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A Historical Essay and Economic Assay of the Capital Asset Definition: The Taxpayer and Courts Are Still Mindfully Guessing While Congress Doesn't Seem to (Have a) Mind

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NOTES

A HISTORICAL ESSAY AND ECONOMIC ASSAY OF THE CAPITAL ASSET DEFINITION: THE TAXPAYER AND COURTS ARE STILL MINDFULLY GUESSING WHILE CONGRESS DOESN'T SEEM TO (HAVE A) MIND

> Nothing in the nature of things makes separation from capital one of the requisites of income from capital. From a practical common-sense point of view there is something strange in the idea that a man may indefinitely grow richer without ever being subject to an income tax.
>
> -Thomas R. Powell[1]

> Why does public discussion of economic policy so often show the abysmal ignorance of the participants?
>
> -Robert M. Solow[2]

> Everything should be made as simple as possible, but not more so.
>
> -Albert Einstein[3]

Forming new businesses, creating new jobs, providing risk incentives, stimulating economic growth—proponents of a capital gains tax reduction sound these putative economic benefits amid the continuing debate concerning the tax status of capital gains.[4] Their political opponents primarily counter with a tax fairness argument:

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1. Thomas R. Powell, *Income from Corporate Dividends*, 35 HARV. L. REV. 363, 376 (1922) (commenting on Eisner v. Macomber, 252 U.S. 189 (1920)).

2. WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 2 (3d ed. 1985).

3. *Id.* at 18.

4. *E.g.*, Jeffrey Bell & John Mueller, *Is There a Tax-Cut Path Through This Thorny Recession?*, WASH. POST, Mar. 8, 1992, at C3; Lee Humphries, *Government, Not the Wealthy, Would Profit from Capital Gains Cut*, STAR TRIB. (Minneapolis), May 9, 1992, at 13A; Steven Mufson, *Bush's Capital Gains Plan Favors Wealthy, Panel Says; Study: 70% of Tax Benefits Go to Top Earners*, WASH. POST, Feb. 6, 1992, at D11.

the principal beneficiary of such tax policy will be the wealthiest members of our nation.[5] The latter's aim, of course, is to create negative sentiments in the minds of the country's middle- and low-income taxpayers. Even amidst the political clamor, though, the unadulterated, nonpartisan economist will acknowledge that lowering the capital gains tax is more akin to a "removal of a penalty" than to a "special privilege."[6] The heart of this purist economist's statement is the essence of this Note: formulating the most functional and economically fitting definition of the capital asset itself.

The importance of capital asset taxation extends far beyond political debate, and the dollar values are indeed significant. According to a recent study, a thirty-percent capital gains tax reduction could result in a cumulative increase in real gross national product (GNP) ranging from $7.2 billion to $47 4 billion over the first five years, depending on the resultant decline in costs of capital.[7] Governmental revenue increases from individual taxpayers alone, based on the same tax reduction, would reach approximately $7 4 billion during the first three tax years before substantial revenue losses ensued.[8] In 1989, for example, roughly fifteen million individual taxpayers generated in excess of $145 billion in net capital gains.[9]

To understand the nature of the "capital asset" and some of the reasoning that supports its historical preferential treatment, consider the following true story Beginning in 1919, an insightful small-town banker encouraged his tobacco farmer neighbors to invest their "meager savings" in a burgeoning company named Coca-Cola.[10] As a result, 7,600 residents of Quincy, Florida now own

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5. *See* Bell & Mueller, *supra* note 4, at C3; Humphries, *supra* note 4, at 13A; Mufson, *supra* note 4, at D11.

6. *See* Bell & Mueller, *supra* note 4, at C3.

7. Brian W Cashell & Jane G. Gravelle, *Potential Economic Effects of a Capital Gains Tax Cut*, 54 TAX NOTES 887, 887 (1992).

