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Corporate Securities As "Business Property"

I. Introduction

The Internal Revenue Code divides taxable gains and deductible losses into two broad classes—ordinary and capital—and prescribes different tax treatment for each.[1] Generally speaking, capital gains are taxed at lower, non-progressive rates.[2] Capital losses are deductible from only a limited segment of income,[3] but, in the case of noncorporate taxpayers, may be carried forward indefinitely.[4] On the other hand, deductible ordinary losses may be deducted from any taxable income,[5] but may be deducted in other years only under certain circumstances.[6]

The Code effects the division between capital and ordinary gain or loss by prescribing "capital" treatment for those gains or losses arising on the "sale or exchange" of "capital assets."[7] Thus, the "capital asset" concept is the Code's principal control point in screening out those transactions which should not be accorded preferential tax treatment. "Capital asset" is initially defined as "property held by the taxpayer (whether or not connected with his trade or business)."[8] Obviously, this broad definition, standing alone, would destroy the distinction it was designed to create; in one sense everything the taxpayer holds is "property." It would thus seem that all income could well be "capital gain," since any moneys received by the taxpayer could be regarded as being derived from the "sale or exchange" of a property interest.[9] Therefore, to give meaning to the definition, five types of property are excluded from the general definition.[10]

The express wording of the statute provides that if the "property" involved is not covered by one of the enumerated exclusions, it remains in the residual category of "capital asset" and the income or loss arising on its disposition will be capital gain or loss. Because of the dramatic difference in the applicable ordinary and capital gains

1. *See* Int. Rev. Code of 1954, §§ 161, 165, 1201, 1202, 1211.

2. *Id.* § 1201. The effect of this section is to subject capital gains to a maximum rate of 25%.

3. *Id.* § 1211.

4. *Id.* § 1212. Corporate taxpayers are limited to a five-year carryover for capital losses, except in the case of a "foreign expropriation capital loss," for which a ten-year carryover is allowed. *Id.* § 1212(a).

5. *Id.* §§ 63(a), 165.

6. *Id.* § 172.

7. *Id.* §§ 1201, 1202, 1222.

8. *Id.* § 1221.

9. *See* Surrey, *Definitional Problems in Capital Gains Taxation,* 69 Harv. L. Rev. 985, 988 (1956). For example, a claim to salary is certainly "property" in one sense of the term. Therefore, a sale of the claim would produce a capital gain.

10. Int. Rev. Code of 1954, § 1221(1)–(5). It should also be noted that the Code contains provisions relaxing the basic requirements, making more difficult the achievement of capital gain treatment, or denying it altogether. For example, capital

rates, most taxpayers have a "terrific stimulus"[11] to seek to classify their income as capital gain.[12] The Code's method of definition works to the advantage of these taxpayers, who often seek to avoid the exclusions by fashioning income-producing activities into dispositions of non-excluded "property."[13] Thus, the "capital asset" definition jeopardizes the very distinction it attempts to create.

If the courts had taken the position that the exclusionary categories provided the only exceptions to the broad warrant for capital treatment of property sales and exchanges, the class of transactions receiving capital treatment might have absorbed a large portion of all income-producing activities. This approach would have been supported by both the Regulations[14] and legislative history.[15] However, to prevent such an erosion of the ordinary income tax base, and to implement what was felt to be the broad congressional intent behind the capital gain-ordinary income distinction, the courts have felt a need to go further than the statutory exclusions in narrowing the range of capital gain treatment.[16] This narrowing has been accomplished in two ways: (1) interpreting the statutory exclusions broadly;[17] and (2) giving the definitional term "property" a restrictive meaning.[18] This latter approach has been increasingly recognized as a more fruitful source of limitations on capital gain treatment than the former. By holding that an asset is not "property" for the purposes of

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gain treatment is often required for certain types of dispositions even though there might not otherwise be a "sale or exchange," or the property might not be a "capital asset." *See, e.g.*, §§ 402(a)(2), 403(a)(2), 421(d)(4), 1231, 1235, 1236, 1237, 1240. In several seetions capital gain treatment is denied even though there may be a "sale or exchange" of a "capital asset." *See, e.g.*, §§ 304, 306, 341, 342, 356(a)(2), 421(b). *See also* Hacker, *Bringing Capital Gains into Focus*, 12 W. RES. L. REV. 252 (1961).

11. Surrey, *supra* note 9, at 988.

12. "A craving for capital gain has come to be a signpost of our tax system, with immeasurable effort being exerted toward creating capital gain in place of ordinary income. The constant stream of human ingenuity aimed at exploring this avenue of tax reduction has left its impact on most profit making activities . . . ." Handfield, *Recent Developments in Capital Gain v. Ordinary Income*, N.Y.U. 19TH INST. ON FED. TAX. 11 (1961). *See* Surrey, *supra* note 9, at 988.

13. *See* Surrey, *supra* note 9, at 988; Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693, 694 (1964).

14. "The term 'capital assets' includes all classes of property not specifically excluded by section 1221." Treas. Reg. § 1.1221-1(a) (1957).

15. Section 117 (1939), now section 1221, was intended to define a capital asset as "all property, except as specifically excluded." H.R. REP. No. 704, 73d Cong., 2d Sess. 31 (1934).

16. *See* Comment, *supra* note 13, at 694-95.

17. *See* 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.11 (Malone ed. 1966).

18. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955); Hort v. Commissioner, 313 U.S. 28 (1941). *See* 3B J. MERTENS, *supra* note 17, at §§ 22.11, 22.12; Katcher, *A Critique of Capital Gains Taxation Problems and Proposals*, U. SO. CAL. 1962 TAX INST. 769, 775; Surrey, *supra* note 9, at 996; Comment, *supra* note 13, at 710-11.

section 1221, a court can deny capital treatment to a transaction even though the asset does not come within the literal language of the statutory exclusions.[19] Generally speaking, this approach should not be considered unwarranted judicial legislation, since Congress failed to indicate in any respect what was meant by the term "property." Because this term can be used so loosely and in so many different ways, Congress necessarily thrust upon the courts the task of infusing a meaning into the word which would be consistent with the basic ordinary income-capital gains distinction.[20] As Surrey has said, these developments "represent the courts' view that Congress . . . did not desire to be taken literally when it used the broad term 'property' in section 1221. The courts are willing to rescue Congress from its statutory strait jacket."[21]

Thus, in several areas the courts have been groping beyond the letter of section 1221 in an effort to apply the spirit of the ordinary income-capital gain distinction. By refusing to view "property" as the broad and flexible concept it has become in the general body of law,[22] the courts have developed a "common law" of capital gains taxation[23] which denies capital treatment to certain transactions, even though they seem to fit within the literal terms of the definition. For instance, in *Hort v. Commissioner*,[24] the Supreme Court was asked to determine the tax status of 140,000 dollars paid by a lessee to his lessor for cancellation of a lease with a fourteen-year term remaining. The taxpayer contended that the lump-sum payment should be taxed as capital gain. The Court held that the disputed amount was "essentially a substitute for rental payments which section [61(a)(5)] expressly characterizes as gross income . . . ."[25] Because the payment was deemed to be a substitute for ordinary income, capital gain treatment was denied. Similarly, in *Commissioner v. P. G. Lake, Inc.*,[26] the taxpayer assigned an oil payment right in consideration for the cancellation of a debt. The taxpayer reported the oil payment

19. *See* Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 51 (1955). "While a capital asset is defined in [§ 1221] as property held by the taxpayer, it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." Commissioner v. Gellett Motor Trans., Inc., 364 U.S. 130, 134 (1960).

20. *See* Zarky, *Capital Gain Concepts: What Is a Capital Asset? When Is There a "Sale or Exchange?"*, U. So. CAL. 1959 TAX INST. 357, 363.

21. Surrey, *supra* note 9, at 995-96.

22. *See, e.g.*, United States v. Causby, 328 U.S. 256 (1946); Pittsburgh Athletic Co. v. KQV Broadcasting Co., 24 F. Supp. 490 (W.D. Pa. 1938).

23. *See* B. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 490 (1946); Brown, *The Growing "Common Law" of Taxation*, 34 S. CAL. L. REV. 235, 249 (1961) (criticizes unnecessary "judicial interpolation into a meticulously drafted statute," *i.e.*, section 1221).

24. 313 U.S. 28 (1941).

25. *Id.* at 31.

26. 356 U.S. 260 (1958).

assignment as a sale of property producing a profit of 600,000 dollars, taxable as long-term capital gain. The Supreme Court acknowledged that under the applicable state property law oil payments are interests in land. However, the Court ruled that the gain on the sale of the payment right was ordinary income because the "lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income."[27] In holding that this payment was a substitute for ordinary income, the Court appeared to be motivated by two related factors: (1) the near identity between the sales price and the discounted value of the pay-out expected from the transferred right,[28] and (2) the short life of the transferred interest.[29] The *Hort* and *Lake* decisions are representative of many others in which courts have more or less candidly held the proceeds from sales of certain types of property to be "substitutes for ordinary income."[30]

II. "Business Property"—"Investment Property" Distinction

Another judicial device designed to effect a proper differentiation between capital gain and ordinary income should be compared with the "substitution" doctrine set forth above. This device involves the drawing of a distinction between "investment property" and "business property." The policy behind this distinction is derived from section 1221(1), which excludes from capital gain treatment:

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

Although the scope of this exclusion is somewhat uncertain, its main objective is reasonably clear. By it, Congress is attempting to exclude from capital treatment all of those gains which it regards as everyday profits of the business world.[31] The courts effect this basic policy in two ways. Under the first approach, the statutory exclusion is gener-

27. *Id.* at 265.
28. *Id.* at 265-66.
29. *Id.* at 262-63.
30. *See generally* B. Bittker, *supra* note 23, at 499-535; 3B J. Mertens, *supra* note 17, at § 22.12; Handfield, *supra* note 12, at 11-16; Rockler, *Frolics and Detours in Capital Gains*, 14 Taxes 858 (1963); Surrey, *supra* note 9, at 1003-08. It has been pointed out that the analytical underpinning of the substitute for ordinary income doctrine is faulty because the market price of *investment* property (admittedly subject to capital treatment) "is composed of the discounted value of the future income anticipated to flow from the investment while its owner holds it plus the discounted value of the proceeds expected upon the resale of the property at the end of that period . . . . All gain on property transactions could thus be characterized as a substitute for ordinary income." Comment, *supra* note 13, at 705.
31. *See* Surrey, *supra* note 9, at 989-90.

