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Tax Aspects of "Property Held Primarily for Sale"

The Supreme Court recently considered the question of whether certain property was "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." An affirmative answer would have resulted in the gain being treated as ordinary income, while a negative answer would have allowed capital gain treatment. By defining "primarily" in Malat v. Riddell as meaning "of first importance" or "principally" and by remanding the case to the Tax Court for a new factual determination in light of this definition, the Supreme Court has overruled a great deal of existing case law and will perhaps materially alter the outcome of future cases arising in this area.

The purpose of this Note is to show the probable effect the Malat definition will have on those sections of the Internal Revenue Code of 1954 which use the phrase "held primarily for sale." The most important sections are those dealing with capital assets and property used in the taxpayer's trade or business. Those sections dealing with corporate liquidation, collapsible corporations, and tax-free exchanges are also slightly affected by the Malat definition of "primarily" and will be lightly treated.

I. CAPITAL ASSETS AND PROPERTY USED IN TRADE OR BUSINESS

A capital asset is defined by excluding certain types of assets from the capital asset classification. Among those items expressly excluded are "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" and "property, used in his trade or business, of a character which is sub-

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3 Id. at 572.
4 CODE § 1221 (1).
5 CODE § 1231 (b).
6 CODE § 337 (b) (1) (A).
7 CODE § 341 (b) (3) (B).
8 CODE § 1031 (a).
9 CODE § 1221.
10 CODE § 1221 (1).
ject to the allowance for depreciation provided in section 167, or real property used in his trade or business."  

Notwithstanding the exclusion of depreciable property and real property used in the taxpayer's business, the Code permits capital gain treatment in the sale of such property held for more than six months where a net gain is realized. If the sale of such property results in a net loss, the taxpayer is allowed a deduction against ordinary income, unless the property is stock in trade, inventory, or is held primarily for sale to customers in the ordinary course of business.  

If both losses and gains occur, it is to the taxpayer's advantage to establish that the property sold at a loss was stock in trade, inventory, or held primarily for sale, since such losses would not be offset against section 1231 gains.

It is clear that the purpose of excluding all property from the capital asset classification, "held primarily for sale to customers in the ordinary course of business," is to treat the "normal source of business income" as ordinary income. The problem arises, however, in the determination of whether the property sold in a particular situation, was in fact held primarily for sale in the ordinary course of business (so that profits would generate ordinary income) or whether, for example, it was held for investment purposes (so that profits would constitute capital gain). The courts, being unable to establish a single formula which would readily answer the question, have been forced to decide each case on its particular facts. To aid in this factual determination the following criteria have been used: (1) the number, frequency, and continuity of transactions, (2) the purpose for which the property

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11 Code § 1221 (2).
12 Code § 1221.
13 Code § 1231 (a).
14 Net gain is achieved if total gains exceed total losses.
15 Net loss is achieved if total losses exceed total gains.
16 Code §§ 1231 (b) (1) (A), (B). For example, real estate is either a capital asset or is treated as a capital asset where the disposition results in a net gain, unless the real estate is held by the taxpayer primarily for sale to customers in the ordinary course of business.
18 Any other purpose except "primarily for sale" will satisfy the Code requirement.
19 The frequency and continuity of the taxpayer's transactions are probably the most important factors in determining whether he is engaged in the business of selling the particular piece of property. The real estate subdivision cases involving systematic and regular sales in substantial quantity compared to the single isolated sale clearly illustrate this factor. Compare Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951), with Austin v. Commissioner, 263 F.2d 460 (9th Cir. 1959).
was acquired and held;\(^{20}\) (3) the proximity of the sale to the purchase;\(^{21}\) (4) the activity of the seller in developing the property and promoting its sale;\(^{22}\) and (5) other miscellaneous factors indicating that the transaction was in furtherance of the taxpayer’s business.\(^{23}\)

