underlying assets. Thus, if the business continues to be operated by the corporation whose stock is sold, separate corporate surtax exemption and accumulated earnings credit, which might be lost if assets were sold, may be preserved. There may be other advantages to the purchaser, such as preservation of net operating loss carryovers, high asset bases for depreciation purposes, etc. *But see* §§ 269, 381, 382, 1551; Elko Realty Co. v. Commissioner, 260 F.2d 949 (3d Cir. 1958).

11. § 341.

assets is that the gain may be eligible for reporting on the installment method.[12] This advantage is not present where the corporation sells its assets on the installment method and distributes the installment obligations to its shareholders in liquidation. In that situation, the liquidating distribution of the installment obligations results in gain (which may be ordinary income) to the corporation, generally to the extent of the gain otherwise deferred under the installment method.[13]

Sale of Assets by Corporation

Generally, where the sale is in fact made by the corporation, two taxes will be imposed as a result of the transaction. First, any gain will be taxed to the corporation. This gain will be measured by the depreciated basis of the assets sold, and the nature of the gain (capital gain or ordinary income), will depend upon the nature of each asset sold.[14] Second, any gain realized by the shareholders upon the liquidation of the corporation will be taxed to them. This, of course, will be taxed as capital gain[15] and will be measured by the difference between the amount of the liquidating distribution and the particular shareholder's basis for his stock. The imposition of two taxes, *i.e.,* a tax upon the corporation and a tax upon the shareholders upon the liquidation of the corporation, may result as well where the corporation negotiates for the sale but, before a contract to sell is entered, the assets are distributed to the shareholders in liquidation and they actually make the sale.[16]

However, this double incidence of tax can be avoided where the corporation sells its property and then liquidates. Generally the tax to the corporation on any gain from the sale of its property is avoided where:

(1) it adopts a plan of complete liquidation,

(2) it sells or exchanges property within a twelve-month period following adoption of the liquidation plan, and

(3) it distributes all of its property (except assets retained to meet claims) in complete liquidation within the same twelve-month period.[17] If the specific terms of this statutory exception are met, the non-recognition of gain is mandatory, not elective.[18]

Even when these three statutory conditions to avoiding gain to the

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12. § 453 and Regs.

13. §§ 336, 453(d). This is not so, as to certain distributions in liquidation under §§ 332 and 337.

14. Grace Bros., Inc. v. Commissioner, 173 F.2d 170, 178 (9th Cir. 1949).

15. § 331(a). Capital gain treatment may be denied, however, if it is a collapsible corporation under § 341.

16. Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

17. § 337(a). See discussion pp. 290-93, 364-76.

18. Reg. § 1.337-2(a).

corporation from the sale of its property are present, there are certain exceptions and situations where gain may be recognized. Thus, unless substantially all of the stock in trade of the corporation (including inventory and property held primarily for sale to customers) is sold or exchanged to one person in one transaction in compliance with these statutory conditions, gain is recognized to the corporation from the sale of such stock in trade. The same is also true as to the sale of installment obligations acquired in respect of the sale or exchange of such stock in trade, whether or not the sale of the obligations is otherwise made in accordance with the statutory conditions.[19]

Often a corporation has some property which it will sell at a loss and other property upon which it will have gain. The question arises whether, if it sells the loss property *before* it adopts a plan of liquidation under section 337, it can deduct the loss and yet not be taxed upon the sale of the rest of its property within the terms of section 337. There is no clear answer to this question, but the Regulations are worded to permit the Commissioner to argue that the loss should not be recognized where it is incurred as part of an overall plan for selling the corporation's property and liquidating.[20]

It should be noted that there is no advantage to a sale of assets on the installment basis which qualifies for non-recognition of gain under section 337, inasmuch as the installment obligations, even though not taxed to the corporation, are taxed in full to the shareholders upon distribution to them in liquidation.[21]

Distribution of Assets by Corporation to Shareholders Who Sell Assets

Where the corporation has not conducted negotiations for the sale of assets, but has distributed assets to the shareholders who then sell them, generally there is no tax to the corporation.[22] The shareholders are taxed at capital gain rates[23] on the gain from the liquidation, *i.e.,* the excess of the value of the property received by them over the cost or other basis of their stock. The shareholders are then taxed upon any further

