THE "CAPITAL ASSET" CONCEPT: A CRITIQUE OF CAPITAL GAINS TAXATION: I*

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THE favorable treatment presently accorded to capital gains is the major exception to the principle of graduated¹ federal income tax rates. Only half of any profit realized upon the "sale or exchange"² of a "capital asset"³ held for longer than six months is included in the seller's taxable income.⁴ Furthermore, this half may not be taxed at a rate in excess of 50%.⁵ The combined effect of these two provisions is to permit the taxpayer⁶ to pay no more than a maximum tax of 25% on his "long-term capital gains,"⁷ notwithstanding the fact that the tax on his "ordinary income" is calculated at progressive rates rising to 82%.⁸

*Part II of this article, consisting of Sections VI and VII, will appear in the next issue of the JOURNAL.

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1. DALTON, *PRINCIPLES OF PUBLIC FINANCE* c. IX (9th ed. 1936); GROVES, *FINANCING GOVERNMENT*, 44-9 (1939); SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE*, esp. 190-200 (1894); Blough, *Ability to Pay Reexamined*, 33 *PROC. OF NAT. TAX ASS'N* 368 (1940); Buehler, *Ability-to-Pay*, 1 *TAX L. REV.* 243 (1946); Fagan *Recent and Contemporary Theories of Progressive Taxation*, 46 *J. OF POL. ECON.* 457 (1938); Kendrick, *The Ability-to-Pay Theory of Taxation*, 29 *AM. ECON. REV.* 92 (1939); Preinreich, *The Theory of Progressive Taxation*, 25 *TAXES* 742 (1947).

But see LUTZ, *GUIDEPOSTS TO A FREE ECONOMY* c. 9 (1945); Allen, *Ability-to-Pay Taxation Not Compatible with Private Property*, 168 *COMMERCIAL AND FINANCIAL CHRONICLE* 204 (1948); Magill, *Report of the Special Tax Study Committee to the Committee on Ways and Means*, reprinted in 25 *TAXES* 1029 (1947), wherein the present law was characterized as "a tax system which, instead of rewarding people in proportion to how much they strive and accomplish, punishes them with a graduated penalty that increases with their success." *Id.* at 1034.

2. Exchanges are included within the meaning of the term "sale" as used in Sections I through IV *infra*. The significance of the phrase "sale or exchange" is considered briefly in Section V *infra*.

3. INT. REV. CODE § 117(a) (1).

4. INT. REV. CODE § 117(b).

5. INT. REV. CODE § 117(c) (2).

6. Although the 25% rate is applicable to corporations under INT. REV. CODE § 117(c) (1), the treatment of corporate gains differs in certain respects from that of gains realized by individuals. See HAMEL *et al.*, *FORMS OF BUSINESS ORGANIZATION AND THE FEDERAL TAX LAWS* 31-2 (1949) (pamphlet in the Practising Law Institute series on Current Problems in Federal Taxation); MORONEY & MOSER, *CAPITAL GAINS AND LOSSES* 47-8 (1948) (pamphlet in the Practising Law Institute series on Fundamentals of Federal Taxation).

7. INT. REV. CODE § 117(a) (4).

8. The 82% figure is derived by adding the 3% normal tax [INT. REV. CODE § 11] to the 88% surtax on net income in excess of \$200,000 [INT. REV. CODE § 12(b)] and reducing the resultant tax by 9.75% [INT. REV. CODE § 12(c) (1)]. However, "in no event" may income tax liability exceed 77% of net income [INT. REV. CODE § 12(c) (2)].

Assuming that the federal income tax should treat like transactions alike, the special treatment accorded capital gains can be justified only if the transactions giving rise to such gains have characteristics which set them apart from transactions resulting in ordinary income. Whether these special characteristics actually exist has long been a focal point for discussion. It is the purpose of this inquiry to reconsider this issue and to attempt to answer the question which underlies all serious inquiry into capital gains taxation—Is the public interest better served by such special treatment than by the taxation of capital gains at the graduated rates applicable to income received in other forms? This requires an examination, not only of the theoretical justification of the capital gain provisions, but also of their practical operation.

Essential to an understanding of capital gains taxation is a familiarity with the several categories of transactions that qualify for capital gains treatment. Sections I through V are devoted to a description and critical appraisal of the principles, both legislative and judicial, which determine whether profit or loss is to be classified as ordinary or capital gain or loss. More specifically, Section I deals with the six-month "holding period" criterion, Sections II, III and IV with the "capital asset" criterion, and Section V with the "sale or exchange" criterion. The discussion of these legal criteria is concerned primarily with the degree of precision with which they attain their several objectives. These objectives are in turn scrutinized in Section VI which considers the various ethical and economic arguments advanced in support of special treatment of capital gains. Section VII sets forth the author's recommendations.

I. THE DISTINCTION BETWEEN INVESTMENT AND SPECULATION—HOW THE MINIMUM HOLDING PERIOD REQUIREMENT WORKS

The rather curious statutory prerequisites to capital gains treatment are attributable chiefly to Congress' attempt to tax gains realized upon the sale of "investments" more leniently than income from other sources. The statute seeks to distinguish "investment" from the other types of profit-making activity—and especially from "speculation"⁹ and "business" which also involve sales of property—primarily by means of two requirements. To differentiate between "investment" and "speculation," the statute provides that favorable treatment is to be accorded to profit realized upon the sale of only such assets as were

9. It must be kept in mind that the statute does not speak of "investment" or "speculation," although the courts often do. These terms are employed here only for the purpose of separating one group of transactions ("speculation") from the many others comprehended within what the statute calls "a sale or exchange of capital assets." The remainder of this class, as will be seen, has a far wider sweep than the usual connotations of the word "investment."

owned by the taxpayer for more than six months preceding sale.¹⁰ To separate "investment" from "business," the statute provides that special treatment is not to be given to profit realized upon the sale of various kinds of business assets, particularly "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (the "trade or business clause").¹¹ It is the purpose of Section I to appraise the efficiency of the first of these two requirements.

As has been indicated, the role of the six-month holding period requirement is to limit the effect of the capital gains provisions to profits realized upon the sale of investment property, so that the profits of speculation are subject to the surtax rates applicable to ordinary income.¹² Unless more than six months elapses between the acquisition of an asset and its sale, the transaction is conclusively presumed not to constitute the sale of an investment.¹³ Gain realized upon the sale of property held for less than this period is thus taxed as ordinary income, regardless of whether the transaction is classified as speculation or business. Therefore it is only in rather special situations¹⁴ that the characterization of the transaction becomes significant prior to the expiration of six months.

Since the six-month period is designed to separate the investor from the speculator, it is helpful, in evaluating this requirement, to examine briefly some of the connotations of the terms "investment" and "speculation." According to popular usage, an owner of securities is not considered a "speculator" merely because he cashes in on appreciation in value by sale.¹⁵ Nor is he classified as an "investor" solely by reason of the fact that he has received a few dividend or interest payments before sale. Although long-continued retention of a security is often considered "investment," this may not be so if the corporation's activities are "speculative," *i.e.*, involve unusual risk.¹⁶ Such varied usage indicates that the factual content of these terms is by no means uniform.

10. INT. REV. CODE §§ 117(b) and 117(c) (2).

11. INT. REV. CODE § 117(a) (1).

12. Cf. note 24 *infra*.

13. The exceptions to this rule are analyzed in Diamond, *Relationship of Basis to Holding Period* in PROCEEDINGS OF THE NEW YORK UNIVERSITY FIFTH ANNUAL INSTITUTE ON FEDERAL TAXATION 477 (1947).

14. For example, any amount of short-term capital gains may be wiped out by short-term capital losses of an equal amount or by long-term capital losses of twice the amount, whereas ordinary income may be reduced by capital losses only up to \$1,000 per year under INT. REV. CODE § 117(d) (2).

15. "It should take no long argument to show that the isolated fact of the sale is not a conclusive indication of the purpose for which the property was held. . . ." Resnick, *Tax Problems in Liquidation Sales*, 26 TAXES 1109, 1110 (1948).

16. Whether the vendor reinvests his sales profit or uses it for consumption purposes may sometimes affect the characterization of the transaction.

Perhaps the most satisfactory single criterion is that suggested in the *Chinook Investment Co.* decision:

"The 'in-and-out' market hanger-on who buys and sells through brokers on margin is a typical example of the pure speculator in stocks. . . . On the other hand, an investor is ordinarily thought to be a person who acquires property for the income it will yield rather than for the profit he hopes to obtain on a resale."¹⁷

When the distinction between investment and speculation is made to depend upon the intention with which property is held¹⁸—i.e., whether for the enjoyment of a more or less regular periodic return or for the enjoyment of a single resale profit¹⁹—the category of "speculator" includes both *A*, the full-time professional trader, and *B*, who makes an isolated purchase in the hope of appreciation. Under this definition, the class of "investors" includes both *C*, who holds gilt-edge securities solely for their periodic yield, and *D*, who holds the common stock of the small company through which he conducts his business. This scheme of classification purports to characterize the transaction and not the taxpayer; an individual or corporation may concurrently hold one property for investment and another for speculation.

A. The Rationale of the Minimum Holding Period Requirement

The minimum holding period has not always been six months. It was two years from 1922²⁰ to 1938, and eighteen months from 1938²¹ to 1942, when the present six-month period was first enacted. The pre-1942 holding periods apparently presumed that the primary justification for special treatment of capital gains is to mitigate the unfairness

17. *United States v. Chinook Investment Co.*, 136 F.2d 984, 985 (9th Cir. 1943). For various reasons that will appear subsequently, the concept of speculation is employed principally in connection with transactions involving securities. It is nonetheless of great importance, not only because 85% of all capital gains reported arise out of sales of securities, H.R. REP. NO. 1860, 75th Cong., 3d Sess. (1938), 1939-1 CUM. BULL. pt. 2, p. 733, but also because of its influence upon the phrasing of the definition of capital assets.

18. The "trade or business" clause in INT. REV. CODE § 117(a)(1) refers, not to the purpose for which property was "acquired," but to that for which it was "held." "[T]he intention of Congress . . . was to include in the comprehensive word 'held,' property which might or might not have been purchased primarily for the purpose of resale." *Richards v. Commissioner*, 81 F.2d 369, 373 (9th Cir. 1936).

19. Even this definition has its difficulties: the owner of property often remains in a state of indecision as to whether to keep or sell, or he may hold an asset for one purpose and then change his mind. It is also necessary to qualify the term "investment" so as to include assets such as discount obligations which in effect accumulate interest till maturity; otherwise the class of "speculators" would include school children paying \$18.75 for United States Series E Bonds in the expectation of receiving \$25 at the expiration of ten years. Cf. INT. REV. CODE § 117(a)(1).

20. Revenue Act of 1921, § 206(a)(6), 42 STAT. 233 (1921).

21. Revenue Act of 1938, § 117(a)(4), 52 STAT. 501 (1938).

of taxing in a single year, and at progressive rates, gains accruing over several years.²² The holding period served to remove from the scope of the capital gains provisions short-term gains which, under this theory of capital gains taxation, were not deserving of lower rates.²³

The present six-month holding period is rationalized quite differently. It is apparently predicated upon the hypothesis that gain upon sale of an investment is entitled to special treatment, not necessarily because it has accrued over more than a single fiscal period, but because, by its very nature, it represents a much lesser ability to pay, and accordingly deserves a lesser tax, than other types of income. No such peculiar quality is attributed, however, to speculative profits; they are thought to be of commoner clay deserving of no better treatment than ordinary income. Since the trader characteristically plays for relatively quick market fluctuations, six months serves to catch the majority of these transactions.²⁴ Such appear to be the premises of the present statute.

22. This argument appears in the Report of the Committee on Ways and Means to the House of Representatives in support of the initial capital gains provisions enacted in 1921. 1939-1 CUM. BULL. pt. 2, p. 176.

23. "Gains from sales of property held less than 1 year do not appear to be entitled to any preferential treatment for income-tax purposes over income realized in the form of salaries, dividends, interest, and so forth." Statement of Roswell Magill, Under-Secretary of the Treasury, *Hearings before Committee on Ways and Means on Proposed Revision of the Revenue Laws*, 75th Cong., 3d Sess. 100, 106 (1933). This view is shared by Harold M. Groves and by Harry J. Rudick. CAPITAL GAINS TAXATION 47, 65, 83 (Tax Institute Symposium, 1946). See also Statement of Acting Secretary of the Treasury (Henry Morgenthau, Jr.) Regarding the Preliminary Report of Subcommittee of Committee on Ways and Means. *Hearings before Committee on Ways and Means*, 73d Cong., 2d Sess. 4 (1933). The Treasury in 1942 favored eighteen months as the minimum holding period; Statement of Randolph E. Paul, Tax Adviser to the Secretary of the Treasury, *Hearings before Committee on Ways and Means on H.R. 6358*, 77th Cong., 2d Sess. 1611, 1635 (1942).

Lower taxes on capital gains realized by investors have been urged, not alone because of the inequity caused by the pyramiding of accrued gains in the year of realization, but because of undesirable repercussions on the national economy thought to result from the deterrence of transfers of capital assets. It is to be noted that this line of argument does not suggest how long a holding period should be required before the profit upon the disposal of capital assets is treated apart from ordinary income from other sources. Indeed the implementation of this criterion may be inconsistent with the requirement of any holding period whatever. The Boland Bill, H.R. 6358, 77th Cong., 2d Sess. (1942), provided for a flat rate of 10% on capital gains without regard to how long assets were held. That this proposal has not yet been adopted is in large measure due to the widely-held sentiment that its enactment would unjustifiably favor professional speculators. Were this policy to be incorporated into the law, it would become necessary to substitute for the minimum holding period requirement some other method of isolating speculative from investment profits, if large-scale traders were not to benefit from the low flat rate. One such device would be the deletion of the words "to customers" from the "trade on business" clause found in INT. REV. CODE § 117(a) (1).

24. "It is believed that a holding period of 6 months will be a sufficient deterrent to

B. Inadequacies of the Minimum Holding Period Requirement

"[A] classification based solely upon the period of holding is not an exact method for segregating speculative from investment transactions. . . ." ²⁵ A man may acquire and hold an asset with the intention of keeping it indefinitely for its recurrent yield as an investment. If less than six months later he sells it to diversify his holdings, any profit on this non-speculative transaction is nonetheless subject to surtax as "short-term capital gain." ²⁶ Conversely, a speculative transaction may not be consummated until six months have elapsed. Nevertheless the profit is taxable only up to the flat maximum rate. This latter problem of long-term speculation arises in two distinct factual contexts. One involves *A*, the professional speculator who engages in substantial and recurrent trading.²⁷ The other concerns *B*, the "amateur" who intermittently plays the market in his spare time.²⁸ The problem will first be considered as it concerns *B*.

the speculator as contrasted with the legitimate investor." SEN. REP. NO. 1631, 77th Cong., 2d Sess. 50 (1941). Cf. Schram, *The Fallacy of Taxes on Capital Gains*, 161 COMMERCIAL AND FINANCIAL CHRONICLE 2606, 2633 (1945). See also statements by Franklin Cole in CAPITAL GAINS TAXATION, 83, 87, 88 (Tax Institute Symposium, 1946). Mr. Cole argues: "A man taking a six-month risk, all things concerned [sic], should be thrown into the investment category" because that period "coincides with the risk taken in inventory, seasonal risk, in business enterprise." *Id.* at 51. However, profits from the sale of inventory held for more than six months constitute ordinary taxable income and are expressly excluded from the capital gain category by INT. REV. CODE § 117(a)(1). For still another defense of the six-month holding period, see the remarks of Beardsley Ruml in CAPITAL GAINS TAXATION, *supra*, at 89.

The selection of six months as the dividing line appears to have been made in reliance upon a supposed analogy to the Securities Exchange Act of 1934, § 16(b), 48 STAT. 896 (1934), which authorizes the recovery on behalf of a corporation of profits realized by corporate officers, directors, and other insiders from the sale of its stock less than six months after purchase. "If six months is a measure of what constitutes a speculative turn for the S.E.C., why is it not as good a measure for the Treasury?" Supplementary Memorandum on the Capital Gains Tax Presented by Elisha M. Friedman, *Hearings before Senate Finance Committee on H.R. 9682*, 75th Cong., 3d Sess. 254 (1938). Cf. testimony of Emil Schram, 1 *Hearings before Senate Finance Committee on H.R. 7378*, 77th Cong., 2d Sess. 1186, 1189 (1942).