This case-by-case determination causes difficulty, particularly when real estate is involved, in determining whether property originally acquired for investment purposes is converted into property held primarily for sale because considerable activities will be necessary to dispose of the property.\(^{24}\) For example, a taxpayer who has held real estate as an investment for twenty years and then decides that the time is right to sell may find it necessary and more profitable to subdivide and improve the land before resale. While section 1237 does permit capital gain treatment on the sale of subdivided real estate by the investor-taxpayer,\(^{25}\) if its requirements are not meticulously followed, the investor-taxpayer may be required to pay ordinary income rates when it is asserted by the government that his development activities established a dual purpose for holding the land: investment and sale, thus, under the old definition, making the sale one of property held substantially (primarily) for sale in the ordinary course of business.

\(^{20}\) This factor calls for an examination of the taxpayer’s intention in acquiring and holding the property. Austin v. Commissioner, \textit{supra} note 19; Fahs v. Commissioner, 161 F.2d 315 (5th Cir. 1957); DesiLu Prods., 34 P-H Tax Ct. Mem. 1856 (1965).

\(^{21}\) The simple rule here is that the longer the holding period, the lesser the probability that the taxpayer is in the business of selling the particular type of property involved. This factor is especially helpful concerning real estate. Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963); James G. Hoover, 32 T.C. 618 (1959).

\(^{22}\) Developing activity is considered to be for the purpose of attracting customers and consequently implies that the property is being held for sale; this type of activity is usually limited to real estate. Certainly the greater the sales effort of the taxpayer, the greater the chance the property will be declared to be held primarily for sale. Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952) (dealing with real estate development activity); Fowler v. United States, 154 F. Supp. 859 (N.D. Ohio 1957) (dealing with real estate sales activity).

\(^{23}\) See 3B MERTENS, FEDERAL INCOME TAXATION § 22.15, at 77 (1958). The courts have considered the amount of time the taxpayer has spent on other activities; the ratio between the taxpayer’s income from his sale’s activity and his income from other activities; whether or not the taxpayer belongs to any “dealer” associations; and how the taxpayer holds himself out on his stationery, telephone listing, or tax return.

\(^{24}\) For capital gain treatment, see Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Alabama Mineral Land Co. v. Commissioner, 230 F.2d 870 (5th Cir. 1957); Consolidated Naval Stores Co. v. Fahs, 227 F.2d 923 (5th Cir. 1955); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955). For ordinary income treatment, see Pennroad Corp. v. Commissioner, 261 F.2d 325 (3d Cir. 1958); Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952).

\(^{25}\) \textsc{Code} § 1237 (a):

(a) \textsc{General}. — Any lot or parcel which is part of a tract of real prop-
The problem is not confined to real estate. A lease and subsequent sale of personal property has resulted in ordinary income treatment where it was asserted that the property was held for the dual purpose of rental or sale.28 Similarly, where an inventor had a history of both selling and licensing his patents, an individual sale could result in ordinary income based upon the dual-purpose doctrine.

The dual-purpose approach gained recognition in Rollingwood Corp. v. Commissioner27 in which the taxpayer constructed seven hundred homes with the approval of the National Housing Administration and the War Production Board on condition that the houses be rented with a thirty-month purchase option in the tenant. The taxpayer neither employed a sales force nor used any "For Sale" signs. It was asserted by the corporation that since the houses were rented on an average of twenty-one months prior to their sale they were not held primarily for sale and that the taxpayer was therefore entitled to capital gain treatment on the proceeds. The Ninth Circuit rejected the taxpayer's contention, relying heavily on the frequency and continuity test,28 and concluded

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27 190 F.2d 263 (9th Cir. 1951).
28 See note 19 supra.
that Rollingwood was in the business of selling real estate. The court went on to define “primarily” as meaning “substantial” or “essential,” theorizing that Congress had only intended to alleviate the tax burden on those whose property increased in value over a long period of time and did not intend capital gain treatment in situations where one of the essential purposes for holding the property is sale.

