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BRINGING CAPITAL GAINS INTO FOCUS

Warren E. Hacker

FOREWORD

Professor Stanley Surrey has characterized the Internal Revenue Code of 1954 as "probably the most complex revenue law" of all time and has asserted that the treatment of capital gains and losses is the "subject singly responsible for the largest amount of complexity..." Few familiar with the field will be disposed to dispute either of these assertions, although there will be many to deny his conclusion that the complexities of capital gain taxation "far outweigh the values which it is asserted are served by that treatment."

This symposium is not a critique of these complexities. It will not discuss whether the resulting "jungle" should be cut down or even thinned out. Its much more modest purpose is to describe both the forest and some of the trees so that those who are not expert jungle trackers can get out of the woods, or possibly venture into it. Indeed, the purpose here is even more limited in that it is confined to only the most valuable part of the jungle — long term capital gains.

IN WHAT KINDS OF TRANSACTION IS GAIN REALIZED?

Not all economic gain, but only realized gain, is taxed. While the statute defines gross income to include "gains derived from dealings in property," other provisions and the decisions make clear that gain upon the sale or other disposition of property is taxable only in those cases where there is realization of the gain. In other words, there are dispositions of property which are regarded as not the kind of disposition upon

2. Ibid.
3. The metaphor is also that of Professor Surrey. *Id.* at 1019.
4. Throughout the symposium the term "capital gain" will frequently be used instead of the more awkward "long term capital gain."
5. INT. REV. CODE OF 1954, § 61(a) (2). (Hereinafter cited as §).
6. § 1001(a) provides that gain from the sale or other disposition of property is "the excess of the amount realized therefrom" over the cost or other basis of the property for determining gain. (Emphasis added.) § 1001(b) defines "amount realized" for this purpose as "the sum of any money received plus the fair market value of the property (other than money) received."
which gain should be treated as realized. Generally, where neither money nor property is received, the taxpayer does not realize a taxable gain even though the property transferred is then worth more than his cost or other basis. Accordingly, gain is not realized upon a contribution of appreciated property to the capital of a corporation, nor upon gifts of appreciated property to natural objects of the taxpayer's bounty or to charity. Thus, the rule in these areas is contrary to the Supreme Court's dictum that:

> Where the taxpayer does not receive payment of income in money or property, realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.

However, that dictum has led to decisions that gain is realized when appreciated property is transferred by an employer as a voluntary bonus to his employees or as a voluntary contribution to an employees' pension or profit sharing trust.

It is difficult to reconcile the rule of these latter cases with the rule that a contribution of appreciated property to charity is not a disposition upon which gain is realized. In both the compensation and the charitable gift cases, the transfer was wholly voluntary, without prior obligation on the taxpayer's part.

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7. Realization of gain is not limited to money or property, but includes other benefits derived from the transfer of property, e.g., discharge of indebtedness or other obligation. See discussion pp. 248-49.

8. Throughout this symposium, the term "appreciated property" will be used to describe property the value of which exceeds the taxpayer's adjusted basis for purposes of gain.

9. While never litigated, this result seems clear from the fact that the corporation is required to use the contributing shareholder's basis for the property (§ 362(a)(2)) and that the shareholder may add to the basis of his stock only his cost or other basis of the property contributed, not its value. See, e.g., Edward Mallinckrodt, 38 B.T.A. 960, 969 (1938), rev'd on other issues sub nom. Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir.), cert. denied, 310 U.S. 725 (1940).


12. Helvering v. Horst, 311 U.S. 112, 115 (1940). The taxpayer attempted to deflect ordinary income by giving away bond interest shortly before he was to receive it. The Supreme Court could have reached the result it desired simply by relying on Lucas v. Earl, 281 U.S. 111 (1930) and similar assignment of income cases. However, the Court chose to justify its decision by more tenuous reasoning, going almost to the extent of holding that the warm feeling generated in the donor on making the gift was itself sufficient to satisfy the concept of "realization." But see Pearce v. Commissioner, 315 U.S. 543, 544 (1942), and cases cited notes 10 and 11 supra.