25. Report of Subcommittee, *Hearings before Committee on Ways and Means on Proposed Tax Revision*, 75th Cong., 3d Sess. 9, 45 (1938).

26. INT. REV. CODE §§ 117(a)(2) and (b).

27. *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), serves to illustrate the activities of the professional speculator. "[D]uring 1933 Leonhard Fuld devoted an average of eight hours per day to the study of new texts, reading services, charting prices of securities, conferring with his broker, attending meetings of corporations in which he owned securities, and consulting with corporate executives. . . .

" . . .

"The main source of livelihood of [the petitioner] was from securities transactions. [He] maintained no business offices [and] had no customers to whom [he] might sell securities." *Id.* at 467.

28. *Chemical Bank and Trust Co. v. United States*, 21 F. Supp. 167 (Ct. Cl. 1937),

1. *The Long-term Profits of the "Amateur" Speculator*

When *B*, the small-scale speculator, profitably sells an asset acquired by him for speculative purposes more than six months previously, the statute treats this as the sale of a "capital asset." Accordingly *B* is taxed at the low flat rate enacted to benefit *C*, the investor. The necessities of administration explain this anomaly. *B* often differs from *C* only in state of mind and not in easily recognizable overt behavior. If "the devil himself knoweth not the thought of man,"²⁹ the Commissioner of Internal Revenue could hardly be expected to.

Much criticism has been directed against the resultant paradox that a man's "sideline" speculations are taxed more leniently than the income from his principal occupation. As Roswell Magill remarked while Under-Secretary of the Treasury, "It is hard to see why an individual who makes \$10,000 from a single sale of stock or other property, or from several sales, has less capacity to pay income tax than a merchant who makes a net profit of the same amount from a great number of sales."³⁰ The full implications of the special treatment of non-recurrent transactions involving assets held for more than six months will become apparent from the later discussion, in Sections III and IV, of sales of property other than securities.

2. *The Long-term Profits of the Professional Speculator*

Having considered why the long-term speculative gains of *B*, the occasional market dabbler, are permitted to enjoy the capital gain provisions, there remains to be answered a similar question concerning the long-term gains of *A*, the professional speculator. Unlike the random purchases and sales of *B* which outwardly may seem identical with those of *C*, the investor, the activities of *A* may be identified by their frequency, regularity, volume, small "spread," and so on. In short, *A* is recognizable because he is engaged in trading on a scale large enough to be characterized as a business.³¹

Legislative History. Prior to 1934 *A*'s profits were taxed in the same manner as the profits of any other business—as ordinary income subject

involved a railroad executive affiliated with some sixty railroads for whom stock speculation constituted a mere sideline activity. "The time consumed by him in the purchase and sale of stocks composing his margin account . . . was practically negligible, being limited to not more than ten or fifteen minutes a day when in his New York office compared to eight hours a day devoted by him to railroad matters." *Id.* at 172-3.

29. Y.B. 17 Edw. IV, f. 2 (1478).

30. *Hearings before Committee on Ways and Means on Proposed Revision of the Revenue Laws*, 75th Cong., 3d Sess. 106 (1938). Cf. view of Secretary Morgenthau, *Hearings*, *supra* note 23, at 4.

31. "A trader on an exchange, who makes a living in buying and selling securities or commodities, may be said to carry on a 'business. . .'" Judge Learned Hand in *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929). Cf. *Fuld v. Commissioner*, 139 F.2d 465, 468 (2d Cir. 1943).

to surtax. They were excluded from the operation of the capital gains provisions by the following definition of capital assets:

" 'Capital assets' . . . does not include . . . property held by the taxpayer primarily for sale in the course of his trade or business." ³²

Because of this phrase a speculator could not avail himself of the flat capital gains rate merely because he had sold an asset held by him for longer than the minimum holding period. He was also required to prove that he was not a professional trader whose purchases and sales were so recurrent and systematic as to constitute a "course of trade or business."

In 1934 the latter requirement was abolished.³³ This change was not motivated by legislative benevolence toward professional speculators. On the contrary it was brought about by a congressional desire to bring certain transactions within the capital gains provisions in order that losses incurred in these transactions could not be deducted from ordinary income. Congress was prompted to this action by the disclosure that several prominent financial leaders had paid no federal income tax during 1930, 1931, and 1932 because their losses on sales of securities offset their very substantial income from other sources.³⁴ This disclosure had resulted in a provision in the National Recovery Act ³⁵ restricting the deduction of losses upon sales of securities when incurred by "traders or other taxpayers who buy and sell securities for investment or speculation, whether or not on their own account, and irrespective of whether such buying and selling constitutes the carrying on of a trade or business." ³⁶ In the Revenue Act of 1934 Congress sought to accomplish this same result ³⁷ by amending the definition of "capital assets" in the new Section 117 so as to exclude, not *all* property held primarily for sale in the course of business, but only such property as was held primarily for sale "to customers" in the "ordinary" course of business. Since sale on a securities exchange is not usually considered to be a sale "to customers," it was asserted that this amendment made it "impossible to contend that a stock speculator trading on his own account is not subject to the provisions of Section 117." ³⁸

32. Revenue Act of 1932, § 101(c) (8), 47 STAT. 192 (1932).

33. Revenue Act of 1934, § 117(b), 48 STAT. 714 (1934). Cf. note 38 *infra*.

34. Latham, *Taxation of Capital Gains*, 23 CALIF. L. REV. 30, 34 n.13 (1935).

35. § 218(b), 48 STAT. 209 (1933), repealing § 23(r) (2) of the Revenue Act of 1932, 47 STAT. 183 (1932).

36. H.R. 708, 72d Cong., 1st Sess. 13, referring to § 23(r) of the Revenue Act of 1932; quoted in Francis Shelton Farr, 44 B.T.A. 683, 691 n.3 (1941).

37. *Id.* at 691.

38. *Report of Conference Committee on H.R. 1385*, 73rd Cong., 2d Sess. 22 quoted in

The fact that a stock speculator would find it to his advantage to make this contention only where he had realized a loss and not a gain suggests that Congress was preoccupied with the immediate problem of protecting the revenue during a depression when aggregate losses exceeded gains. However, even if Congress had envisioned the consequences of its amendment when a rise in market prices would make possible a greater volume of gains, it would have had no reason to think that the amendment unduly favored trading profits. This amendment was part of a comprehensive revision of the method of taxing capital gains and losses. Discarding the flat $12\frac{1}{2}\%$ rate³⁹ on capital gains which had prevailed since 1922, the 1934 Act subjected such gains to full surtax rates but provided that only a part of the gain was to be taken into account, depending on the length of time during which the asset was held—the so-called "step-scale" method.⁴⁰ Thus even if classified as capital gain, 80% of the profit realized by a trader upon sale of stock held by him for a little over one year would be subject to surtax. By 1942, however, the "step-scale" system had been transformed by a series of statutory amendments into the present 25%-effective-rate-after-six-months-scheme⁴¹—with little mention in Congress of the growing benefits which these changes afforded to persons deriving their income from the business of trading in "capital assets."⁴²

Criticism. Probably no aspect of the present law on capital gains has occasioned more vigorous criticism than the exemption from the surtax of the long-term trading profits of the professional speculator. Thus Professor Robert Murray Haig asks:

"But what is to be said for the fairness of an income tax that levies its toll on the pay envelope of the wage-earner, the monthly check of the salaried man, the annual profit of the merchant and manufacturer, and the interest coupon of the widow, but that, at the same time, exempts the winnings of the successful stock-gambler and the unearned increments of the fortunate speculator in vacant land?"⁴³

This sentiment should not be dismissed as merely reflecting a provincial hostility to speculation as "gambling." While recognizing that "spec-

O. L. Burnett, 40 B.T.A. 605, 609 (1939), *aff'd in part*, 118 F.2d 659 (5th Cir. 1941); *Gruver v. Commissioner*, 142 F.2d 363, 368 (4th Cir. 1944).

39. Revenue Act of 1921, § 206(b), 42 STAT. 233 (1921).

40. The 1934 step-scale method is described in Hendricks, *Federal Income Tax: Capital Gains and Losses*, 49 HARV. L. REV. 262 (1935).

41. See INT. REV. CODE §§ 117(b) and (c). Cf. Wells, *Legislative History of Treatment of Capital Gains under the Federal Income Tax, 1913-1948*, 2 NAT. TAX J. 12 (1949).

42. "An important fact to be kept in mind is that during a large part of the period in which the $12\frac{1}{2}$ percent [capital gain] rate was in effect, the top surtax rate on ordinary income was only 20 percent, whereas the present [1938] surtax rates reach 75 percent." Report of Subcommittee, *supra* note 25, at 37.

43. *Taxation of Capital Gains*, The Wall Street Journal, March 23, 1937, p. 4, col. 3.

ulation . . . serves a useful economic function," Randolph Paul has expressed a similar view on the part of the Treasury:

"Speculation is a way of securing a living in whole or in part. This income should be treated exactly the same as the income of a merchant, a lawyer, or a wage earner. . . .

" . . . The Treasury . . . would not discriminate against such income; it would merely subject such income to taxation at the same rates as apply to all other types of income." ⁴⁴

It is noteworthy that in Great Britain, "a man who devoted the majority of his time to buying and selling securities on his own account . . . [and who] would be held to be dealing in capital assets under the definition in our Federal law . . . would be taxed on the gains from such transactions" at progressive rates.⁴⁵

3. *Circumvention of the Minimum Holding Period Requirement*

As has already been indicated,⁴⁶ the rationale of the present holding period requirement is that it conforms to economic actualities in that the great majority of speculative transactions are completed in less than six months and that, as a practical matter, sale of an asset held for longer than this period is likely to represent "a change of investments." This may well be true. It does not take into account, however, the fact that an arbitrary holding period necessarily invites the timing of sales according to the vendor's tax advantage. This problem is not peculiar to the six-month criterion.⁴⁷ Thus it was reported in 1933 that "[t]axpayers take their losses within the 2-year period and get full benefit therefrom,⁴⁸ and delay taking gains until the 2-year period has expired, thereby reducing their taxes."⁴⁹

44. *Hearings before Committee on Ways and Means*, 77th Cong., 2d Sess. 1611, 1634 (1942).

45. Parker, *Capital Gains and Losses*, 14 TAX MAG. 604, 605 (1936).

46. See text at note 24 *supra*.

47. "[T]he setting up of any time limit beyond which the status of a profit or loss is substantially altered not only falls far short of its purpose even if it could be successfully carried out, but on the contrary may be avoided by taxpayers when it would operate to their disadvantage and made use of in other cases to gain advantages which it was quite obviously never intended that it should bestow." Hogan, *The Capital Gains Tax*, 9 TAX MAG. 165, 166 (1931).

48. Under present law this benefit is somewhat smaller because net capital losses may reduce ordinary income only to the extent of \$1,000 in the year when sustained, INT. REV. CODE § 117(d)(2), the balance being carried forward as an offset against capital gains and \$1,000 of ordinary income in each of the ensuing five years. INT. REV. CODE § 117(e)(1).

49. Report of Committee on Ways and Means rendered Feb. 12, 1934, 1939-1 CUM. BULL. pt. 2, p. 561. Cf. Hendricks, *Capital Gains and Losses*, 49 HARV. L. REV. 262, 286 (1935).

Similar results may be achieved by more sophisticated devices. For instance, what is factually a short-term profit may receive the benefits of the rates intended for long-term investment by skillful manipulation of a device known as the "put." The purchaser of a "put" obtains the right to require the seller of the "put" to buy specified stock at a set price within a stated period.

" 'Puts' can be used to insure realization of a gain within the six-month period without having it classified as short term. For example, if stock bought in January at \$30 has risen to \$40 in June, its sale would result in short-term gain, fully taxable. If the taxpayer purchased a 'put' in June . . . and waited until the end of the option period to 'put' the stock, his gain would be long term, only fifty per cent taken into account. If by July the stock had risen to \$50, he would sell the stock (at a twenty-point long-term gain) and would let his 'put' option lapse. . . ." ⁵⁰

Other methods of avoiding the six-month holding period requirement involve combinations of familiar devices such as "wash sales," "short sales," and "sales against the box." For example, a taxpayer, having acquired a given stock at less than the current price, may agree to sell the stock at the current price, delivery being postponed until some future date.⁵¹ He expects that a fall in price prior to delivery will enable him to perform his contract by delivery of the shares already owned by him—thus insuring the realization of his long-term gain ⁵²—and that he will then reacquire the stock at the anticipated low price.⁵³ If, however, the market has risen by the delivery date, the taxpayer need not bewail his bargain. He will then sell his original shares in the market, realizing an even larger long-term gain, and will pay little or no tax on this gain because of a short-term loss resulting from the use of new shares, purchased by him at the new high price, to fulfill his commitment. By his choice of old stock or new stock for delivery under his contract, the taxpayer may at his pleasure shift the transaction into either the long-term or the short-term category so as to minimize his tax bill.

Thus, the methods employed by the law to segregate speculation

50. Mills, *Tax Problems in the Purchase and Sale of Securities*, 25 TAXES 555, 561 (1947). "Since 'puts' . . . are options, losses from failure to exercise them are short-term regardless of the time held [under INT. REV. CODE § 117(g)(2)]." *Id.* at 561.

51. A cash-basis seller's gain or loss is recognized for tax purposes, not when the contract is made, but when the sale is "covered" by delivery of the stock.

52. *I.e.*, assuming that, by the time the sale is consummated the shares will have been held for more than six months.

53. As the "wash sale" results in a gain rather than a loss disallowed by INT. REV. CODE § 118(a), the basis of the new shares is their cost and is unaffected by INT. REV. CODE § 113(a)(10), even though the new shares are acquired less than 30 days before or after the sale of the old shares.

from investment are not only questionable in theory but are often circumvented in practice.⁵⁴

II. THE DISTINCTION BETWEEN SPECULATION AND BUSINESS—HOW "SALE TO CUSTOMERS" HAS BEEN INTERPRETED

"The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . ." ⁵⁵

The statute attempts to distinguish not only between "speculation" and "investment," but also between "speculation" and "business." This is done by excluding from the definition of "capital assets" property which is held for sale "to customers." As has already been indicated,⁵⁶ the speculator trading through a broker is not generally considered to be selling "to customers." Accordingly, his long-term profits are taxed at capital gains rates rather than as business profits subject to surtax, even though he has sold property "held . . . primarily for sale . . . in the ordinary course of his trade or business. . . ." ⁵⁷

It has often been difficult to distinguish between a sale made by a professional speculator and that made by a businessman out of his stock-in-trade for the reason that they share an important common factor; in both cases the property sold has, before its disposition, been held primarily for the purpose of resale as part of a more or less systematic course of buying and selling. This factual similarity is so much more conspicuous than the legal distinction (*i.e.*, that a businessman is one who sells "to customers" whereas a speculator does not) ⁵⁸ that it is not surprising to find much hair-splitting as to the meaning of these magic words.

The many factors scrutinized in determining whether securities have been sold "to customers" ⁵⁹ are succinctly set forth in the case of *Achille O. Van Suetendael*.⁶⁰ Van Suetendael maintained an office in

54. See also Bachrach, *Advantageous Tax Positions in Securities Transactions*, 25 TAXES 720 (1947); Hogan, *The Capital Gains Tax*, 9 TAX MAG. 165, 166 (1931); Stone, *How the Capital Gains Tax Affects Buying and Selling Securities*, 26 TAXES 1041 (1948).

55. INT. REV. CODE § 117(a)(1).

56. See text at note 38 *supra*.

57. See note 31 *supra*.

58. This rather tenuous distinction is often overlooked. Cf. Beardsley Ruml in CAPITAL GAINS TAXATION 88 (Tax Institute Symposium, 1946): "It seems to me . . . that at Macy's when we buy some women's dresses to sell in six months or six weeks, that is speculation, if we want to use that horrid term."

59. If the statutory syntax is scrutinized closely, it may be interpreted as saying that the actual sale consummated by the taxpayer need not be to a "customer" so long as the property was previously held for the purpose of sale "to customers."

60. 3 T.C.M. 987 (1944), *aff'd*, 152 F.2d 654 (2d Cir. 1945).