ally applied broadly in those cases dealing with transactions which arguably come within its language.[32] However, it should be noted that a recent Supreme Court decision[33] has narrowed the range of this exclusion by holding that the phrase *"primarily* for sale to customers" means *"principally,"* rather than *"substantially,"* for sale to customers. The second approach is not concerned with the statutory exclusion. Rather, the "business"-"investment" distinction is achieved by viewing the definitional term "property" as an elastic concept, a rough distinction being drawn between "business property" and "investment property." Only if the transaction concerns a disposition of "investment property" will capital treatment be accorded. In effect, a judicial concept of "property" has been superimposed upon section 1221, excluding from that section all non-investment property held in the taxpayer's business. By narrowing the range of "property," the "capital asset" concept is narrowed, and thus the number of transactions receiving capital treatment is reduced.[34]

III. Corporate Securities as "Business Property"

A. *Prior to 1955*

The remainder of this note deals with one aspect of the general business-investment distinction outlined above—the judicial erosion of the concept of securities as capital assets. By utilizing the "business property" and "investment property" concepts, the courts have contracted the definition of the term "capital asset" to exclude, in some circumstances, securities acquired for reasons connected with the taxpayer's trade or business. This is a development of relatively recent origin. Prior to 1955, the "capital asset" concept was not seen as a fruitful source of limitation on capital gain treatment. Courts adhered fairly strictly to the view that the only types of assets which are non-capital are those which come within the enumerated exclusions.[35] Often those exclusions were applied rather loosely so as to withdraw the asset

32. *See* 3B J. Mertens, *supra* note 17, at § 22.15.

33. Malat v. Riddell, 383 U.S. 569 (1966).

34. *See generally* Katcher, *supra* note 18, at 775-76; Surrey, *supra* note 9, at 989-96; Comment, *supra* note 13, at 710-16.

35. *See* Exposition Souvenir Corp. v. Commissioner, 163 F.2d 283 (2d Cir. 1947); Logan & Kanawha Coal Co., 5 T.C. 1298 (1945); McGhee Upholstery Co., 12 CCH Tax Ct. Mem. 1455 (1953). In three cases, courts allowed the cost of stock to be deducted as a business expense. These cases all involved the purchase of stock without hope of any recovery by the taxpayer. Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935) (purchase of stock of sales agency injuring taxpayer's good will); Commissioner v. The Hub, 68 F.2d 349 (4th Cir. 1934) (purchase of stock in non-profit corporation designed to lure industry into area); Pressed Steel Car Co., 20 T.C. 198 (1953) (purchase of stock of corporation whose sole asset was disputed contract with taxpayer). *See* Troxell and Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 Tax L. Rev. 185, 188-93 (1964).

from capital gain treatment.[36] However, in 1955 three different courts, in three important cases, departed from the literal wording of section 1221 and firmly established the "business property"-"investment property" distinction. Two of these cases involved securities;[37] the third, *Corn Products Refining Co. v. Commissioner,*[38] did not deal with securities, but its reasoning is generally regarded as controlling cases dealing with securities acquired in connection with business activities.

B. *Bagley & Sewall Co., Tulane Hardwood Lumber Co., Corn Products Refining Co.*

Commissioner v. Bagley & Sewall Co.,[39] decided by the Court of Appeals for the Second Circuit, involved the purchase of United States Government bonds by a machinery manufacturer and their deposit, pursuant to a contract, with the purchaser's customer as security for the performance of the contract. Two weeks after the bonds were released from escrow they were sold at a loss. The Commissioner urged that the "all inclusive language of section [1221] requires that, since the bonds are 'property,' they must be treated as capital assets unless exempted by the specific language of the section."[40] The court refused to accept this argument, and held the loss to be deductible as an ordinary and necessary business expense. The court found that the taxpayer did not intend to hold the bonds as an investment, but acquired them solely to carry out the terms of the principal contract. Therefore, the bond transaction was not to be considered independently of the principal contract. The purchase and sale of the bonds "was merely an incident in the carrying on by the petitioner of its regular business."[41] The purchase of the bonds could not be distinguished from the "ordinary premium expense of a surety company bond which is a usual item of contractor's costs."[42] Thus, the court

36. In Western Wine & Liquor Co., 18 T.C. 1090 (1952), the taxpayer bought American Distilling Co. stock, which carried with it the right to buy a certain quantity of whiskey from the issuer at cost. Soon after exercising its rights, taxpayer sold the stock at a loss. Finding that the taxpayer had purchased the stock solely to replenish its whiskey inventories, the court held the loss to be a part of the cost of the whiskey. The shares were fitted into the "held primarily for sale to customers" exclusion. For similar results, see Hogg v. Allen, 105 F. Supp. 12 (M.D. Ga. 1952), *aff'd sub nom.* Edwards v. Hogg, 214 F.2d 640 (5th Cir. 1954); Gilbert v. Commissioner, 56 F.2d 361 (1st Cir. 1932); Flom v. Hofferbert, 56-1 U.S. Tax Cas. ¶ 9236 (D. Md. 1955); Charles A. Clark, 19 T.C. 48 (1952); Joe B. Fortson, 47 B.T.A. 158 (1942).

37. Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955); Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955).

38. 350 U.S. 46 (1955).

39. 221 F.2d 944 (2d Cir. 1955).

40. *Id.* at 946.

41. *Id.*

42. *Id.*

felt that since the circumstances and factual background showed that the purchase and sale of the securities were merely an incident of the taxpayer's business, the capital gain and loss sections should not be considered:

> In brief, it is urged that the all inclusive language of Section 117 [capital gain provisions], require that, since the bonds are 'property,' they must be treated as capital assets unless exempted by the specific language of the Section. The argument carries with it the necessary conclusion that the circumstances of the transaction, its factual background, the necessities of the business involved and intentions of taxpayer are of no importance except in determining whether the bonds are exempted under the Section. We are not persuaded that Section 23 [deductions from gross income] is so completely subordinate to Section 117. . . . [B]usiness expense, Section 23, has been many times determined by business necessity without a specific consideration of Section 117.[43]

It is interesting to note that the Tax Court had found that the bonds "were held for sale to purchasers as soon as released from escrow and available for sale."[44] Thus, the Tax Court reached the result that the loss could be deducted from ordinary income on the theory that "the sale of bonds was of assets held for sale in the ordinary course of . . . business."[45] This placed the bonds into one of the enumerated exclusions in the definition of capital assets. Although not explicitly disagreeing with that line of reasoning, the court of appeals implicitly disapproved the Tax Court's rationale by reaching its decision without a consideration of the capital gain and loss provisions. *Commissioner v. Bagley & Sewall Co.* was probably the first case to find directly that, with regard to securities, the "capital asset" definition of the Code is not an adequate expression of the concept.[46] In effect, it held that the bonds held by the taxpayer constituted "business property" and, hence, were excluded from capital treatment.[47]

In *Tulane Hardwood Lumber Co.*,[48] taxpayer was a lumber and plywood wholesaler. Solely for the purpose of obtaining a needed supply of plywood, taxpayer purchased debentures issued by a ply-

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43. *Id.* at 946-47.
44. *Id.* at 946.
45. Bagley & Sewall Co., 20 T.C. 983, 989 (1953).
46. *See* discussion accompanying notes 35 & 36 *supra;* Surrey, *supra* note 9, at 995; Troxell & Noall, *supra* note 35, at 188-94.
47. Judge Frank dissented on the ground that the majority improperly "invented" another exception to § 117(a)(1) (now § 1221). He felt that the court's approach disregarded "one of the most sensible canons of statutory construction, *i.e.*, that, where a statute sets forth specific exceptions, further exceptions, by way of mere implication, are not permissible." Commissioner v. Bagley & Sewall Co., 221 F.2d 944, 950 (2d Cir. 1955). For other criticisms of *Bagley & Sewall*, see Freeman, *Is There a New Concept of Business Asset?*, 36 TAXES 110, 111-13 (1958).
48. 24 T.C. 1146 (1955).

wood supplier who agreed to allocate a portion of its production to debenture holders. After several years in which the taxpayer received substantial amounts of plywood from the supplier, it became apparent that taxpayer could obtain no further production through its debenture holding, nor could it expect to realize any return on the cost of its debentures. The Tax Court, in holding that the worthless debentures could be fully deducted as a business expense or business loss, said:

> Petitioner's action in purchasing the debenture was a reasonable and necessary act in the conduct of its business. The loss of the purchase price was proximately related to that acquisition. Hence under section 23 [deductions from gross income] the amount was a deductible business expense, or business loss, properly taken in the instant year since that was the first time the reason for holding the debenture disappeared and the extent of the loss could be accurately measured.[49]

The court expressly relied on *Bagley & Sewall* by holding that the loss was a business expense or business loss under section 23 of the 1939 Code, without specifically considering section 117. In so holding, the court disapproved and disregarded two prior cases which had established a contrary precedent. A 1945 Tax Court case, *Logan & Kanawha Coal Co.*,[50] was "no longer . . . regarded as authoritative."[51] In that case, taxpayer contended that he had acquired corporate stock for the primary purpose of maintaining favorable commercial relations and securing a needed supply of coal. When the disposition of the shares brought a loss, business expense or loss treatment was claimed by taxpayer. The court ruled that the stock was a capital asset because it did not fall within one of the enumerated exclusions of section 117. The court would consider section 23 only if the securities were not "capital assets" according to the strict terms of section 117. *Tulane Hardwood*, following the *Bagley & Sewall* rationale, approached the problem in exactly the opposite manner—section 117 would be considered only if the disposition of the securities were not first found to be a business expense or loss.[52]

The *Tulane Hardwood* court rejected the reasoning of another important case, *Exposition Souvenir Corp. v. Commissioner*.[53] In this Second Circuit case, taxpayer purchased World's Fair debentures as a condition precedent to obtaining concessions at the 1939 World's Fair. The debentures were sold at a loss shortly after the Fair closed.

49. *Id.* at 1150.

50. 5 T.C. 1298 (1945).

51. Tulane Hardwood Lumber Co., 24 T.C. 1146, 1150 (1955).

52. The court quoted from Commissioner v. Bagley & Sewall Co.: "business expense, Section 23, has been many times determined by business necessity without a specific consideration of Section 117." *Id.* at 1150-51.

53. 163 F.2d 283 (2d Cir. 1947).