8. *Id.* at 887-88. The preliminary "unlocking" of accumulated capital asset appreciation, known as the "lock-in" effect, prompted by the advantageous circumstance of lower tax rates, causes the short-term increase in revenues followed by periods of revenue losses. *See infra* notes 76-78 and accompanying text.

9. INTERNAL REVENUE SERVICE, PUB. No. 1304, STATISTICS OF INCOME—1989 INDIVIDUAL INCOME TAX RETURNS 2 (rev. Sept. 1992).

10. Durwood McAlister, *Here's Why Capital Gains Tax Should Be Cut*, ATLANTA J. & CONST., Apr. 16, 1992, at A8.

shares of Coca-Cola worth approximately $300 million, which represents a one thousand-percent increase during the last ten years alone.[11] This example demonstrates some of the distinctions between capital asset appreciation and currently earned income. It also is evidence of the inequities of taxing such appreciation as current income. Together, these distinctions and inequities have created a unique perspective relative to the meaning of "capital asset" and the taxation of associated transactions.

Special tax provisions have applied to capital asset transactions since 1921.[12] Economic policy has been the primary basis for singling out the capital asset for special treatment. Each of the standard justifications[13] has its underpinning in the nature of the capital asset itself. Logically, then, the definition of a capital asset operates on two levels: first, it separates categories of assets for differing tax treatment, and second, it operates as the basis for the differing treatment.

Because preferential taxing provisions have applied to capital transactions virtually without interruption during the history of United States income taxation,[14] certainty as to what assets will receive these preferences is desirable.[15] The form of the preferences and the extent to which they will be granted are appropriately tied to the generally understood tax policy functions: raising revenue, effecting certain social purposes, and generating certain economic outcomes.[16] Clearly, if the politics of these functions re-

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11. *Id.* The dramatic appreciation in value consists of both inflationary and real economic increases.

12. *See* Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233.

13. The typical four rationales are: "income bunching" marked by realization of long-term appreciation upon sale or exchange; the "lock-in effect," which is a tendency to hold such assets as a result of income bunching; the effect of inflationary deterioration on long-term gains; and the possible stimulation of savings, investment, and general economic activity under appropriate conditions. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.5.7 (2d ed. 1981). Each of these economic bases receives more detailed attention in subsequent sections of this Note.

14. *See infra* notes 138-62 and accompanying text (providing a historical overview of the statutory development).

15. The requirement of certainty to prevent unfairness was one of Adam Smith's taxation maxims. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 778 (Modern Library ed., Random House 1937) (1776).

16. *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 5 (5th ed. 1987). For illustrative purposes, consider the social goals behind low-income housing credits and historical building rehabilitation credits, *see* I.R.C. §§ 42, 46-47 (1988), and the economic reasons behind the

sulted in *no* tax preferences or differential treatment related to capital transactions, the concern over the definition of the capital asset would be wasted.

However, assuming the current trend will continue, a clear and meaningful definition of what assets are to receive graces—or distinguished handling in any form—is essential. The functions of taxation may govern the proper measure of special treatment but should not control the base to which the treatment applies. Instead, the capital asset definition must coincide with its economic nature.[17] Essentially, the *extent* of special treatment afforded is the more fluid element; the *purpose* of separating capital gains and losses from ordinary gains and losses is the more fundamental, static concept. The term "static," here, does not imply that the distinction will never change. The functions and attitudes regarding a given asset indeed do change, but the economic ideas supporting the differences are relatively fixed.[18] The current statutory definition, although seemingly explicit, has proven to be a disaster in terms of transforming intent into language.[19] The statute strangely provides that select provisions apply to a category of as-

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former regular investment credit and the myriad of concessions aimed at small business, such as bonus depreciation and lenient accounting methods, *see id.* §§ 179, 448. The function of revenue raising is self-evident.

