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# SALES, EXCHANGES AND CAPITAL ASSET TRANSACTIONS*

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The Internal Revenue Code of 1954, like the previous code and the revenue acts before that going back to 1913, includes in the concept of taxable income gains resulting from the sale or exchange of property. Because of the non-recurring nature of such a gain, it has received special treatment if the property sold or exchanged qualified as a capital asset. The determination of the gain or loss to be recognized upon the sale or exchange of property involves several factors. First, there is the factor of the cost or other tax basis of the property. Not all property is acquired by purchase for cash and hence the nature of the acquisition (by gift, by inheritance, in a non-taxable exchange) affects the tax basis.

Another factor is that of adjustment to the basis because the taxpayer may have made capital improvements to the property or he may have recovered part of his cost or other basis through depreciation. A third factor is the length of time the property was held by the taxpayer. This is important because of the special technical requirement in determining the kind of capital gain or loss that may result on the sale of the property (long term or short term).

Since capital gain or loss treatment of taxable income is more favorable taxwise than ordinary income treatment, taxpayers have sought where possible to bring income within the favored classification.

In a number of situations Congress has deliberately permitted taxpayers to treat as a capital gain income that might otherwise be considered ordinary income. This paper will be concerned with some of the changes made by the 1954 code in the treatment of certain sales and exchanges as capital asset transactions. The discussion will be limited to those special situations in this area of the code that the Institute felt should be brought to the attention of the members. These will be considered in the order in which they appear in the code.

## Losses Between Related Taxpayers—Section 267

A gain or loss is usually recognized when a transaction has been completed. Under prior laws it was comparatively easy to establish a loss on the sale of property by selling it to a related taxpayer, and still retain some control over the property because it remained in the family, so to speak. Congress closed what it considered a tax loophole by disallowing a deduction for a loss on a sale between a taxpayer and members of his family, or between an individual and a corporation, if more than 50 per cent in value

* From an address given at the University of Denver Tax Institute, 1954.

of the outstanding stock is owned, directly or indirectly, by such individual. If the same individual owns more than 50 per cent in value of the outstanding stock of two corporations, a loss on a sale between the corporations is disallowed if either corporation was a personal holding corporation or a foreign personal holding company for the year preceding the date of sale. A loss on a sale between the grantor of a trust and the fiduciary of the trust is likewise not deductible. The disallowance of a loss in a transaction within these relationships was in the 1939 code.

The new code adds three other categories in this loophole-closing provision: a transaction between the fiduciaries of two trusts if the grantor of both trusts was the same person; a transaction between the fiduciary of a trust and a corporation if more than 50 per cent in value of the outstanding stock of the corporation is owned by the trust or by the grantor of the trust; and a transaction between an individual and an exempt charitable or educational organization controlled by such individual or members of his family.

Constructive ownership rules are applied in determing whether taxpayers are related, just as under the 1939 code.

A loss resulting from the distribution of property in a corporate liquidation does not come within this rule of disallowance of losses.

Under the 1939 code, not only was the loss on the sale disallowed, but the transferee took his cost as a basis for subsequent gain or loss. The loss was irretrievably wasted for tax purposes. The 1954 code alleviates somewhat the harshness of the effect of the disallowance of the loss by minimizing any gain recognized on a subsequent sale by the transferee. The gain is taxable only to the extent that it exceeds the disallowed loss to the transferor. The benefit of the transferor's disallowed loss is allowed only to the original transferee. However, if the transferee disposes of the property in a tax free exchange, the benefit is extended to a disposition of the property received in the exchange. But neither the basis of the property to the transferee nor the holding period is affected. Nor is this provision available to the transferee if the disallowed loss results from a wash sale.

This section also contains a provision disallowing unpaid expenses and interest if the taxpayer and the person to whom the payment is to be made are within the relationships mentioned above at the close of the year or within 2½ months thereafter. Two additional conditions must be present for this disallowance. Within the period mentioned above, the expenses or interest have not actually been paid and the amount was not includable in the taxable income of the person to whom the payment is to be made. The second condition is that by reason of the method of accounting of the person to whom the payment is to be made (cash basis, for example) the item was not includable in such person's taxable income for his taxable year because it was not paid to him.

