

1961

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## Recommended Citation

Bruce Griswold, *Advance Planning for Capital Gain--Generally (cont'd) Controlling the Holding Period*, 12 Cas. W. Res. L. Rev. 293 (1961)

Available at: <http://scholarlycommons.law.case.edu/caselrev/vol12/iss2/23>

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## VIII

**ADVANCE PLANNING FOR CAPITAL GAIN — GENERALLY (cont'd)**  
**CONTROLLING THE HOLDING PERIOD**

Bruce Griswold

In order for the holder of a capital asset to obtain long term capital gain treatment of the proceeds of the sale or exchange of his capital assets, it is generally necessary that he have "held" the capital asset "for more than 6 months" at the time of the sale or exchange.<sup>1</sup>

This article will explore several methods available (or not available) for the "control" of the required holding period. Attention is directed to other articles herein for general discussion of other aspects of a long term capital gain transaction, including problems involving the definition, commencement, termination, computation and "tacking" of holding periods, and the special problems related to various types of property, such as buildings under construction, stock rights, patents, etc.<sup>2</sup>

## THE PROBLEM

In many instances a taxpayer has an opportunity to sell at a substantial profit a capital asset which he has held for less than six months. In other instances he might want to sell a capital asset which he has held less than six months and which has appreciated in value during this period in order to terminate the risk of a loss of the current appreciation. But the taxpayer is unwilling to take his profit if this will result in short term capital gain. For the most part there is no solution to the taxpayer's dilemma since the taxpayer must hold, that is, *own* the capital asset "for more than 6 months." But there are available in some cases methods of attaining a favorable solution to this problem, for instance, options, lease-option arrangements and executory contracts.

It must be kept in mind that the termination of a holding period is of great interest to the buyer as well as the seller of a capital asset, since most probably the commencement of the buyer's holding period will be delayed if the seller's holding period is effectively extended.

METHODS NOT AVAILABLE FOR EXTENDING THE  
HOLDING PERIOD

Two types of transactions are clearly not available to a taxpayer to extend the holding period of certain capital assets to the long term statu-

1. INT. REV. CODE OF 1954, § 1222(3). (Hereinafter cited as §).

2. See discussion pp. 267-70.

tory minimum without the retention of the risk of decrease in value incident to ownership. These will serve to illustrate the aims and problems of possible "controls" and some of the limitations on them.

### *Short Sales*

Section 1233 imposes an effective prohibition on the use of a "short sale" as a device to obtain long term capital gain treatment of the appreciation in value to date of *stocks, securities* or *commodity futures* contracts held for less than six months. A knowledge of the mechanics of a short sale is important to understand fully the limitations imposed by section 1233. A short sale is commenced by the sale of borrowed stock (or securities or commodity futures). At a later date the seller usually "closes" the short sale by purchasing the same stock (or other property) to return to the lender. In the interim, if the market price has decreased in an amount greater than the expenses incident to the sale, he will have made a profit on the short sale. Of course, if the market price has increased, he will sustain a loss.

However, if at the time of a short sale the seller owns stock, securities or commodity futures "substantially identical" to the property sold short, it is impossible for him to lose anything but the expenses of the short sale. The loss on the one transaction will be offset by the gain on the other transaction.

But for section 1233, it would be possible for a taxpayer to purchase stock, securities or commodity futures, hold them for less than six months, eliminate his risk by a short sale of identical property, sell the original stock, securities or commodity futures after the six-month period has elapsed, and be taxable only at long term capital gain rates. Section 1233 has effectively eliminated the possibility of long term capital gain treatment of gain in such a transaction. This section provides *inter alia* that, if on the date of a short sale, "substantially identical property"<sup>3</sup> has been held by the taxpayer for not more than six months, any gain on the closing of the short sale shall be considered as a short term gain and the holding period of the "substantially identical property" shall be considered to begin on the date of the close of the short sale, or on the date of the sale, gift or other distribution of such property, whichever occurs first.

### *Puts*

Section 1233(b) provides that the purchase of an option to sell (a "put") stocks, securities or commodity futures contracts at a fixed price shall be considered a short sale.