Yonkers and had one employee. He had a teletype machine, four telephones, and statistical financial publications in his office. He was registered with the Securities and Exchange Commission and the State of New York as a security dealer, was listed as a "dealer" in certain publications, and advertised himself as willing to buy or sell securities. To a small degree he had participated in selling groups for the purpose of distributing new issues of securities. These are hardly the indicia of a "speculator" but rather connote a "business" in securities. Nevertheless the Tax Court held that Van Suetendael might deduct his losses on sales of securities, not to their full amount as business losses, but only to the extent permitted capital losses. In support of its finding that the taxpayer, although perhaps a "dealer,"⁶¹ had not held his securities "Primarily for sale to customers," the court emphasized that (1) his purchases were not at wholesale but "were in relatively small quantities and were diversified";⁶² (2) he was not a middleman selling to a class of persons unlike the class from whom he purchased,⁶³ but rather resold most of the securities "to or through the same brokers from whom they were bought";⁶⁴ and (3) his intention was not to create a stock of securities to take care of future buying orders in excess of selling orders⁶⁵ but to dispose of the securities "at a profit on the same day in which he purchased them or a short time thereafter."⁶⁶

61. "[W]hether he was engaged in business as a dealer in securities . . . is not the issue. . . .

"[T]here are many sales by so-called dealers in securities which do not come within the exceptions set forth in the definition of capital assets." *Achille O. Van Suetendael*, 3 T.C.M. 987, 992 (1944); *cf. Shafer v. Helvering*, 299 U.S. 171 (1936); *Helvering v. Vaughan*, 85 F.2d 497 (2d Cir. 1936), *cert. denied*, 299 U.S. 606 (1936); *Francis Shelton Farr*, 44 B.T.A. 683, 690 (1941); I.T. 3891, 1943-1 CUM. BULL. 69.

62. *Achille O. Van Suetendael*, 3 T.C.M. 987, 993 (1944): "We think it apparent that, in describing the excepted class by reference to the term 'customers,' Congress was characterizing not the vendee but the type of business." *Francis Shelton Farr*, 44 B.T.A. 683, 690 (1944).

63. *Seeley v. Helvering*, 77 F.2d 323 (2d Cir. 1935).

64. *Achille O. Van Suetendael*, 3 T.C.M. 987, 993 (1944). In *Trading Associates Corporation v. Magruder*, 112 F.2d 779 (4th Cir. 1940), this same criterion was applied in determining that a corporation was not exempt under § 351(b)(1)(A) as a "regular dealer in stock or securities" from the surtax imposed upon personal holding companies by § 351(a) of the Revenue Act of 1934, 48 STAT. 751 (1934); it employed no salesmen and was not actually dealing with the general public in the purchase and sale of securities but merely bought and sold stock for speculation on its own account through one firm of brokers. *Id.* at 781. It has been suggested that one is not in the "business" of "dealing" with "customers" as a securities "merchant" if he has no "regular clientele." *Sack, Profit and Loss from the Sale or Exchange of Securities*, 18 TAXES 152, 156 (1940).

65. *Schafer v. Helvering*, 299 U.S. 171, 174 (1936).

66. *Achille O. Van Suetendael*, 3 T.C.M. 987, 993 (1944). Some of the securities purchased through the two brokerage houses were not delivered to petitioner but were

The *Van Suetendael* and similar decisions⁶⁷ may well represent Pyrrhic victories for the Commissioner. By narrowly construing the category of persons in the securities business, they made it possible for taxpayers such as Mr. Van Suetendael to pay no more than a 25% tax upon the high volume of long-term profits which resulted from the coming of World War II and the attendant upswing in the stock market.⁶⁸ Thus have the courts intensified the artificial⁶⁹ distinction made by Congress.

Although the criteria set forth in the *Van Suetendael* opinion are typical of the decisions involving sales of securities, several securities cases significantly fail to apply these criteria.⁷⁰ By broadening the interpretation of "sale to customers," these cases afford a possible mode of escape from the anomalous consequences of a statute which, by singling out one particular type of business,⁷¹ implies that neither the gains nor the losses to which it gives rise affect ability to pay taxes as much as gains or losses of equal amount realized in any other line of endeavor. There is, however, at least one outside limit to the process of restricting the category of capital gains and losses by enlarging the meaning of "property held primarily for sale to customers." Because the words "to customers" were inserted in the statute to distinguish professional traders in securities from dealers in securities,⁷² the courts can not very well say that any purchaser of securities is a "customer"⁷³ and thus, by depriving that term of all effect, defeat the unmistakable

kept by the brokers. "In this respect, his operations were similar to a trader purchasing securities on margin." *Id.* at 993.

67. *Shafer v. Helvering*, 299 U.S. 171 (1936); *Trading Associates Corporation v. Magruder*, 112 F.2d 779 (4th Cir. 1940); *Helvering v. Vaughan*, 85 F.2d 497 (2d Cir. 1936), *cert. denied*, 299 U.S. 606 (1936); *Seeley v. Helvering*, 77 F.2d 323 (2d Cir. 1935); *Francis Shelton Farr*, 44 B.T.A. 683 (1941).

68. "If the situation here had been the other way around, that is to say, if the transaction had resulted in gains instead of losses, it would not be surprising to find the Commissioner occupying the position now championed by the taxpayer and vice versa. So things are apt to go in the domain of tax litigation." *United States v. Chinook Investment Co.*, 136 F.2d 984, 985 (9th Cir. 1943).

69. "[T]he difference between buying and selling as a business and doing so as an investment avocation is rather artificial." GROVES, *POSTWAR TAXATION AND ECONOMIC PROGRESS* 217 (1946). *Cf.* GROVES IN *CAPITAL GAINS TAXATION* 17 (Tax Institute Symposium, 1946).

70. *United States v. Chinook Investment Co.*, 136 F.2d 984 (9th Cir. 1943); *Harry Dunitz*, 7 T.C. 672 (1946); *cf.*, *Gilbert v. Commissioner*, 56 F.2d 361 (1st Cir. 1932), *reversing* 21 B.T.A. 1245 (1931); *Joe B. Fortson*, 47 B.T.A. 158 (1942); *Hercules Motor Corp.*, 40 B.T.A. 999 (1939).

71. See note 31 *supra*.

72. See notes 37 and 38 *supra*.

73. Compare: "Where, as here, one is regularly engaged in the business of buying and selling real estate, as was petitioner, any person who can be found to buy such property is a customer, as that term is ordinarily understood. . . ." *Charles H. Black, Sr.*, 45 B.T.A. 204, 210 (1941).

legislative intent. Congressional purpose, however, is no obstacle to the employment of a broader interpretation of "sale to customers" in connection with property other than securities.

"There has . . . been no disposition in the cases to carry this distinction over to the real estate field and to create a class of real estate 'trader' who is engaged in the business of buying and selling real estate, but who is not a dealer because he does not sell 'to customers in the ordinary course' of his business. . . . The thought underlying the real estate decisions may be that sales of real property are, because of the uniqueness of each property, personalized from the viewpoint of the buyer, thus constituting him a 'customer' of the business. On the other hand, the trader who is engaged in the business of selling securities over an exchange offers a fungible commodity to an anonymous group of bidders, so that the sale of a particular security by the trader to any particular buyer is impersonalized almost to the point of coincidence; the buyer would just as readily have taken an identical security from any other seller, and therefore cannot be said to be a 'customer' of the particular trader." ⁷⁴

It should be noted that this hypothesis is inconsistent with cases holding that the sale of a patent by an inventor is not "to customers" even though the vendor has close personal contacts with the vendee and the property sold is the most "non-fungible" imaginable.⁷⁵ It is in these cases—which concern not the business versus speculation problem but the business versus investment problem—that one can never tell when "sale to customers" will evoke in the judge's mind the image of the neighborhood grocer and Mrs. Jones,⁷⁶ with utterly fantastic tax consequences. The ensuing sections will show that the "customers" concept, enacted as a means of separating dealers from professional speculators, operates in many other areas as a dangerous roving element whose path is unpredictable and whose impact may shatter equity.

III. THE DISTINCTION BETWEEN BUSINESS AND INVESTMENT—HOW THE "TRADE OR BUSINESS" CLAUSE APPLIES TO SALES OF PATENTS BY INVENTORS

Having indicated the principal criteria by which the tax law attempts to distinguish between investment and speculation and between speculation and business, there remains the task of tracing the blurred and convoluted line which has been drawn between business and investment, or, in terms of the statute, between those transactions which

74. Fink, *"Dealing" in Real Estate*, 2 TAX L. REV. 111, 114-115 (1946).

75. William M. Kelly, 6 T.C.M. 646 (1947); Lester T. Barlow, P-H 1943 TC MELL. DEC. ¶ 43,237. See discussion of patent cases in Section III *infra*.

76. "The analogy to groceries is particularly strong." Groves in CAPITAL GAINS TAXATION 17 (Tax Institute Symposium, 1946).

give rise to ordinary income and fully deductible loss, and those—other than long-term speculation—which give rise to capital gain and loss. This boundary is largely spelled out of the “trade or business” clause. Its contours are tortuous partly because this deceptively simple clause is applied to diverse factual situations, partly because it embodies not one but several overlapping criteria. In order to elucidate the interaction of these two sets of factors, factual and legal, the present Section endeavors to study the various criteria inherent in the statute as they operate in a narrow field: the sale of patents by inventors. By thus isolating the component elements of the “trade or business” clause, the present Section serves as a convenient introduction to the following Section which examines the application of this clause to a great variety of factual situations for the purpose of determining how well the statutory scheme does its job of segregating investment from business.

A. The Requirement of Repeated Transactions

Under what circumstances will the sale⁷⁷ of a patented invention by its inventor generate capital gain because it is not a sale of “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business”? Most of the judicial opinions which address themselves to this question purport to answer it by comparing the facts of the case at bar with those found in the case of *Harold T. Avery*.⁷⁸ Avery, the chief engineer of a manufacturing corporation, was required by contract to assign to his employer any inventions he might make while directing its experimental work, except for about a dozen inventions conceived before his employment commenced. In 1935 Avery sold to the corporation one of the dozen inventions. Before this sale, he had sold two patents and licensed two others out of the dozen. The Board of Tax Appeals held that the proceeds of sale in 1935 were not capital gain.

“[P]etitioner was engaged outside of his regular hours of employment in the business of inventing and selling and licensing of patents obtained by him. . . . [T]he inventions and patents which he was not contractually obligated to transfer to his employer constituted property held by him ‘primarily for sale to customers in the ordinary course of trade or business.’ ”⁷⁹

77. See note 2 *supra*. Concerning the distinction between sales and licensing agreements, see Edward C. Meyers, 6 T.C. 258 (1946). But see MIM. 6490, issued March 20, 1950, 5 CCH 1950 FED. TAX REP. ¶ 6095 (T.C. 1950).

78. 47 B.T.A. 538 (1942).

79. *Id.* at 541. In *Goldsmith v. Commissioner*, 143 F.2d 466 (2d Cir. 1944), Judge Learned Hand cited the *Avery* case with approval and said: “I can find nothing in the history of the legislation which intimates the contrary of this construction.”

The *Avery* case is to be contrasted with the case of John W. Hogg,⁸⁰ a clerk employed in a non-inventive capacity in an engineering department. Mr. Hogg invented several devices by working about four hours each week at night in his basement. Over twenty years he took out four patents. In 1937 he licensed one of them to an airplane manufacturer. In 1940 he sold this patent to the licensee. The Tax Court decided that Mr. Hogg had realized only capital gain because an isolated sale did not constitute a "course of business."⁸¹

In common parlance, Mr. Hogg could hardly be said to have been "in business," since that term connotes repeated transactions, and the entire extent of his dealings was to license a single patent and then sell it. Yet is this result really as self-evident as it appears at first blush? After all, if Mr. Hogg was not in business, what was he doing when he was tinkering down in the basement in his spare time? If his activity were only a hobby, it is fair to ask, as did the Board in the *Avery* case, why did he trouble himself to patent his inventions?⁸² Suppose that Mr. Hogg subsequently found purchasers for his three other patents; presumably the repetition of the sale would cause a finding that he had gone into "business"⁸³ and therefore that his profits were no longer taxable merely as capital gain. Yet is it not strange that one of the sales, identical with the others except that it happened first, should receive a different tax treatment? This anomaly springs from the conception of "business" as a series of recurrent dealings.⁸⁴ But why should "business" be defined in this way? There is no reason to suppose that Hogg's first sale gave rise to a lesser ability to pay than did *Avery*'s third. Whatever may be the validity of discriminating in favor of gain arising upon a change in the form of investments,⁸⁵ the invention sold by Hogg hardly presents a very close analogy to the corporate stock or real estate sold by the typical investor.

Assuming that Mr. Hogg and Mr. *Avery* are so similarly circumstanced that they should be taxed similarly, the question arises whether parity of treatment could be established under any reasonable interpretation of the present statute. Section 117(a) contains no definition

80. John W. Hogg, P-H 1944 TC MEM. DEC. ¶44,066 (1944).

81. The *Avery* case was distinguished on the ground that *Avery* was a "professional inventor" whereas Hogg was only a clerk. Since in both cases the inventions were not made in the course of the taxpayer's employment, the nature of that employment would seem to have little relevance to the characterization of his outside activities.

82. Harold T. *Avery*, 47 B.T.A. 538, 541 (1942).

83. *Avery* was held to be "in business" upon making his third sale.

84. This conception furnished the theoretical basis of the much publicized ruling of the Bureau of Internal Revenue that, as an "amateur" writer, General Dwight D. Eisenhower realized long-term capital gain rather than ordinary income upon the sale of the copyright to his memoirs. Fulda, *Copyright Assignments and the Capital Gains Tax*, 58 YALE L.J. 245 n.1 (1949).

85. See discussion in Section VI *infra*.

of the phrase "trade or business."⁸⁶ In passing upon the validity of the Federal Corporate Excise Tax of 1909 in *Flint v. Stone Tracy Co.*,⁸⁷ the Supreme Court defined this phrase as "that which occupies the time, attention and labor of men for the purpose of a livelihood or profit." "Business" is a very comprehensive term and embraces everything about which a person can be employed."⁸⁸ This characterization contains no suggestion that profits are not business profits if they are not recurrent. However, in *Higgins v. Commissioner*,⁸⁹ construing the statutory provision permitting the deduction of ordinary and necessary expenses incurred in the carrying on of a "trade or business"⁹⁰ the same Court considered its previous definition of the phrase inappropriate.⁹¹ In *United States v. Wooten*, the Court of Appeals for the Fifth Circuit held that the *Higgins* interpretation of "trade or business" in connection with the expense deduction was to be applied to the same phrase when used in the exclusionary clause of the definition of capital assets.⁹² It would appear, therefore, that the broad definition of "trade or business" contained in *Flint v. Stone Tracy* is not readily applied in the interpretation of Section 117.⁹³

The opinion of the Board of Tax appeals in the case of *Samuel Diescher*⁹⁴ is typical of those in which "trade or business" is construed to mean recurrent transactions. Mr. Diescher was unquestionably in business as a member of a partnership of consulting engineers engaged in the inventing, patenting, and licensing of various processes and devices. The partnership realized a recognized⁹⁵ gain of some

86. Nor is the phrase defined as used in other sections of the Code, *e.g.*, § 23(k) (4) on bad debts and § 122(d) (5) on net operating loss deductions. See Friedman, *Bad Debts: Business or Non-Business?* 5 TAX L. REV. 412 (1950).

87. 220 U.S. 107 (1911).

88. *Id.* at 171.

89. 312 U.S. 212 (1941).

90. Revenue Act of 1932, § 23(a), 47 STAT. 179 (1932).

91. "The immediate issue [in the *Flint* case] was whether corporations engaged principally in the holding and management of real estate were subject to the [Corporation Tax law which levies a tax on corporations engaged in business]. A definition given for such an issue is not controlling in this dissimilar inquiry." *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941).

92. *United States v. Wooten*, 132 F.2d 400 (5th Cir. 1942): "While the wording of the sections [23(e) (1) and (2) and 117(a) (1) (b) and (d) of the Revenue Act of 1932] with respect to engaging in and carrying on a business is slightly different [from that of 23(a) of the same Revenue Act construed in *Higgins v. Commissioner*], their meaning is the same, and what is said in *Higgins v. Commissioner*, defining 'carrying on a business' is controlling here." *Id.* at 402.

93. The *Flint v. Stone Tracy* definition of "trade or business" was, however, quoted with approval in *Fackler v. Commission*, 133 F.2d 509 (6th Cir. 1943) holding that rented real estate was "used in a trade or business" rather than a capital asset. See also discussion of *Goldsmith v. Commissioner*, notes 101 and 102 *infra*.

94. 36 B.T.A. 732 (1937), *aff'd*, 110 F.2d 90 (3d Cir. 1940).

95. The transaction did not meet the requirements for non-recognition imposed by INT. REV. CODE §§ 112(b) (5) and 112(c) (1).