17. Referring to income definitions, Professor Robert M. Haig cautioned that should legal concepts "depart[] in any very fundamental fashion from the economic concept," serious injustices would occur. Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* 1 THE FEDERAL INCOME TAX (R.M. Haig ed., 1921), *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 58, 66 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

18. The example of land during feudal times in England is helpful here. Viewed in its fixed quantities, physical use of land was vitally important. Whether farmed, resided upon, or built upon, it was the ultimate capital asset. Only the detachments of land, i.e., crops, were appropriately considered income creators. *See infra* notes 36-43 and accompanying text.

Today, land is often the subject of speculation and trade, and although investments are also capital assets, one deriving income from frequent trades in land likely would find the income categorized as ordinary because the land's status has changed to that of inventory. *See infra* notes 101-108 and accompanying text. Throughout this example, the economic theories supporting the classifications have remained constant.

19. The intended meaning is generally understood to have been roughly equal to the economic substance of the capital asset. *See infra* notes 164-72 and accompanying text. The written result, however, does not convey such meaning in all respects, thus causing courts much discontent. *See infra* notes 173-211 and accompanying text.

sets, which it defines as *everything except* for five exclusions.[20] Commentators have criticized this inverted, circuitous approach intensely, blaming it for the courts' failure to develop a "coherent, consistent standard."[21] The courts have run the gamut from trying judicially to provide decisions supporting the economic nature of the capital asset to simply deferring to the statute.[22]

This Note addresses what the proper definition of the capital asset should be in light of its economic substance and the economic purposes of our revenue system. First, an introduction to early notions of income provides a feel for the economic essence of the capital assets because our ideas of what constitutes capital assets originated largely in these early conceptions of income.[23] Thereafter a more academic treatment of the economic foundation, followed by a historical dialogue of the statutory development, allows for analysis of the current state. This Note then explores judicial decisions based on the reasoning behind truncating a special group of assets. It concludes by recommending a legislative adoption of a fairer and more workable definitional representation of the capital asset's economic core.

PRELUDE: WHAT IS INCOME?[24]

This section primarily tracks the development of the legal concept of income as related to the capital asset in the United States.

20. The five exclusions are inventory, depreciable and real property used in a business, trade receivables, copyrights, and certain government publications. *See infra* notes 164-72 and accompanying text.

21. *E.g.*, Glenn C. Shrader, Note, *Broad Reading of Corn Products Doctrine Rejected:* Arkansas Best Corp. v. Commissioner of Internal Revenue, 42 TAX LAW. 357, 368 (1989).

22. *See infra* notes 173-211 and accompanying text.

23. The following editorial statements appeared in the *New York Times* in 1921: "The economic distinction between capital and income is one of natural law, independent of either statutes or Constitutions," *Taxation of Capital Gains*, N.Y. TIMES, Feb. 15, 1921, at 8, *quoted in* Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 Sw. L.J. 869, 877 (1985); and "It may be right to tax profits as profits, but it cannot be right to tax capital as income, nor can capital be made income by statute," *Trading and Taxing*, N.Y. TIMES, Mar. 4, 1921, at 10, *quoted in* Kornhauser, *supra*, at 877 n.46.

24. A myriad of theories concerning "what is income" exist. In the widely accepted view of Henry Simons, income is an algebraic summation of the value of everything a person consumes, plus his net increase or decrease in personal wealth as determined both by additions/deletions and changes in value. RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FI-

The English Beginnings

The need for a legal definition of income originated in England and continental Europe because of the entailed[25] system of land ownership.[26] These countries developed legal concepts that defined capital as the physical estate and income as the separable product of the estate.[27] In distinguishing between what belonged to the body or corpus of the estate and what the tenant could consume, the courts could not consider an entailed estate to be saleable.[28] Changes in the value of the estate had virtually no impact on wealth because of this restraint on alienation.[29] Wealth was a function of regularly recurring and reasonably expected gains, detached from any capital value.[30]

With the advent of the London Stock Exchange in 1773, commerce in securities and bonds rose dramatically.[31] Instead of being regarded as a "value," however, a security was regarded as "a *res*, a thing."[32] A rise or fall in price, therefore, did not alter the investment itself "and was not an element of income."[33] Further, the realization of a change in value upon disposition was merely an accretion or declination of capital.[34] Though these concepts largely