## Disposal of Coal with a Retained Economic Interest—Section 631 (c).

If the general rule defining capital assets were followed, the disposal of coal would result in ordinary income. But the coal industry is one of those sick industries that needs assistance if it is to survive. Even under the 1939 code it received some tax help in that it was given capital gain treatment under specified conditions. (Section 112(k) (21)). That is continued in the 1954 code with some additional helpful features. The disposal of coal (including lignite) held for more than six months by the owner under any form of contract under which he retains an economic interest results in a capital gain instead of ordinary income. The gain is measured by the difference between the amount realized and the adjusted basis for depletion plus deductions disallowed under another section of the law (Section 272). The latter provision is new and refers to expenditures attributable to the making and administering of the contract and to the preservation of the economic interest retained under the contract. The Senate Finance Committee report states that such expenditures include *ad valorem* taxes imposed by state or local authorities, costs of fire protection, insurance costs of all kinds (not including liability insurance), costs incurred in administering a coal lease including bookkeeping and technical supervision, interest on loans attributable to the coal, expenses of flood control, legal and technical expenses incurred in connection with the making of the contract, and expenses of measuring and checking quantities disposed of under the contract. Under prior law nothing was said concerning the treatment of such expenses with the result that capital gain treatment did not reduce the tax.

The new law makes certain that the taxpayer will get the maximum tax benefit of these deductions. If the proceeds are less than the costs, the excess is deductible as an ordinary loss under Section 1231, since coal comes specifically within the definition of property used in the trade or business (former 117(j)). If there is no income under a coal contract, the expenses become deductible as such from other ordinary income. If this capital gain treatment is availed of, the taxpayer may not have the benefits of percentage depletion. Coal royalty contracts are covered by this section, and the term owner includes a sublessor. The date the coal is mined is the date of disposal.

## Basis of Property Acquired from a Decedent—Section 1014

It would obviously be inequitable to use the original cost of such property as a basis for determining gain or loss on the disposition of the property, since the value of the property at death or the optional valuation date one year thereafter is subject to an estate tax. Consequently, the general rule has been, and is continued in the 1954 code, that the basis is the value of the property

as of the date of death or the optional valuation date. The gross estate may include the value of property disposed of by a decendent during his lifetime (transfers in contemplation of death, for example), or the gross estate may include the value of jointly-held property where the surviving joint tenant gets the property by reason of his survivorship. Under prior law the basis of the property could be the decedent's cost. The new code applies the general basis rule to all property included in the gross estate. The code enumerates nine types of transfers of property that are intended to be covered by the new rule.

The new basis rule does not apply if the property, though includible in the gross estate, has been sold or disposed of before the death of the decedent. One possible adjustment to the basis may be required. The value at the applicable valuation date must be reduced by any income tax deductions that were allowed for depreciation or depletion before decedent's death.

Property representing a right to receive income is valued for estate tax purposes. The person who thereafter receives such income receives the benefit of an income tax deduction for the portion of the estate tax resulting from the inclusion of such property in the gross estate. For that reason the basis section is not applicable to such property. For similar reasons this new basis provision does not apply to restricted stock options owned by a decedent and which he has not exercised at the time of his death.

ADJUSTMENTS TO BASIS—SECTION 1016

Capital expenditures and capital recoveries require an adjustment to the tax basis in determining gain or loss in the event of a sale. The new code enumerates fifteen situations that may require such an adjustment. A few of these will be considered. A taxpayer may elect to capitalize taxes and carrying charges. If he does not do so, he obviously may not add these to the tax basis of property sold. The same is true of expenditures relating to circulation expenses that are allowed as a deduction under Section 173.

The adjustment required for depreciation and depletion merits special comment. The general rule is the same as under the 1939 code. The recovery of capital by reason of depreciation or depletion allowed as deductions is a required adjustment, but the adjustment may not be less than the amount so allowable. To the extent that the amount allowed or allowable did not result in a reduction of tax, no adjustment to basis need be made. The latter provision is not aplicable to the period prior to January 1, 1952, unless the taxpayer so elects.