\$250,000 upon the assignment of certain patents to a newly organized corporation. In holding that Mr. Diescher's share of this sum was taxable as capital gain, the Board of Tax Appeals remarked: "It is evident that the patents and inventions here in dispute did not constitute stock in trade, held for sale by the partnership in the course of its business."⁹⁵ This reference to stock in trade suggests that the Board interpreted the clause found in the 1932 statute, "property held primarily for sale in the course of the trade or business of the taxpayer," to mean precisely the same as, and no more than, the two preceding clauses—excluding inventory and stock in trade from the capital asset category⁹⁷—both of which connote repeated sales.

In *Gilbert v. Commissioner*,⁹⁸ decided five years before the *Diescher* case, this interpretation had been rejected by the Circuit Court of Appeals for the First Circuit:

"The difficulty with this view is that it gives no effect whatever to the provision under discussion. It is a well-settled rule of construction that a statute should, if possible, be so construed as to give meaning to all parts of it. Stock in trade and inventory property having been covered by the first two classifications, the final provision was evidently intended to cover something else. It included in our opinion all property which was owned by the taxpayer in connection with his business and held primarily for sale, but which was not stock in trade or part of the inventory. This was the understanding of the matter by the Ways and Means Committee as appears by its report to the House of Representatives on the 1924 Act when clause (8) received its present form. '(2) The last part of the definition of capital assets is changed to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory.'"⁹⁹

By adding the italicized words—"property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"—Section 117 (b) of the Revenue Act of 1934¹⁰⁰ made possible the argument that, by this amendment, Congress made the clause

96. Samuel Diescher, 36 B.T.A. 732, 743 (1937).

97. "Capital assets" . . . does not include 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. . . . Revenue Act of 1932, § 101(c) (8), 47 STAT. 192 (1932).

98. 56 F.2d 361 (1st Cir. 1932), reversing 21 B.T.A. 1245 (1931).

99. *Id.* at 362, quoting H.R. REP. No. 179, 68th Cong., 1st Sess. 19 (1923). Arthur J. Hogan states that the enactment of the "trade or business" clause in 1924 "was not a widely heralded change and no one seems to have regarded it as of any great significance at that time." Hogan, *The Capital Gains Tax*, 9 TAX MAG. 165, 167 (1931).

100. 48 STAT. 714 (1934).

synonymous with the two preceding exclusionary categories. This argument was rejected by Judge Learned Hand concurring in *Goldsmith v. Commissioner*:¹⁰¹

"[T]here may be also goods which are neither 'stock in trade' nor of a kind which would ordinarily be inventoried. Nevertheless, the business may consist of selling goods in 'ordinary course,' to those whose custom the taxpayer seeks, and these are his 'customers.' That the purpose of Congress was also not to treat such transactions as 'capital gains and losses' is patent."¹⁰²

The fact of recurrent transactions has also received undue emphasis in the administration of the British income tax.¹⁰³ Schedule D has long authorized the taxation of "'the annual profits or gains arising or accruing . . . from any property whatever . . . or from any trade, profession, employment or vocation.'" This language can be interpreted as excluding "profits from casual transactions not in the course of a trade."¹⁰⁴ However, in a much-quoted report issued in 1920, a Royal Commission on the Income Tax championed the view that, although—

101. 143 F.2d 466 (2d Cir. 1944). Mr. Goldsmith, the author of a single stage play, "spent his time in exploiting it in various ways," *e.g.*, adapting it for radio broadcasting. Judge Hand found that Goldsmith was "in 'business' as a playwright" and that the grant of movie rights by him to Paramount Pictures constituted a sale of property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

102. *Id.* at 468. The paragraph continues: "Although each transaction is the sale of 'property held by the taxpayer,' it is not considered as separate, but the transactions are all massed together for tax purposes as a single source of ordinary income, quite as though the taxpayer were giving his services for hire upon separate occasions. How numerous such transactions must be the statute answers only by the test that collectively they must constitute a 'trade or business.'" It would seem therefore, that where a man's main occupation is the exploitation of his "brainchild," his profit upon its sale is to be taxed as ordinary income, regardless of the absence of an "ordinary course" of preceding sales or of a prior intention to hold the property "primarily for sale."

With reference to § 23(a)(1) of the statute authorizing the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," Justice Cardozo remarked: "Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. . . . [A situation may be] unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part." *Welch v. Helvering*, 290 U.S. 111, 113-114 (1933).

103. "The British have the time-honored practice of disregarding casual income and rating a taxpayer for income tax purposes according to his *regular* receipts. This seems to be one of those anomalous institutions with which British life abounds—about as plausible as the British House of Lords." GROVES, *TROUBLE SPOTS IN TAXATION* 65 (1948).

104. MAGILL, *TAXABLE INCOME* 84 (1945). *Cf.* GROVES, *POSTWAR TAXATION AND ECONOMIC PROGRESS* 207-11 (1946).

"Profits that arise from ordinary changes of investment should normally remain outside the scope of the tax . . . any profit made on a transaction recognizable as a business transaction, *i.e.*, a transaction in which the subject matter was acquired with a view to profit-seeking, should be brought within the scope of the Income Tax, and should not be treated as an accretion of capital simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly or at short intervals."¹⁰⁵

Following this report, the British courts have tended to construe the exemption of capital gains narrowly¹⁰⁶ and have imposed progressive income tax rates upon the profits of numerous non-recurrent transactions which would qualify for capital gains treatment under American law.¹⁰⁷

B. The "Held Primarily for Sale" Requirement

Although an invention need not have constituted stock in trade to be excluded from the capital asset category under the "trade or business" clause, it must have been "held primarily for sale." It was the absence of this element, rather than the absence of repeated sales, which controlled the *Diescher* case:

"So far as we know, the patents involved here are the first which the partnership ever sold, although it has been in business for many years. All of the other transactions having to do with the patents of the partnership have been connected with the licensing of their use."¹⁰⁸

As the "trade or business" clause refers to property "held primarily for sale," the Board reasoned that it does not apply to property held for licensing or for any purpose other than sale.¹⁰⁹ Although this retro-

105. REPORT OF THE ROYAL COMMISSION ON THE INCOME TAX, CMD. NO. 615, §§ 90, 91 (1920); Note, 52 YALE L.J. 400 (1943).

106. MAGILL, TAXABLE INCOME 82-103 (1945). Lachs, *Income Taxation of Capital Profits*, 6 MOD. L.R. 148 (1943); May, *The British Treatment of Capital Gains*, 73 J. ACCOUNTANCY 505 (1942); *Accretions of Capital or Income Receipts*, 76 L.T. 85 (July 29, 1933). But see *Withers v. Nethersole*, 1 All E.R. 400 (1948), discussed in *Commissioner v. Wodehouse*, 337 U.S. 369, 422 (1949).

107. When the British scheme was proposed to a congressional committee in 1927, it was rejected on the ground that: "The distinction between trader and nontrader is not a desirable one to incorporate into our law." REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 47 (1927). Cf. Haig, *Taxation of Capital Gains*, Wall Street Journal, March 25, 1937, p. 6; Paul, *supra* note 23, Exhibit 6; GROVES, POSTWAR TAXATION AND ECONOMIC PROGRESS, 209-10 (1946).

108. See 36 B.T.A. 732, 734 (1937), *aff'd*, 110 F.2d 90 (3d Cir. 1940). Because the patents were depreciable property used in the trade or business of licensing, their sale would, under present law, give rise to capital gain under INT. REV. CODE § 117(j).

109. Cf. *Edward C. Meyers*, 6 T.C. 258 (1946); *Leo P. Curtin*, 6 T.C.M. 457 (1947).

spective process is what the statute seems to command, one may well question the relevance of the taxpayer's original intention to license his patent, after he has changed his mind and has in fact obtained profit from it by sale rather than by licensing.¹¹⁰ There having been a sale, it seems strange that the tax consequences of this event should depend, not upon an examination of the measurable change it brought about in the seller's financial capacity, but upon the uses to which the property was put before it was sold.

C. The "Sale to Customers" Requirement

Even if an inventor holds his patent "primarily for sale," it does not follow that his profit on its sale will be taxed as ordinary income. In the case of *William M. Kelly*,¹¹¹ the Tax Court found that the taxpayer-inventor had held his patents "primarily for sale"¹¹² but decided that the sale was not "to customers." "[A]t no time did petitioner ever attempt to sell or license his patents to anyone other than the corporation which employed him. . . . He was not, as to all his later inventions and improvements, free to sell them to any customer" because of his contract to assign all his inventions to his employer.¹¹³ Hence the patents did not constitute "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

It would indeed be an extraordinary phenomenon if the words "to customers," inserted in the statute for the single express purpose of restricting the loss deductions of professional speculators in securities,¹¹⁴

110. Under the particular facts of the *Diescher* case, where the "buyer" corporation represents substantially the same interests as the "seller" partnership, this argument has less strength than in the more usual situation where the buyer is a stranger.

111. 6 T.C.M. 646 (1947).

112. This finding was necessary to the Tax Court's conclusion that the patents were not excluded from the capital asset category as "property . . . used in the trade or business, of a character which is subject to the allowance for depreciation provided in § 23(1)." INT. REV. CODE § 117(a)(1). "Section 23(1) of the Code provides a reasonable allowance for the exhaustion, wear and tear, only of property used in the trade or business, or held for the production of income. Property held primarily for sale is not, therefore, subject to an allowance for depreciation. There is no suggestion in the record that petitioner used these patents in any business of his own or held them . . . for the production of income. Hence they are not excluded from the category of capital assets by virtue of being depreciable." *William M. Kelly*, 6 T.C.M. 646, 649 (1947). Cf. *James H. Adamson*, 5 T.C.M. 1071 (1946), *aff'd*, 161 F.2d 942 (9th Cir. 1947). Since the enactment of INT. REV. CODE § 117(j) in 1942, the sale of depreciable business property held for more than six months gives rise either to capital gain or ordinary loss.

113. 6 T.C.M. 1071 (1946). Similarly, *Avery* was obliged by his employment contract to assign his later inventions to his employer; nevertheless when he sold his employer an invention not covered by the contract, it was held that the employer was a "customer." Of *Avery's* two previous sales, one was to his employer and one to an outsider. *Harold T. Avery*, 47 B.T.A. 538, 542 (1942).

114. See discussion in Section I *supra*.

were the cause of an inventor's income being taxed at capital gain rates. The *Kelly* decision, however, could have been reached without the "customers" argument since Mr. Kelly had not been engaged in a continuing course of selling. Hence it would seem that, at least in patent cases, the concept of a sale "to customers" does little more than restate the requirements that "business" involve the execution of repeated transactions and that these transactions must be sales.

D. The Overlapping of the Requirements

The preceding cases on sales of patents by their inventors serve to demonstrate that the words "property held primarily for sale to customers in the ordinary course of trade or business" embody not one but a whole series of capital gain tests. Thus, in the course of a Tax Court decision¹¹⁵ taxing as capital gain an award made to the taxpayer for patent infringement most of these overlapping criteria were invoked. Notwithstanding its finding that the taxpayer had been "engaged since 1910 in the business of inventing, developing, and exploiting inventions for profit," the Tax Court reasoned:

"The evidence shows, however, that Barlow was not in the business of selling¹¹⁶ inventions or patents. He had no 'customers' in an ordinary course of business. Of his many and various inventions, he sold only the drop bomb invention in 1917 [and one other] not in the ordinary course of business, but because of special circumstances. In view of the careful definition of the term capital assets in Section 117(a) (1), it is not permissible to exclude patents or inventions which are not held for sale to customers, but only licensed by one who is in business as an inventor and derives gain from giving licenses on his inventions."¹¹⁷

115. Lester T. Barlow, P-H 1943 TC MEM. DEC. ¶43,237. Barlow invented a drop bomb in the summer of 1914. In 1917 he sold all his rights under the invention to Marlin (who became the original patentee) in consideration of \$50,000 cash and 49% of the profits or royalties. In 1923 Marlin went into receivership and in settlement of Barlow's rights under the 1917 contract of sale, Marlin assigned to Barlow the invention, the patent rights, and Marlin's claim against the United States for infringement or "for use of the invention." In 1940 Barlow received \$296,359.60 from the United States in partial payment of an award made by the Court of Claims. Barlow's cost for the invention was zero. It was held that the award from the United States was taxable as long-term capital gain.

116. The Tax Court admitted: "The decision in *Harold T. Avery*, 47 B.T.A. 538, contains language suggesting that one who holds patents which he licenses to others at a profit may for that reason be denied the capital gain provision." Lester T. Barlow P-H 1943 TC MEM. DEC. ¶43,237, pp. 43-761, 43-762. What the *Avery* opinion said was: "Until disposed of, his patents were held primarily for sale or other disposition to customers." 47 B.T.A. 538, 542. This statement was dismissed as a dictum by the *Barlow* opinion, apparently because *Avery* had been found to be in the business of selling. Yet it is at least arguable that *Avery* had not held his patents "primarily" for sale because he had licensed just as many as he had sold prior to the sale in issue.

117. Nevertheless, the Commissioner continues to resist inventors who claim the

To the cumulative effect of all these arguments, the reader must nod his head in assent—until he pauses to consider just what is being done. A statutory provision, supposedly justified by the desirability of special tax treatment for “investment,” has been employed to reduce the taxes of a man who cannot possibly be considered an “investor.” Perhaps it is in the public interest to offer special tax incentives to inventors. Yet it is hard to see how such a policy can be invoked to justify the application of the present capital gains provisions which capriciously confer a “subsidy” on some inventors but withhold it from others because of the operation of such irrelevant factors as “sale to customers,” “course of business,” and “held primarily for sale.” Such fantastic tax consequences suggest that the validity of the present treatment of capital gains should be re-evaluated, not only in terms of the abstract theorizing that is usually put forward to justify it,¹¹⁸ but also in the light of how the law operates in practice.¹¹⁹ It is the purpose of the next Section to examine the workings of the various concepts latent within the “trade or business” clause in a wide variety of factual situations more commonplace than the sale of a patent by an inventor. From this survey it will be possible to draw conclusions as to just how well the present law succeeds in doing what it purports to do—to segregate “investment” from “business.”

IV. THE DISTINCTION BETWEEN BUSINESS AND INVESTMENT—HOW WELL IT IS EFFECTUATED BY THE “TRADE OR BUSINESS” CLAUSE

In order to estimate how well the “trade or business” clause distinguishes between “business” and “investment,” it is necessary first to consider the import of these terms. The word “investment” has innumerable connotations. To define it as the holding of property for the enjoyment of a more or less periodic yield may serve to distinguish it from “speculation,” but when contrasted with “business,”

benefit of the long-term capital gains treatment. His intransigence is attributable, at least in part, to the fact that the typical inventor holds his patent at a low cost basis so that loss is seldom realized upon its sale. If patents held by inventors were removed from the capital asset category, the increased revenue collected from successful inventors would not be offset to any appreciable extent by the increased loss deductions which would then be permitted to unsuccessful inventors. Another factor conducive to continuing litigation is the constant flow of new decisions which, in applying section 117 to sales of corporate securities, real estates, etc., contain language inconsistent with that used in the patent cases, *e.g.*, “Nor is it fatal that those to whom the sales were made were not regular or recurrent patrons. The subject matter of the sale was not conducive to repetition.” J. L. Greene, P-H 1942 BTA and TC MEM. DEC. ¶ 42,582, 42-1505 (sale of oil properties).

118. See Section VI *infra*.

119. Cf. Lowndes, *The Taxation of Capital Gains and Losses under the Federal Income Tax*, 26 TEXAS L. REV. 440, 441, 454 (1948).

such a definition is altogether inadequate.¹²⁰ Thus the entrepreneur may speak of plant, machinery, and even inventory as representing his "investment"; yet such assets are very different from his Government bonds, characterized as "investments" by his accountant, which produce periodic income without any productive activity by their owner. The holder of a few shares of General Motors is seldom regarded as being in the automobile business; yet it is hard to discover the precise point at which to draw the line between him and the local shopkeeper who incorporates.