The court held that the debentures were an investment, did not fit within any of the exclusionary clauses, and therefore were capital assets. *Bagley & Sewall* did not expressly overrule *Exposition Souvenir*, but attempted to distinguish it on the ground that in *Exposition Souvenir* the purchase of the bonds was not an integral part of the concession contract. Also, in that case the Tax Court had made an express finding of fact that the stock was held as an investment.[54] However, it is clear that the reasoning of *Exposition Souvenir* was undermined by *Bagley & Sewall*. The *Exposition Souvenir* rationale was similar to that of *Logan & Kanawha Coal Co.*—the court would consider section 23 (business expense or loss) only if the securities were not "capital assets" according to the strict terms of section 117. As pointed out above, *Bagley & Sewall* determined the question of whether a business expense or loss had occurred, without a prior consideration of section 117. Furthermore, the facts of *Exposition Souvenir* do not appear to be sufficiently dissimilar to those of *Bagley & Sewall* to warrant the difference in result.[55] This was recognized by the *Tulane Hardwood* court: "[T]he facts scarcely warrant a finding of 'investment' purpose in the acquisition by a concessionaire of essential World's Fair debentures [*Exposition Souvenir*] and not in the purchase of Government bonds to be used as security for performance of a contract [*Bagley & Sewall*]."[56] The court, implying that *Bagley & Sewall* had overruled *Exposition Souvenir*, expressly followed the *Bagley & Sewall* rationale. By refusing to follow those cases holding that a security must be classified as a capital asset, the *Tulane Hardwood* court thereby contributed to the development of the "business property"-"investment property" distinction.[57]

The third important case of 1955 was *Corn Products Refining Co. v. Commissioner*.[58] In this landmark case, the Supreme Court clarified the "business property" doctrine which had been introduced by *Bagley & Sewall* and *Tulane Hardwood*, and extended that doctrine by excluding from the definition of "capital asset" *all* property held without investment intent in connection with taxpayer's business. Here, taxpayer manufactured products made from grain corn. During

54. Commissioner v. Bagley & Sewall Co., 221 F.2d 944, 946 (2d Cir. 1955).

55. *See* 3B J. Mertens, *supra* note 17, at § 22.16.

56. Tulane Hardwood Lumber Co., 24 T.C. 1146, 1149 (1955). *But see* Wilaka Builders, Inc. v. United States, 64-2 U.S. Tax Cas. ¶ 9519 (S.D.N.Y. 1964) (*Exposition Souvenir* followed, and *Bagley & Sewall* distinguished because in instant case taxpayer was not required to submit bonds as security). In Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958), the court felt that the effect of *Exposition Souvenir* was substantially weakened in view of the fact that it was decided under Dobson v. Commissioner, 320 U.S. 489 (1943), which obligated the court to follow the Tax Court's "findings of evidentiary facts." The *Dobson* rule was rescinded by statute in 1948 (presently section 7482).

57. *See* Herzberg, *Capital Loss or Business Deduction*, 43 Taxes 176 (1965).

58. 350 U.S. 46 (1955).

the mid-thirties, droughts in the corn-raising areas of the country caused the price of spot corn to rise to a point at which taxpayer discovered that its goods could not compete profitably with non-corn substitutes. As a result it adopted a program of buying corn futures in order to avoid future drought-caused increases in raw material costs. This program was the most economical method of obtaining an adequate supply of corn without entailing the expenditure of large sums for additional storage facilities. Taxpayer would take delivery on the futures contracts as it found necessary, and would sell the excess futures if no shortage were imminent. In this manner it reached a balanced position with reference to any increase in corn prices. The gains and losses from the sale of futures were originally reported as ordinary income and loss, but taxpayer later contended that they should have been taxed as capital gains and losses. Taxpayer did not dispute that the futures transactions were an integral part of its trade or business; rather, it insisted that the futures contracts were "property" entitled to capital treatment under section 117 of the 1939 Code, whether or not they were acquired for business purposes.

The Supreme Court held that the futures contracts were not capital assets despite the fact, as the Court acknowledged, that "petitioner's corn futures do not come within the literal language of the exclusions set out in [section 117]."[59] The Court felt that the preferential tax treatment provided by the capital gain and loss sections should be applied only when consistent with the congressional purpose. This purpose was seen to be the separation, for tax purposes, of investment activities from everyday business activities:

> Congress intended that profits and losses arising from the *everyday operation of a business* be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."[60] (Emphasis added).

The Court was convinced that taxpayer was not a capital investor or "legitimate capitalist"[61] seeking to make a profit by trading in corn futures, but a self-insurer seeking to protect its profit margin on the sale of corn products:

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59. *Id.* at 51.

60. *Id.* at 52.

61. "Legitimate capitalists" are investors who purchase and sell such things as commodity futures for "future delivery with a view to profit based on the laws of supply and demand." 3B J. MERTENS, *supra* note 17, at § 22.14.

> [I]n labeling its activity as that of a "legitimate capitalist" exercising "good judgment" in the futures market, petitioner ignores the testimony of his own officers that in entering that market the company was "trying to protect a part of [its] manufacturing costs;" that its entry was *not* for the purpose of "speculating and buying and selling corn futures" *but* to fill an actual "need for the quantity of corn [bought] . . . in order to cover . . . what [products] we expected to market . . . ." *[T]his is not the talk of the capital investor but of the farsighted manufacturer.* For tax purposes petitioner's purchases have been found to "constitute an integral part of its manufacturing business . . . ."[62] (Emphasis added).

Because the futures transactions were an integral part of taxpayer's everyday business operations, the futures contracts themselves were held to be non-capital assets.

The *Corn Products* case was a very significant development in capital gains taxation. *Bagley & Sewall* and *Tulane Hardwood* had introduced a rudimentary "business property"-"investment property" distinction. In effect, they had held that by definition section 117 (now section 1221), which deals with investment activities, does not reach the items that are covered by section 23 (now sections 162(a) and 165(a)). Section 23 items are those expenditures and losses arising from the everyday operation of the taxpayer's business. In order to hold that section 117 did not reach such expenditures, the *Bagley & Sewall* and *Tulane Hardwood* courts necessarily held by implication that the term "property" as used in section 117 meant less than all items capable of being sold. *Corn Products* is significant because it clarified these earlier cases by specifically holding that "property" does not include property acquired in connection with the everyday business activities of the taxpayer.[63] This decision in effect rewrites section 1221 by excluding from the definitional concept "capital asset" all property[64] held, without investment intent, in connection with the taxpayer's everyday business operations. With this "everyday operations" test as the determinant of the proper taxation treatment, the use made of the property, rather than its external characteristics, becomes the critical factor.[65] This approach was

62. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 51 (1955).

63. See the analysis of Troxell and Noall, *supra* note 35, at 195.

64. It is clear that *Corn Products* is not limited to hedging transactions. The Supreme Court chose to affirm the Second Circuit's decision on this broad "business property" rationale. The Second Circuit had held that the futures contracts came within the inventory exclusionary clause. Corn Products Ref. Co. v. Commissioner, 215 F.2d 513, 516 (2d Cir. 1954). The Supreme Court opinion has been criticized for failing to fit the futures into the section 1221(1) exclusion. *See* Brown, *supra* note 23, at 249 (*Corn Products* is an "entirely unnecessary opinion"); Freeman, *Is There a New Concept of Business Asset?*, 36 TAXES 110 (1958); Kaufmann, *A Second Look at the Corn Products Doctrine*, 41 TAXES 605, 607 (1963).

65. *See* Silverstein, *The Capital Asset Definition*, 2 TAX REVISION COMPENDIUM 1285, 1287-88 (House Committee on Ways and Means 1959) (comparison made between "historical" or traditional characterization and "characterization based on use").

borrowed from the definitional section itself. Section 1221(1) excludes assets from capital treatment if they are used in a specified way by the taxpayer—*i.e.*, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The Court used these excluded categories as indicia, pointing toward the type of property Congress intended to exclude.[66] From this, the Court inferred the basic congressional policy: the exclusion from capital treatment of everyday business transactions. As explained before, this policy was effectuated by rewriting the term "property" to read "investment property." Thus, the *Corn Products* decision actually did little more than give this definitional term a meaning consistent with congressional policy.[67]

C. *Post-Corn Products Cases*

Since the Supreme Court's decision twelve years ago in *Corn Products,* the courts have had a number of opportunities to consider the implications of the "business property"-"investment property" distinction, as applied to transactions in securities. All of these subsequent cases have involved losses on the disposition of securities. The general rule applied in these cases is well stated in a 1962 Court of Claims case, *Booth Newspapers, Inc. v. United States:*

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.[68]

1. *Source-of-Materials Cases.*—Ten of these post-*Corn Products* cases have been "source-of-materials" cases. These deal with a single pattern of facts: the taxpayer acquired the securities in order to obtain a supply of goods in short supply and needed by the taxpayer in his business.[69] Typical of these cases is *Electrical Fittings*

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66. *See* text accompanying note 31 *supra.*

67. There are several excellent discussions of the *Corn Products* case. *See* Herzberg, *supra* note 57, at 179; Surrey, *supra* note 9, at 989-96; Troxell & Noall, *supra* note 35, at 187-88; Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion,* 65 YALE L.J. 401 (1956); Comment, *supra* note 13, at 710-12.

68. 303 F.2d 916, 921 (Ct. Cl. 1962).

69. Journal Co. v. United States, 195 F. Supp. 434 (E.D. Wis. 1961) (shortage of newsprint); Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958) (to obtain a line of women's clothing); Planter's Exchange, Inc. v. United States, 57-1 U.S. Tax Cas. ¶ 9565 (N.D. Fla. 1957) (shortage of nitrogen used in fertilizer); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (shortage of newsprint); Missisquoi Corp., 37 T.C. 791 (1962) (shortage of sulphite pulp); Electrical Fittings Corp, 33 T.C. 1026 (1960) (shortage of iron castings); Gulftex Drug Co.,

Corp.,[70] in which the taxpayer manufactured and sold electrical conduit fittings. Because of the Korean conflict, the taxpayer was faced with a shortage of iron castings, the raw material which it fashioned into fittings. To overcome this shortage, the taxpayer joined with two other corporations and an individual in organizing a corporation to produce suitable castings. The new corporation's product was unsatisfactory, and it experienced financial difficulties. As the Korean conflict ebbed, castings became available from other sources, and the taxpayer's orders to the new corporation decreased, until by the end of the conflict they had completely stopped. Shortly thereafter, taxpayer sold its stock for a nominal amount.