The determination of the amount allowable presents some problems because of the new provisions expanding the method that may be used in computing the deduction for depreciation. This section therefore provides that allowable depreciation for basis adjustments will be computed under the straight line method if none of the several methods under the depreciation section have

been adopted. This section also provides that the use of one of the methods prescribed in Section 167 for any one year will be considered as the adoption of that method for all years, even though the deduction may have been omitted in other years.

The basis of property must be adjusted for depreciation and depletion even though the property was held by a person or an organization not subject to income taxation. That would apply to a tax exempt organization, a nonresident who later became a resident, or to a nonresident foreign corporation from which property is acquired with a substituted basis.

Other adjustments enumerated include tax free distribution in the case of stock, amortizable bond premium in the case of bonds, unrecognized gain in the case of a residence, deferred expenses relating to expenditures made in the development of mines and research and experimental expenditures.

The basis of property is determined in many situations by reference to a transferor's basis or to the basis of other property held at any time by a taxpayer. Such a basis is known as substituted basis.

### Sale of Annuities—Section 1021

This is a one sentence provision in the code providing that the adjusted basis in case of the sale of an annuity contract shall in no case be less than zero. This is a provision favorable to the taxpayer. Under the new provisions for determining the taxable portion of an annuity, it is possible for a long-lived taxpayer to recover tax free more than the cost of the annuity. If he should thereafter sell his annuity contract, which is a capital asset, he will not have a negative basis.

### Involuntary Conversions—Section 1033

An involuntary conversion of property is not a completed transaction under certain conditions and therefore need not be a taxable exchange of property. This provision applies to the destruction of property, seizure or condemnation, or theft. No gain is recognized if such property is converted into property similar or related to it in service or use.

If the property is converted into money or into property after December 31, 1950, not similar to the converted property, gain is recognized unless the taxpayer acquires similar property within one year after the first taxable year in which the gain on the conversion was realized. The purchase of stock in a corporation satisfies this requirement if the taxpayer acquires control of the corporation. To the extent that the amount realized on the conversion exceeds the cost of the other property, the gain is recognized. A loss is also recognized. If the taxpayer acquires other property or stock before the conversion, it will not be considered replaced property unless he holds it at the time of the conversion. Such property must be acquired by purchase only. With the consent of the Secretary or his delegate the one year period may be extended.

An assessment of a deficiency in tax attributable to a gain upon the conversion of property may be made within three years from the time the Secretary is notified of the replacement of the converted property, or of an intention not to replace the property.

If no gain is recognized on the involuntary conversion under the above provisions, the basis of the new property is the same as the basis of the converted property, with the capital adjustments to the date of the conversion. If a loss was recognized, the basis of the new property is its cost. If a gain was recognized on the conversion, the basis of the new property is its cost less any portion of the gain not recognized. If no gain was recognized because the cost of the replacement exceeded the amount received, there has been a partial recovery of the cost of the old property, and the unrecognized gain reduces the basis of the new property.

The involuntary conversion of a residence comes within the rules of this section. Added to the involuntary conversion rules by the new code is a provision treating the sale of property under the acreage limitation provisions of the Federal Reclamation laws as an involuntary conversion, and also the sale or destruction of livestock on account of disease. The latter provision will involve problems of replacement period, accounting method, etc., which perhaps the regulations will clarify.

SALE OR EXCHANGE OF RESIDENCE—SECTION 1034

Because there is no specific provision in the code allowing a deduction for personal loss, except for casualty losses, a loss on the sale of a personal residence is not deductible. Because the definition of gross income is so sweeping, "income from whatever source derived", a gain on the sale of a personal residence is taxable. This situation in recent years developed some inequities, particularly in the period of inflation and a war economy. As a result, Congress introduced a provision under the 1939 code which is continued in the 1954 code that utilizes the principles of involuntary conversions in the case of sales of a personal residence.