A. *Is Busyness Business?*

It has been suggested that the "test of being in business . . . must be broadly the amount of time and attention that you give to the particular type of activity."¹²¹ This test has received judicial approval:

"This taxpayer must, to defeat his claim to a capital gains rate, have been in the business of selling his lands. An occasional sale of land held as an investment is not such a business though profit results. The word, notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation. It need not be one's sole occupation, nor take all his time.¹²² It ordinarily is implied that one's own attention and effort are involved, but the maxim *qui facit per alium facit per se* applies, and one may carry on a business through agents whom he supervises."¹²³

Although this approach is orthodox in cases involving sales of real estate, it has been decreed heresy where securities are involved. In *Higgins v. Commissioner*,¹²⁴ the Supreme Court held that the statutory provision permitting the deduction of "expenses paid or incurred in carrying on any trade or business"¹²⁵ did not apply to the substantial outlays made by the taxpayer in looking after his investments in securities.¹²⁶ Mr. Higgins had resided in France but "by cable, telephone,

120. For example, the courts have said that "property originally acquired for purposes of resale at a profit," was not necessarily excluded from the investment category; its "resale by the taxpayer does not of itself give the taxpayer the status of one being in the real estate business." *Phipps v. Commissioner*, 54 F.2d 469 (2d Cir. 1931). Cf. *Harriss v. Commissioner*, 143 F.2d 279, 280, 281 (2d Cir. 1944). Similarly, the possibility of "holding an investment for sale" is contrasted with business in *Boomhower v. United States*, 74 F. Supp. 997, 1004 (N.D. Iowa 1947).

121. Eustace Seligman in *CAPITAL GAINS TAXATION* 45 (Tax Institute Symposium, 1946).

122. Cf., e.g., *Snyder v. Commissioner*, 295 U.S. 134, 138 (1935) and other cases too numerous for citation.

123. *Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938).

124. 312 U.S. 212 (1941).

125. NOW INT. REV. CODE § 23(a) (1).

126. "The line comes between those who are in the position of passive investors, doing

and mail . . . kept a watchful eye over his securities" and over his New York and Paris offices which "kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports. . . . He sought permanent investments . . ." rather than speculative profits, changes in his portfolio being attributable to redemptions, maturities, and the like. Despite the real estate cases supporting Mr. Higgins' contention that "the 'elements of continuity, constant repetition, regularity and extent' differentiate his activities from the occasional like actions of the small investor" so as to constitute "carrying on business," ¹²⁷ the Court upheld the Commissioner who insisted that "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or one's employees' time they may occupy." ¹²⁸

Although the *Higgins* case has relevance to the present discussion because a later case ¹²⁹ has said that this interpretation of "trade or business" is applicable, not only to the deduction of expenses, but also to the definition of capital assets,¹³⁰ the really significant aspect of this decision lies in the fact that Section 23(a) which provides for the deduction of expenses does not qualify the term "business" with "held primarily for sale to customers" as does the present Section 117 which defines capital assets. Thus it was not the statute but only the powerful connotations of the word "business" which led the Court to subject Mr. Higgins to an unjust tax on his gross income by denying him the right to offset his dividend and interest income with his outlay in securing that income. It is the very preposterousness of this result, promptly overruled by statute,¹³¹ that highlights the tremendous force of the concept which dominated the Court's thinking, *i.e.*, that there cannot be such a thing as a business of investing in securities.

only what is necessary from an investment point of view, and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business." *Foss v. Commissioner*, 75 F.2d 326, 328 (1st Cir. 1935). *Cf. Miller v. Commissioner*, 102 F.2d 476, 479 (9th Cir. 1939); *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929).

127. "From the cases [on sales of real estate] it would appear that the facts necessary to create the status of one engaged in 'trade or business' revolve largely around the frequency or continuity of the transactions claimed to result in a 'business' status." *Commissioner v. Boeing*, 106 F.2d 305, 309 (9th Cir. 1939).

128. *Higgins v. Commissioner*, 312 U.S. 212, 215 (1941). The words are the Commissioner's.

129. *United States v. Wooten*, 132 F.2d 400, 402 (5th Cir. 1942).

130. Any sales by Higgins would, of course, generate capital, rather than ordinary, gains and losses under the criteria set forth in *Achille O. Van Suetendaël*, 3 T.C.M. 987 (1944), *aff'd*, 152 F.2d 654 (2d Cir. 1945), discussed on pages 848-9 *supra*.

131. Revenue Act of 1942, § 121(a), 56 STAT. 819 (1942), added INT. REV. CODE § 23(a)(2) providing for the deduction of "expenses paid or incurred . . . for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

B. Is Business Busyness?

The *Higgins* decision suggests that even a large "amount of time and attention" ¹³² is by itself insufficient to characterize economic behavior as "business" rather than as "investment." Cases like *Brown v. Commissioner* ¹³³ show that an utter absence of any personal expenditure of "time and attention" does not prevent the taxpayer from being classified as engaged in "business" rather than investment. Upon her husband's death in 1928 Mrs. Brown received as his sole asset his community property interest in 500 acres of unimproved grazing land covered by a mortgage held by a bank. The bank demanded payment and so, early in 1929, Mrs. Brown listed the land for sale with a licensed real estate broker. Having failed to sell the tract after eight years, the broker began to subdivide it with Mrs. Brown's consent, having streets cleared, sewers, gas, and electric lines constructed, etc. The proceeds from sale of the lots from 1937 through 1939 were held taxable as ordinary income and not as capital gain.

"While the petitioner did not personally conduct the business of selling lots, she did conduct it through another. . . . Her sales were not isolated transactions; neither were they casual rather than continuing. They were substantial and frequent. . . ." ¹³⁴

It is at once apparent that the facts of Mr. Higgins' case exhibit many indicia of "business" not present in Mrs. Brown's case. Mr. Higgins was to some extent personally occupied; Mrs. Brown did not even exercise that supervision with which the *Snell* opinion ¹³⁵ qualifies the doing of business through agents.¹³⁶ Whereas he made purchases

132. See text at note 121 *supra*.

133. 143 F.2d 468 (5th Cir. 1944).

134. *Id.* at 470. Mrs. Brown's case is to be contrasted with that of Minnie Steinau Loewenburg, 7 T.C.M. 702 (1948), a widow who inherited from her husband a note secured by a mortgage on land which had already been subdivided and improved. After foreclosure and without making any further improvements, Mrs. Loewenburg sold several lots, at intervals of a year or two, to purchasers who came to her unsolicited and on their own initiative. The Tax Court held that she had realized capital gain and not ordinary income. Thus, merely because Mrs. Loewenburg acquired her land *after* it had been improved and sold the lots *slowly*, she was taxed differently than Mrs. Brown. *Cf.* Frieda E. J. Farley, 7 T.C. 198 (1946).

For a representative sampling of the hodgepodge of decisions on real estate sales, see *Boemhowe v. United States*, 74 F. Supp. 997 (N.D. Iowa 1947). *Cf.* Fink, "Dealing" in Real Estate, 2 TAX L. REV. 111 (1946).

135. See text at note 123 *supra*.

136. It is difficult to foretell just when the agency concept will be used to cancel out the "time and attention" concept. The *Brown* case may profitably be contrasted with *Reynolds v. Commissioner*, 155 F.2d 620 (1st Cir. 1946), *affirming* P-H 1945 TC MEM. DEC. ¶ 45,276. Along with other properties, Reynolds inherited \$523,000 worth of jewelry from his aunt. Like Mrs. Brown he employed an "agent," the Cartier jewelry firm, to "subdivide" his legacy. In 1940 he received \$3,500 upon an isolated sale of a necklace

as well as sales as part of a continuing procedure for making a living, she was merely liquidating a single asset acquired by bequest.¹³⁷

C. Is Business a Qualitative Concept?

If time and attention do not constitute business, what does? Cases like *United States v. Robinson*¹³⁸ suggest that business status depends less upon *how much* the seller does than upon *what* he does. Miss Robinson and her brothers and sisters formed a partnership to manage the extensive properties left to them by their father. The partnership carried on a substantial farm and ranch business and extensive oil, gas, and mineral leasing activities; it received a large rental income from 75 city houses and 140 tenant farms, and "carried on a money lending business larger than the two regular banks in the town." The firm also entered into several long term contracts to sell timber on its

valued at \$5,000 for estate tax purposes. It was held that his \$1,500 "loss" had resulted from a transaction entered into for profit within INT. REV. CODE § 23(e) (2), citing *Estelle G. Marx*, 5 T.C. 173 (1945), but that he might deduct it only to the extent permitted a capital loss, because of the Tax Court's finding that "in the management or liquidation of his own properties, including those acquired under his aunt's will, petitioner was not engaged in a trade or business." This result may be reconciled with the *Brown* case on the ground that Mr. Reynolds sold but one piece of jewelry whereas Mrs. Brown sold many building lots—and hence was engaged in a "course of business." Less easy to reconcile is the court's disposition of Mr. Reynold's contention "that the efforts of Cartier's to sell the jewelry, involving the efforts of fifteen or more persons, and including advertising, exhibiting and negotiating with possible purchasers, would have been a business if carried on by Cartier for its own account and is no less so because carried on for the account of the petitioner." The Tax Court responded: "Cartier is engaged in the jewelry business, regardless of its contract with petitioner. We do not agree that the owner of property placed with an agent for sale is thereby engaged in the same business as the agent." P-H 1945 TC MEM. DEC. ¶ 45,276, at 45-933.

Cf. *Pope v. Commissioner*, 77 F.2d 599 (6th Cir. 1935), in which the court refused to find that "a director and officer of a corporation, owning a substantial amount of its stock but not active in its affairs, is engaged in the business in which the corporation is engaged." *Id.* at 600.

137. "In effect, what the taxpayer was doing was to render more attractive a capital asset already owned, in order to sell it, in much the same way as an owner would paint and redecorate an old house, and landscape the grounds, in order that his broker could more readily dispose of it for him." *Fahs v. Crawford*, 161 F.2d 315, 317 (5th Cir. 1947). "In the present case the plaintiff found himself the owner of a tract which was unsaleable in its unplatted and unimproved condition. . . . Such improvement [as plaintiff made] only constituted the placing of the property in saleable condition and did not give him the status of one engaged in the real estate business." *Boomhower v. United States*, 74 F. Supp. 997, 1009 (N.D. Iowa 1947).

The *Brown* opinion, 143 F.2d 468 (5th Cir. 1944), follows the opposite approach, as does *Ehrman v. Commissioner*, 120 F.2d 607, 610 (9th Cir. 1941): "We fail to see that the reasons behind a person's entering a business—whether it is to make money or to liquidate—should be determinative of the question of whether or not the gains resulting from the sale are ordinary gains or capital gains. The sole question is—were the taxpayers in the business of subdividing real estate?"

138. 129 F.2d 297 (5th Cir. 1942).

lands to companies "engaged in the business of purchasing timber, cutting it into logs and lumber for sale to the public." The court held that Miss Robinson's share of the proceeds of these contracts for the sale of the timber was taxable only as capital gain. This result was subsequently codified in Section 117(k) of the Internal Revenue Code, providing for special treatment of timber sales.¹³⁹

Although Miss Robinson had no more to do with the sale of the timber than Mrs. Brown with the sale of the lots,¹⁴⁰ it would seem that she was no less in "business." The partnership of which Miss Robinson was a member was certainly engaged in a vigorous "course of business." Part of the business (farm and ranch) involved recurrent sales "to customers." The timber sold was apparently held "primarily for sale" rather than for any other purpose. Under conventional partnership law the business was conducted by "agents" of Miss Robinson. Nevertheless Miss Robinson's profit on the sale was held not to constitute business profit because "the partnership was not in the business of selling timber," *i.e.*, it had never sold timber before, and therefore "the timber sold was not held by it for sale to customers in the ordinary course of its trade or business."¹⁴¹ Had the partners decided to have the timber cut and marketed by some of their farm employees, Miss Robinson's share of any profit upon its sale would probably, under the pre-1942 statute, have been taxed as ordinary income,¹⁴² despite the

139. Added by Revenue Act of 1943, § 127(a), 58 STAT. 46 (1944).

140. The court found that Miss Robinson "is not and has never been personally engaged in any kind of business."

141. *Cf.* Isaac S. Peebles, Jr., 5 T.C. 14 (1945).

142. Thus in *Commissioner v. Boeing*, 106 F.2d 305 (9th Cir. 1939), the taxpayer had by inheritance and purchase acquired co-ownership of large tracts of timberland which he held "for investment purposes." Along with his co-owners he contracted to "employ" two logging companies which agreed to construct logging railroads, logging camps, and other necessary structures at their own expense, to cut and remove a minimum quantity of timber each year, to transport the timber and sell it to purchasers at the current market price, and to pay one-third of the gross proceeds to the owners. One of the contracts provided that title to all the logs was to remain in the owners at all times until sold and that the purchasers were to be billed separately for the amount due the owners to whom remittance was to be made directly. Although "the taxpayer gave practically no time or attention to the operations under these contracts during the taxable years involved," the court of appeals found that he was in the business of selling logs and reversed the Board of Tax Appeals which had held that he had realized mere capital gain and had reasoned that his sales were "casual," that there was "no continuous course of dealings with a group of regular buyers," and that the sales were "isolated transactions . . . involving merely casual buyers, as distinguished from 'customers.'"

Unable to hurdle the "trade or business" wall around the capital gain category, timber owners have nevertheless tunneled their way into the happy land. INT. REV. CODE § 117(k)(2) provides that timber held for more than six months may be disposed of at capital gain rates "under any form or type of contract by virtue of which the owner retains an economic interest in such timber," irrespective of whether the sale would generate ordinary business profit under the tests applied to sales of all other kinds of

absence of prior sales of timber.¹⁴³ Hence the decisive element appears to be the fact that Miss Robinson (like Mr. Higgins) did nothing to the property before she sold it, unlike Mrs. Brown who, through her agents, developed her land for sale. Thus it would seem that "business" status depends far less upon "the amount of time and attention" expended than it does upon the nature of "the particular type of activity,"¹⁴⁴ and that the distinction between business and investment is as much qualitative as quantitative.

This is implicit, not only in the *Higgins* case,¹⁴⁵ but also in the tests—set forth in the *Van Suetendael* case¹⁴⁶—for distinguishing the long-term profits of the securities merchant from those of the professional securities speculator who, like the investor, is treated as a seller of "capital assets." For example, the requirement that a true securities business involves buying at wholesale and selling at retail is much akin to the notion that a true timber business involves the cutting and marketing of timber by the seller, at least in the case of an isolated sale. In both cases the law refuses to find a business unless there is present what, for want of a better term, may be called an "economic transformation." However the analogy is incomplete. Whereas in the real estate field a large volume of sales of unaltered property may take the place of an "economic transformation," mere volume of sales can never replace the prerequisite of "economic transformation" necessary to the finding of a securities business.¹⁴⁷

The discrepancy between the rules applied in these two areas springs, of course, from the inevitable resort to common usage to determine what constitutes a "business" in any given field of activity. The *Robinson* case illustrates the futility of this enterprise. Because the timber sold by Miss Robinson was the first she had ever sold, and because it was not sawed, carted away and marketed by her own employees, timbermen would not consider her to be in the timber business. Yet it is patent that the change in Miss Robinson's economic position was

property. Such legislative favoritism does not imply that the prior judicial interpretations of § 117(a) were erroneous but indicates merely that the substantial benefits accorded to sales of capital assets are a standing invitation to interested groups with sufficient influence to secure lower taxes for themselves without regard to the policies which supposedly justify the special treatment of capital transactions.

143. The *Robinson* opinion, 129 F.2d 291, 300 (5th Cir. 1942), recognizes "that the liquidation of the timber . . . could have been conducted in such fashion" as to generate ordinary business profit, citing *Commissioner v. Boeing*, 106 F.2d 305 (9th Cir. 1939); *Ehrman v. Commissioner*, 120 F.2d 607 (9th Cir. 1941); *Welch v. Solomon*, 99 F.2d 41 (9th Cir. 1938); *Richards v. Commissioner*, 81 F.2d 369 (9th Cir. 1936).

144. See text at note 121 *supra*.

145. 312 U.S. 212 (1941).

146. 3 T.C.M. 987 (1944), *aff'd.*, 152 F.2d 654 (2d Cir. 1945). See pages 848-9 *supra*.

147. This is because of the words "to customers" in the "trade or business" clause. See discussion of legislative history in Section I *supra*.

the same, regardless of whether the men who cut and transported the trees were employed by her or by the buyer. Why then should the tax law concern itself with irrelevant considerations of this sort?