In summary, it is not possible for a taxpayer to achieve long term

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3. See Treas. Reg. § 1.1233-1(d), as to what property is "substantially identical."

capital gain treatment of the appreciation in value of his stocks, securities or commodity futures contracts by making a short sale or purchasing an option to sell a substantially identical item within the six month period. However, an option to sell or a short sale might be useful if the capital asset owned is not a stock, security or commodity futures contract. The practical difficulty here is that short sales, and to a great extent options to sell, cannot be made or purchased except when stock, securities and commodity futures are involved.

#### CERTAIN METHODS AVAILABLE FOR EXTENSION OF THE HOLDING PERIOD

##### *An Option To Purchase<sup>4</sup>*

Rather than sell a capital asset held for less than six months and obtain short term capital gain treatment of the gain realized, the holder might grant an option to purchase the capital asset which is not exercisable until the minimum holding period for the capital asset has expired. The grant of an option to purchase a capital asset is not considered to be the sale of the underlying asset.<sup>5</sup> Therefore, the seller's holding period will not terminate before the option is exercised.<sup>6</sup>

However, this procedure still presents problems for the owner of the asset. He, not the holder of the option, retains the economic risk of a decrease in the market value of the asset, but does not have the benefit of an increase in the market value. But, as a practical matter, the owner's economic risk can be substantially reduced by granting the option at a price which will induce the buyer to exercise the option, or at a price which is most probably greater than the increment of value that would be lost if the market took a downward turn in the period necessary to complete the "more than 6 months" period.

Since the optionee is not bound to exercise the option, it would seem that the arrangement should not constitute a sale of the capital asset, if the option price is reasonable in amount. If the economic effect of a transaction is a sale, the fact that the transaction is only an option under state law is not controlling,<sup>7</sup> and the holding period will be treated as terminated on the date of the granting of the option.

The question remains how large the option cost can be in relation to the purchase price. There is no authority as to the reasonableness of the

4. The word "call" is a synonym for an option to purchase. The optionee is given the right to call, that is, purchase, a given capital asset at some future time for an agreed-upon price, no matter what the market value is at the time of the exercise of the option.

5. See *Virginia Iron, Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938).

6. *Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496 (1936); *Lucas v. North Tex. Lumber Co.*, 281 U.S. 11 (1930); Rev. Rul. 54-607, 1954-2 CUM. BULL. 177.

7. *Carrie C. Cunningham*, 12 CCH Tax Ct. Mem. 1315 (1953).

relative cost of an option. The fact that the optionee is not bound to exercise the option would indicate that the option cost could reasonably be large in relation to the purchase price of the asset. Obviously this is an area where care and judgment should be used. A reasonable option cost would depend on the facts in each case and on various factors, including the period of the option and possible fluctuations in value. Probably, the crucial question is: has the optionee paid so much for the option that he is bound to exercise it? If so, the transaction is a sale. In summary, it would appear that the tax risk is increased as the economic risk of the holder of the capital asset is reduced but that it is possible to reduce greatly this economic risk with no increase in the tax risk.

A potential *buyer* of a capital asset should not be adverse to paying for an option. He would not usually be placed at any disadvantage, since he could take immediate possession of the capital asset, subject to the option.<sup>8</sup> Furthermore, the grantee of an option to purchase a capital asset is *not* at a disadvantage insofar as the commencement of his holding period is concerned, since he may realize capital gain by selling the option itself after holding it more than six months (rather than by exercising it and selling the underlying property).<sup>9</sup> It should be mentioned that the holder of such an option must use care in any later sales transaction. He must sell the *unexercised* option, not the underlying capital asset, in order to obtain long term capital gain treatment.<sup>10</sup> Also, the holder of an option to purchase cannot exercise the option and "tack" the period during which he held the option to the period during which he owns the underlying *capital asset*, in order to obtain a long term gain.<sup>11</sup>

Parenthetically, the holder of an option to purchase stocks, securities or commodity futures (or any other capital asset) may protect a gain before the six month holding period has expired by making a short sale of the underlying capital asset (or purchasing an option to sell) despite the limitations of section 1233. A recent Revenue Ruling states that stocks, securities and commodity futures are not "substantially identical" with options to purchase stocks, securities or commodity futures.<sup>12</sup>

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8. Delivery of possession of real property under an option agreement will not terminate the holding period of the prospective seller. Rev. Rul. 54-607, 1954-2 CUM. BULL. 177.