A gain on the sale is not recognized if a residence is sold after December 31, 1953, and within the period of one year before the sale and one year after the sale another residence is purchased and the cost of the new residence exceeds the adjusted sale price of the old residence. The latter term is new in the 1954 code and is defined as the amount realized less expenses for work performed on the old residence to assist in its sale. Such work must be performed within ninety days ending on the day on which the contract to sell the old residence is entered into. The work must be paid for within thirty days after the sale of the old residence and the expenditures are not allowable as deductions in computing taxable income. Selling expenses, including broker's commissions, are deducted from the sales price to compute the gain.

If a taxpayer constructs a new residence, the one year period

after the sale is extended to eighteen months. The adjusted basis of the new residence is reduced by the amount of the gain not recognized on the sale of the old residence. If any part of the new residence is acquired by gift or inheritance it is not included in computing the gain on the sale of the old residence; but it is included in determining the basis of the new residence. The term residence includes stock held by a tenant-stockholder in a cooperative housing corporation, if the taxpayer used the house as a principal residence or will use it as such.

If a husband and wife use the old and new residence, the cost of the new residence is that of the husband, wife, or both, no matter how they hold the property. The unrecognized gain and the basis adjustments will be allocated to husband and wife in accordance with regulations to be promulgated.

The one year period will be suspended during any time a taxpayer serves on extended duty with the Armed Forces of the United States and during an induction period. Such period, however, may not extend beyond four years from the date of sale of the old residence. This period applies also to the spouse of a taxpayer.

The involuntary conversion of a residence is covered by the section dealing with such conversions. This works as an advantage to the taxpayer, since it gives him the privilege of applying for a longer replacement period.

### Capital Asset Defined—Section 1221

The definition is the same as in the 1939 code with one additional exclusion: accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory. The disposition of accounts or notes need not be in the ordinary course of business.

### Bonds and Other Evidences of Indebtedness—Section 1232

The problem considered in this section is the treatment of original-issue discount where bonds are issued at a discount. Under the old law a redemption at face value could result in a capital gain, except for non-interest-bearing obligations redeemable at a fixed amount at stated intervals (old Section 42(b)), short term obligations issued at a discount (old Section 42(c)), and U. S. Savings Bonds. Under the new law the discount is apportioned over the entire period to the maturity of the bond and treated as ordinary income. If the bond is sold before maturity, a pro rata portion of the discount is ordinary income. Any gain in excess of the discount is long term capital gain. These rules do not apply to tax exempt state government bonds or discount bonds purchased at a premium.

Original issue discount is the difference between the price at which the bonds were sold originally to the public and the stated redemption price at maturity. If such discount is less than one-fourth of one percent of the redemption price for each year of the life of the bond, the discount will be considered as zero.

Under the old law, the gain on the sale of bonds with excess coupons attached was claimed to be capital gain. Under the new law, if a bond is purchased after August 16, 1954, and any coupons due more than twelve months after purchase date have been detached, an artificial discount is deemed to be created and any subsequent gain up to such artificial discount will be treated as ordinary income.

GAINS AND LOSSES FROM SHORT SALES—SECTION 1233

The device of a short sale had been used by taxpayers to convert long term losses into short term losses. The opportunities for increasing allowable deductions by means of the short sale were partially closed even under the 1939 code.

A gain or loss from the short sale of property results in a capital gain or loss to the extent that the property used to close the short sale is a capital asset to the taxpayer. This provision includes transactions in commodity futures but does not include a hedging transaction. Under the 1939 code all short sales resulted in capital gains or losses. A dealer in securities with an unrealized profit could make a short sale and close the sale by the delivery of dealer security. The result would be a capital gain.

Under former Section 117(g)(1), a literal interpretation would make a gain or loss on hedging transactions involving a short sale a capital gain or loss. As interpreted by the Treasury Department such gain or loss was held to be ordinary income or loss.[1] The 1954 code excludes short sales in hedging transactions from the rule that gains or losses from short sales are capital gains or losses.