The Rollingwood definition of “primarily” as meaning “essentially” or “substantially” recognized that, although sale often was not the predominant purpose, it was always a “substantial” one in certain types of businesses. Thus, the dual-purpose distinction was expanded by the courts to such an extent that the Ninth Circuit stated in *Malat v. Riddell*:

If, however, the property was acquired and held with the purpose of realizing gain from it in any feasible manner which might present itself; if the owner stood ready to adapt his program to such changes as falling prospects might require and to realize gain wherever and however he could; then surely the realization of gain by sale is pursuant to the purpose of the holding. The taxpayer in such a case could be said throughout the course of his holding to have had several alternative purposes (all of which were substantial reasons for his holding within the Rollingwood definition of “primary”), each of which in turn actually became the primary purpose as efforts were concentrated in its direction.

This statement seems to suggest that a taxpayer’s profits will be subjected to ordinary income treatment whenever his purpose for holding the property has changed and he anticipates a profit on a sale of property after the investment possibilities have become frustrated. The Tax Court in *Joan E. Heller Trust*, certainly appeared to adopt this suggestion when it ruled that duplex homes which had been rented for several years after their construction were “held primarily for sale.” In reaching its decision the Tax

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29 190 F.2d at 266.
30 Ibid.
32 347 F.2d 23 (9th Cir. 1965), rev’d, 383 U.S. 569 (1966).
33 Id. at 26-27.
35 Id. at 1828.
Court relied upon both the Ninth Circuit's decision in *Malat* and its own finding that the owners had contemplated sale from the outset in the event that the rental efforts were not profitable.

Although the *Malat* decision involves real estate, it is equally applicable to personal property. For example, one is struck by the similarity between Revenue Ruling 62-141 and the Ninth Circuit's statement in *Malat*. In denying capital gain treatment to the gain arising from a lessor's sale of television films, the Internal Revenue Service declared:

> In view of the fact that television film producers are aware of the market that exists for sales of television films after initial leasing periods, it is reasonable to assume that generally, from the time of their production, a producer's intention is either to sell, to rent, or to rent and then sell, whichever method proves most profitable in its business.

The Tax Court in *Desilu Prods., Inc.* renounced the principle of Revenue Ruling 62-141 when it stated:

> [I]t would be the height of naivete to assume that any person in the business of renting property does not realize that at some point he may have to sell some of it, be it to raise funds to expand his operation or purchase newer rental property, divest himself of outmoded rental property, or to pay his just debts. The recognition of this possibility is a far cry from harboring an outright intent to sell.

In *Desilu* the taxpayer produced television films for rental and also rented its facilities to others. The Tax Court found that prior to 1962 the taxpayer had never sold or offered for sale any of its films and that the taxpayer was not in the business of selling television films. The Tax Court went on to say that, based upon these facts, it did not have to consider "primarily" since the taxpayer did not have a "principal," "chief," "essential," or "substantial" purpose to hold these films for sale.

Shortly before the Ninth Circuit reaffirmed the definition of "primarily" as meaning "substantial" or "essential" in *Malat*, the Eighth Circuit defined "primarily" in *Municipal Bond Corp. v. Commissioner* as meaning "of first importance" or "principal-

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37 347 F.2d at 26-27. See text accompanying note 33 supra.
40 Id. at 1862.
41 Id. at 1864.
42 341 F.2d 683 (8th Cir. 1965), reversing 41 T.C. 20 (1963).
ly." The facts in that particular case showed that the taxpayer, in the business of renting real estate, had made substantial sales during the tax years in question, reporting the profit from these sales as capital gain. In denying capital gain treatment, the Tax Court held that "while the sales purpose, in some instances, may not have been predominant over the investment purpose, it was, nevertheless, substantial throughout the entire period of review." The Eighth Circuit reversed and remanded, defining "primarily" as meaning "of first importance" or "principally" and stressing that the plain meaning of unambiguous words in a statute should not be disregarded. The court went on to say that the Tax Court should determine whether each parcel of land sold was held "primarily for sale in the ordinary course of business" and that this factual determination should be made by considering the following criteria: (1) the purpose for which the property was acquired; (2) the purpose for which the property was held; (3) the motive at the time of sale; and (4) the method of sale.