13. International Freightng Corp. v. Commissioner, 135 F.2d 210 (2d Cir. 1943). This case rests firmly on the case of Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), wherein the Horst dictum was relied upon as an "illuminating analogy."

the part of the transferor.\textsuperscript{18} It is true that the employers obtained an income tax deduction equal to the appreciated value of the property transferred. But, this is also true in the charitable gift cases and in those cases, it has been regarded as immaterial to the question of realization of gain. At the same time, it is difficult to believe that the compensation cases forecast a reversal of the charitable contribution rule.

The charitable contribution and gift cases involve situations wherein the transferor had no pre-existing obligation to transfer the appreciated property and the recipient had no pre-existing right to it. However, even where such an obligation or correlative right exists, a transfer in kind of the appreciated property in recognition of such right or in satisfaction of such obligation is held not to be a disposition upon which gain is realized. The clearest case of this type is one in which the transfer is a step in the partitioning of jointly owned real or personal property among the several holders of legal title.\textsuperscript{18} Thus, if Blackacre is owned in undivided half interests by \(A\) and \(B\) with a basis of $1,000 and is partitioned between them when its value has appreciated to $5,000, neither \(A\) nor \(B\) has a profit when \(A\) transfers to \(B\) his interest in one portion of Blackacre in consideration of his receiving a transfer of \(B\)'s interest in the other portion. The same rule would appear to apply if each owned undivided interests in both Blackacre and securities, each worth $2,500, and \(A\) transferred his interest in Blackacre to \(B\) in consideration of \(B\)'s transfer of his interest in the securities.\textsuperscript{17} Similarly, no gain is realized when appreciated property is distributed in kind by a partnership to or among the partners,\textsuperscript{18} or by an executor or trustee to or among the beneficial owners of the property.\textsuperscript{19} The rule in these situations is simply justified by the fact that the appreciation in value occurred while the recipients were the legal or beneficial owners, that distribution to them is in recognition

\begin{itemize}
\item[\textsuperscript{15}] In Rev. Rul. 55-410, 1955-1 CUM. BULL. 297, the Commissioner held that there is no realization of gain even where the transfer of appreciated property discharges a pre-existing pledge to pay money to the charity.
\item[\textsuperscript{16}] Apparently the principle is regarded as so clear that it has never been litigated. It is confirmed by several rulings. Rev. Rul. 56-457, 1956-2 CUM. BULL. 507; Rev. Rul. 55-179, 1955-1 CUM. BULL. 340; Rev. Rul. 55-77, 1955-1 CUM. BULL. 339.
\item[\textsuperscript{17}] \textit{Quaere:} Whether gain would not be recognized in both examples if the value of the property partitioned to each person were out of line with his interest or if money or separately owned property were used to equalize the partition.
\item[\textsuperscript{18}] Annie Laurie Crawford, Ex'rx, 39 B.T.A. 521 (1939), appeal dismissed, (3d Cir. 1940); I.T. 2010, III-1 CUM. BULL. 46 (1924); Sol. Op. 42, 3 CUM. BULL. 61 (1920). This situation is now expressly covered by statute. See §§ 731(b), 736 and 751.
\item[\textsuperscript{19}] M. L. Long, 35 B.T.A. 95 (1936); Rev. Rul. 55-117, 1955-1 CUM. BULL. 233; O.D. 667, 3 CUM. BULL. 52 (1920). See also Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), aff'd per curiam, 83 F.2d 1019 (2d Cir.), corr. denied, 229 U.S. 573 (1936). The rule now appears in Treas. Reg. § 1.661(a) (2) (f) (1) (hereinafter cited as Reg.) that no gain is realized by a trust or estate (or the other beneficiaries) upon a distribution of the property in kind "unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed."
\end{itemize}
of their “right” in the property, including its appreciated value, and hence, that there is no realization of gain to the transferor of the property.