With respect to short term gains and holding periods for short sales, several rules are set forth in the 1954 code. The first rule is that the gain resulting from the closing of the short sale is a short term capital gain if on the date of the short sale the taxpayer has held substantially identical property for not more than six months and, also, if the taxpayer on or before the closing date of the transaction acquires substantially identical property. This rule applies regardless of when the property actually used to close the sale was acquired. Furthermore, the holding period of the substantially identical property is considered to begin on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever occurs first.

The acquisition of an option to sell property at a fixed price (a put) is treated as a short sale. The exercise of the option, or the failure to exercise it, is treated as a closing of such short sale. The new code provides an exception to the rule that the acquisition of a "put" is a short sale where the "put" is acquired on the same day that property identified as intended to be used in exercising the option to sell is acquired, and the option is actually exercised

[1] GCM 17, 322, XV-2 CB 151.

through the sale of property so identified. If the option is not exercised, the cost of the option is added to the basis of the property with which the option is identified. This section applies only to "puts" acquired after August 16, 1954.

A loss resulting from the closing of a short sale is a long term loss if on the date of the short sale the taxpayer has held substantially identical property for more than six months. This rule applies without regard as to when the property was acquired that was used to close the short sale.

The provisions with respect to short term gains and long term losses apply to a contract to sell stock or securities on a "when issued" basis. The performance of the contract or assignment of it for value is considered as a closing of a short sale.

In the case of commodity futures such as wheat, cotton, hides, etc., different commodities which are not generally used as hedges for each other would not be considered substantially identical property, nor would commodities requiring deliveries in different months be so considered.

In the application of the provision with respect to short sales the term taxpayer includes the spouse of the taxpayer.

OPTIONS TO BUY OR SELL—SECTION 1234

As in the former law, an option is subject to the general capital gain provisions if the holder of the option is not in the business of dealing in such options. This provision applies to options acquired after February 28, 1954. It governs a loss resulting from the failure to exercise the option. The option must be held for more than six months for the transaction to be a long term gain or loss. An unexercised option entered into for hedging purposes related to stock in trade results in an ordinary loss.

SALE OR EXCHANGE OF PATENTS—SECTION 1235

Under the former code there was some confusion as to the treatment of the sale of patents. An assignment of rights under a patent was a capital asset if the holder was an "amateur" inventor, but not if he was a professional. That seemed to be definite if payment was made in a lump sum. If the payment was conditioned on the use or profitability of the invention (royalties), the cases have held that there was a sale or exchange, although the Commissioner said it was ordinary income.[2]

The new law treats an assignment or a license as a sale or exchange of a capital asset held for more than six months without regard to the actual holding period. Whether the inventor is a professional or an amateur is immaterial. If the transfer covers all substantial rights or an undivided interest in the patent, the exact form or interest transferred is immaterial. Nor is the form of payment material. It may be in the form of royalties. But the

[2] Mim. 6490, 1950 CBA.

transfer must be made by an individual whose efforts created the patent, or by one who acquired an interest in the property for money or money's worth paid to the inventor prior to the time the invention was actually reduced to practice. There are two exceptions to the latter provision. An employer of the inventor does not qualify. Nor does an individual related to the taxpayer qualify, as that term is defined in Section 267(b). Brothers and sisters are expections to the exception, so that an assignment or license to such persons qualifies for capital gain treatment under this section.

The new provisions apply to amounts received after August 16, 1954, even though the assignment took place in a period before August 16, 1954, provided the assignment or license under which the patents arise would qualify if they were made after August 16, 1954.

Any loss resulting from the assignment or license under the new rule will result in a long term capital loss.

### Holding Period in Exchanges of Noncapital for Capital Assets—Section 1223(1)

The holding period becomes important in determining whether a gain or loss is long term or short term. The general rule is that where property received in an exchange has a carryover, in whole or in part, of the basis of the property exchanged (a substituted basis), the taxpayer may add the holding period of the property exchanged to the holding period of the property received. In other words, there is a carryover of the holding period as well as the basis. However, the tacking on of holding periods is allowed only where the property exchanged was a capital asset in the hands of the taxpayer, or property used in a trade or business for which capital gain treatment may be availed of (former Section 117(j)), or property which is the subject of an involuntary conversion. This provision applies to exchanges after March 1, 1954.