The conflicting definitions of "primarily" by the courts of appeal would seem to be the main reason the Supreme Court reviewed the Malat decision. However, there are three other strong reasons for the Court's having granted review. First, the apparent degree of departure by the Ninth Circuit, the Tax Court, and the Internal Revenue Service from the original purpose of the exclusion — to treat the normal sources of business revenue as ordinary income — had created great uncertainty and complexity in the capital gain area. Second, the word "primarily" had a clear and unambiguous meaning, and had been construed as meaning "of first importance" or "principally" in cases dealing with other sections of the Internal Revenue Code. And, third, the Supreme

43 Id. at 688-89.
44 Municipal Bond Corp., 41 T.C. 20, 29 (1965).
45 Municipal Bond Corp., 341 F.2d 683, 687-89 (8th Cir. 1965).
46 Id. at 689.
47 Compare Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951) and American Can Co. v Commissioner, 317 F.2d 604 (2d Cir. 1963), cert. denied, 378 U.S. 993 (1964), with United States v. Bennett, 186 F.2d 407 (5th Cir. 1951) and Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965). See Recordak Corp. v. United States, 325 F.2d 460 (Ct. Cl. 1963).
49 Benitez v. Bank of Nova Scotia, 125 F.2d 523 (1st Cir. 1942) (whether primarily engaged in the poultry business so as to be entitled to file bankruptcy as a farmer); McCaugh v. Electric Storage Battery Co., 63 F.2d 715 (3d Cir. 1933) (whether storage battery was primarily used in automobiles so as to be taxable); Bowles v. Nelson-Ricks Creamery Co., 46 F. Supp. 885 (D. Idaho 1946) (whether defendant was primary wholesaler under the Emergency Price Control Act).
Court itself in *Crane v. Commissioner*\(^6\) had endorsed the plain meaning rule of statutory interpretation for revenue acts.

The Supreme Court in a per curiam opinion defined "primarily" as meaning "of first importance" or "principally" and remanded the case to the district court.\(^7\) The Court concluded that "the words of statutes — including revenue acts — should be interpreted . . . in their ordinary everyday business sense"\(^8\) unless plainly contrary to legislative intent. The Court then stated that since the purpose of the "held primarily for sale" exclusion

is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one hand (*Corn Products Co. v. Commissioner*, 350 U.S. 46, 52) and "the realization of appreciation in value accrued over a substantial period of time" on the other (*Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134). A literal reading of the section is consistent with this legislative purpose.\(^9\)

Certainly the *Malat* case is a landmark decision and will require the lower courts and the Internal Revenue Service to change their position regarding "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The use of the term "primarily" now means that the property sold will receive capital gain treatment unless the purpose "of first importance" for which the property is held is sale in the ordinary course of business.

The Supreme Court certainly seems to reject the statement made by the Ninth Circuit that, because each purpose becomes the primary purpose as efforts are made in its direction,\(^4\) a sale of property acquired and held for the sole purpose of realizing gain, will result in ordinary income. The Court seems rather to imply that the critical period for characterization of property goes further back than to the time of disposition. Certainly property at the time of sale is property held primarily for sale, but such a literal approach would nullify the statutory provisions conferring capital

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\(^6\) 351 U.S. 1 (1947). In *Yunker v. Commissioner*, 256 F.2d 130, 133 (6th Cir. 1958), the court, in dealing with the same section, stated: "With respect to the interpretation of the statute, the words and phrases, 'trade or business,' 'ordinary' and 'customers' are to be construed in their ordinary and not in an artificially created meaning." See BLACK, LAW DICTIONARY (4th ed. 1951) defining "primary" as "first; principal; chief; leading."