This same justification exists, although to a somewhat lesser degree, where the recipient’s pre-existing “right” is less immediate and direct. For example, the right of a shareholder in the property of his corporation is only in the most general way analogous to a beneficiary’s right in the property of his trust. Nevertheless, the rule is firmly established that a corporation does not realize gain upon a distribution in kind of appreciated property to its shareholders. However, the courts have refused to apply the same principle in the divorce area and have held that a husband realizes gain when he transfers appreciated property to his wife on divorce. In doing so, the courts have emphasized that the husband thereby satisfies or discharges an obligation to the wife, rather than emphasizing that the transfer occurs in recognition of her inchoate rights in the husband’s property and estate, and have overlooked the fact that the obligation of the one is correlative to and commensurate with the right of the other.

Here again, it is difficult to reconcile the rules in principle. To the extent that a property settlement upon divorce is properly to be treated as a transfer for a consideration and to be analogized to a sale or exchange, the husband is taxable only because he is regarded as receiving a release of his wife’s inchoate rights to his property. The value of those rights at any particular time depends, in large measure, upon the value of the husband’s property at that time. As the husband’s property increases in value, those rights also become more valuable. When the husband shares that increased value with her upon divorce, it seems harsh to hold that he thereby realizes gain. Calling her rights “inchoate” adds nothing. It merely emphasizes that during coverture and until the husband’s death, she has no claim on the property as such. He may lose it, thereby destroying her right eventually to share in it, or may sell it without her consent. A shareholder’s right in the property of his corporation is “inchoate” in precisely the same sense. The corporation may lose it,

20. General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935); Natural Gasoline Corp. v. Commissioner, 219 F.2d 682 (10th Cir. 1955); Commissioner v. Columbia Pac. Shipping Co., 77 F.2d 759 (9th Cir. 1935). This rule is now embodied in the statute. See §§ 311(a)(2), (b) and 453(d).


22. Curiously, the Commissioner has never asserted that the wife realizes a gain upon receipt of a consideration for her release of these same inchoate and zero basis rights. The wife obtains a stepped-up basis for the property received by her from the husband. Cristina de Bourbon Patino, 13 T.C. 816 (1949), aff’d, 186 F.2d 962 (4th Cir. 1950); Aleda N. Hall, 9 T.C. 55 (1947), aff’d, 1947-2 CUM. BULL. 2.
thereby destroying the shareholder's right eventually to share in it, or may sell it without his consent. Yet the courts hold that there is realization of gain in the one case and not in the other.

**HOW IS REALIZED GAIN COMPUTED?**

The statute defines gain as the excess of the "amount realized," i.e., "the sum of any money received plus the fair market value of the property (other than money) received," over the basis of the property sold or otherwise disposed of. The courts have interpreted "money" and "property" to include money equivalent, e.g., the satisfaction of the taxpayer's debt by transfer of property. Indeed, as pointed out above, the courts have in some cases held that gain is realized even where no money or property is received and where there is no obligation which is discharged by the transfer.

Where property is received, the statute requires that it be taken into account at its "fair market value." Where, as in many cases, there is no established market for the property, a difficult practical problem arises. The Commissioner has for many years asserted that "only in rare and extraordinary cases will property be considered to have no fair market value." While the courts have occasionally criticized this bold assertion, they have strained on occasion to avoid holding that what the taxpayer received had no fair market value. Thus, if the property disposed of by the taxpayer had a fair market value, the courts have sometimes used that value as establishing the fair market value of what he received on the transaction. There are obvious practical limitations upon the assumption that what was received equals what was given, partic-

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23. Except in certain special instances, e.g., where the property disposed of is "substantially all" of the assets of the corporation. See, e.g., Ohio Rev. Code § 1701.76(A).

24. §§ 1001(a) and (b). (Emphasis added.) Discussion of the problems of determining cost or other basis is outside the scope of this symposium. See generally, Hacker, Tax Problems Incident To The Acquisition Of Real Estate — Determining And Allocating "Cost" And Prorating Property Taxes, 11 West. Res. L. Rev. 158 (1960).

25. See, e.g., C. L. Gransden & Co. v. Commissioner, 117 F.2d 80 (6th Cir. 1941).

26. See cases cited notes 13 and 14 supra. See also Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), aff'd per curiam, 83 F.2d 1019 (2d Cir.), cert. denied, 299 U.S. 573 (1936); cases cited note 21 supra.