The Tax Court found that the taxpayer did not intend to hold the stock as an investment, but to insure itself a supply of needed castings. Therefore, the loss was held to be ordinary because "where the only purpose is to insure a vital source of inventory [the stock] is not a capital asset, and the loss upon its sale is deductible from ordinary income."[71] The court acknowledged that the stock was listed as an investment on the taxpayer's books, but held this fact to be inconclusive. Instead, the following factors were considered indicative of the lack of an investment purpose: taxpayer owned no other securities; the new corporation sold all of its product at cost to the shareholders; taxpayer was unable to purchase the needed castings elsewhere; and taxpayer held the stock only so long as was reasonably necessary under the relevant market conditions.[72]

The "source-of-materials" cases have almost uniformly[73] resulted in victory for the taxpayer. Courts have had little difficulty in finding that stock purchased to insure a needed supply of goods is "business property."[74] The acquisition of needed raw materials or supplies is readily identified with the everyday business operations of the taxpayer.

Inc., 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958) (shortage of whiskey); Old Dominion Plywood Corp., 25 CCH Tax Ct. Mem. 678 (1966) (shortage of lumber products); Helen M. Livesley, 19 CCH Tax Ct. Mem. 133 (1960) (shortage of potatoes); Arlington Bowling Corp., 18 CCH Tax Ct. Mem. 896 (1959) (shortage of bowling pins).

70. 33 T.C. 1026 (1960).

71. *Id.* at 1031.

72. *Id.*

73. Two "source-of-materials" cases have been decided against the taxpayer because the underlying business reason for purchasing the securities had ceased to exist at the time of their disposition. Missisquoi Corp., 37 T.C. 791 (1962); Gulftex Drug Co. v. Commissioner, 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958). For a discussion of these cases, see text accompanying note 96 *infra.*

74. *See* Herzberg, *supra* note 57, at 176-78; Troxell & Noall, *supra* note 35, at 196-204. Rev. Rul. 58-40, 1958-1 Cum. Bull. 275, indicates the Commissioner's acceptance of ordinary loss consequences in "source-of-materials" cases.

2. *Other Cases.*—However, the judicial erosion of the concept of securities as capital assets is not limited to the "source-of-materials" situation. The "business property"-"investment property" distinction has been extended into other, widely diverse areas. Securities have been held to be non-capital "business property" when the purpose for their acquisition was: protecting and retaining a valuable source of purchases of the taxpayer's products;[75] diversifying the taxpayer's business;[76] enabling taxpayer, who operated an insurance agency, to enter into a favorable agency contract;[77] obtaining a source of competent personnel to market taxpayer's products;[78] enabling the taxpayer to sell mortgages to the Federal National Mortgage Association;[79] and ridding the taxpayer of a shareholder whose continued ownership of stock in the taxpayer-corporation jeopardized its continued existence.[80] As is well demonstrated by a recent Seventh Circuit case, *John J. Grier Co. v. United States*,[81] it is impossible to predict the outer boundaries of the rapidly expanding application of the "business property" concept.[82] In the *Grier* case, the taxpayer-corporation operated restaurants adjacent to railroad stations. Wishing to diversify because of reduced railroad activity, it purchased other types of eating establishments. As part of this diversification program, the taxpayer purchased all of the stock of a corporation operating a supper club. Stock, rather than assets, was acquired because the taxpayer felt that the owner of the land upon which the club was located would not consent to an assignment of the lease. The price paid for the stock was identical to the sales price of the selling corporation's assets. The supper club's operations were integrated with taxpayer's business. Three years after the acquisition, the stock was sold at a loss. The court, in holding that the loss sustained was an ordinary loss, said:

> Corporate stock is not invariably classified as a capital asset. To ascertain whether stock is bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business, all the surrounding circumstances must be considered. The substance, as distinguished from the

75. Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963).
76. John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964).
77. Southeastern Aviation Underwriters, Inc., 25 CCH Tax Ct. Mem. 412 (1966).
78. Weather-Seal, Inc., 22 CCH Tax Ct. Mem. 471 (1963).
79. Schumacher Mortgage Co., v. United States, 60-2 U.S. Tax Cas. ¶ 9524 (W.D. Tenn. 1960); McMillan Mortgage Co., 36 T.C. 924 (1961).
80. Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966).
81. 328 F.2d 163 (7th Cir. 1964).
82. Several post-*Corn Products* non-"source-of-materials" cases have rejected the taxpayer's claim that the securities were "business property." Light Aggregates, Inc. v. United States, 225 F. Supp. 253 (D.S.D. 1963); Wilaka Builders, Inc., v. United States, 64-2 U.S. Tax Cas. ¶ 9159 (S.D.N.Y. 1964); Duffey v. Lethbert, 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963); Martin v. United States, 56-2 U.S. Tax Cas. ¶ 9990 (N.D. Ga. 1956); Ancel Greene & Co., 38 T.C. 125 (1962).

> form, of the taxpayer's actions determines whether the sale of the stock results in ordinary gain or loss in this particular case . . . .
>
> The Evergreen stock had value only to someone who wished to operate the Club. Grier bought the stock and retained it only to secure the assets as an incident to conduct of its restaurant business and not for investment . . . .
>
> Nor can we agree with the government that this case is basically distinguishable in principle from those cases involving purchase of stock to insure a source of supply for inventory or to post security for performance of a contract.[83]

This decision appears to bestow the benefits of ordinary tax treatment upon a transaction which is something more than an "everyday business transaction." The stock was purchased to enable the taxpayer to use the club and all of its accompanying assets in his business. The objects of the transaction—the club and its furnishings—are not the type of assets which are normally transferred or consumed in the ordinary course of business. Therefore, the Seventh Circuit's concept of "business property" appears to be broader than that of the "sources-of-materials" cases, because in those cases the reasons prompting the stock acquisition were truly "everyday business" reasons. The *Grier* case is representative of the judicial expansion of the "business property" concept.[84]

D. *Factors Indicating Purpose of Acquisition and Holding*

As noted earlier,[85] the "business property"-"investment property" distinction places an emphasis on the use made of the property rather than its external characteristics. Therefore, the purpose for which the taxpayer purchases and holds the securities is determinative. It is important to examine the factors relied on by the courts in their attempts to ascertain the reasons for which securities are purchased and held.

Of course, the first question asked by the courts is: What was the exact reason for the acquisition of the securities by the taxpayer? Usually, the answer to this question is decisive in determining whether the taxpayer possessed the requisite "business purpose." If the taxpayer's purpose is to insure a needed supply of goods, a "business purpose" is almost automatically found.[86] However, if the court is faced with a non-"source-of-materials" case, the difficulty of its task is increased due to the uniqueness of the factual situation with which it is confronted.[87] The question of relevant taxpayer intent is a

83. John J. Grier Co. v. United States, 328 F.2d 163, 165 (7th Cir. 1964).

84. *See* Troxell & Noall, *supra* note 35, at 206-07.

85. *See* text accompanying note 65 *supra.*

86. *See* notes 69-73 *supra.*

87. "A legislative attempt to draw a distinction between the tax on capital gain and ordinary income must necessarily produce a puzzling line of decisions for the facts

factual one in which "the circumstances of the transaction, its factual background, the necessities of the business involved and the intentions of [the] taxpayer"[88] must be considered. These factors will reveal the taxpayer's purpose—be it "business" or "investment"—for acquiring and holding the stock.

Various minor factors aid the court in its determination of the reason for which the securities were purchased and held by the taxpayer. The cumulative effect of these minor factors may change the result in a close case. However, their importance is not great when taken individually. For instance, the fact that the taxpayer has made little or no expenditure for other securities may indicate that he is not holding the securities in question for an "investment" purpose.[89] If a taxpayer has only a slight chance of recovering his investment, a "business" purpose is indicated.[90] However, hope or expectation of recovering money spent on the securities does not require the loss to be capital in nature.[91] Also, an actual failure to receive dividends or other income from the issuer of the securities is indicative of a "business" purpose.[92] But the receiving of dividends from the issuer does not necessitate the finding of an "investment" purpose if countervailing "business" factors are present.[93] The fact that the securities are entered in accounting records or tax returns as "investments" is competent evidence showing an "investment purpose," but is of little consequence in the face of conflicting evidence.[94]

It is very important to note that the "business" purpose for acquiring the stock can change to an "investment" purpose while the stock is held. The taxpayer's intent may change after the securities have been acquired, and with the change of intent there is a change in the character of the securities. For a loss on the sale or worthlessness of securities to be given ordinary loss treatment, a "business" purpose must still exist at the time of the sale or worthlessness. If the securities are not disposed of within a reasonable period of time after the

are as variable as human activities." Curtis Co. v. Commissioner, 233 F.2d 167, 170 (3d Cir. 1956) (Goodrich, J.).

88. Commissioner v. Bagley & Sewall Co., 221 F.2d 944, 946 (1955).

89. *See* Electrical Fittings Corp., 33 T.C. 1026, 1031 (1960); Rev. Rul. 58-40, 1958-1 CUM. BULL. 275. *But see* Arlington Bowling Corp., 18 CCH Tax Ct. Mem. 896 (1959) (fact that taxpayer had other investments is no barrier to finding "business" purpose).

90. Weather-Seal, Inc., 22 CCH Tax Ct. Mem. 471 (1963); Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955).

91. Journal Co. v. United States, 195 F. Supp. 434 (E.D. Wis. 1961).

92. Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963); Electrical Fittings Corp., 33 T.C. 1026 (1960).

93. *See* Smith & Welton, Inc. v. United States, 164 F. Supp. 605, 608 (E.D. Va. 1958).

94. Journal Co. v. United States, 195 F. Supp. 434 (E.D. Wis. 1961); Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958); Electrical Fittings Corp., 33 T.C. 1026 (1960).

underlying business reason for their acquisition ceases to exist, the purpose of the taxpayer's holding will be considered to be of an "investment" nature from the time of the end of that reasonable period.[95] This point is illustrated by a Tax Court case, *Missisquoi Corp.*,[96] in which the taxpayer purchased debentures to protect its supply of an essential raw material, unbleached sulphite pulp. The acute shortage of suitable pulp was ended by 1952, but the taxpayer did not sell the debentures until 1955. The court felt that if the debentures had been sold or had become worthless within "a reasonable time" after the reason for acquisition had ceased to exist, the *Tulane Hardwood* rule would have controlled. However, a reasonable time for resale had passed, and the taxpayer could no longer claim "the cloak of . . . business purpose for which [the debentures] were originally acquired."[97] The "reasonableness" of the holding period will be determined from the facts of the case. Although it does not appear that the taxpayer is precluded from endeavoring, for a reasonable period of time, to obtain the best possible price for the securities,[98] *Missisquoi* emphasized that the taxpayer may not hold the securities indefinitely while waiting for a better price.