\(^8\) *Id.* at 571.

\(^9\) *Id.* at 572.

\(^4\) See text accompanying note 33 *supra.*
gain benefits and goes far beyond the legislative intent that "income from everyday business operations" be taxed as ordinary income. Thus the Court realized that the recognition of the possibility of sale at some time in the future is quite different from having an intent to sell at the time of purchase. This position is clearly contrary to the position previously taken that a taxpayer is subject to ordinary income rates whenever he recognizes a profit on a sale of property after investment possibilities are frustrated.\footnote{See text accompanying note 34 supra.}

The action of the Court in remanding the case to the Tax Court for fresh fact-findings implies that the determination of whether property is held primarily for sale is a factual question to be decided upon consideration of various factors such as the purpose for which the property was acquired, the purpose for which it was held, the motive at the time of sale, and the method of sale.

The only case that has been decided under the new definition of "primarily" is \textit{Municipal Bond Corp.}\footnote{46 T.C. 219 (1966).} the same one that had been remanded to the Tax Court by the Eighth Circuit for further proceedings consistent with its definition of "primarily" as meaning "of first importance" or "principally."\footnote{\textit{Municipal Bond Corp. v. Commissioner}, 341 F.2d 683, 691 (8th Cir. 1965).}

In \textit{Municipal Bond Corp.} there were several properties sold, the Eighth Circuit holding that the Tax Court would have to determine whether each parcel sold was held primarily for sale in the ordinary course of business.\footnote{For an enunciation of the criteria to be utilized by the courts, see text accompanying note 46 supra.}

One property was sold to a church of which the petitioner (the principal shareholder of the Municipal Bond Corporation) was a member. The officials of the church selected the property and requested the petitioner to arrange for its purchase from the corporation. In declaring that this parcel was not "held primarily for sale to customers in the ordinary course of business," the Tax Court took particular notice of two facts: (1) that the property had never previously been offered for sale by petitioner; and (2) that the sale resulted more from the church's desire to purchase than from the petitioner's desire to sell.\footnote{46 T.C. at 234.}

With respect to the sale of property to the Kansas City Power and Light Company and to a school district, the Tax Court permitted capital gain treatment for two reasons: (1) the sale was

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\begin{itemize}
  \item \footnote{Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 691 (8th Cir. 1965).}
  \item \footnote{46 T.C. at 234.}
\end{itemize}
initiated by the buyers of each parcel, and (2) the sale was made reluctantly and with the knowledge that both the school board and the utility company had the power to acquire the property by condemnation.

In permitting capital gain treatment on the sale of a parcel of land to a filling station that had exercised a pre-existing option to purchase, the Tax Court placed particular emphasis upon the fact that when the taxpayer acquired the property it was already subject to the lease and option to purchase.

The Tax Court denied capital gain treatment on the sale of certain parcels of land to the St. Louis-San Francisco Railway. The court emphasized the fact that at the time the lease was made the taxpayer had given the railway a continuing offer to purchase the whole tract at a price in excess of its fair market value. The fact that the taxpayer also placed a "For Sale" sign on the property and advertised the property for development in newspapers was a further indication that the property was "held primarily for sale to customers."

Thus, it can be concluded from the Municipal Bond Corp. decision that under the Malat definition of "primarily," the courts will continue to use the same factors in order to determine whether property is held primarily for sale. According to the Malat formula, one selling property will pay ordinary income rates whenever gain is realized from an ordinary business transaction. To determine whether ordinary tax treatment or capital gain will result from the sale of property, two questions must be answered.

First, is the taxpayer engaged in the business of selling the particular piece of property involved? This question entails a factual determination based on the following factors: (1) the frequency, continuity, and number of transactions; (2) the purpose for which the property was acquired and held; (3) the proximity of the sale to the purchase; (4) the activity of the taxpayer in promoting the sale; and (5) any other factor indicating the taxpayer was in that particular business.