28. See, e.g., Judge Learned Hand's statement in Helvering v. Walbridge, 70 F.2d 683, 684 (2d Cir. 1934) that "'fair market value' is not nearly so universal a phenomenon as to justify such a comment, and the implication is misleading."

larly in transactions which are not profit-motivated. Furthermore, where neither what is given nor what is received has an ascertainable fair market value, the assumption is not available at all. In other cases, the courts have seized upon a stated or agreed value by the parties to avoid the difficulties of ascertaining fair market value. Here again, however, there are practical limitations, among them, that the parties by agreement cannot in any event bind the Commissioner to an unrealistic valuation, whether high or low, and may themselves be at liberty to dispute it.

**WHEN IS REALIZED GAIN RECOGNIZED AND TAXABLE?**

Assuming that the disposition is one in which gain may be realized and having determined that there was in fact a gain, the questions then arise whether that realized gain is "recognized" for tax purposes and, if so, when it is properly taxable. In general, if gain is realized, it is recognized. This general rule is avoided only if the particular disposition comes strictly within one of the several non-recognition provisions.

Generally, the gain, if recognized, is to be returned and is subject to tax in full in the year of the sale or other disposition. This rule is also subject to several exceptions, both statutory and judge-made. Where the

30. *E.g.*, a transaction within the family may be partially donative. See Reg. § 1.1015-4 for basis of property acquired in a transaction which was in part a gift and in part a sale. Other motives may also operate. See Marshman v. Commissioner, 279 F.2d 27, 32 (6th Cir.), *cert. denied*, 364 U.S. 918 (1960), stating that "A property settlement in a divorce proceeding is usually influenced and often dictated by numerous intangible, personal and practical considerations which play no part in a transaction between a willing seller and a willing buyer in the open market. The value of what is given up is no criterion of the fair market value of the 'property' received."

31. For example, assume that each of two parties asserts a disputed cause of action or other unliquidated claim against the other and the matter is settled by an exchange of releases. It is difficult to believe that each has a gain. No such case has been found. *But see* the alternative ground for decision in Marshman v. Commissioner, 279 F.2d 27 (6th Cir.), *cert. denied*, 364 U.S. 918 (1960). The blunt fact is that there is no market, fair or otherwise, for such claims. See Champlin v. Commissioner, 71 F.2d 23, 30 (10th Cir. 1934).

32. See, *e.g.*, Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943).

33. It is difficult to believe that in the hypothetical case assumed in note 31 *supra* gain would be recognized because each had asserted that his claim was worth $1,000,000. Or assume that the taxpayer gave up valuable property for property worth very little because he was uninformed or misinformed without fraud on the other side and, therefore, believed it to be a good deal.

34. The problem here discussed cannot be divorced from the problem of cost basis because the taxpayer's cost for the property received is the fair market value of the property given up in order to acquire it. See Reg. § 1.1012-1(a). See also Hacker, *Tax Problems Incident to the Acquisition of Real Estate — Determining and Allocating "Cost" and Prorating Property Taxes*, 11 West. Res. L. Rev. 158, especially n. 4 and pp. 166-67 (1960).

35. §§ 1001(c), 1002.

36. *E.g.*, §§ 332(a), 333(a), 336, 337(a), 354(a), 355(a), 1031(a), 1032(a), 1033(a), 1034(a), 1035(a), 1071(a), 1081 and 1101. See also Hacker, *Tax Problems Incident to the Disposition of Real Estate — Problems of Nontaxable Dispositions*, 11 West. Res. L. Rev. 207 (1960).
consideration received or to be received is indeterminate, the disposition is regarded as an "open transaction." The consideration may be indeterminate either because, where it is a promise of money in the future, it is not fixed in amount but is left to future events, or because it otherwise has no presently ascertainable fair market value. In such cases, no gain is returned until the amounts actually realized exceed the transferor's cost or other basis of the property disposed of and thereafter all amounts realized are returned in full as gain upon the disposition.