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NANCE: A STUDY IN PUBLIC ECONOMY 164-65 (1959). Irving Fisher's conception of income is not so well accepted as Simons'. It considers only consumption and ignores changes in wealth and amounts saved indefinitely until finally consumed. JOHN F. DUE & ANN F. FRIEDLAENDER, GOVERNMENT FINANCE: ECONOMICS OF THE PUBLIC SECTOR 354 (5th ed. 1973). In a tax system, the Fisher approach would make revenue estimation a virtual impossibility.

25. "Entailed" is defined as "[s]ettled or limited to specified heirs." BLACK'S LAW DICTIONARY 530 (6th ed. 1990).

26. LAWRENCE H. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 26 (1951).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *See id.* at 27. Before 1773, stocks and bonds were sold in England only to a limited extent: "[T]hey were only a tiny and unrepresentative fraction of accumulated private wealth." *Id.*

32. *Id.* ("The capital investment was not the quantity of money that had been paid for the ... [security] or its market value, but the ... [security] itself.").

33. *Id.* The capital asset is held for its production of income, not its inherent value; changes in the capital asset's value do not alter the owner's position because to dispose of the asset and remain in his same position, he would need the same amount of proceeds to buy the same or similar good. *Id.* at 48.

34. *Id.* at 27.

continue in Europe today, England developed a tax system that could reach the capital gain.[35]

The Agrarian Influence

During the eighteenth and nineteenth centuries, economists developed formal concepts of income that hinged upon agricultural proceeds.[36] We owe to our agrarian past the idea of a fixed, producing source and an independent, expendable sum that detaches from, but does not diminish, its source.[37] Notions of regularity and periodicity, as applied to income, are related easily to economic pursuits such as farming.[38] The most salient of these features is certainly the element of periodicity—the tendency to occur at regular intervals.[39]

Outside this periodic realm of income lay those gains attributable to defined occurrences.[40] Examples include sales of property, gifts, inheritances, or other windfalls. The expectation of any recurrence obviously did not apply to these items.[41] "A prudent man will therefore regard them differently from ordinary income. He will treat them as additions to his capital, not available for ordinary consumption."[42] As defined under this approach, capital gains encompassed all irregular, unexpected receipts.[43]

American Development

Although the economy of the early United States was largely agricultural, land was much more available and easily acquired than in England.[44] Transfer of ownership occurred more frequently and profit from such activities was more common.[45] Therefore, al-

35. *Id.* at 28-29. Great Britain began taxing capital gains during the 1960s; Canada began taxing capital gains in 1972. DUE & FRIEDLAENDER, *supra* note 24, at 261.
36. SELTZER, *supra* note 26, at 25.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 29-30.
45. *Id.* With a focus shifting toward the purchaser's intent in ownership and transfer, the departure from the *res* theory and early notions of the capital asset had begun. *Id.* at 31.

though America borrowed heavily from the English common law and regarded capital investments as *res*, Congress expressly included gains to such capital in income for tax purposes in the Revenue Act of 1862.[46]

Problems with taxing unchartered territory were immediately evident. For example, the Civil War Income Tax Act of 1867[47] provided that assessment of taxes on gains and income would occur "annually."[48] Based on the inclusion of the word "annually," the Supreme Court in *Gray v. Darlington*[49] ruled that only accretion occurring in the tax year of sale was taxable.[50] The result was that none of the $20,000 accruing on a bond held for four years was taxable.[51] The Court came to this conclusion despite an 1867 amendment[52] to the Revenue Act of 1864[53] deleting the word "annual" from the general definition of the tax base.