### Real Property Subdivided for Sale—Section 1237

Under the former code a taxpayer who disposed of a tract of real property by subdividing it into lots, and who was not otherwise a dealer in real estate, might be taxed on his gains as ordinary income. Cases go both ways. The new law clears up this situation. It applies to a taxpayer other than a corporation and provides that a tract of real property in the hands of such a taxpayer shall not be deemed to be held primarily for sale to customers in the ordinary course of business solely because the taxpayer has subdivided the tract into lots for purposes of sale. In other words, he will receive some capital gain treatment.

Like so many of the provisions in the code, there are conditions. The tract must not previously (before August 16, 1954) have been held for sale in the ordinary course of business, nor in the year of sale may the taxpayer hold any other real property (he must not be a dealer). The taxpayer must not make any substantial improvement to the tract of land which substantially enhances the

value of the lot sold. This provision includes the federal, state or local government, if it constitutes an addition to the basis of the property, such as a special assessment for paving a street. Except in the case of inherited property, a lot or parcel must be held for five years.

If the above condtions are met, the first five lots sold qualify for capital gain treatment. In a year in which the sixth lot is sold, 5 per cent of the selling price will be treated as ordinary income for all lots sold in that year. To get full capital gain treatment, therefore, no more than five lots may be sold in the first year.

Expenditures incurred in connection with the sale of the lots shall be applied against ordinary income first, and the balance will reduce the amount realized on the sale.

The substantial improvement provision is clarified in the law. It does not cover any improvement made, if the lot has been held by a taxpayer for at least ten years and the improvement consists of the building or installation of water or sewer facilities or roads. Furthermore, the taxpayer must satisfy the Secretary or his delegate that the lot would not have been marketable at the prevailing price without the improvement. The taxpayer must elect to make no adjustment to the basis of the lot or of any other property owned by the taxpayer on account of the improvements. The law adds that such election does not make any item deductible which would not otherwise be deductible.

A tract of real property is defined as a single piece of real property. Two or more pieces will be considered a tract if they were ever contiguous, or would be except for a road, street, etc.

If the last sale was made more than five years ago, the remainder of the tract becomes a new tract, and the sale of the first five lots rule starts anew.

The new rules are applicable to sales made after December 31, 1953, except for purposes of the definition of tract and determining the number of sales. For the latter, all sales during the period of five years before December 31, 1953, will be taken into account.

### Termination Payments to Employee—Section 1240

Under the 1939 code capital gain treatment was accorded to certain payments to an employee (old Section 117(p)). The employee must have been employed for more than twenty years. The rights to receive the payments had to be included in the employment agreement for not less than twelve years, and the total amounts had to be received in one taxable year after termination of the employment. This tailor-made provision is continued in the 1954 code with one addition, namely, that these rights were included in the terms of employment before August 16, 1954.

### Cancellation of Lease or Distributor's Agreement—Section 1241

Under the 1939 code it was uncertain as to whether an amount received by a lessee resulting from the cancellation of a lease, or by

a distributor for cancellation of a distributor's agreement, constituted an amount received on the sale or exchange of property. That element is essential for capital gain. The new code leaves no doubt that such a transaction is a sale or exchange and will result in a capital gain. In the case of a distributor of goods, the result would be the same, provided the distributor has a substantial capital investment in the distributorship. It should be noted that the new provision does not apply to an amount received by a lessor on the cancellation of a lease.

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The Editorial Staff of DICTA plans to have a spring issue with a symposium on the general subject of EVIDENCE. We would greatly appreciate an article or comment in this field from you.

We hope that in the future we will continue to receive your writing, and in that manner further the purpose of DICTA in serving you as a Colorado lawyer.

Please address all writing or comments to Mr. Arnold M. Chutkow, 750 Equitable Bldg., Denver, Colo., or to Mr. Richard Harvey, University of Denver College of Law, Denver, Colo.

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