The statute does not in terms distinguish between those sellers who use the cash method and those who use the accrual method of accounting. In principle the result should be the same in both cases because whether the "amount realized" is indeterminate is not affected by the seller's accounting method. It will also be noted that the principle applies only where the transaction is truly open-end. If, for example, promissory notes maturing serially are received and have some value (even though less than face), only the excess of such value over the basis of the property sold is returned as gain in the year of sale, but the value of the notes then becomes the taxpayer's basis for them. Accordingly, there is risk in some cases that receipt of principal payments on the notes in excess of that basis will be ordinary income. The latter problem, as well as possible dispute as to the fair market value of the purchaser's obligations, can be simply avoided in most cases by the taxpayer's electing the installment method of reporting his gain. In that event, the taxpayer returns a proportionate part of his gain in each year in which he receives the deferred payments.

THE NATURE OF THE CAPITAL GAINS BONANZA

Realized and recognized gains upon the disposition of property fall into three categories, viz., noncapital or "ordinary" gain, short-term capital gain and long-term capital gain. The first two of these generally

37. But see notes 27 and 28 supra and accompanying text.
38. See, e.g., Burnet v. Logan, 283 U.S. 404 (1931); Estate of Clarence W. Ennis, 23 T.C. 799 (1955), non-aq., 1956-2 CUM. BULL. 10; Nina J. Ennis, 17 T.C. 465 (1951), gov't's appeal dismissed on stipulation (6th Cir. 1952). The Ennis cases involved a sale of land under land contract by a cash-basis taxpayer, where the purchaser's obligation was not negotiable and was not regarded as having a readily realizable market value.
39. See discussion, p. 254, especially note 10. The same principle may require income or gain to be returned pro rata as principal payments are received even where there is a single note payable in installments. Victor B. Gilbert, 6 T.C. 10 (1946), aq., 1946-1 CUM. BULL. 2, Shafpa Realty Co., 8 B.T.A. 283 (1927).
41. The installment method contemplates that the gross profit to be realized on the disposition can be computed at the outset. See, e.g., § 453(a) and Reg. § 1.453-1(b). Therefore, it would appear that this method is not available where the total amount to be realized is indeterminate, even though a minimum realization is fixed.
attract income tax in full at the usual rates. In contrast, long-term capital gains carry several special advantages: First, non-corporate taxpayers are entitled to deduct fifty per cent of the excess of net long-term capital gain over net short-term capital loss for the year. This means that if such a taxpayer has only a long-term capital gain, half of it is excluded from taxable income, and the effective tax rate even at the lowest bracket is only half of what it would be for an equivalent amount of ordinary income. Secondly, the excess of net long-term capital gain over net short-term capital loss is never taxed at more than a twenty-five per cent effective rate either to a corporate or non-corporate taxpayer. If the taxpayer has only a long-term capital gain, the effective tax rate may be less but will never be more than this ceiling rate. In these days when the top corporate rate is fifty-two per cent and the rates graduate up to ninety-one per cent for others, this twenty-five per cent ceiling is truly a bonanza. Finally, there are additional advantages to certain special classes of taxpayers.

These important advantages make it extremely attractive for taxpayers to realize long-term capital gains as compared to other forms of income and, to the extent possible, for taxpayers' counsel to plan transactions to assure that result. Basically, this involves meeting the requirements that the disposition of property be a "sale or exchange;" that the property sold or exchanged be a "capital asset;" and that the property be "held for more than 6 months." In addition, there are certain statutory provisions which relax the basic requirements in particular situations, and still others which deny or make more difficult the achievement of