D. Is the Business Concept a Valid Measure of Taxpaying Ability?

The legal status quo has been defended by Thomas N. Tarleau:

"Taxpayers have frequently complained that the Treasury is utterly unreasonable in finding as few as ten or fifteen transactions in real estate in one year constitute a business so that the profits are ordinary income, while several hundred transactions in the [stock] market may be made and taxed only at capital gain rates. Personally, I think that is right, because what we are looking for is a trade or business concept, and the number of transactions that constitute a trade or business varies in different fields of endeavor. I think if I sold fifteen or twenty parcels of real estate down in Florida in the course of a year, the extent to which that constitutes business is different from having fifteen or twenty phone calls to my broker in New York." ¹⁴⁸

The essential fallacy of this argument lies in the attempt to reason in tax matters from preconceived notions about "business" derived from popular usage or developed in other branches of the law for purposes ¹⁴⁹ having little or no relevance to the problem of taxing similarly-circumstanced persons similarly. Thus Mr. Tarleau asserts that "[a] person can be a lawyer and have a number of stock transactions which still don't constitute a sufficient participation in a trade or business to justify taxing the [profits as] ordinary income." ¹⁵⁰ But what is so magical about "business" that to come within its connotations automatically increases one's ability to pay taxes? On the contrary, it would seem that the person engaged in business has often a lesser capacity than one who is not so engaged but who receives an equivalent income; the law does not take into account the businessman's expenditure of energy and the wear and tear on his "human capital." ¹⁵¹ Furthermore, it is extraordinary that a society so deeply concerned with the fostering of productive activity should, by its tax laws, reward people who refrain from engaging in transactions for fear that their sales will constitute a "business." Even if one assumes the validity of some of the arguments advanced in support of the view that gains realized upon

148. CAPITAL GAINS TAXATION 42 (Tax Institute Symposium, 1946).

149. *E.g.*, the concept of "doing business" employed in determining jurisdiction over foreign corporations. *Cf.* *International Shoe Co. v. State of Washington*, 326 U.S. 310 (1945).

150. CAPITAL GAINS TAXATION 42 (Tax Institute Symposium, 1946) (emphasis added).

151. Silversen, *Earned Income and Ability to Pay*, 3 TAX L. REV. 299, and especially note 5 (1948).

sales of property do not always augment the seller's economic position to the same extent as income from other sources,¹⁵² these arguments have little or nothing to do with whether the seller is regarded in trade circles as a "professional." Inquiry as to the nature or "the number of transactions that constitute a trade or business . . . in different fields of endeavor"¹⁵³ is altogether irrelevant to whether a particular receipt of money (or other property) results in bettering the recipient's relative economic position in the community to such an extent that the dollar amount of the receipt represents a fair measure of the increase in the recipient's ability to contribute to the support of the Government.¹⁵⁴ In overruling the *Higgins* case¹⁵⁵ by permitting the deduction of "expenses paid or incurred . . . for the production or collection of income,"¹⁵⁶ regardless of whether incurred in connection with "business," Congress recognized that the judicial interpretation of "business" was narrow, artificial, and unfair, and that, for tax deduction purposes, no valid distinction can be made among the various types of profit-making activity according to whether they happen to come within the irrelevant connotations of words like "business" and "investment."

E. Is the Sale of Rented Real Estate a Business Transaction?

The anomaly of taxing the sale of Miss Robinson's legacy¹⁵⁷ differently from the sale of Mrs. Brown's¹⁵⁸ has been characterized as a bizarre "borderline" situation which does not truly test the validity of the distinction between business and investment.¹⁵⁹ However,

152. See Section VI *infra*.

153. CAPITAL GAINS TAXATION 42 (Tax Institute Symposium, 1946).

154. The classic definition of taxable income includes "power exercised for consumption purposes": "The appropriate general conception of income, for purposes of personal taxation, may be defined as the algebraic sum of the individual's consumption expense and accumulation during the accounting period." SIMONS, PERSONAL INCOME TAXATION 206 (1938). See definition by R. M. Haig, cited in Lutz, *Should Capital Gains be Taxed as Income*, 22 BULL. NAT. TAX ASS'N 130, 131 (1937). Cf. HEWITT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION 34 (1925).

155. 312 U.S. 212 (1941).

156. See note 131 *supra*.

157. 129 F.2d 297 (5th Cir. 1942).

158. 143 F.2d 468 (5th Cir. 1944).

159. Professor Seltzer: "They both sold their legacies. . . . Is there sufficient difference in the kind of income these two [taxpayers] derive to justify you in saying that we will tax one on one basis, and the other on another? . . . [I]f . . . there isn't a great deal of difference in substance, the question is raised as to whether you [should] make a distinction between capital gains and other income."

Mr. Seligman: "Isn't the answer [that] in every classification in science and everything else . . . when you get two cases on the edge of the line in Class A and Class B, those two cases look pretty much alike. That doesn't mean that if you take Class A as

the classification of loss realized upon the sale of real estate held for rental purposes is certainly an every-day, run-of-the-mill question. Nevertheless this prosaic question was the subject of a controversy¹⁶⁰ generated by the very same set of inconsistent concepts which were responsible for the anomalous results in the *Robinson* and *Brown* cases.

For example, in deciding that Mr. Fackler's sale of a 99-year leasehold in a six-story office building was a sale of "property used in trade or business,"¹⁶¹ the court of appeals felt obliged to show that he "was not holding the property merely as an investment and solely for the purpose of collecting rents without rendering personal service to tenants." This was done by demonstrating that the "management of the property necessarily involved alterations and repairs . . . [the furnishing of] elevator service, heat, light, and water which required regular and continuous activity and the employment of labor, the buying of material and many other things which come within the definition of business." Confronted with the "difficulty . . . that petitioner here was engaged in a profession which admittedly occupied all of his business hours," the court responded that "there is such a thing as carrying on a business through agents."

Here again is the same futile process of setting up an artificial antithesis between "investment" and "business" in terms of personal activity, and then circumventing it by finding such personal activity in another legal fiction—doing business through agents—despite the fact that little truly personal activity is present. The court succeeds in pulling the rabbit out of the hat because the court hid it there. The incantation of the hocus-pocus about "business" and "investment" with which the court accompanies its feat of prestidigitation may delude the unsuspecting into a belief that these words really compel the result. Yet Mr. Fackler's activities might easily be characterized as "investment" rather than as "business." Thus it appears that even in this simple factual context, these categories are not mutually ex-

a whole and B as a whole, there isn't a difference. You are just taking the borderline cases and saying that they are almost the same." *CAPITAL GAINS TAXATION*, 45 (Tax Institute Symposium, 1946).

160. Berguido, *Rental Property as "Business" Property*, 25 *TAXES* 112 (1947); Dane, *When is Real Estate Held for the Production of Income Used in the Trade or Business of the Taxpayer?*, 59 *HARV. L. REV.* 119 (1945); Roehner, *Tax Court in Error in Holding All Rental Property is "Used in Trade or Business"*, 25 *TAXES* 1000 (1947); Silverman, *Is Loss on Sale of Real Property Ordinary or Long-Term Capital Loss?*, 24 *TAXES* 1154 (1946).

161. *Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943) (decided under the law of 1938 which excluded from the definition of capital assets "property used in trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1)"). Fackler's leasehold was held to be depreciable under 23(1) because found to have been used in a business. After 1942 the sale of such property would generate capital gain under *INT. REV. CODE* § 117(j).

clusive, have no self-evident meanings, and are merely elliptical symbols for opposite legal conclusions. Accordingly it should be recognized that the attempt to reason from such premises must be a circular and futile process.

This confusion of legal fiction with economic fact has continued to obfuscate the taxation of rental property. The Revenue Act of 1942¹⁶² removed "real property used in the trade or business of the taxpayer" from within the definition of capital assets in Section 117(a)(1) and placed it in a new Section, 117(j), providing that any long-term gains realized upon sale of property within this category would be taxed only up to the same low flat 25% rate which applies to capital assets under 117(a), but that losses might be deducted in full and not merely to the limited extent permitted in the case of capital assets.¹⁶³ The Treasury promptly promulgated an interpretation¹⁶⁴ of the phrase "real property used in the trade or business of the taxpayer" which implied that rented real estate would fall within the phrase only if the taxpayer could show himself to be in the business of renting his property rather than merely holding it for the production of income as a passive investor.¹⁶⁵ This interpretation obviously stems from the concept set forth by the Supreme Court in the *Higgins* opinion¹⁶⁶ that investment is somehow intrinsically and qualitatively different from business.

In contending that all losses upon the sale of all rented real estate fall outside 117(a)(1) and within 117(j), spokesmen for taxpayers emphasized that, prior to the enactment in 1942 of Sections 23(a)(2) and 23(l)(2) which explicitly authorize the deduction of expenses and depreciation in connection with income-producing property,¹⁶⁷ owners of rented real estate were permitted to take deductions for depreciation, maintenance costs, repairs, etc. on the theory that these deductions were "incurred in trade or business" under Sections 23(a)(1) and 23(l)(1). A lessor was not required to spend any time in managing the property in order to obtain the deductions. Had this not been per-

162. Revenue Act of 1942, § 151, 56 STAT. 846 (1942).

163. Because § 117(j)(2) requires that gains and losses from sales of this type of property and from "involuntary conversions" be offset against each other, it is the net gain from the combined transactions which enjoys 25% ceiling rate and the net loss which is fully deductible from ordinary income. Cf. Lowndes, *supra* note 119, at 450.

164. "Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term 'capital assets' even though depreciation may have been allowed with respect to such property under Section 23(l) prior to its amendment by the Revenue Act of 1942." T.D. 5217, 1943 CUM. BULL. 319.

165. This interpretation has been approved on the ground that "[t]he language in the Senate Report [SEN. REP. NO. 1631, 77th Cong., 2d Sess. 50 (1942)] would seem to show that Section 117(j) was intended to apply not to rental property but only to real estate and buildings used as subsidiary to non-rental purposes, such as manufacturing." Rochner, *supra* note 160, at 1013.

166. 312 U.S. 212 (1941).

167. See note 131 *supra*.

mitted, he would have been taxed on gross rather than net rentals. "In the absence of any specific indication to the contrary, the words 'used in the trade or business' must have the same meaning in Section 117(a)(1) [and also 117(j)] that they had for many years in Section 23(l)." ¹⁶⁸ Hence, contrary to the Treasury's interpretation, ¹⁶⁹ management activity would be unnecessary. ¹⁷⁰

It is submitted that the taxpayer's position was correct ¹⁷¹—not because the same words must necessarily always mean the same thing regardless of their context—but because the decrease in economic power suffered by the real estate owner is the full amount of his loss upon the sale, and whether or not he can be said to have managed the property before selling it has little, if any, relevance to this fact. True, 117(j) puts the taxpayer in a heads-I-win-tails-you-lose position with respect to the Treasury. However, it is an artificial symmetry which, because Congress has not seen fit to tax profits on these sales as ordinary income, would refuse to permit losses on such sales to be deducted as ordinary losses. As the late Professor Simons pointed out, "There can be little reason for limiting loss deductions for some taxpayers because others have enjoyed concessions as to capital gains." ¹⁷²

F. What Is a Businessman's Business?

The pernicious consequences of a narrow conception of "business" are not confined to persons outside the popular stereotype of "the businessman," such as Mr. Higgins, ¹⁷³ Miss Robinson ¹⁷⁴ and Mr. Fackler. ¹⁷⁵ In many commercial situations taxpayers incontrovertibly engaged in business incur a gain or loss upon a transaction falling somewhat outside the scope of their usual activities. Because of the connotations of the word "business," such taxpayers are often taxed too much or too little.

This problem is exemplified by the case of the *Thompson Lumber Co.*, ¹⁷⁶ which during the depression of the 1930's acquired considerable

168. Dane, *supra* note 160, at 124. Compare the Board of Tax Appeal's opinion in the *Fackler* case, 45 B.T.A. 708 (1941).

169. See note 164 *supra*.

170. Leland Hazard, 7 T.C. 372 (1946), *acq.*, 1946-2 CUM. BULL. 3, adopts this view of § 117(j).

171. *I.e.*, that proof of management activity should not be required before the taxpayer is permitted full deduction of loss upon the sale of rented real estate.

172. SIMONS, *supra* note 154, at 160. Cf. REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 7 (1927); Professor Lawrence H. Seltzer in CAPITAL GAINS TAXATION, *supra* note 159, at 13; Lowndes, *supra* note 119, at 448.

173. 312 U.S. 212 (1941).

174. 129 F.2d 297 (5th Cir. 1942).

175. 133 F.2d 509 (6th Cir. 1943).

176. 43 B.T.A. 726 (1941).

real estate ¹⁷⁷ in payment of accounts receivable for lumber sold by it and by way of foreclosure of liens. The Board of Tax Appeals held that the losses sustained by the company upon sale of eight of these properties in 1936 were only capital losses on the ground that its real estate activities were only "incidental" to its lumber business and were not of sufficient magnitude to constitute an additional business.

"[Petitioner] made no purchases of such property for sale to customers. Its real estate (other than lumber yards) appears to have been acquired solely for the purpose of minimizing or preventing loss upon lumber and building materials sold by it. The time devoted by petitioner's officers and employees to disposing of its real estate was infinitesimal in comparison with the time devoted to the lumber or material business. So far as the record shows, petitioner never held itself out to be engaged in the real estate business to any extent . . . [but only] . . . in the wholesale and retail lumber business. This clearly was its real business and its 'customers' were . . . only the purchasers of lumber. . . ." ¹⁷⁸

Here again are the familiar motifs—the "time and attention" test, the notion that if activities do not have all the characteristics of certain fixed and familiar types of business (here that of the typical real estate dealer), they do not constitute business at all.¹⁷⁹ Here, too, these ideas obscure the real question—why should the taxpayer be prevented from offsetting its income from sales of lumber with losses analogous to bad debts? Similarly, if the Lumber Company had waited till market values rose and had disposed of the properties at a profit, there would seem to be little reason why it should not have been taxed just as much as if it had realized the profit upon the sale of lumber. To attempt a compartmentalization of the taxpayer's activities into several distinct and independent "businesses"—each of which must exhibit a full set of the characteristics of business, such as "frequency," "continuity," and "extent" ¹⁸⁰—is to do far more violence to economic reality than must inhere in the statutory language "held . . . primarily for sale to customers in . . . ordinary course. . . ." ¹⁸¹

177. Its holdings averaged thirty-six parcels at any one time.

178. 43 B.T.A. 726, 730.

179. The absurdity of the *Thompson Lumber* rationale was thrown into bold relief by the case of *Thompson Yards, Incorporated*, P-H 1943 TC MEM. DEC. ¶ 43,142 (1943), wherein another and much larger lumber company was held to have realized mere capital losses upon 45 sales of real estate during 1937-9. These were but part of some 221 acquisitions and 183 sales made over a 15 year period. Ten employees "devoted from 15 to 50 per cent of their time to real estate matters." Nevertheless the Tax Court insisted that the corporation was not engaged in the real estate business, emphasizing the fact that the time put in by the ten employees was but 1 per cent of the total spent in the conduct of the corporation's affairs.

180. See note 127 *supra*.

181. To see how easily an opposite result could have been reached in the *Thompson Lumber* case, see *Avery Brundage*, P-H 1941 BTA MEM. DEC. ¶ 41,508 (1941).

This artificial distinction between a taxpayer's "real business" and his "incidental" activities is repeatedly invoked, especially with regard to financial institutions having restricted charter powers. For example, a ruling of the Treasury's General Counsel provides that banks acquiring real estate by mortgage foreclosure realize only capital gain or loss upon its subsequent disposition.¹⁸² Similarly, the sale of bonds held as investments by insurance companies is treated as the sale of capital assets.¹⁸³

The enactment of Section 117(j) of the Internal Revenue Code has to some extent widened the category of property "integral" ¹⁸⁴ to the taxpayer's business and correspondingly narrowed that of property merely "incidental" ¹⁸⁵ to it.¹⁸⁶ With regard to all property "used in business," which is either real or depreciable property, 117(j) abandons the requirement that it have been "held primarily for sale to customers in the ordinary course" before loss realized upon its disposition can be fully deducted as ordinary business loss. Thus in the case of the soft drink manufacturer ¹⁸⁷ who bought several hundred water coolers to rent out (with a favorable option for purchase) so as to stimulate sales of his beverage, deduction of any loss realized by him upon a subsequent resale of the water coolers would no longer be restricted as a capital loss but could be taken in full as a loss upon the sale of depreciable property used in business. However, if resale occurred after six months ¹⁸⁸ and resulted in a gain (*i.e.*, the sale price exceeded the depreciated cost basis of the water coolers), the question would arise as to whether the asset should be classified as "held for sale" under Section 117(a)(1) or "used in business" under Section 117(j).¹⁸⁹ The former would result in the entire gain being taxed at ordinary rates.