19. § 337(b). Moreover, gain is recognized from the sale or exchange of installment obligations acquired in respect of property which is not stock in trade sold or exchanged before adoption of the liquidation plan. § 337(b)(1)(C). Further exceptions to the non-recognition of gain provisions of § 337 are: sales or exchanges made by collapsible corporations. § 337(c)(1)(A) (see § 341(e)(4) for special rules as to collapsible corporations for purposes of § 337); or which follow adoption of plans of complete liquidation to which § 333 or § 332 (under certain circumstances) apply. §§ 337(c)(1)(B), (c)(2). See also Rev. Rul. 57-482, 1957-2 CUM. BULL. 49 for a further non-statutory exception.

20. Reg. § 1.337-2(b).

21. § 453(d).

22. The corporation may, however, be taxed as a result of the distribution of installment obligations. See §§ 336 and 453(d).

23. Unless it is a collapsible corporation under § 341.

gain which they may realize from the sale of this property. Since the value of the property for purposes of determining the gain to the shareholders from the liquidation of the corporation will usually be approximately the same as its sale price when the shareholders sell it, there will generally be no appreciable taxable gain from the sale.[24]

If there is gain, it will generally be taxed as capital gain unless the shareholders are considered to have entered into business in disposing of the property.[25] The controlling consideration is the *manner* in which the property is sold by the shareholder, *i.e.,* whether the *activities* in selling the property distributed to him in liquidation amount to carrying on a business.

There is always the danger here, that the Commissioner may find that the sale was in fact made by the corporation.[26] This is true, also, where there is a *partial* liquidation followed by a sale by the shareholders.[27] Section 337, discussed above, is not, of course, applicable to partial liquidations.

MAXIMIZING CAPITAL GAIN IN ORDER TO MINIMIZE ORDINARY INCOME

Situations have been discussed above in which capital gain may be *reduced* by care in the selection of the particular asset to be sold. This section is not concerned with reducing the capital gain but with *increasing* it so that other gain, which may be treated as ordinary income, will be *reduced or eliminated.*

Allocating Sale Price to Particular Assets

Generally, where several assets are sold in one transaction, the proceeds of the sale, for purposes of determining gain or loss, are allocated to the particular assets in proportion to the relative fair market value of each asset at the time of sale.[28] This means that gain and loss are separately figured for each asset.

It thus becomes important to determine the character of the asset in the seller's hands. There are three basic categories of property for tax purposes: (1) capital assets; (2) property used in the trade or business; (3) other property, such as inventory. The amount of the sale price allo-

24. Thus, the installment method may be of no avail.

25. See Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956), and cases cited therein. See also real estate cases involving liquidations of holdings pp. 373-75.

26. *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945), *with* United States v. Cumberland Pub. Ser. Co., 338 U.S. 451 (1950).

27. Reg. § 1.346-3.

28. Rev. Rul. 55-79, 1955-1 CUM. BULL. 370; Bryant Heater Co. v. Commissioner, 231 F.2d 938 (6th Cir. 1956).

cated to each category will, of course, determine both the amount and the character of the gain or loss.

Despite the general rule of allocating the sales price in proportion to the market value of each asset sold, the taxpayer may show that a premium was paid or a discount was given for a particular asset.[29] This makes it desirable to spell out in the sales contract the consideration being paid for each asset. While this specification is helpful as a matter of proof, it is far from conclusive.[30] The Commissioner may reallocate the sales price according to the "realities" or substance of the transaction.[31]

Since allocation specified in the sales contract may not be controlling, the prudent tax counsellor would do well to consider supporting the contract allocation by a competent independent appraisal. Such an appraisal might then be further integrated into the transaction by a reference to it in the contract of sale as the basis for determining the gross or aggregate sales price.

The foregoing principles are equally applicable to the sale of a business. Such a sale is treated as the sale of the individual business assets. The gain or loss will be capital or ordinary depending upon the nature of the particular asset.[32]

There are, however, special difficulties in the sale of a business where the seller enters into a covenant not to compete at the time of the sale. A covenant not to compete is in the nature of an agreement to perform services, and therefore compensation attributable to such a covenant is vulnerable to classification as ordinary income.[33] A troublesome test has evolved for determining whether any gain which may be allocated to the covenant is ordinary income rather than capital gain. This test asks whether the covenant is "severable" from the assets sold. If not, the gain is capital gain.[34] In determining whether the covenant is severable, the controlling consideration is not whether it can be separately valued, but rather whether it has been dealt with by the parties as a separate item.