60 Id. at 232-33.
61 Id. at 235-36.
63 46 T.C. at 235-36.
64 Desilu Prods., Inc., 34 P-H Tax Ct. Mem. 1856, 1866 (1965) states: "It is axiomatic that nobody sells without an intent to sell, but it is the nature of the impetus to sell and the degree of sales activity that control. To hold property for sale in the ordinary course of business requires a reasonably free choice to do so, manifested by substantial selling activity."
The second question to be answered is whether the particular property involved was held *primarily* for sale in the *ordinary* course of business. To answer this question one must consider: (1) whether its sale is "of first importance" to the taxpayer, and (2) whether the actual sale took place in the ordinary course of the taxpayer's trade or business.

An affirmative answer to both inquiries will subject any gain to ordinary income treatment.

II. OTHER SECTIONS OF THE CODE DIRECTLY AFFECTED BY MALAT

The phrase "property held by the [taxpayer] . . . for sale to customers in the ordinary course of [his] . . . trade or business," appears in several other sections of the Code, the most important of which are: (1) section 337 involving tax-free liquidations; (2) section 341 involving collapsible corporations; and (3) section 1031 involving tax-free exchanges of property. The Supreme Court's definition of "primarily" as meaning "of first importance" or "principally" will definitely have some effect on the above-mentioned sections.

A. Tax-free Liquidations

Assuming that a corporation adopts a plan of complete liquidation and sells all of its assets within the twelve-month period provided by statute, there arises the question of what types of transactions in the course of liquidation will receive tax-free treatment. Section 337(a) states that "no gain or loss shall be recognized to such corporation from the sale or exchange by it of property." However, stock in trade, inventory, property held for sale in the ordinary course of business, and certain installment obligations when not sold in bulk are excluded from the term "property." The purpose of subsection 337(b) was very aptly summarized by the Senate Finance Committee when it stated: "It is intended that, during the 12-month period, sales in the ordinary course of business shall result in ordinary gain to the corporation as if the corporation were not in the process of liquidating." This certain-

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65 This phrase appears in all the sections to be discussed except § 1031. Section 1031 excludes property "held primarily for sale."
66 CODE § 337(b).
68 Id. at 259.
ly indicates an intent on the part of the Congress to prevent corporations from using section 337 to avoid ordinary income treatment on profits arising from normal business operations.

The Malat definition of "primarily" puts in issue the authority of Hollywood Baseball Ass'n\(^{69}\) in which the sale of certain baseball players to the Pittsburgh Pirates by the liquidating corporation was held not to be within the non-recognition provisions of section 337.\(^{70}\) The rules of organized baseball required the taxpayer to hold its player contracts for sale to major league clubs under certain procedures, and the taxpayer did have a working agreement with the Pittsburgh organization which provided a ready outlet for its player contracts. The liquidating corporation argued that the baseball players were not held "primarily for sale in the ordinary course of business" but on the contrary were developed at a great expense to the ball club primarily for the purpose of playing baseball.\(^{71}\)

The Tax Court held that it was unnecessary to determine whether the major purpose for which the player contracts were held was for playing baseball or for sale, since "primarily" did not necessarily mean "principal" or "chief" but rather "essential" or "substantial."\(^{72}\) The court, deciding that the sale of such contracts was "essential" to the baseball club's business, and produced "substantial" profits, held the sale to be within the section 337 exclusion.\(^{73}\)

The reliance by the court upon "primarily" meaning "essential" or "substantial" suggests that the result might be different under Malat. Certainly the court's approach will have to be changed, because the Supreme Court vacated and remanded the case for further consideration in light of Malat.\(^{74}\)

The new definition of "primarily" as meaning "of first importance" or "principally" will continue to disallow corporations to escape ordinary income treatment on profits derived from sales in the ordinary course of their business. At the same time, the decision will reinforce the fact that section 337 was enacted to per-


\(^{70}\) Id. at 64195.