182. G.C.M. 24910, 1946 INT. REV. BULL. No. 11 at 101 (1946), revoking G.C.M. 21497, 1939-2 CUM. BULL. 187. Cf. *Kanawha Valley Bank*, 4 T.C. 252 (1944).

183. It is significant that "in England gains or losses arising from such sales would be taken into account for tax purposes [as ordinary income or ordinary losses] on the theory that the buying and selling of securities is a necessary part of the insurance business." Parker, *supra* note 45, at 605.

184. Avery Brundage, *supra* note 181.

185. *Thompson Lumber Co.*, 43 B.T.A. 726 (1941).

186. However, it seems rather unlikely that the real estate acquired from insolvent vendees by the *Thompson Lumber Co.* would be considered as "used in business" under § 117(j).

187. *John Graf Co.*, 39 B.T.A. 379 (1939).

188. Under § 117(j), capital gain treatment is accorded only to assets held for more than six months. As depreciable business property (like real estate used in business) does not qualify for capital gain treatment under 117(a)(1), the sale of such property prior to the expiration of the six-months period apparently gives rise to ordinary income.

189. A similar problem has arisen in connection with the classification of gain realized upon the sale of animals held partly for breeding purposes. *Albright v. United States*, 173 F.2d 339 (8th Cir. 1949), discussed in Hart & Embree, *Sale of Breeding Livestock*, 27 TAXES 829 (1949). Cf. Boice & Hart, *Selling Breeding Stock: Means Capital Gains*, 23 TAXES 350 (1945).

The latter would lead to capital gains treatment. In this situation all the familiar irrelevancies would come back into play. The taxpayer would stoutly assert that the water coolers were not "property held primarily for sale to customers in the ordinary course of his trade or business" because the ordinary course of his business is to sell soft drinks, not water coolers; that the sale was casual, unrepeatable, and extraordinary; that the water coolers were held as "investments" for their rentals and not as stock in trade for sale; that he is a merchant whose customers are the consumers of beverages, not the purchasers of the water coolers. The Commissioner would reply that the coolers were not merely "used in business," but, like the taxpayer's inventory of soft drinks, were "held for sale to customers." He would emphasize the favorable terms of the option to purchase given all lessees of the water coolers and would argue that "primarily" the purpose of the taxpayer was to induce the lessee to buy the water cooler once it was in his possession and that thereby the taxpayer had embarked upon a whole new and separate line of business; that there is nothing to prevent a man from being in two businesses at once; that the water cooler enterprise had sufficient continuity, regularity, etc., to constitute a business; that even if the taxpayer gave it little personal attention, a man can do business through agents. It is to such artificial considerations that the law would look, rather than to the basic economic question of whether the taxpayer's profit from the sale of the water coolers would augment his economic well-being any less than an equal sum realized from the sale of beverages.¹⁹⁰

Not only where gain is involved may Section 117(j) of the Internal Revenue Code fail to eliminate fruitless controversy. Section 117(j) does not even purport to touch upon the status of that entire class of losses realized upon the sale of property used in business which is neither real property nor depreciable property, *i.e.*, stocks, bonds, and similar intangible assets. Within this realm casuistry still holds sway unlimited. A stock brokerage firm is found to have realized only capital gain upon the sale of bank stocks held by it "to show an interest in [those] particular banking institutions with which the firm was doing business."¹⁹¹ A corporation engaged, both as wholesaler and broker,

190. By permitting the full deductibility of loss upon sale of real property used in business, INT. REV. CODE § 117(j) also overrules cases such as *Butler Consolidated Coal Co.*, 6 T.C. 183 (1946), which held that a coal mine operator had realized a mere capital loss upon the sale of coal in place. The mechanical reasoning of the *Butler* opinion is typical: "The business of the petitioner was the mining and sale of coal—not the sale of coal which it had purchased from others, but the sale of coal which it produced itself. Coal in place is a part of the realty. . . . The petitioner was not engaged in the business of selling real estate or 'coal in place.'" *Id.* at 189.

191. *Wallace v. United States*, 50 F. Supp. 178, 179 (W.D.N.Y. 1943), *rev'd on other grounds*, 142 F.2d 240 (2d Cir. 1944). The decision rests on the customary construction of the statutory language: "[I]t does not seem that there was such a continuity

in the business of selling coal to utilities, railroads, and retailers, is held to have sustained no more than a capital loss upon the sale of mining company stock acquired "for the primary purpose of maintaining favorable relations" and of insuring its supply of coal.¹⁹² In neither case was the court moved by the fact that the "shares were acquired as a necessary incident to the successful operation of its business."¹⁹³

In sharp contrast to these cases is the line of decisions begun by *Gilbert v. Commissioner*.¹⁹⁴ As payment for their services as contractors and engineers, Mr. Gilbert and his partner accepted, and reported as income, 500 shares of the preferred stock of a company employing them to erect an apartment house. The partners sold these shares at a loss in 1926. The Board of Tax Appeals found that "[t]he partnership did not receive the said shares of stock with any intention of holding them. It accepted them in lieu of cash as a means of securing the contract, with the intention of converting the shares of stock into cash as soon as possible."¹⁹⁵ The Court of Appeals held that the loss was fully deductible as an ordinary business loss.

The *Gilbert* decision was said to be "readily distinguishable" when cited as a precedent in the case of *The Exposition Souvenir Corporation*.¹⁹⁶ This company, in order to obtain its concession at the New York World's Fair, had been obliged to bid and pay \$130,000 for debentures payable out of the Fair's gate receipts. When the Fair closed, the taxpayer sold the debentures at a loss of \$92,400. In holding that this constituted no more than a capital loss, the court reasoned:

"Both in form and in substance this was an investment; a risky one to be sure and motivated not by a desire to make capital gains or to earn 4% interest but by the desire to acquire the concessions, but none the less an investment since money was exchanged for property, *i.e.*, the debentures."¹⁹⁷

True, Mr. Gilbert received his interest in the apartment house by way of compensation for his services as a contractor and did not pay cash for it as did the World's Fair concessionaire for the debentures. It is

of purchases or that such time could have been expended in connection with these transactions as brings such transactions within the meaning of stock held by the taxpayer primarily for sale in the course of his trade," *i.e.*, the brokerage firm was not also engaged in a separate business as a "dealer" in bank stocks. *Id.* at 180.

192. *Logan and Kanawha Coal Co.*, 5 T.C. 1298 (1945).

193. *Id.* at 1302.

194. 56 F.2d 361 (1st Cir. 1932), *reversing* 21 B.T.A. 1245 (1931). Cf. *Joe B. Fortson*, 47 B.T.A. 158 (1942); *Hercules Motors Corp.*, 40 B.T.A. 999 (1939). See also *Harry Dunitz*, 7 T.C. 672 (1946).

195. *Royce Gilbert*, 21 B.T.A. 1245, 1246 (1934).

196. 163 F.2d 283 (2d Cir. 1947).

197. *Id.* at 286.

also true that Mr. Gilbert contemplated an early resale of the stock at the time he received it, whereas the souvenir company apparently did not make a definite decision to dispose of its debentures until some time after their acquisition. However, it has been said that "the intention of Congress . . . was to include in the comprehensive word 'held,' property which might or might not have been purchased primarily for the purpose of resale."¹⁹⁸ Furthermore, the apparent differences between the two cases are of less significance than the essential similarities. In both cases the taxpayer had acquired securities, not as an independent investment to be held for recurrent yield, but only as a necessary step in obtaining a contract under which substantial profit-making activities were carried on and ordinary taxable income was generated. The souvenir company's loss resulted just as much from this type of activity as did that of the building contractor. If the "ordinary course" of the business of the Exposition Souvenir Corporation was the sale of souvenirs rather than the sale of debentures, it is equally true that the "ordinary course" of Mr. Gilbert's "trade or business was that of engineering and contracting, not the purchase and sale of stock."¹⁹⁹ Hence, it seems arbitrary to find that the debentures were any more an "investment" than was the stock.

A sequel to this saga of Tweedledum and Tweedledee is found in the *Rockford Varnish Co.* decision.²⁰⁰ In 1936 the taxpayer, a manufacturer of varnish and shellac, accepted "secured trust deed notes" from two of its regular customers, who had been in default in their open account indebtedness since 1933. In 1943 the company sold these notes for far less than their face value and claimed an ordinary business loss under the *Gilbert* and two other decisions. The Tax Court, in denying the full deduction, reasoned:

"the property came into the hands of the petitioner in the ordinary course of its business and was not acquired to be held as an investment. But in those cases there was a regular practice shown of taking property in payment for products . . . and then selling the property, while, here, the notes were taken long after the goods had been sold, the notes were not sold for many years, and the transactions in the notes were isolated rather than mere incidents of a regularly used practice. It cannot fairly or properly be said that they were held primarily for sale to customers in the ordinary course of the petitioner's business."²⁰¹

198. *Richards v. Commissioner*, 81 F.2d 369, 373 (9th Cir. 1936).

199. *Royce Gilbert*, 21 B.T.A. 1245, 1247 (1934).

200. 9 T.C. 171 (1947).

201. *Id.* at 172-3. The Tax Court concluded that "the sales resulted in capital losses which did not reduce taxable income, since there were no capital gains against which to offset the losses." *Id.* at 172. "This may be unfortunate, but it is in accordance with our understanding of the law as enacted by Congress." *Id.* at 173. *Cf. Graham Mill and Elevator Co. v. Thomas*, 152 F.2d 564 (5th Cir. 1945).

Neither the Board of Tax Appeals nor the circuit court report of the *Gilbert* case contains one shred of evidence indicating that Mr. Gilbert had on any prior occasion received stock in payment for his construction work. It may be argued that such evidence was unnecessary under Section 208 of the Revenue Act of 1926,²⁰² which did not preface "course of business" with the word "ordinary" or require that the anticipated sale be "to customers." Yet the legislative history of these 1934 amendments shows a congressional purpose only to curtail the loss deductions of professional stock market speculators,²⁰³ not a purpose to restrict losses resulting directly from the everyday operations of a manufacturing enterprise such as the Rockford Varnish Co. Hence it seems that here is still another example of the utter absurdity of denying to such a taxpayer—or to the World's Fair concessionaire—the right to deduct the full amount of its loss on the ground that the "isolated" sales of the notes—or debentures—were not "ordinary" or "to customers."

G. What the Decisions Signify

The foregoing exposition of judicial decisions on the distinction between business and capital transactions is hardly complete. Only a few of the hundreds of cases concerning the definition of the term "capital asset" have been considered. Furthermore, a transaction will not generate capital gain merely because it involves the disposition of a "capital asset"; ordinary income will arise unless the disposition is by way of a "sale or exchange."²⁰⁴ Compared with the complexity of the problems which have arisen in connection with the phrase "sale or exchange,"²⁰⁵ the decisions interpreting the term "capital asset" read like Tales from Mother Goose. Nevertheless the latter cases are better suited as illustrations of the fundamental issues in capital gains taxation. It is submitted that they afford a sufficient variety of specimens from the jungle of tangled verbiage in this area of the law to support some measure of generalization.

First, these decisions show that much futile quibbling is invited by the words "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."²⁰⁶ For each of the supposedly fundamental principles enunciated by the courts in attempting to apply this clause, a contrary quotation can usually be found which vitiates its force. This tends to prevent the development of a corpus of consistent doctrine available for the resolution of new problems as they arise. Taxpayers, therefore, enjoy much less predic-

202. 44 STAT. 19 (1926).

203. See discussion in Section I *supra*.

204. INT. REV. CODE § 117(a) (2), (3), (4), and (5).

205. See Section V *infra*.

206. INT. REV. CODE § 117(a) (1).

tability as to tax consequences than they deserve, at least in commercial transactions.

More important is the fact that taxpayers are often denied their right to be taxed no more severely than others in substantially similar circumstances. The cases demonstrate that very many of the lines drawn by the law are arbitrary and often operate unfairly. Furthermore, it should especially be observed how often it is not the tax collector but the taxpayer who gets bogged down in the doctrinal morass. This suggests that the benefits enjoyed by one segment of the public from the favorable treatment of capital gains are, because of the corresponding limitations on the deduction of capital losses, obtained at the cost of severe hardship to other less fortunate persons.

What is most significant about the foregoing decisions, however, is that they indicate that the law does not achieve with reasonable accuracy the end to which it is supposedly directed—the isolation and special treatment of gain arising in “investment” transactions. This failure is easily understood. The word “investment” refers to no readily ascertainable economic phenomenon. When scrutinized closely “investment” becomes indistinguishable from other kinds of activity whereby income is obtained by virtue of the ownership of property. Nor do the shifting connotations of “business” and “speculation,” the two abstractions contrasted with “investment,” afford more stable criteria. As employed in the decisions, all three of these words have little economic substance and still less relevance to the problem of achieving equity in taxation. It is because these underlying concepts purport to differentiate transactions which are far more alike than they are dissimilar²⁰⁷ that a contrary decision could so easily have been made in many of the cases. The result is that “there is no clear separation, in practice, between capital gains and ordinary income.”²⁰⁸

V. THE “SALE OR EXCHANGE” CONCEPT—HOW IT INTERACTS WITH THE “CAPITAL ASSET” CONCEPT

The foregoing conclusion—that in operation the distinction between capital gains and ordinary income proves unsatisfactory—can easily be reinforced by an examination of the “sale or exchange” concept. This concept does not come into play unless the subject matter of the transaction qualifies as a “capital asset.” Otherwise ordinary income rather than capital gain will result, even if a “sale or exchange” has occurred.

207. “While capital gains have some unique features, in the main there is more similarity than difference between the income from the sale of real estate and capital assets on the one hand, and the more ordinary sale of groceries and furniture, for instance, on the other.” Professor GROVES in CAPITAL GAINS TAXATION 17 (Tax Institute Symposium, 1946).

208. *Report of Subcommittee, Hearings before Committee on Ways and Means on Proposed Tax Revision*, 75th Cong., 3d Sess. 9, 38 (1938).

However, once the subject matter of the transaction has been characterized as a "capital asset," its disposition must constitute a "sale or exchange" to qualify for capital gain treatment. Because many transactions involving "capital assets" do not also involve a "sale or exchange," this latter requirement offers a means for effecting a substantial curtailment of the anomalies inherent in the capital gain provisions. However, a mere enumeration of some notorious problems which have arisen in connection with the "sale or exchange" concept will serve to indicate that this additional requirement has itself become the source of still further anomalies.

A. Sales

If the owner of unimproved real property "leases" it for 99 years, the rent from the "lessee" is ordinary income taxable at progressive rates.²⁰⁹ If he "sells" it in consideration of the "purchaser's" promise to make non-interest-bearing installment payments, he is entitled to receive the equivalent of his cost basis tax-free, the balance constituting mere capital gain. In either case he receives a series of cash payments in lieu of his, and later his children's, right to immediate possession, a right which ordinarily represents the major portion of the current market value of the property. The question whether a "sale" or a "lease" has been made is, of course, relevant to the measure of his economic benefit insofar as it concerns the right of his heirs to repossess the land at the expiration of the 99 years. However, in a free market it may be assumed that the "purchase price" would exceed the sum of the 99 year "rentals" by approximately the value of the reversion.²¹⁰ Hence it is hard to see why the two types of transaction require different tax treatment.

This disparity in tax consequences is intensified where the subject matter of the transaction is not land but property having a relatively short useful life. "Royalties" paid by a "licensee" for the use of patents or copyrights are subject to surtax when received by the "licensor."²¹¹ However, by the simple expedient of phrasing the contract in "sale" rather than "license" terminology—and apparently with no substantial loss of protection for the party disposing of the intangible²¹²—the capital gains provisions can be made to apply.²¹³ Here too the

209. INT. REV. CODE § 22(a). Rental income from improved property is, of course, partially offset by depreciation deductions. INT. REV. CODE § 23(1)(2).

210. Even though the landowner were to receive no more for an outright sale than under a long-term lease, under present law he might prefer the former alternative if the resultant tax-saving exceeded the value of the reversion.

211. INT. REV. CODE § 22(a).

212. Cf. *Commissioner v. Celanese Corporation*, 140 F.2d 339 (D.C. Cir. 1944) and related cases involving "conditions subsequent."

213. Fincke, *An Analysis of the Income Aspects of Patents, Copyrights, and Their*

law fails to inquire whether the resultant income represents an increase in the recipient's ability to pay equal to that represented by an equal amount of income from other sources. It has yet to be demonstrated that a profit realized upon the sale of a patent or copyright does not benefit the seller as much as a royalty of like amount. In the absence of such proof, there seems little basis for the view that fairness requires that income received upon a "sale or exchange" of the recipient's entire "bundle of rights" should be taxed differently ²¹⁴ than income received in consideration of a "license" of less than all of his rights.