Congress further relaxed the idea of limiting taxation to a certain period of accretion by enacting the Corporation Excise Tax Act of 1909.[54] A 1918 Supreme Court interpretation of the Act dis-

The nature of the physical asset, versus the value represented, presumes the intent of the owner for purposes of determining the asset's classification. The owner of a capital asset will want to reinvest the proceeds and restore his previous capital position. *Id.* at 48-49. Intentions in a modern economy vary greatly, so that ideally the individual holder determines the classification of assets held.

46. Revenue Act of 1862, ch. 119, § 90, 12 Stat. 432, 473. The first income tax act passed in 1861, Act of Aug. 5, 1861, ch. 45, §§ 49-51, 12 Stat. 292, 309-11 (repealed 1862), was repealed by the 1862 Act, and never went into effect.

47. Civil War Income Tax Act of 1867, ch. 169, 14 Stat. 471.

48. *Id.* § 13, 14 Stat. at 478.

49. 82 U.S. (15 Wall.) 63 (1872).

50. *Id.* at 66-67.

51. *Id.* at 64-67; *see infra* notes 67-71 and accompanying text (discussing realization and recognition concepts).

52. Ch. 169, § 13, 14 Stat. at 477-78. Prior to the amendment, the statute stated "[t]hat there shall be levied . . . annually upon the *annual* gains, profits, or income of every person . . . a duty." Revenue Act of 1864, ch. 173, § 116, 13 Stat. 223, 281 (emphasis added).

53. Ch. 173, 13 Stat. 223.

54. Corporation Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 112. The Revenue Act of 1870, ch. 255, 16 Stat. 256, defined income in substantially the same manner as the Act of 1867 and was the last of the Civil War tax laws.

After the income tax provisions of the 1870 Act expired in 1871, ch. 255, § 6, 16 Stat. at 257, Congress did not again impose an income tax until 1894. Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553. This Act broadly taxed the "gains, profits, or income . . . from any kind of property, rents, interest, dividends, or salaries . . . or from any other source whatever." *Id.* The Supreme Court, however, ruled the Act unconstitutional as a direct tax violating the constitutional requirement of apportionment. Pollock v. Farmers' Loan &

missed the contention that realized appreciation in property values represented a rise in the value of capital assets and not taxable gain.[55] The Court reasoned:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."[56]

This reasoning is consistent with an earlier decision, *Stratton's Independence, Ltd. v. Howbert*,[57] which also involved a broad understanding of income: " '[I]ncome' may be defined as the gain derived from capital, from labor, or from both combined . . . ."[58]

Trust Co., 157 U.S. 429, 605-07 (citing U.S. CONST. art. I, § 9, cl.4), *aff'd on reh'g*, 158 U.S. 601 (1895). The Sixteenth Amendment removed the apportionment requirement. U.S. CONST. amend. XVI.

55. Doyle v. Mitchell Bros. Co., 247 U.S. 179, 187-88 (1918). This decision was one of three "Capital Gains Cases" that the Supreme Court handed down on the same day. The other two cases were United States v. Cleveland, Cincinnati, Chicago & St. Louis Railway, 247 U.S. 195 (1918), and Hays v. Gauley Mountain Coal Co., 247 U.S. 189 (1918). The Court ruled in both instances that net accretion on the sale of property was recognizable income. *Cleveland*, 247 U.S. at 196; *Hays*, 247 U.S. at 193.

56. *Doyle*, 247 U.S. at 183. The interpreted act was an excise—or privilege—tax provision, not an income tax provision. Because the excise tax was *measured* by income, however, the excise-income tax distinction likely did not affect the Court's theory of what was to be included in income. In characterizing the sale as a "familiar . . . *business* transaction," *id.* (emphasis added), the Court indicated that it may have been influenced by the corporate status of the taxed entity.

The idea that corporations always have a "one track" business profit purpose indicates a presumed profit motive for corporate and business tax determinations; this belief or mode of operation is present in our current tax system. *See* I.R.C. § 162 (1988) (defining trade or business expenses). Court decisions considering whether purpose, motive, or intent relating to a sale is important in the income context may assist in determining whether such notions should be considered in an ordinary versus capital gain determination. *See, e.g.*, *infra* notes 179-210 and accompanying text (explaining the contrast between Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (finding that corn futures are inventory, not capital assets), and Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988) (holding that motivation for investment is irrelevant in determining the existence of a capital asset)).