There are other problems with which courts are concerned in the corporate stock area. One of these involves the control the taxpayer exercises over the corporation issuing the stock in question. The Commissioner apparently feels that the stock involved must represent a minority interest and must not be equivalent to the control of the corporation.[99] This rule has been rejected, both explicitly[100] and implicitly,[101] by the courts. Ordinary loss treatment has been given to taxpayers holding 100 per cent of the stock of the issuing corpora-

95. *See* Rev. Rul. 58-40, 1958-1 Cum. Bull. 275 (securities must be disposed of within relatively short time after acquisition); 3B J. Mertens, *supra* note 17, § 22.16 at 105-06; Troxell & Noall, *supra* note 35, at 199-200.

96. 37 T.C. 791 (1962). Other cases denying ordinary loss treatment because of failure to dispose of securities within a reasonable period are Gulftex Drug Co. v. Commissioner, 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958), and Ancel Greene & Co., 38 T.C. 125 (1962).

97. Missisquoi Corp., 37 T.C. 791, 797 (1962).

98. *See* Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962). An interesting problem is raised by Troxell & Noall, *supra* note 35, at 202. Because the classification of the asset at the time of its sale or disposition controls the tax treatment given, the purpose of the acquisition of the asset should be irrelevant except as an indication of the taxpayer's purpose in holding the asset. Therefore, a taxpayer should be allowed to prove that securities have been converted into non-capital assets through the occurrence of some event subsequent to the acquisition. There have apparently been no cases ruling on this situation.

99. *See* Rev. Rul. 58-40, 1958-1 Cum. Bull. 275; Herzberg, *supra* note 57, at 177.

100. Old Dominion Plywood Corp., 25 CCH Tax Ct. Mem. 678 (1966).

101. John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962); Southeastern Aviation Underwriters, Inc., 25 CCH Tax Ct. Mem. 412 (1966).

tion,[102] and the same result has been accorded to taxpayers with very small stock holdings.[103] The amount of stock held by the taxpayer probably should be a neutral factor. For instance, ownership of a large percentage of the stock of a corporation supplying a needed raw material to the taxpayer might indicate a "business" purpose because of the taxpayer's increased ability to get the goods he needs. On the other hand, the same high percentage ownership might tend to indicate an "investment" purpose, in that it could be argued that the taxpayer bought the stock for the purpose of controlling and managing the corporation, rather than insuring a needed supply of goods. The "source-of-materials" cases seem to say that actual control of the supplier, or a contractual right to the goods, is not necessary. An unenforceable understanding may be sufficient.[104]

Another question raised by these cases involves the degree of business need motivating the purchase of the stock. It seems clear that it need not be a "life-and-death" matter for the stock to be held noncapital. The Tax Court has stated:

> It is not necessary for petitioners to prove that, absent the claimed expense, [taxpayer's] business would have been crippled or would have failed. Responsible businessmen make legitimate expenditures every day that would not measure up to such a "survival" test.[105]

A district court has expressly recognized that the section 1221 "business" purpose test is the same as that used under section 162(a) for determining what constitutes an "ordinary and necessary" expense.[106] Thus, in the words of Mr. Justice Cardozo, the purchase of the securities must be "appropriate and helpful"[107] to the carrying on of the taxpayer's everyday business operations; it must be a "common and accepted means"[108] used in these business operations. However, this view would not be completely accurate in those cases where business loss treatment is given.[109] The *Tulane Hardwood*[110] case, which held that the worthless debentures could be fully deducted as either a business expense or business loss, stated that the taxpayer purchased the debentures as a "reasonable and necessary act in the conduct of

102. John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).

103. Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958).

104. *See id.*; Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955). *See* general discussion in Troxell & Noall, *supra* note 35, at 202-03.

105. Helen M. Livesley, 19 CCH Tax Ct. Mem. 133, 140 (1960).

106. Smith & Welton, Inc. v. United States, 164 F. Supp. 605, 609 (E.D. Va. 1958).

107. Welch v. Helvering, 290 U.S. 111, 113 (1933).

108. *Id. See also* 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.09 (Riordan ed. 1966).

109. *See, e.g.*, John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964).

110. Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955).

its business."[111] This test would be more inclusive, applying both to sections 162(a) and 165(a).[112] It is clear that "reasonable and necessary," as applied in the cases, means "reasonable" and "appropriate," rather than "reasonable" and "absolutely necessary." The degree of need should be regarded as evidence of the probable intent of the taxpayer.[113]

A related problem concerns the distinction often drawn between securities acquired for the purpose of expanding the taxpayer's business and securities acquired for the purpose of protecting an existing business. Several securities cases have suggested that a division should be drawn between these two types of transactions, with only the latter classified as "business property."[114] A district court has stated that it

> believes that a distinction has been drawn between cases in which securities are acquired for the purpose of obtaining an advantage which did not previously exist, as contrasted with situations in which securities are purchased for the purpose of protecting that which existed and is now threatened.[115]

However, only one post-*Corn Products* securities case has utilized this expansion-protection division to deny ordinary loss treatment. In *Duffey v. Lethert*,[116] a district court ruled that stock of a newly organized publishing company, acquired by a paper jobber in order to make sales of paper to the publisher, was a capital asset. The court felt that there is a vital difference between buying a source of supply of a needed raw material to keep from going out of business and "buying stock in a new and totally unproved company in an effort to increase sales. The former case is one of a necessary expenditure; the latter is a speculative one."[117] *Bagley & Sewall* was distinguished on the ground that in that case the bond purchase was necessary if

111. *Id.* at 1150.

112. Since *Tulane Hardwood Lumber Co.*, the loss on disposition of "business" securities has been consistently treated as a business expense under section 162(a) or a business loss under section 165(a). The deduction is taken in the year of the loss. Some of the pre-1955 "tie-in" cases treated the loss as an element of the cost of goods sold. *See* note 36 *supra.* For a discussion of the merits of the cost-of-goods-sold approach, see Note, *Tie-In Sales: Treatment of Loss on Resale of Property Purchased for the Purpose of Obtaining Other Property,* 10 Tax L. Rev. 145 (1954).

113. *See* Troxell & Noall, *supra* note 35, at 198-99.

114. *See* Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963); Duffey v. Lethert, 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963); Weather-Seal, Inc., 22 CCH Tax Ct. Mem. 471 (1963); Smith & Welton, Inc., v. United States, 164 F. Supp. 605 (E.D. Va. 1958); *cf.* Chase Candy Co. v. United States, 126 F. Supp. 521 (Ct. Cl. 1954). This general distinction is recognized in several non-securities cases. *See especially* Welch v. Helvering, 290 U.S. 111 (1933). *See generally* 4A J. Mertens, *supra* note 108, at §§ 25.09, 25.20, 25.40.

115. Smith & Welton, Inc. v. United States, 164 F. Supp. 605, 609 (E.D. Va. 1958).

116. 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963).

117. *Id.* at 88, 191.

the taxpayer were to obtain the manufacturing contract involved, while the issuer in *Duffey v. Lethert* was a new corporation and sales might never be made to it. The court concluded:

> But it is not so much the speculative nature of this transaction which takes it from the purview of Section 162(a), it is the fact that the expenditure looked principally to the future, promising additional gain, and not to the matter of keeping what business the [taxpayer] already had.[118]

This latter statement appears to have considerable precedent against it. Several cases have involved purchases clearly motivated by a desire to expand, diversify or gain business.[119] These taxpayers "looked principally to the future," and still received ordinary loss treatment.

IV. Major Problem Areas

A. *The Definitional Problem*

By developing the "business property"-"investment property" distinction, the courts have attempted to give the definitional term "property" a meaning consistent with basic congressional policies.[120] In the *Corn Products* case, the Supreme Court approved this basic distinction, and thereby authorized the use of the "business property" concept as a tool by courts faced with difficult definitional problems. This concept has received further, specialized development in the securities area. In the source-of-materials area, the "business property" rationale has been firmly established. However, as pointed out in the discussion of the "protecting present business"-"acquiring new business" distinction,[121] the source-of-materials area is still in a state of uncertainty and evolution. Furthermore, the newest area of development for the "business property" concept is in cases not dealing with the traditional source-of-materials situation. Because these new cases involve factual situations never before faced by the courts, uneven and perhaps inconsistent capital gain and loss treatment has resulted.[122] The major reason for this uncertainty is that objective,

118. *Id.*

119. *See* John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964) (see discussion accompanying notes 81-83 *supra*); Journal Co. v. United States, 195 F. Supp. 434 (E.D. Wis. 1961), where stock purchased for purpose of obtaining newsprint was shown to be "business" property by fact that additional newsprint resulted in vastly increased profits through expansion in circulation and advertising linage. Also, Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955), clearly involves a taxpayer who "looked to the future" and gained business he would not otherwise have had; Southeastern Aviation Underwriters, Inc., 25 CCH Tax Ct. Mem. 412 (1966) (stock bought for purpose of enabling taxpayer to obtain an advantageous new contract).

120. *See* text accompanying notes 63-67 *supra.*

121. *See* text accompanying notes 114-19 *supra.*

122. *Compare* John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964),

easily ascertainable limits to the "business property" concept have not yet evolved. The rules are fairly easy to state: "profits and losses arising from the everyday operation of business [shall] be considered as ordinary income or loss;"[123] an ordinary loss results if the taxpayer's "action in purchasing the [security] was a reasonable and necessary act in the conduct of its business."[124] However, it is unrealistic to expect the courts to apply these broad, somewhat vague rules to widely diverse factual situations and achieve uniform orderly results. Both Congress and the courts have sensed the basic difference between "everyday business operations" and "investments." But to be able to solve the difficult problems arising on the "business property" frontiers, the courts must be guided by more than this general notion. Instead, specific, reasoned answers must be given to the questions: What is "business property"? What are "everyday business operations"? It is one thing to state that the "business"-"investment" distinction exists; it is quite another to make that distinction workable in unforeseen factual situations. Taxpayers and courts should be provided with workable standards which provide a greater degree of foreseeability as to the category into which a transaction will be placed. The distinction must be clarified so that a more conclusive dividing line can be drawn in future cases.[125]

B. *The Administrative Problem*

The "business property" cases have also raised a severe administrative problem for the Commissioner. All of the post-*Corn Products* corporate securities cases have involved claims by taxpayers that an ordinary loss should be allowed because securities were "business property." No case has been found in which the Commissioner was able to establish that a gain on sale of securities should be treated as ordinary income under the *Corn Products* doctrine.[126] In fact, there is apparently no post-*Corn Products* court case where the Commissioner has even taken such a position.[127] The reason for this is fairly

with Duffey v. Lethert, 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963). *See* Troxell & Noall, *supra* note 35, at 207-08.

123. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955).

124. Tulane Hardwood Lumber Co., 24 T.C. 1146, 1150 (1955).

125. Several commentators have noted that the taxpayers and courts are deprived of a sufficiently objective guide in this area. *See* Freeman, *supra* note 47; Herzberg, *Capital Loss or Business Deduction*, 43 TAXES 176, 179 (1965); Kaufmann, *supra* note 64, at 607; Surrey, *supra* note 9, at 995; Troxell & Noall, *supra* note 35, at 207-08; Note, *supra* note 67, at 409. "The boundary line between capital gains and other income is arbitrary, capricious, subject to manipulation, and an invitation to litigation." Groves, *Taxation of Capital Gains*, 2 TAX REVISION COMPENDIUM 1193, 1196 (House Committee on Ways and Means 1959).

126. *See* Kaufmann, *supra* note 64, at 612.

127. *Id; cf.* Harry Dunitz, 7 T.C. 672 (1946), *aff'd per curiam*, 167 F.2d 223 (6th Cir. 1948).

obvious. If the securities are sold at a loss, the taxpayer may report the loss as an ordinary deduction. If the treatment of the loss is subsequently questioned on an examination of the return, the taxpayer can emphasize the underlying business context, and take the question to court if necessary. But if the property is sold at a profit, the taxpayer may report the increment as capital gain without mentioning any surrounding circumstances. Thus, on the strength of the information contained in the return, the Commissioner will not be able to differentiate between dispositions of "business property" and "investment property." The Commissioner is obviously unable to scrutinize the circumstances surrounding all reported capital gains. Therefore, he does not possess an effective enforcement tool.

The above result does not necessarily presuppose bad faith on the part of the taxpayer. Securities may be purchased for a variety of reasons. A taxpayer may invest in stock for valid "business" purposes, but at the same time feel that the stock has a good chance for appreciation. If the stock is subsequently sold at a gain, the taxpayer, in his own mind, may emphasize the "investment" motive. If the stock is subsequently sold at a loss, he is likely to think of the loss as an unavoidable business expense, and not as an indication of his own lack of investment expertise. As one commentator says: "The taxpayer in effect is almost forced to take advantage of the present 'loophole' by operation of human psychology."[128]

In summation, the two major problems in this area seem to be: (1) the lack of objective, easily ascertainable limits to the "business property" concept; and (2) the opportunity offered taxpayers to take unwarranted advantage of the "business property" concept by taking capital gains treatment in the case of a gain and ordinary loss treatment in the case of a loss.[129]

C. *Solving the Definitional Problem*

1. *Basic Capital Gains Policies.*—The drawing of the "business property"-"investment property" distinction should be based on those basic policy considerations associated with capital gain and loss treatment. The dividing line should not be arbitrarily drawn, but should be consistent with the objectives sought to be achieved by the statutory distinction. This is not to say that the preferential treatment given capital gains is necessarily wise from a tax policy viewpoint.[130] An

128. Kaufmann, *supra* note 64, at 613. *See* Note, *supra* note 67, at 409.

129. This is similar to the treatment afforded "section 1231" assets. INT. REV. CODE of 1954, § 1231.

130. A vast amount of literature deals with arguments for and against special treatment for capital gains and losses. For a convenient summary of these arguments see Blum, *A Handy Summary of the Capital Gains Argument*, 35 TAXES 247 (1957). For more detailed comments on policy issues, see 2 HOUSE COMM. ON WAYS AND MEANS,

examination of operative economic, accounting and tax administration policies has led many to reject the present statutory distinction, and to urge either complete elimination of the capital gain-ordinary income differentiation, or substantial revision of the capital gain and loss provisions.[131] This note does not pursue those inquiries. Instead, it assumes the continuance of preferential statutory treatment of capital gain and the general capital gain statutory and case law principles.[132] For the purpose of this present study, it is assumed that the relevant tax policy considerations favor the continued maintenance of a special capital gains tax category. This study will briefly examine the major policies associated with preferential capital gain treatment, and will then use these policies as a basis for a proper definition of the "business property" concept.

Many arguments have been advanced in support of the present treatment of capital gain and loss.[133] However, the preferential treatment accorded capital assets appears to rest primarily on three basic policies:[134] (1) ameliorating the effect of "bunched" income; (2) increasing the mobility of investment funds; and (3) furnishing a positive incentive for capital formation and risk-taking. For the distinction derived from these policies to be meaningful, they must be accompanied by an intensely practical policy consideration: taxpayers must not be allowed to avoid taxes by converting ordinary income into capital gain.

The first of these basic policies is: relief should be provided against the impact of progressive rates on the bunching of gain in one tax

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TAX REVISION COMPENDIUM 1193-1299 (1959); JOINT COMM. ON THE ECONOMIC REPORT, FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY, 84th Cong., 1st Sess. 367-404 (1955); L. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES (1951); TAX ADVISORY STAFF, TREASURY DEPARTMENT, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES (1951); Blum, *Taxation of Capital Gains in the Light of Recent Economic Developments—Some Observations*, 18 NAT'L TAX J. 430 (1965); Slitor, *Problems of Definition under the Capital Gains Tax*, 10 NAT'L TAX J. 26 (1957); Somers, *Reconsideration of the Capital Gains Tax*, 13 NAT'L TAX J. 289 (1960); Wallich, *Taxation of Capital Gains in the Light of Recent Economic Developments*, 18 NAT'L TAX J. 133 (1965).

131. *See, e.g.*, Groves, *Taxation of Capital Gains*, 2 TAX REVISION COMPENDIUM 1193 (House Committee on Ways and Means 1959).

132. These are the same basic assumptions as those of an American Law Institute study of definitional problems in capital gains taxation. ALI DISCUSSION DRAFT STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION (1960) [hereinafter cited as DISCUSSION DRAFT STUDY].

133. Professor Blum lists 25 arguments for preferential treatment for capital gains. Blum, *A Handy Summary of the Capital Gains Argument*, 35 TAXES 247, 248-61 (1957).

134. The conclusion that these three policies are "basic" was reached after a consideration of the writings listed in note 130 *supra*; DISCUSSION DRAFT STUDY; Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964); Katcher, *A Critique of Capital Gains Taxation Problems and Proposals*, U. SO. CAL. 1962 TAX INST. 769.

year.[135] This bunching results from the holding of property over a period of several years during the course of which there is an increment in the value of the property. When the property is sold, taxation at ordinary rates of the entire gain which has accumulated during the holding period may result in an unusually large tax because of the concentration of the gain in the year of sale. Because of the progressive rate structure, the taxpayer may be taxed at a higher rate than that resulting from taxation spread throughout the holding period. This result is generally considered objectionable from the viewpoint of fairness to the taxpayer.[136]

The second basic policy favoring preferential treatment of capital gains is: the tax structure should relieve the impediment to the transfer of investment assets which may result from the imposition of a tax on the gain at the time of the transfer. This is the so-called "locked-in" aspect of capital gains taxation. A taxpayer holding appreciated income-producing property has the choice of holding or selling the property. If he continues to hold the property he pays only a tax on the income from the property. If he sells and reinvests the proceeds he pays a tax both on the appreciation in value of the property and on the income from the reinvested proceeds. Therefore, a full tax on capital gains might influence the taxpayer to hold the property instead of selling it and realizing gain. As a result, some sales which would have been made in the absence of tax considerations may not be made. This decreased mobility of capital investment is undesirable because it would tend to prevent the most efficient allocation of resources.[137]

The third basic policy associated with capital gain treatment is: a positive incentive for capital formation and risk-taking should be furnished. A lower rate for capital gains operates to attract funds into activities which may produce capital gains. A premium is placed on risky business ventures because when they are successful the capital appreciation is likely to be relatively large and the ordinary income relatively small. To subject this large capital appreciation to progressive rates would be to discourage capital formation and risky business ventures. This policy of encouraging risk-taking is a positive one—the tax system is employed to direct economic activity

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135. The policy of relieving the taxpayer from the effects of "bunching" has been stated to be the reason for the original enactment of special treatment for capital gains. Burnet v. Harmel, 287 U.S. 103, 106 (1932).

136. *See generally* Discussion Draft Study 187-89; Blum, *supra* note 133, at 253.

137. For general discussions of the "locked-in" aspect, see Brown, The Locked-In Problem, Federal Tax Policy for Economic Growth and Stability 367 (Joint Committee on the Economic Report 1955); Discussion Draft Study 183-87; Blum, *supra* note 133, at 256-58; Wallich, *supra* note 130, at 142-50.

along lines of economic expansion.[138] This should be distinguished from the anti-"lock-in" policy, a neutral policy based on the view that the tax system should not interfere with the operation of market mechanisms.

2. *The ALI Discussion Draft Study—General Definition.*—The present uncertainty in the capital gains definitional area indicates the extreme difficulty of fashioning a workable capital asset classification from the three basic policies discussed above. However in 1960, the Tax Policy Committee and Tax Advisory Group of the American Law Institute undertook to achieve this very goal. The results of this exhaustive study are reported in the *Discussion Draft Study of Definitional Problems in Capital Gains Taxation* (hereinafter referred to in text as *Discussion Draft Study*). Because of the expertise of the participants in the study[139] and the high quality of their discussion and proposals, the *Discussion Draft Study* will be used as the basis for this note's attempt to clarify the "business property" concept.