9. § 1234.

10. Barber v. United States, 215 F.2d 663 (8th Cir.), *cert. denied*, 348 U.S. 897 (1954); Joseph Pursglove, Jr., 20 T.C. 68 (1953); Herman J. Miller, CCH TAX Ct. RBP. (19 CCH Tax Ct. Mem.) ¶ 21,166 (May 9, 1960).

11. E. T. Weir, 10 T.C. 996 (1948), *aff'd*, 173 F.2d 222 (3d Cir. 1949).

12. Rev. Rul. 58-384, 1958-2 CUM. BULL. 410. See also, Dixon, *Short Sales Can Still Transmute Short-Term Calls Gains into Long*, 7 J. TAXATION 14 (1957); Rev. Rul. 56-406, 1956-2 CUM. BULL. 523 (a stock warrant may be "substantially identical").

### *Cross Options*

Another method for the holder of a capital asset to extend his holding period would be to grant an option to purchase and minimize his risk of loss by taking an option to sell the capital asset. This type of arrangement is called a "cross option" arrangement. It might be contended by the Government that the net effect of the two options is a sale on the premise that, if the capital asset involved decreases in value, the owner of the option to sell will exercise it; whereas, if the property appreciates in value during the option period, the owner of the option to purchase will exercise his option. But it is submitted that no sale in fact takes place and therefore the holding period does not terminate until one of the options is exercised. The optionees are not legally bound to exercise their options. Changing conditions may make it impossible or unfeasible for an optionee to exercise his option, even though a substantial loss would thereby be sustained or a gain foregone. The rights are completely different from those under an unconditional contract of sale. The use of cross options to extend a holding period is not available in stock, securities, or commodity futures transactions because of the limitations imposed by section 1233(b) on transactions involving options to sell.

### *Lease-Option Arrangements*

Rather than an outright sale of real property or tangible personal property before the expiration of the minimum holding period necessary for long term capital gain treatment, the holder might lease the property with an option to purchase. The holding period of the owner-lessor would not terminate until the option is exercised.

This type of arrangement is practical only if the owner's risk of loss is effectively minimized without giving rise to a substantial risk that the gain realized on the exercise of the option will be treated as short term rather than long term capital gain. These aims might be achieved by a lease providing for reasonable rental payments with an option to purchase the property at a price that is not reduced by the prior rental payments, together with a provision for a substantial increase in rent if the option is not exercised by a certain date. The latter provision should induce the optionee to exercise his option and therefore minimize the owner's risk as to a decrease in value.

Again, it must be emphasized that careful draftsmanship is of the utmost importance. In other aspects of the lease-sale type of transaction, the Internal Revenue Service has stressed that "substance" rather than the "form" is controlling.<sup>13</sup> Thus the Service might contend that a sale

13. Cf. "rent v. sale" problem generally, Rev. Rul. 55-540, 1955-2 CUM. BULL. 39, and related cases.

took place at the time the lease-option agreement was entered into if the arrangement as a whole indicates that this was the intention of the parties. But it is submitted that if the arrangement is properly and reasonably handled, the holding period of the owner will not terminate until the option is exercised (or at least until the lessee, on failure to exercise, commences rental payments at the higher rate).<sup>14</sup> Before the occurrence of one of these events, the lessee is not bound to purchase the property and he is not penalized for non-exercise.

A disadvantage implicit in a lease-option arrangement is that rental payments are ordinary income to the seller. But the fact that these payments are reported as ordinary income is an additional argument that a sale has not taken place until the option is exercised or some other event indicative of a sale has occurred.

To minimize ordinary income, provision should be made for low rental payments and a substantial payment for the option to purchase.<sup>15</sup> But the danger remains that it might be contended that part of the payment for the option is actually additional rent and hence includible as ordinary income.<sup>16</sup>

### *Executory Contracts*

The holding period of *real property* subject to an unconditional contract of sale terminates, not when the purchase agreement is executed, but on the day title passes or on the day on which delivery of possession is made and the burdens and privileges of ownership are assumed by the purchaser, whichever occurs first.<sup>17</sup>

Clearly the owner's holding period can be extended even though a binding contract for the sale of the property has been executed, by delaying the closing and taking of possession until the "more than 6 months" period has elapsed.