\(^{71}\) Id. at 64192-93.

\(^{72}\) Id. at 64193.

\(^{73}\) Id. at 64194.

\(^{74}\) 383 U.S. 824 (1966).
mit a corporation to escape taxation of the proceeds derived from
the sale of corporate assets when the sale is followed by the distribu-
tion of the proceeds to the shareholders and to the extent that the
corporation would have avoided taxation if it had distributed its
assets in kind.75

B. Collapsible Corporations

A collapsible corporation for purposes of this discussion will be
defined as one formed or used in order to purchase property which
is to be held for less than three years and which is held primarily
for sale to customers in the ordinary course of business76 or is de-
preciable or is real estate used in the business and not held pri-
marily for sale in the ordinary course of business.77

There are three aspects of section 341 which should be re-
called in determining whether a corporation falls within the “col-
lapsible” category. First, the corporation must be “formed or
availed of, principally . . . for the purchase of property with a
view to”78 liquidation before the corporation has realized a “sub-
stantial part”79 of the intended profit. Second, the property pur-
purchased is not a section 341 asset if it has been held for more than
three years.80 Finally, a corporation will be presumed collapsible
if at the time of liquidation the fair market value of section 341
assets is (1) fifty percent or more of the fair market value of its
total assets,81 and (2) 120 percent or more of the adjusted basis of
such assets.82

The case of Braunstein v. Commissioner,83 recently decided by
the Supreme Court, paradoxically indicates that while the individ-
ual shareholder of a corporation will realize ordinary income from
the distribution to him of the corporation’s real estate held for
rental for less than three years, an individual owning the same

75 S. REP. NO. 1662, 83d Cong., 2d Sess. 258 (1954); H. R. REP. NO. 1337, 83d
Cong., 2d Sess. (1954). See also Commissioner v. Kukenberg, 309 F.2d 202 (9th Cir.
1962).
76 For an excellent discussion of collapsible corporations in general, see Cavitch,
77 See text accompanying notes 14-16 supra.
78 CODE § 341 (b) (1).
79 CODE § 341 (b) (1) (A).
80 CODE § 341 (b) (2).
81 CODE § 341 (c) (1) (A).
82 CODE § 341 (c) (1) (B).
real estate for the same purpose would receive capital gain treatment under section 1231(b). The paradox results from the fact that section 341 assets include not only "property held primarily for sale to customers in the ordinary course of . . . business" but also real property used in the trade or business and other property, used in the trade or business, subject to depreciation under section 167. This type of property would normally include corporate-owned television and motion picture films, copyrights, and land rich in natural resources, since all could appreciate in value in a short period without any production activity on the part of the taxpayer.

Thus it can be concluded that the Malat decision will have little effect on section 341, for the new definition will simply transfer the questioned property from the "held primarily for sale in the ordinary course of business" category into the real or depreciable property used in the taxpayer's trade or business category, both of which are 341 assets.\(^8\)

C. Tax-free Exchanges

Section 1031 provides for the non-recognition of gains or losses upon the exchange, solely for property of a like kind, of property held for productive use in business or for investment. Expressly excluded, however, are (1) inventory, (2) property held primarily for sale, and (3) stocks, bonds, notes, choses in action, trust certificates, and other securities of indebtedness.\(^5\)

The purpose of section 1031 is merely to postpone the recognition of a gain or loss; it is in no way intended to produce a forgiveness of the tax. This tax postponement objective is accomplished through appropriate use of the basis provisions.\(^8\) The basis of the property transferred after a tax-free exchange remains the same in the hands of its transferee and thus permits proper recognition of gain or loss when an actual disposition occurs. It is clear, then, that the aim of section 1031 is to recognize gains or losses to their full extent once, but only once.