The *Discussion Draft Study* "assumes the continuance of a preferential statutory treatment of capital gain . . . and the broad assumptions of statutory and case law as to the general principles governing the classification of gain or loss as capital or ordinary."[140] Using the three basic policy justifications for the present preferential capital gain treatment as a basis for discussion, the *Discussion Draft Study* evolves a general residual capital asset definition:

> An asset . . . shall be treated as a capital asset if it satisfies the following conditions—
> (A) the asset is of a class which characteristically requires either an outlay of funds or a commitment of credit at the time of its acquisition; and
> (B) the asset is not a limited duration asset . . . .[141]

A "limited duration asset" is defined as:

> [A]n asset other than an asset which is of a character such that—
> (A) the future period during which the asset can reasonably be expected (at the time of its disposition) to have substantial value is not less than ___ years, or
> (B) the length of the future period during which the asset can reasonably be expected (at the time of its disposition) to have substantial value cannot be ascertained to be less than ___ years.[142]

The *Discussion Draft Study* does not fix the specific number of years of anticipated future life to be required for qualification as a capital

138. For general discussion of the "incentive" aspect, see Discussion Draft Study 189-91; Blum, *supra* note 133, at 259-60; Groves, *supra* note 125, at 1197-98.
139. The ALI reporters were Stanley S. Surrey and William C. Warren.
140. Discussion Draft Study 1.
141. *Id.* at 21.
142. *Id.* at 28.

asset, but leaves this question open. However, the relevant factors for this determination are discussed, and the desired time interval would appear to be between 19 and 30 years.[143]

The two facets of the *Discussion Draft Study's* general capital asset definition are reflections of the relevant capital gains policies. The first facet—"the asset is of a class which characteristically requires either an outlay of funds or a commitment of credit at the time of its acquisition"—requires that the asset represent a substantial capital investment. This "capital investment" requirement is significant from the viewpoint of the third basic policy—capital gain treatment should furnish a positive incentive for capital formation and risk-taking. If the inherent nature of the asset is such that its acquisition does not characteristically involve an outlay of funds or commitment of credit, the according of capital gain treatment cannot be justified on the ground of encouraging risk-taking. Hence, capital gain treatment should not be given to sales of assets not requiring substantial capital investment.[144]

The second facet of the *Discussion Draft Study's* definition—"the asset is not a limited duration asset"—requires that the asset represent a fairly long period of "capital commitment." This requirement is primarily related to the second basic policy—capital gain treatment should not discourage the mobility of capital. The *Discussion Draft Study's* analysis shows that the tax impediment to the sale of an asset which has a relatively short future life is less than the impediment to the sale of an asset which has a relatively long future life. The decision to sell an appreciated asset involves the relinquishment of the power to defer tax on the appreciation inherent in the asset. This power is worth less in the case of short-lived assets than in the case of long-lived assets. Inasmuch as a less valuable power to defer tax is relinquished, a sale of a short-lived asset which is subject to a higher rate of tax involves a deterrent or impediment to sale which is approximately equivalent to that involved in a correspondingly lower rate of tax on the sale on longer-lived assets. This equivalence may be made specific by means of interest computations, which lead to the determination of a specific number of years to place in the definition of "limited duration asset."[145] In summation, the second

143. *Id.* at 55-58, *see* note 150 *infra.*

144. For a discussion of the "capital investment" requirement, see DISCUSSION DRAFT STUDY 11, 53, 189-91. Examples of assets not requiring an outlay of funds or commitment of credit at the time of acquisition are: (1) right of privacy; and (2) employment contract.

145. "If an after-tax rate of return [on the investment in the asset] is assumed, then a full tax on the sale of an asset with a future life of a particular number of years can be shown to involve the same impediment to sale as a corresponding reduced rate of tax on the sale of an asset with an indefinite life. Thus, computation at an after-tax rate of return of 5 per cent shows that a tax at regular rates when applied to the sale of

facet of the *Study's* definition operates to bestow capital gain treatment only on those transactions in which a higher tax would tend to produce a "locked-in" effect.[146]

The *Study* also recognizes that the non-"limited duration" requirement is related to the first basic policy—capital gain taxation should provide relief against the impact of progressive rates on the bunching of gain in the year of sale. The sale of an appreciated asset will bunch into a single year income reflecting the asset's appreciation. In the case of a continued holding, this income would be spread over a longer period of time. Obviously, the bunching effect is not as severe if the asset is relatively short-lived. Hence, full taxation in a single year of a short-lived asset's appreciation is not as unfair to the taxpayer. Although the *Discussion Draft Study* recognizes the relationship between the bunching-avoidance policy and the non-"limited duration" requirement, it does not regard the providing of relief against bunching as an appropriate function of the capital asset definition. Because there is a pronounced difference between the length of asset life which will make the bunching effect significant and the length of asset life which will make the "locked-in" effect significant, it is felt that the capital asset definition is not an appropriate mechanism to effectuate both of these policies.[147] The *Discussion Draft Study* concludes that relief against bunching can be more effectively provided by an averaging device, which operates outside the context of capital gain treatment. For this reason, the bunching aspect is not used as a factor upon which to base the capital asset definition.[148]

The *Discussion Draft Study's* general definition of "capital asset" is a reasonably accurate reflection of the three major capital gain policies. As shown above, these policies would seem to demand that capital gain treatment be restricted to transactions involving assets requiring a substantial amount of "capital investment" and representing a fairly long period of "capital commitment." It is submitted that these general criteria should guide the drawing of a distinction between "investment property" and "business property." However, the

an asset with a future life of 30 years is approximately equivalent impediment to the sale as is a tax at one-half the regular rates when applied to the sale of an asset with an indefinite life." *Id.* at 9. Similarly, computation at after-tax rates of return of 6 and 8 per-cent shows that a tax at regular rates when applied to the sale of assets with future lives of 26 and 19 years, respectively, is equivalent, as an impediment to sale, to a tax at one-half the regular rates when applied to the sale of assets with indefinite lives. *Id. See also id.* at 55-58.

146. For a discussion of the relationship between the "locked-in" aspect and the "capital commitment" requirement, see *id.* at 8-10, 53-58, 183-87.

147. The study's analysis shows that the bunching effect may become significant after three years. In contrast, the "locked-in" effect may not warrant special treatment of gain unless the asset has a much longer life, such as 19, 26 or 30 years. *Id.* at 188-89.

148. *Id.* at 8, 10-11, 188-89. Sections X1300 and X1309 of the Draft Statute provide the averaging mechanisms. *Id.* at 41-45, 49-51. *See id.* at 101-23.

general definition itself is not entirely adequate for this purpose, since its deals with the inherent nature of the asset; that is, the definition specifies the type of asset which requires an "outlay of funds or a commitment of credit" and is relatively long-lived. This is to be contrasted with the functional approach of the *Corn Products* doctrine which makes the use made of the asset rather than its inherent nature controlling. The inherent nature of corporate securities would almost invariably cause them to be classified as capital assets. However, the *Corn Products* doctrine would disregard their inherent nature if they are used in the everyday business operations of the taxpayer.[149] The relevant capital gain policies teach that the "business property"-"investment property" distinction should be based upon the concepts of "capital investment" and "capital commitment." However, *Corn Products* teaches that this distinction must be drawn along functional lines, rather than along lines of inherent differences in the characteristics of assets.

3. *The ALI Discussion Draft Study—"Permanent Capital"-"Current Capital" Dichotomy.*—The *Discussion Draft Study*, recognizing the functional approach of *Corn Products*, gives separate consideration to the treatment of gain or loss on the disposition of property held in connection with the taxpayer's business.[150] The classification of gain or loss on the disposition of these assets is made to turn upon whether the assets are a part of "permanent business capital" or "current business capital." The distinction between "permanent" and "current" business capital is intended to present a more precise formulation of the functional "everyday business operations" test employed by *Corn Products*.[151] "Permanent business capital," which corresponds to "investment property," is defined in this manner:

> [T]he permanent capital of a trade or business shall consist of those assets which are of such a character that they are not normally transferred or consumed in the ordinary course of that trade or business.[152]

Permanent, or fixed, capital is an economist's concept denoting assets having a useful life of some duration and performing a repetitive or specialized function. In performing a repetitive function, permanent

149. *See* Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 51-52. *See also* text accompanying notes 64 & 65 *supra*.

150. *See* DISCUSSION DRAFT STUDY 1, 60.

151. "The distinction between permanent and current business capital is intended to reflect a principle referred to in the *Corn Products* case. The distinction is primarily functional . . . ." *Id.* at 60. This distinction has been adopted by courts in British Commonwealth countries. *Id.* at 358. *See* Slitor, *Problems of Definition Under the Capital Gains Tax*, 10 NAT'L TAX J. 26 (1967) (brief examination of Commonwealth approach).

152. DISCUSSION DRAFT STUDY 22.

capital assets transfer utility to other assets. The most common types of permanent capital are land, buildings, machinery and equipment. Corporate securities would normally be classified as permanent capital because they are not "normally transferred or consumed in the ordinary course" of business. This is recognized by the *Discussion Draft Study's* Draft Statute which lists "securities" as one of the classes of permanent capital assets.[153]

"Current business capital" is the *Discussion Draft Study's* equivalent to the "business property" concept.

> [T]he current capital of a trade or business shall consist of those assets which are of such a character that they are normally transferred or consumed in the ordinary course of that trade or business.[154]

Assets which are the recipients of the transfer of utility from permanent capital, and assets which facilitate that transfer, are current capital. Current capital "circulates" during the course of the normal operating cycle of the business. The most common types of current capital assets are raw materials, work-in-process, finished products on hand, trade receivables, and working bank balances.[155]

4. *The ALI Discussion Draft Study—Securities as "Current Capital."* —The current capital-permanent capital dichotomy would seem to offer a satisfactory solution to the definitional problem. The *Discussion Draft Study's* definitions provide the objective and easily ascertainable limits to the "business property" concept which are needed by courts facing novel factual situations. Furthermore, the *Discussion Draft Study's* solution is basically consistent with both sets of standards examined in this note. First, the three basic capital gains policies demand that a capital asset be the type of asset which requires an outlay of funds or commitment of credit, and is relatively long-lived. A permanent capital asset would usually possess these characteristics, whereas a current capital asset would not. Second, the

153. *Id.* at 21. The general residual capital asset definition and the definitions of permanent and current business capital are contained in the *Discussion Draft Study's* proposed statute. Although an understanding of the proposed statute is not necessary to the understanding of the textual discussion of this note, a brief description of the classification mechanism will be helpful. An asset which cannot be classified as either permanent business capital or current business capital is a capital asset only if it meets the terms of the general residual definition: (A) "outlay of funds or commitment of credit;" (B) "not a limited duration asset." If an asset falls into *both* the permanent business capital and current business capital classifications, it is classified as current business capital.