57. 231 U.S. 399 (1913).

58. *Id.* at 415.

The Sixteenth Amendment

Interpretations of the Sixteenth Amendment[59] firmly entrenched the taxation of capital gains into the United States tax system. The first act passed under the amendment became effective March 1, 1913,[60] and was the advent of our present income tax laws. During 1920 and 1921, the Supreme Court firmly pronounced that "income" under the tax law included capital gains. In *Eisner v. Macomber*,[61] the majority acquiesced to the famous definition of income in *Stratton's Independence*[62] but stipulated that "it be understood to include profit gained through a sale or conversion of capital assets."[63]

Judicial interpretation also doomed the occasional buyer or seller. Reasoning that any other ruling would undermine the Sixteenth Amendment's meaning of "income" and its grant of taxing power, the Court in *Merchant's Loan & Trust Co. v. Smietanka*[64]

59. The Sixteenth Amendment to the Constitution, ratified in 1913, reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

For discussion of the constitutional restrictions on the taxing powers of the federal and state governments, see DUE & FRIEDLAENDER, *supra* note 24, at 243-47.

60. Revenue Act of 1913, ch. 16, § II, 38 Stat. 114, 166. The Act defined net income as follows:

> That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever

Id. § II, 38 Stat. at 167.

61. 252 U.S. 189 (1920).

62. *See supra* text accompanying note 58.

63. *Eisner*, 252 U.S. at 207. In addition, the Supreme Court affirmed on constitutional grounds that realization was a necessary prerequisite to taxing such gains. *Id.* In describing realization, the Court noted that "*sever[ance] from* the capital" and availability for "*separate* use, benefit and disposal" were elements of "income derived from property." *Id.*

The court subsequently construed "attainment" of realization quite liberally. *See, e.g.*, Peabody v. Eisner, 247 U.S. 347, 349-50 (1918) (deciding that realization need not be in money but could occur upon receipt of any exchangeable property).

64. 255 U.S. 509 (1921).

found that, in terms of income, the gain from a single, isolated sale of property was no different from profits arising from repeated sales by one engaged in such business.[65] In light of these and other Court decisions, Congress' power to tax capital gains clearly was affirmed. Congressional dominion in this area is virtually limitless: capital gains may be taxed fully, at reduced rates, or not at all.[66]

Realization, Lock-in, and Capital Transactions

Although the Internal Revenue Code does not explicitly include a requirement of realization prior to taxing gains,[67] the concept is entrenched in our system.[68] Aside from judicial acknowledgment,[69]

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65. *Id.* at 520. To be consistent with the legislative history, however, tax treatment of real and personal property transactions would have to differ. In congressional discussion of the Act of 1913, Congressman Hull spoke of reporting both gains and losses on securities transactions, but "as to an occasional purchase of real estate not by a dealer , this bill would only apply to profits on sales where the land was purchased and sold during the same year." J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 991 (1938).

66. The Supreme Court has curtailed only the power to tax unrealized gains. Towne v. Eisner, 245 U.S. 418, 426-27 (1918). One member of the Court considered removing even this limitation. Justice Douglas, reconsidering the question presented in *Towne* of whether stock dividends were income, declared that treating an increase in wealth measured by the earnings supporting the stock dividend as income would be within Congress' power. Helvering v. Griffiths, 318 U.S. 371, 409-10 (1943) (Douglas, J., dissenting).

67. Section 61(a)(3) provides for the inclusion of "[g]ains derived from dealings in property." I.R.C. § 61(a)(3) (1988). This section arguably requires "dealings" in property before taxing any gain but is void of any explicit exclusion of unrealized appreciation.