If its primary function is to assure the purchaser of beneficial enjoyment of what he has acquired, such as goodwill, the covenant is *nonseverable* and simply contributes value to the assets sold.[35] In other words, if the covenant is ancillary or incidental to the sale of the assets,

29. Bryant Heater Co. v. Commissioner, 231 F.2d 938 (6th Cir. 1956).

30. Giulio Particelli, 11 CCH Tax Ct. Mem. 150 (1952), *aff'd*, 212 F.2d 498 (9th Cir. 1954).

31. Commissioner v. Chatsworth Stations, Inc., 6 Am. Fed. Tax R.2d 5243 (2d Cir. 1960); Copperhead Coal Co. v. Commissioner, 272 F.2d 45 (6th Cir. 1959).

32. Note 28 *supra*.

33. Salvage v. Commissioner, 76 F.2d 112, 113 (2d Cir. 1935), *aff'd*, 297 U.S. 106 (1936).

34. Aaron Michaels, 12 T.C. 17 (1949), *acq.*, 1949-1 CUM. BULL. 3.

35. *Ibid.*

any consideration received for the covenant will be treated as capital gain, provided, of course, that the sale of the related assets gives rise to capital gain.[36] A problem may arise where stock, instead of the underlying assets, is sold. In that case it is easier to sever a covenant which accompanies the sale of stock and any consideration attributable to it is vulnerable to treatment as ordinary income.[37]

Generally, when a business is sold at a gain, it will be preferable from the seller's viewpoint to allocate the greatest portion of the sales price to assets such as goodwill, property used in the business, patents, copyrights, etc., and the smallest portion to assets such as inventory and stock in trade, accounts and notes receivable, and agreements not to compete. The buyer's and seller's interests are often in opposition in this respect. Of course, if the basis of an asset resulting in capital gain is very low, it may be preferable to allocate a lower amount of the sales price to that asset even at the expense of increasing ordinary income from the sale of other assets.

Where there are separate sales of portions of property acquired as a whole, gain or loss is determined on the sale of each part, and gain is not deferred until the entire property has been sold.[38]

Under a special provision of the Code,[39] a growing crop is now eligible for capital gain treatment where the land is used in the taxpayer's business and is sold or exchanged with the crop to the same buyer at the same time. This provision is inapplicable to unharvested crops sold with leaseholds,[40] in which case allocation of the proceeds must be made between the crop (ordinary income) and the leasehold.

Sale With Deferred Payment Without Interest

Where the property is sold under an arrangement deferring the payment of the full price to the future, the question may arise whether any portion of the price may be treated as ordinary interest income. This question becomes important where the sales proceeds are eligible for capital gain treatment.

Generally, where no interest is provided for in the contract, the en-

36. Louis H. Zipp, 28 T.C. 314, 328 (1957). See also Toledo Newspaper Co., 2 T.C. 794 (1943), and Toledo Blade Co., 11 T.C. 1079 (1948).

37. Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959). Compare Louis H. Zipp, 28 T.C. 314, 328 (1957).

38. Reg. § 1.61-6(a). Basis must be "equitably apportioned" among the several parts.

39. § 1231(b)(4).

40. Bidart Bros. v. United States, 262 F.2d 607 (9th Cir. 1959); Reg. § 1.1231-1(f). Capital gain treatment from sale of the crop may also be lost where the seller retains any right or option to reacquire the land, directly or indirectly, other than the retention of a security right.

tire agreed price is treated as proceeds from the sale.[41] The general rule that interest will not be found by implication in a gross selling price which does not specify interest, is not applicable, however, where either the contract or evidence outside the contract shows that a portion of the contract price was either intended or treated by the parties as interest. Where the contract or other evidence, such as the negotiations leading up to the contract, shows that interest figured in determination of the contract price, that portion of the selling price determined by the parties to represent interest is likely to be treated as ordinary income even though the proceeds are otherwise eligible for capital gain treatment.[42] However, the mere fact that the contract permits the purchaser to reduce the contract price by an allowance for interest, where prepayment of the deferred contract price is made, has been held not to cause that portion of the sales price represented by the allowance to be treated as interest.[43]

Payment of Sales Price Deferred, Dependent Upon Future Events

Where payment of the sales price has been deferred and the *amount* is dependent upon future events, a difficult problem arises as to whether the deferred payments are eligible for capital gain treatment. Typical is a sale where the amount of the purchase price is geared to future production, sales or profits.