It is difficult to make a general statement as to the termination of the holding period of *personal property* subject to an unconditional contract of sale. Most probably the holding period terminates when the burdens and benefits of ownership of the property pass.<sup>18</sup> The execution

14. As an added inducement to the lessee to exercise the option, in certain situations it might be pointed out that the high rental payments after failure to exercise the option might be treated as non-deductible payments of the purchase price. See Rev. Rul. 55-540, 1955-2 CUM. BULL. 39.

15. The amount paid for an option is not reportable by the optionor until the option is exercised or lapses. If the option is exercised, it is included as part of the proceeds of the sale. If the option is allowed to lapse, the amount paid for it is includible as ordinary income at that time. Rev. Rul. 58-234, 1958-1 CUM. BULL. 279.

16. Cf. *C. V. L. Corp.*, 17 T.C. 812 (1951), *nonacq.*, 1952-1 CUM. BULL. 5; *Mary G. Gordon*, 17 T.C. 427 (1951), *aff'd*, 201 F.2d 171 (6th Cir. 1952).

17. *Lucas v. North Tex. Lumber Co.*, 281 U.S. 11 (1930); Rev. Rul. 54-607, 1954-2 CUM. BULL. 177.

18. *Mayer v. Donnelly*, 247 F.2d 322 (5th Cir. 1957).

and delivery of an unconditional contract of sale constitutes the passage of title and the holding period is most probably terminated.<sup>19</sup>

The termination of the holding period of a capital asset, whether it be real or personal property, can be deferred by interposing a substantial condition or conditions to the transfer of ownership in the contract.<sup>20</sup> But the holding period is not necessarily extended by deferring delivery,<sup>21</sup> by deferring the date of payment of the purchase price,<sup>22</sup> by deferring the determination of the actual purchase price according to the terms of the contract to which the parties are bound,<sup>23</sup> or by the utilization of an escrow arrangement.<sup>24</sup>

In general, the date of termination of the holding period of personal property is essentially a question of fact. No one factor is controlling. The transaction must be analyzed in context.

### CONCLUSION

In some instances, it is possible for a taxpayer who has "held" a capital asset for less than six months to be assured of long term capital gain treatment of his asset's appreciation in value, by entering into a transaction which will enable him to continue to hold the capital asset until the six-month period has expired, without retaining the risk of a decline in value. But to achieve this result sound analysis of the available and possible terms and forms for the transaction and careful drafting of the documents involved are essential.<sup>25</sup>

19. Albert E. Dyke, 6 T.C. 1134 (1946), *acq.*, 1946-2 CUM. BULL. 2.

20. Howell v. Commissioner, 140 F.2d 765 (5th Cir.), *cert. denied*, 322 U.S. 735 (1944) (sale of gas and oil lease conditioned on drilling well by a certain date); Albert E. Dyke, 6 T.C. 1134 (1946), *acq.*, 1946-2 CUM. BULL. 2; Vincent Coraci, 13 CCH Tax Ct. Mem. 533 (1954) (sale conditioned on court approval).

21. Commissioner v. Sporl & Co., 118 F.2d 283 (5th Cir. 1941).

22. W. H. Hay, 25 B.T.A. 96 (1932), *acq.*, XI-1 CUM. BULL. 4 (1931); George S. Lavin, 3 CCH Tax Ct. Mem. 228 (1944); *cf.* R. O'Brien & Co., 1956-1 U.S. Tax Cas. ¶ 9261 (D. Mass. Jan. 9, 1956).

23. Patterson v. Hightower, 245 F.2d 765 (5th Cir. 1957); William A. Cluff, 17 T.C. 225 (1951).

24. Shillinglaw v. Commissioner, 99 F.2d 87 (6th Cir. 1938). *But see* Albert E. Dyke, 6 T.C. 1134 (1946), *acq.*, 1946-2 CUM. BULL. 2.

25. For discussions of the control of the holding period in general, see Dibble, *Current Problems in Determining Holding Period*, U. SO. CAL. 1951 TAX INST. 359; Katcher, *Tax Problems Incident to the Disposition of Real Estate — Problems of Taxable Dispositions*, 11 WEST. RES. L. REV. 222 (1960); Lippitz, *Tax Guide For a Seller of "Puts" and "Calls,"* 38 TAXES 829 (1960).