The critical dichotomy existing under section 1031 lies not in the difference between property held for investment purposes and property held for productive use in the taxpayer's trade or business, since these purposes are fully interchangeable, but rather between

\(^8\) Code \(\$\) 341(b)(3).
\(^5\) Code \(\$\) 1031(a).
\(^8\) Code \(\$\)\(\$\) 1011-23.
property held primarily for sale and all other property held for
investment or productive use in trade or business.87

The phrase "stock in trade or other property held primarily for
sale" is much broader in scope than is the section 1221 definition
of capital assets, which refers more narrowly to

stock in trade of the taxpayer or other property of a kind which
would properly be included in the inventory of the taxpayer if on
hand at the close of the taxable year, or property held by the tax-
payer primarily for sale to customers in the ordinary course of
his trade or business.88

This broader language of section 1031(a) excludes all trader
items from tax-free treatment, which term includes certain non-
dealer assets.89 For example, in the classic case of Harr v. Mac-
Laughlin,90 a bank acquiring an apartment building through a
mortgage foreclosure, later exchanging that property for three va-
cant lots, was permitted to take an ordinary loss, as opposed to the
tax-free treatment accorded property held for productive use or
investment. The court reasoned that the bank's policy of reselling
foreclosure property rather than holding it for productive use or
investment caused the property to fall within the "held primarily
for sale" exception, thus excluding it from the capital asset cate-
gory and thereby subjecting the loss on the exchange to deductible
ordinary income treatment rather than to non-deductible tax-free
treatment. This case illustrates the broader scope of section 1031(a)
because, had the bank sold the apartment rather than exchanging
it, the bank would have received capital gain treatment upon the
gain or loss arising from the transaction. The sale by the bank,
being incidental to its normal business operation, would have
caused the property to be classified as a capital asset.91

Thus, the absence of the words "to customers in the ordinary

87 CODE § 1031(a); Treas. Reg. § 1.1031 (a)-1 (1956). Also excluded are stocks,
bonds, notes, choses in action, trust certificates, and other securities of indebtedness.
CODE § 1031(a).
88 CODE § 1221(1).
89 The "trader" classification is the result of a historical belief that the sale of secur-
ities on an exchange is not a sale "to customers." This is so because a trader who is en-
gaged in the business of selling securities offers a fungible commodity to an anonymous
group of bidders, so that the sale of a particular security by a trader to any particular
buyer is impersonalized to the point of coincidence, since the buyer could have just as
easily purchased an identical security from any other seller.
90 Kanawah Valley Bank, 4 T.C. 252 (1944), acq., 1946-1 CUM. BULL. 102. Cf.
Thompson Lumber Co., 4 B.T.A. 726 (1941).
course of his trade or business" in the statute excludes property from a tax-free exchange even if the taxpayer is not in the business of selling such property. The case of Ethel Black clearly illustrates this point. The taxpayer exchanged desert property for a residence subsequently held for sale. In denying the taxpayer a tax-free exchange, the Tax Court stated that gain is recognized where the property is held primarily for sale, even though it is not held primarily for sale in the ordinary course of business.

The Malat definition of "primarily" means that the holding purpose requirements of section 1031 may be completely satisfied even with respect to property acquired and held with the ultimate intent of disposition after "the realization of appreciation in value accrued over a substantial period of time." Thus it can be concluded that the holding purpose requirements will fail only if the sale of the property is "of first importance."

III. CONCLUSION

By defining "primarily" to mean "of first importance" or "principally," the Supreme Court implied that it will allow capital gain treatment of the gains derived from the disposition of property, real or personal, whenever the realization of gains accrues over a substantial period of time but that ordinary income rates will be applied to profits and losses arising from ordinary business transactions. Similarly, this new definition will continue to disallow businesses an escape from ordinary income rates in such everyday business transactions, regardless of whether it is sought through liquidation, creation of collapsible corporations, or attempted tax-free exchanges.

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92 The words "to customers in the ordinary course of his trade or business" appear in all the other sections discussed.
93 35 T.C. 90 (1960).
94 Id. at 96.