Generally, where the right to receive future payments can be valued, that value is used as the sales price for purposes of determining capital gain. Later, when the amount of the value assigned to this right has been received by the seller, any excess is taxed as ordinary income.[44] The theory is that the transaction is *closed* when the sale is made. Subsequent gain is then not eligible for capital gain treatment because it does not relate to the sale or exchange, which has already been closed, but rather

41. Paine v. Commissioner, 236 F.2d 398 (8th Cir. 1956). If the property is sold in exchange for a corporate obligation and if the obligation should be considered as having been issued at an "original issue discount," such discount might be treated as ordinary income when the obligation is sold, exchanged or retired. See § 1232 and discussion pp. 350-62. A limited exception to this general rule exists where there is a sale of personal property under an installment contract in which carrying charges are separately stated but the interest charge cannot be ascertained. In that situation, the carrying charge payments made under the contract are treated as if they included interest at 6% of the average unpaid balance for purposes of determining the interest *deduction.* § 163(b). *Quaere,* whether the interest so constructively determined for the buyer is treated as interest to the seller.

42. See Judson Mills, 11 T.C. 25 (1948).

43. See Daniel Bros. Co. v. Commissioner, 28 F.2d 761 (5th Cir. 1928).

44. Glenn E. Alexander, 34 T.C. No. 78 (July 29, 1960); A. B. Culbertson, 14 T.C. 1421 (1950), *acq.,* 1950-2 CUM. BULL. 1. Of course, the entire gain may be treated as ordinary income where the substance of the transaction is the assignment of the right to receive future income rather than the sale of an asset which has increased in value. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958).

to the collection of a claim or chose in action, the proceeds of which are generally ordinary income.[45]

There is an exception to this general rule where the right to future payments either cannot be valued or has no value. In that event, the later receipt of payments may qualify for capital gain treatment.[46] The burden of proof, of course, is on the taxpayer to show that the right either cannot be valued or has no value. It should be noted that the Commissioner takes the position that value must be assigned to the right except in rare and extraordinary cases.[47]

Apparently the Commissioner feels that the right to receive payments in the future, measured by receipts, sales, production, etc., in the case of the sale or exchange of patents or copyrights is not capable of valuation. He has ruled that the future payments are eligible for capital gain treatment where the sale or exchange of the patent or copyright otherwise qualifies for capital gain treatment.[48]

Typical recent cases holding that deferred payments qualify for capital gain treatment involve recoveries on refund claims distributed in a corporate liquidation[49] and restitution of profits awarded on legal claims distributed in a corporate liquidation.[50] Holding deferred payments to be taxable as ordinary income are cases involving payments received on rights to renewal commissions distributed in a corporate liquidation[51] and payments of royalties under a license agreement received from the sale of stock.[52]

45. Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

46. Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948). Compare Arrowsmith v. Commissioner, 344 U.S. 6 (1952), holding that shareholders had capital loss from payment of a judgment against the corporation where they had treated gain on liquidating distributions in earlier years as capital gain.

47. Reg. § 1.453-6(a); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

48. Rev. Rul. 60-226, 1960 INT. REV. BULL. NO. 25, at 8; Rev. Rul. 58-353, 1958-2 CUM. BULL. 408. See discussion 338-50.

49. McDonald v. United States, 181 F. Supp. 332 (W.D. Wash. 1960).

50. Nakatani v. Cullen, 5 Am. Fed. Tax R.2d 519 (N.D. Cal. 1959).

51. Estate of Abraham Goldstein, 33 T.C. 1032 (March 18, 1960).

52. Warren v. United States, 171 F. Supp. 846 (Ct. Cl. 1959); John W. Chamberlin, 32 T.C. 1098 (1959).