Nor is it clear that this is necessary in the interests of an efficiently functioning economy. National policy does not seem to require the encouragement of certain transactions merely because they take the form of a "sale" rather than a "license." It is equally doubtful that socially useful transfers of intangibles of this sort would be impeded unless there were some way in which they could be effected without subjecting the transferor to ordinary surtax rates. Even if it be assumed that this argument is valid for certain types of property, ²¹⁵ it would seem inapplicable to patents and copyrights. Unless the owner of a patent or copyright utilizes it in a business of his own, he cannot derive any income from it until he disposes of some or all of his rights in it. In this respect his position is factually unlike that of the owner of corporate stock or improved real estate who enjoys the alternative of a recurrent yield if he chooses not to sell. Hence there seems little merit in the argument that the holders of patents and copyrights would refuse to permit exploitation of their property if there were no way to avoid surtax rates upon the resultant income.

The patent and copyright field affords but one illustration of the many anomalous situations created by special treatment of "sales." Such anomalies are undesirable, not only in themselves, but also because they generate prolific litigation as to whether particular transactions are to be classified as "sales." ²¹⁶ Detailed analysis of this litigation lies beyond the scope of a discussion primarily concerned with the "capital asset" concept.²¹⁷ For present purposes it must suffice to

Analogues, 5 TAX L. REV. 361 (1950); Fulda, *Copyright Assignments and the Capital Gains Tax*, 58 YALE L.J. 245 (1949); Geller & Levitan, *A Study of Tax Problems Relating to Patents*, 25 TAXES 313 (1947); Greenlee & Kramer, *Capital Gains on Sales of Patents*, 26 TAXES 779 (1948); Schulman, *The Artist and His Tax Burden*, 27 TAXES 101 (1949); Schwartz, *Authors and the Federal Income Tax*, 26 TAXES 51 (1948).

214. See Fulda, *Copyright Assignments and the Capital Gains Tax*, 58 YALE L.J. 245 (1949).

215. See discussion in Section VI *infra*.

216. This problem too is well illustrated by the cases involving patents and copyrights, collected in the articles cited in note 213 *supra*.

217. In a Note, *Sale or Exchange of Capital Assets: Scope and Treatment for Tax Purposes*, 27 VA. L. REV. 795, 806 (1941), appears a brief discussion of "the broadening

state that the vexatious problem of what is a "sale" has arisen in many factual contexts, including the disposal of partnership interests,²¹⁸ trust interests,²¹⁹ oil and gas interests,²²⁰ covenants not to compete,²²¹ leases,²²² evidences of indebtedness,²²³ and even radio shows.²²⁴ It is believed that a systematic study of these cases would demonstrate that the "sale" concept is just as inappropriate for tax purposes as is the "capital asset" concept and that there are numerous instances in which ordinary income has been transformed into capital gain—for no better reason than that it was received under circumstances which could be characterized as a "sale," as that term has been developed in other branches of the law for purposes having little to do with taxation.

B. Exchanges

The various anomalies which stem from the "sale" concept indicate that it is not "only through corporations that special treatment of capital gains opens the way to easy, systematic avoidance of personal income tax on a large scale."²²⁵ Nevertheless there can be little doubt

of the meaning of 'sale and exchange' both by legislative enactment and by judicial interpretation to include: retirement of corporate bonds, whether through pre-arranged agreement or compulsory surrender; redemption of stock; loss of property by mortgagor under foreclosure (the courts here sweeping away the distinction between voluntary and involuntary sale); losses from failure to exercise stock rights; and losses on worthless stocks or bonds." Cf. 3 MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.17 (1942).

218. *Bull v. United States*, 295 U.S. 247 (1935); *Allen S. Lehman*, 7 T.C. 1088 (1946), *aff'd*, 165 F.2d 383 (2d Cir. 1948); *Rabkin & Johnson, The Partnership under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942); *Scott, Capital Gain on Sale of Partnership Interest*, 41 MICH. L. REV. 739 (1943); *Brookes, The Strange Nature of the Partnership Under the Income Tax Law*, 5 TAX L. REV. 35, 45 (1949).

219. *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); Note, *Taxability of Proceeds on Sale of a Right to Income for Life*, 56 YALE L.J. 570 (1947).

220. Note, *Taxation of Net Profit Interests in Oil Properties*, 56 YALE L.J. 170 (1946); *Miller, Selling "Oil Payment"*, 27 TAXES 185 (1949); *Rabkin & Johnson, The Income Tax upon Oil and Gas Interests*, 90 U. OF PA. L. REV. 383 (1942).

221. *Rainier Brewing Co.*, 7 T.C. 162 (1946), *aff'd*, 165 F.2d 217 (9th Cir. 1948); *Seattle Brewing and Malting Co.*, 6 T.C. 856 (1946), *aff'd*, 165 F.2d 216 (9th Cir. 1948); *Ellen J. Franklin*, 6 T.C.M. 1099 (1947); *Kamens & Ancier, Tax Consequences of a Covenant Not to Compete*, 27 TAXES 891 (1949).

222. *Hort v. Commissioner*, 313 U.S. 28 (1941).

223. *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936). *Bingham v. Commissioner*, 105 F.2d 971 (2d Cir. 1939) and cases involving mortgages are discussed in *Lowndes, The Taxation of Capital Gains and Losses Under the Federal Income Tax*, 26 TEXAS L. REV. 440, 451-4 (1948); *Brown, Outline of Mortgagee's Tax Liability*, 25 TAXES 1035 (1947).

See also INT. REV. CODE § 117(f) and *Commissioner v. Caulkins*, 144 F.2d 482 (6th Cir. 1944), discussed in *Mandell, Using Section 117(f) to Convert Ordinary Income (Interest) into Capital Gain*, PROCEEDINGS OF THE NEW YORK UNIVERSITY SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION, 405-17 (1949).

224. *Altman, Tax Effects of the Sale of a Radio Show*, 27 TAXES 19 (1949); *Mintz, Entertainers and the Capital Gains Tax*, 4 TAX L. REV. 275 (1949).

225. *SIMONS, supra* note 154, at 158.

that the "sale or exchange" component of the capital gain provisions, and especially its "exchange" element, takes on its greatest practical importance in connection with transactions involving corporate securities. This is, of course, attributable to the fact that securities are certain to qualify as "capital assets" unless held by a "dealer."²²⁶

It is common knowledge that the problem presented in securities transactions stems from the taxation of capital gains at rates lower than those applicable to ordinary distributions of corporate earnings. This discrepancy makes it possible for a stockholder who makes a "sale or exchange" of all, or a part, of his stock to enjoy the benefit of an increase in corporate net worth at capital gains rates,²²⁷ despite the fact that those earnings would be subject to surtax if received as a dividend.²²⁸

Although logically and historically it is the root of the problem,²²⁹ the fundamental disparity in tax consequences found in this commonplace occurrence does not, in itself, account for all of the opportunities for "systematic avoidance . . . on a large scale." These opportunities result not so much from this simple phenomenon as they do from collateral rules which supposedly are necessary corollaries to the capital gains provisions in Section 117 of the Code. Thus Section 115(c) provides that the distribution of all of a corporation's assets to its shareholders and the surrender of all of the stock to the corporation shall be regarded as an "exchange,"²³⁰ so that capital gains rates apply to any part of the distribution which may be in excess of the amount of the shareholder's investment. Apparently consistency is thought to require that if a gain realized upon the sale of stock is to receive special treatment, so must a gain realized upon the surrender of stock when the corporation is liquidated.²³¹ Otherwise the size of the tax would depend upon a circumstance having little relevance to the change in the stockholder's economic position, *i.e.*, whether the consideration for the stock was furnished by a third party purchaser or by the issuing corpora-

226. Cf. the criteria set forth in the *Van Suetendael* opinion, 3 T.C.M. 987 (1944), discussed in Section II *supra*.

227. Note, *Dividend-On Purchases*, 14 U. OF CHI. L. REV. 281 (1947).

228. This tax saving may be partially offset if the purchase price of the stock is reduced to reflect the tax which the purchaser will have to pay when the earnings are eventually distributed. This later tax may be considerable where the business activities of the corporation are to continue unabated.

229. Comment, *Stockholder Realization of Corporate Earnings and the Income Tax*, 17 U. OF CHI. L. REV. 338 (1950).

230. INT. REV. CODE § 115(c) begins: "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. . . ."

231. Another argument in support of capital gains treatment of corporate liquidations is that fairness requires some mitigation of the impact of progressive tax rates upon the receipt, within a single year, of corporate profits accumulated over many years. Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. OF PA. L. REV. 907, 931 (1941).

tion. By thus placing complete liquidations on a parity with sales, Section 115(c) substantially simplifies the task of stockholders who seek to cash in on corporate earnings at capital gains rates.²³² It eliminates the necessity of finding a purchaser willing to pay a sufficiently high price for the stock.

However, if consistency requires that distributions in complete liquidation are to be taxed like sales at capital gains rates, it also requires similar treatment of distributions in partial liquidation, *i.e.*, liquidations in which part of the corporate assets are distributed in exchange for part of the stock.²³³ Otherwise, the amount of the tax would depend upon whether, after the retirement of the particular stock held by the taxpayer, the corporation continued in business or wound up its affairs.²³⁴ Accordingly the statute²³⁵ now provides that distributions in partial liquidation can also give rise to long-term capital gains,²³⁶ provided, however, that if the distribution is found to be "essentially equivalent" to an ordinary dividend, progressive rates will apply.²³⁷

Because capital gains treatment is available to at least some distributions in partial liquidation, it is possible for a stockholder to avoid the payment of surtax rates upon a distribution of corporate earnings made long before business considerations permit a complete liquidation of the corporation. What is even more important, a shareholder who owns stock of more than one class may be able to enjoy the benefit of capital gains treatment without major impairment of his right to share in future profits²³⁸—an advantage which is not possible with complete

232. *E.g.*, the use, especially in the motion picture industry, of the "collapsible corporation" organized in anticipation of liquidation. For incisive and competent discussion see Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1950).

233. The term "partial liquidation" is defined in INT. REV. CODE § 115(i).

234. However, during the period when distributions in partial liquidation were taxed at progressive rates, the holder of the shares to be redeemed could obtain capital gain treatment by selling them to a friend who would then surrender them to the corporation. Stanley D. Beard, 4 T.C. 756 (1945); W. P. Hobby, 2 T.C. 980 (1943).

235. INT. REV. CODE § 115(c), as amended by Revenue Act of 1942, § 147, 56 STAT. 841 (1942). *Cf.* Murphy, *Partial Liquidations and the New Look*, 5 TAX L. REV. 73, 74 (1949); Bittker & Redlich, *Corporate Liquidations and The Income Tax*, 5 TAX L. REV. 437 (1950).

236. *Cf.* Joseph W. Imler, 11 T.C. 836 (1948); Samuel A. Upham, 4 T.C. 1120 (1945).

237. INT. REV. CODE § 115(g). Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir. 1946); Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940) and related cases discussed in Danzig, *Distributions in Liquidations and Reorganizations—Their Tax Consequences*, 26 TAXES 645 (1948); Miller, *Stock Redemptions*, at 455. PROCEEDINGS OF THE NEW YORK UNIVERSITY SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 307 (1948); Gutkin & Beck, *Stock Redemptions as Taxable Events Under Section 115(g)*, 24 TAXES 1172 (1946); Crown, *Essentially Equivalent to the Distribution of a Taxable Dividend*, 25 TAXES 146 (1947); Bittker & Redlich, *supra* note 232, at 455.

238. Despite the caveat in U.S. Treas. Reg. 111, § 29.115-9 that a distribution in partial liquidation will generally be considered as "essentially equivalent to the distribution

liquidations. This advantage can be enjoyed, however, only in cases where some of the outstanding stock may conveniently be retired. Where no such stock is already outstanding, it is first necessary for the corporation to get this extra stock into the hands of the shareholders. If this can be done without levy of a tax upon the receipt of new stock,²³⁹ then it might later be feasible for the corporation to reacquire stock in "exchange" for a distribution of earnings.²⁴⁰

Although the foregoing sketch is hardly adequate to the manifold intricacies of the law relating to corporate readjustments,²⁴¹ it does serve to indicate that the full significance of the capital gains provisions cannot be appreciated merely by considering how they affect the "typical investor" who owns ten shares of United States Steel. To appraise these provisions properly it is necessary to view them, not in artificial isolation, but as they operate in conjunction with other rules, especially those which assist the owners of closely-held corporations in their attempts to receive the benefit of corporate profits in a form which will be taxed as capital gain. When so viewed, it will be observed that special treatment of capital gains lends itself to, and indeed invites, extensive manipulation of corporate structures solely to avoid taxes.²⁴² This end is very different from those, to be discussed in Section VI below, which supposedly justify the capital gains provisions.

An argument can be advanced that the various opportunities for tax avoidance latent in the "sale or exchange" concept indicate the abuse rather than the use of the capital gains provisions. This implies that such phenomena are no more than extraneous and infrequent by-products which could be eliminated without alteration in the underlying concepts of Section 117.²⁴³ Such reasoning, however, diverts

of a taxable dividend" where unaccompanied by a shift in the proportionate interests of the stockholders, such distributions have nevertheless been taxed at capital gain rates. See the cases collected in Danzig, *Distributions in Liquidations and Reorganizations—Their Tax Consequences*, 26 TAXES 645, 649 (1948).

239. Darrell, *Recent Developments in Nontaxable Reorganizations and Stock Dividends*, 61 HARV. L. REV. 958 (1948); DeWind, *Preferred Stock "Bail-Outs" and the Income Tax*, 62 HARV. L. REV. 1126 (1949).

240. Retirement of the new shares after acquisition by a bona fide purchaser or retirement of the old shares rather than the new, might help to prevent frustration of the scheme by the operation of INT. REV. CODE § 115(g). See note 237 *supra*. A sale of either the old or the new stock would not be affected by 115(g), although it may some day be affected by a new Treasury policy. See note 239 *supra*. Because of the additional shares, such a sale might, like a stock redemption, enable a stockholder to cash in on undistributed surplus at capital gain rates without major sacrifice of his stake in the corporation's future.

241. For a more comprehensive analysis, see Comment, *Stockholder Realization of Corporate Earnings and the Income Tax*, 17 U. OF CHI. L. REV. 338 (1950).

242. *Ibid.*

243. This argument overlooks the anomalies which stem from the everyday use of the capital gain provisions, *e.g.*, the fact that, while depreciation deductions reduce fully-tax-

attention from the enduring sources of the problem and towards whatever may happen to be its current symptoms. The practical consequences of this point of view is an apparently interminable succession of piecemeal palliatives.

Without denying all value to the slow process of plugging loopholes as they appear, it is submitted that, like the labors of Sisyphus, this task is likely to be endless, unless there occurs a more general appreciation of some of the basic aspects of the problem. There is need for a recognition that simple terms such as "business," "capital asset," "sale," and "exchange" do not refer to simple economic facts but to subtle legal categories which, though perhaps useful in some areas of the law, have little relevance for taxation. To employ such concepts to discriminate among the infinite variations and gradations of income-producing transactions is therefore, of necessity, a futile endeavor. Nevertheless these alien distinctions have been made to serve as a dike creating an artificial haven from the buffeting of surtaxes. Therefore it is only natural that the difference between the levels of taxation on the two sides of this dike should cause leakage into the low pressure area. It is also natural that this leakage should have increased during the past decade as the pressure differential was intensified by higher surtaxes and lower capital gains rates. So long as this differential exists the most diligent efforts to plug each new crack in the wall may be inadequate to prevent substantial loss of revenue.

It is submitted that this brief discussion of the "sale or exchange" criterion serves to emphasize the conclusion drawn from the more detailed analysis of the "capital asset" concept—that in practical application the distinction between capital gains and ordinary income has been highly unsatisfactory. The difficulties encountered have been so numerous and important that it is necessary to inquire why the law attempts to make such a distinction. Why should capital gains be singled out for favored tax treatment? This question will be considered in Part II in the light of the various theories advanced to justify the capital gains provisions.

able ordinary business income, the accompanying reduction in cost basis increases a mere capital gain upon the subsequent sale of the asset. Still another such anomaly is found in the case of the "dividend-on" purchaser. See Note, *Dividend-On Purchases*, 14 U. OF CHI. L. REV. 281 (1947).