68. Interpreting the Revenue Act of 1913, the Supreme Court implied a requirement of realization, enunciating a now-famous definition of income:

> "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets
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> [T]he essential matter [is]: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital and *coming in*, being *"derived"*

Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)). Four equally famous cases adjusted the income definition, quickly eroding this requirement. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (finding no exclusion for the taxation of punitive damages, restricting *Eisner* to its facts, and adding "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" to the definition of gross income); Helvering v. Horst, 311 U.S. 112, 116 (1940) (referring to "the rule that income is not taxable until realized" as one of "administrative convenience"); Helvering v. Bruun, 309 U.S. 461, 469 (1940) (holding that a landlord realized a gain on lessee's capital improvement upon repossession) (statutorily reversed by allusion to the notion is implicit in the statutes. For instance, in computing gains and losses from property dispositions, section 1001 of the Internal Revenue Code provides for recognition of gains and losses "on the sale or exchange of property,"[70] implying that mere increases and decreases in property value are not accounted for during accrual, but only upon realization by a taxable event.[71]

From an economic theorist's viewpoint, however, a widely accepted concept of income recognizes all regular, irregular, expected, and unexpected accretions or diminutions to wealth.[72] The formulation of measurement under this approach is to combine all consumption with the net change in wealth, which is the sum of the market value of all assets and liabilities.[73] Uniquely, this method is unconcerned with realization and succinctly accounts for depreciation automatically because the overall change in wealth will reflect value changes in assets, whether from wear and tear or otherwise.[74] As is obvious, though, the primary critique is practical administration. Valuation without sale, disregarding realization, indeed may be imprecise and costly.[75]

Several propositions, though, militate for the economic theorist's position or similar viewpoints. Assuming that valuation absent realization is not pragmatic and that capital gains are ignored until a

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I.R.C. § 109); United States v. Kirby Lumber Co., 284 U.S. 1, 2-3 (1931) (holding that a corporation realized income when it purchased its own bonds at less than issue price).

69. *See supra* notes 55, 63, 68 and accompanying text.

70. I.R.C. § 1001(c).

71. Supporting the implication is the computation of the gain or loss itself—generally the excess of the amount received over the cost of the property adjusted for depreciation. *Id.* § 1001(a). The calculation makes no mention of any previously recognized increase or decrease in value or basis adjustment for the same.

72. MUSGRAVE, *supra* note 24, at 165; *see supra* notes 24-58 and accompanying text (discussing income theories).

73. MUSGRAVE, *supra* note 24, at 165.

74. *Id.* at 165-66. Except for its inclusion of depreciation in its calculations, this method conflicts with several accounting purposes. For example, both the cash and accrual accounting methods attempt to incorporate a measure of realization to indicate properly the timing of revenues. *Id.* at 166. Reporting all changes in value results in a loss of the measure of business performance. The function of reliability may also be distorted. Despite criticisms of historical cost, it does maintain certainty, whereas the constant revaluation of assets invites a degree of arbitrariness. *Id.* at 166-67.

75. DUE & FRIEDLAENDER, *supra* note 24, at 266; MUSGRAVE, *supra* note 24, at 166-67.

taxable event, those who choose not to enter a taxable event[76] will be favored with untaxed appreciation.[77] Although this state of waiting is seemingly advantageous, the disincentive it creates, known as "lock-in," offends the natural decision to enter into capital transactions.[78] The market would operate more efficiently if such drastic tax alternatives were not available to influence the decision whether to buy, sell, or hold an asset.

To prevent such obstruction of the decisionmaking process, the elimination of capital transactions taxation is an alternative to continually taxing appreciation.[79] Such a policy seems unfair, however, considering that capital gains statistically make up a more significant portion of large incomes than small incomes.[80] Without a restructuring of the tax system, then, the effect of removing capital gains taxes would be to shift more of the tax burden to those

76. Of course, not all dispositions are subject to choice. For example, owners do not normally will condemnation, destruction, and theft of their property. These situations are accommodated with some limitations by certain rollover, nonrecognition provisions in the Code. *See* I.R.C. § 1033 (1988).