42. § 1202.
43. This deduction is not made in determining the limitations applicable to such special deductions as for dividends received, dividends paid and partially exempt interest. Reg. §§ 1.54-2, 1.35-1 (1956) as amended, T.D. 6297, 1958-2 CUM. BULL. 11; Rev. Rul. 56-161, 1956-1 CUM. BULL. 382.
44. This "alternative tax" is provided by § 1201 (a) and (b). For corporations it is simply 25% of the excess because corporations are excluded from the deduction under § 1202. For noncorporate taxpayers the same ceiling rate is obtained because an alternative tax rate of 50% is applied to the 50% remaining after the deduction under § 1202. However, the taxpayer may fail to obtain the full advantage of this ceiling rate in special situations, e.g., when the capital gain is absorbed by a net operating loss of the current year or by carryforward or carrybacks which in other circumstances would have been offset against ordinary income carrying a higher effective tax rate, or when deductions (including charitable deductions) exceed ordinary income for the year in which the gain is returnable. In the latter case, the taxpayer loses the benefit of such excess deductions under the alternative tax computation. Well v. Commissioner, 229 F.2d 593 (6th Cir. 1956), affirming 23 T.C. 424 (1954); Rev. Rul. 56-247, 1956-1 CUM. BULL. 383.
45. The ceiling rate becomes effective for trusts, estates and individuals filing separate returns with taxable income of $16,000 or more and for married individuals filing a joint return with taxable income of $36,000 or more.
46. § 1222(3).
47. See, e.g., § 545 (b) (3), permitting personal holding companies to accumulate long-term capital gains without penalty tax.
Finally, the statutory provisions have received a good measure of judicial rewrite which has further constricted the favored area. The balance of this symposium will be a discussion of these basic requirements, of their modification by statute and by decision in certain areas, and of the use of both in capital gain planning.

49. The statute contains a number of special exceptions, the more important of which have been or will be cited and discussed in this symposium. For convenient reference, a rather comprehensive list of such provisions follows: First, the statute requires that certain kinds of dispositions shall be treated as a "sale or exchange," thus making capital gain treatment possible. See, e.g., redemption of corporate shares (§§ 302, 303); receipt of distributions in partial or complete liquidation of a corporation (§§ 331(a), 333 and 546); disposal of timber and coal (§ 631); distributions from a partnership (§§ 731(a), 751(b); retirement of evidences of corporate indebtedness (§ 1232(a)(1)); and cancellation of lease or distribution agreement (§ 1241). Secondly, the statute requires capital gain treatment for certain kinds of dispositions even though there might otherwise not be a "sale or exchange" or the property might not be a "capital asset." See, e.g., certain distributions from a qualified employee trust, etc. (§§ 402(a)(2), 403(a)(2)); gifts and certain other transfers of stock purchased under a restricted stock option (§ 421(d)(4)); sales and involuntary conversions of business property (§ 1231); sales and licenses of patents (§ 1235); sales of real property subdivided for sale (§ 1237); sale of securities by a dealer (§ 1236); and certain termination payments to an employee (§ 1240). Thirdly, the statute denies capital gain treatment for certain kinds of dispositions even though there may be a "sale or exchange" of a "capital asset." See, e.g., sale of stock to a related company (§ 304); sale of "hot stock" (§ 306); sale of and liquidating distributions on stock in collapsible corporations (§ 341); liquidation of certain foreign personal holding companies (§ 342); "boot" distributions in reorganizations (§ 356(a)(2)); disposition of stock purchased under certain restricted stock options (§ 421(b)); sales of bonds, etc. by banking institutions (§ 582(c)); sale of property to a controlled partnership (§ 751(a)); disposition of a partnership interest (§ 751(a)); sale or other disposition of installment obligations (§ 453(d)); sale of bonds, etc. issued at discount (§ 1232(a)(2)); sale or other disposition of bonds, etc. with coupons detached (§ 1232(c)); short sales of property (§ 1233(b)); sale of options to buy or sell (§ 1234(a)); sale of emergency facilities (§ 1238); and sale of depreciable property to a related party (§ 1239). Finally, the statute provides that the character of income in the hands of the taxpayer is determined in certain cases by the character which the income had in the hands of another, and thus provides capital gain treatment to the taxpayer where otherwise it would not be available. See, e.g., distributable income of trusts and estates (§ 662(b) and 622(b)); income in respect of a decedent (§ 691(a)(3)); partnership income (§ 702(b)); dividends from mutual investment companies (§ 852(b)(3)) and dividends from Subchapter S corporations (§ 1375(a)).