154. *Id.* at 23.

155. For the *Discussion Draft Study's* discussion of current capital, see *id.* at 358-59. The *Discussion Draft Study* notes that the economist's functional "current capital" concept should be distinguished from the accountant's concept of "current assets," in which the degree of liquidity is stressed. *Id.* at 358. *See also* Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev. 985, 986-87 (1956).

Corn Products doctrine characterizes as "business property" those assets used in the everyday business operations of the taxpayer. The express purpose for the creation of the "current capital" classification is the delineation of the "business property"-"investment property" distinction. Furthermore, defining "current capital" as those assets "normally transferred or consumed in the ordinary course of that trade or business" accurately reflects the *Corn Products* "everyday business operations" test.

The current capital concept is made more specific with respect to securities. The *Discussion Draft Study's* Draft Statute specifically categorizes as current capital:

> securities acquired in connection with a particular business transaction or a particular series of business transactions and disposed of with reasonable promptness after the business purpose of the acquisition has been fulfilled . . . .[156]

The purpose of this language is to make certain that the "current capital" concept is applied to "situations such as that involved in *Commissioner v. Bagley & Sewall Co.*"[157] The effect of these requirements is to force the acquisition and holding of the securities into a direct relationship with a specific business transaction or series of transactions.[158] This is the equivalent of both the general "current capital" requirement that the assets be "consumed in the ordinary course" of business, and the *Corn Products* requirement that the asset be used in the taxpayer's everyday business operations. Ordinary treatment will not be given if the acquisition and holding are tied only to the general purposes of the taxpayer's business.[159]

The scope of the *Discussion Draft Study* statement is much narrower than the so-called general rule which is repeated by most of the securities cases:

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred [is] ordinary loss.[160]

Both the *Discussion Draft Study* rule and the traditional rule are consistent with the *Corn Products* doctrine. However, the specificity of the *Discussion Draft Study* rule goes further to insure that only securities truly connected with everyday business operations will be given ordinary treatment. Under the *Discussion Draft Study* rule, the court would examine one factor: the directness of the connection between the acquisition and holding of the securities and a specified

156. Discussion Draft Study 23-24.
157. *Id.* at 63.
158. *See id.* at 63-64, 373-77.
159. *See id.* at 63-64.
160. Bcoth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962).

business transaction or group of business transactions. While the court may not always have an easy task, its determination would be guided by an objective, easily ascertainable standard. In contrast, the very generality of the traditional rule has led to some confusion. Thinking that any purchase advancing the well-being of the business is an "integral and necessary act in the conduct of the business," courts have given ordinary treatment to transactions which had as an objective the obtaining of permanent capital assets, such as land and buildings.[161] The *Discussion Draft Study* rule would largely prevent this result because it forces courts to compare the facts with specific standards rather than with a general maxim.

5. *Comparison of the ALI Discussion Draft Study Definitions with Present Case Law.*—The *Discussion Draft Study* securities rule appears to be generally consistent with the source-of-materials cases,[162] in which securities are acquired "in connection with a . . . particular series of business transactions." The "particular series of business transactions" with which the acquisition of the securities is connected would be that series of purchases of the needed supply of goods which begins with the purchase of the securities and ends with the resumption of a normal supply of the goods. The only source-of-materials cases not receiving "current capital" treatment would be those in which the securities were not disposed of with reasonable promptness after the business purpose of the acquisition has been fulfilled,[163] and those in which the securities, being acquired for general business purposes, become permanent income-producing capital. A recent Tax Court case, *Old Dominion Plywood Corp.*,[164] seems to fit into this latter category. In this case, stock was acquired in order to assure that the taxpayer's short-range and long-range needs for lumber core would be satisfied.[165] The stock was not acquired in connection with a "particular series of transactions," but in connection with general business needs extending into the indefinite future. The Tax Court's holding that the stock was a non-capital asset would probably be reversed by the *Discussion Draft Study* rule.

It should be noted that the *Discussion Draft Study* is very restrictive in its application of its securities rule. In commenting on the rule,

161. See discussion of John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964), in text accompanying notes 81-84 *supra.*

162. *See* text accompanying notes 69-74 *supra.*

163. *See* Missisquoi Corp., 37 T.C. 791 (1962); Gulftex Drug Co. v. Commissioner, 29 T.C. 118 (1957) *aff'd per curiam,* 261 F.2d 238 (5th Cir. 1958). *See* text accompanying notes 95-98 *supra.*

164. 25 CCH Tax Ct. Mem. 678 (1966).

165. The shortage of lumber core was not one of fairly short duration, but apparently extended into the indefinite future.

the authors indicate that the definitional phrase "particular series of business transactions" denotes only those situations in which the number of transactions and the terms of those transactions are already known before the purchase of securities is made.[166] Thus, ordinary treatment would be given only in cases such as *Bagley & Sewall Co.*,[167] in which a specified contract was the sole object of the purchase of securities. This restrictive approach would deny ordinary treatment to most of the source-of-materials cases. In these cases, the number and terms of the transactions are not known with exactitude until the shortage of needed goods has ended. Thus, the *Discussion Draft Study* application appears to be overly restrictive. There seems to be no reason why the number and terms of the transactions in the series need be exactly known, if the purchases are to be made during a defined and confined period of time. This latter requirement would insure that the securities would be current capital, circulating during the normal operating cycle of the business.

As noted earlier, the non-source-of-materials area is the scene of rapid, and sometimes inconsistent, development of the "business property" concept.[168] It is believed that the *Discussion Draft Study* rules provide objective, easily ascertainable limits to the concept, which can be applied by the courts to cases raising these definitional questions. By applying these rather specific standards, the courts may be able to achieve relatively uniform results, even in widely diverse factual situations. The *Discussion Draft Study* rules would probably reverse the decision in *John J. Grier Co. v. United States*,[169] in which the acquisition of securities was in connection with the general, long-range business activities of the taxpayer, rather than in connection with a limited series of everyday business transactions. Neither the securities nor the objects of their purchase—the land, building and furnishings of the club—were to be "consumed in the ordinary course" of the business. Instead, they all appear to be "permanent capital," or "investment property." The *Grier* decision can be viewed as applying a step-transaction doctrine because the taxpayer bought the stock solely to get the assets of the club.[170] Regardless of the soundness of this view, any attempt to base the *Grier* decision upon the "business

166. *See* DISCUSSION DRAFT STUDY 375-76.

167. 221 F.2d 944 (2d Cir. 1955).

168. *See* text accompanying notes 73-84 *supra*.

169. 328 F.2d 163 (7th Cir. 1964).

170. The federal district court reasoned that if the taxpayer had purchased the physical assets of the club, it would have had ordinary loss on the sale of these assets. Therefore, ordinary loss on the sale of the stock was thought to be warranted. *See* John J. Grier Co. v. United States, 216 F. Supp. 928 (N.D. Ill. 1963). For an expression of doubt as to the validity of that view, see Troxell & Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 TAX L. REV. 185, 206-07 (1964).

property" doctrine appears to be an unwarranted extension of the concept.

It is believed that the *Discussion Draft Study* rules would reject the distinction often drawn between securities acquired for the purpose of expanding the taxpayer's business and securities acquired for the purpose of protecting an existing business.[171] If securities are acquired in connection with a series of everyday business transactions, they should be regarded as "current capital" or "business property" even though the effect of the acquisition is the expansion of the taxpayer's business. The expansion-protection division does not appear to bear any particular relationship to the "business property"-"investment property" distinction. In a sense, all of a taxpayer's everyday business activities are directed toward "expanding" his business, by means of gaining new sources of income through improved service or products. Several well-considered cases have implicitly rejected the distinction.[172]

D. *Solving the Administrative Problem*

As noted above, present methods of reporting income give taxpayers an opportunity to take unwarranted advantage of the "business property" concept by taking capital gain treatment in the case of a gain on the sale of "business property" and ordinary loss treatment in the case of a loss. This problem stems from the fact that the taxpayer is not forced to commit himself to any classification until long after the asset has been acquired. If the asset were classified at the time of its acquisition, the administrative problem would be largely solved. It has been proposed that the Commissioner promulgate a regulation providing that any security acquired by a taxpayer, other than a dealer in securities, will be treated as an investment unless, within thirty days after the date of acquisition, the Commissioner is notified that the security is being held for specified business purposes as "business property."[173] This initial classification would be determinative in the case of any later disposition, unless the Commissioner finds that the taxpayer's election is unrealistic. The Commissioner would not be bound by the election, and could challenge the taxpayer's chosen classification during the holding of the security, or at the filing of the taxpayer's return for the year of disposition. A closely similar solution would be the imposition of a record-keeping requirement similar to the present statutory requirement imposed

171. *See* text accompanying notes 114-19 *supra.*

172. *See* note 119 *supra.*

173. Kauffman, *A Second Look at the Corn Products Doctrine,* 41 Taxes 605, 613 (1963); Note, *supra* note 67, at 411-12 (1956).

upon securities dealers holding investment securities.[174] Under this solution, the security would not be treated as "business property" unless so identified in the taxpayer's records within thirty days after the date of its acquisition.

Neither of these requirements is a complete solution to the administrative problem. The notification requirement would impose other administrative difficulties upon the Commissioner; the record-keeping requirement might not be an effective means of enforcement. Furthermore, it may not be appropriate to impose a notification or record-keeping requirement upon persons who, unlike securities dealers, cannot be expected to know about such a requirement.[175] However, if either requirement could be effectively administered, it would accomplish a worthy objective: requiring the taxpayer to elect the tax treatment he prefers, and to state the grounds for that preference, before he knows whether there will be a gain or loss.

V. Conclusion

Inadequacies of the statutory definition of "capital asset" have led the courts to develop the concept of "business property," which serves to distinguish everyday business activities from investment activities. This concept is now being applied by courts in a wide variety of factual situations involving corporate securities. However, unless objective, easily ascertainable limits to the "business property" concept are found, confusion and inconsistency may mark the development of future case law. The rules developed by the American Law Institute's *Discussion Draft Study of Definitional Problems in Capital Gains Taxation* appear to provide these objective limits. Because they are consistent with the *Corn Products* doctrine, they should be used by courts confronted with a "business property" question. However, the best solution to the problem would be congressional enactment of a more meaningful definitional statute.

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174. *See* INT. REV. CODE of 1954, § 1236.

175. *See* DISCUSSION DRAFT STUDY 376-77.