Tax laws afford similar treatment to certain other voluntary transactions, such as like-kind exchanges and the sale and replacement of one's principal residence. *See id.* §§ 1031-1032, 1034-1043; *see also id.* § 1091 (concerning the postponement of "paper" losses from wash sales of securities).

77. MUSGRAVE, *supra* note 24, at 167.

78. DAVID G. DAVIES, UNITED STATES TAXES AND TAX POLICY 105 (1986). Scholars often advocate preferential capital gains treatment simply because it mitigates this effect, thus reducing the impediment to the capital markets. DUE & FRIEDLAENDER, *supra* note 24, at 260, 262, 264.

One proposal aimed solely at alleviating the lock-in effect also meshes with the original conception of a capital asset. The proposal would allow rollover treatment of capital gains that are reinvested, probably within certain guidelines. *Id.* at 266; *see supra* note 76 (describing some existing rollover provisions). This handling jibes with the true nature of the capital asset because it considers the asset itself of utmost import and does not treat accretions to capital as true income; the owner's reinvestment of the sale proceeds exemplifies the import of the physical asset. *See supra* notes 24-35 and accompanying text (describing the *res* theory of capital and early conceptions of capital and income).

79. MUSGRAVE, *supra* note 24, at 167.

80. "Whereas capital gains constitute one half of 1 percent of the income of persons with incomes from $5,000 to $10,000, they constitute 10% in the $50,000 to $100,000 range, 25% in the $100,000 to $500,000 range, and 51% in the $500,000 to $1,000,000 group." DUE & FRIEDLAENDER, *supra* note 24, at 263. Although these figures represent 1964 data, the allocation and distribution is clear.

Some describe this situation as vertical equity, or rather, "inequity." MUSGRAVE, *supra* note 24, at 160, 167. Many social ramifications, such as whether the wealthy should pay a greater percentage of taxes, and whether wealth redistribution is consistent with a capitalist society, relate to this principle.

with less ability to pay Of course, the U.S. tax law has generally taken an approach that provides some preference to capital gains.[81]

Many other proposals run the gamut between the ideal and the pragmatic. Some of the more noteworthy include valuation—but only at specified intervals—and an accounting of net capital gains at death taxable upon settling the estate.[82] A more easily administered approach involves proration, which would allow taxation on gains at the taxpayer's marginal rate based on the length of time he held the property [83] Finally, the most idealistic procedure would average total income during a significant period, conceivably even one's lifetime, thereby eliminating all irregularities and fluctuations associated with any earnings.[84]

Each of these attempts, too, bears obvious administrative difficulties or inequities, but certainly no one can honestly assert that our present tax system is a model of convenience, clarity, or fairness. Still, the question of how to treat capital transactions is only attendant to the more fundamental problem of defining what a capital asset is.

ECONOMIC FOUNDATION

Relevant Principles

Economic Attributes of the Capital Asset

Many of the arguments for preferential treatment of capital gains, or their exclusion from taxation altogether, arise from cer-

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Perhaps the more palatable ideology is horizontal equity. Although horizontal equity can be rooted in the "ability to pay," its fundamental tenet is to treat people in equal positions equally. *Id.* at 160.

81. *See infra* notes 138-62 and accompanying text (discussing the development of statutory provisions related to capital gains); *infra* notes 164-72 and accompanying text (discussing the current tax treatment of capital gains and losses).

82. MUSGRAVE, *supra* note 24, at 167.

83. DUE & FRIEDLAENDER, *supra* note 24, at 267. For example, a share of stock held for eight years is sold and the owner realizes $80 in capital gain. Ten dollars, one eighth of that gain (one divided by the number of years held), would be taxed at the seller's marginal rate.

84. *Id.* at 267-68. Although the record-keeping under such a procedure would be significant, it would not necessarily be unmanageable assuming a manageable period of time—possibly five, six, or even eight years. *Id.* The result would be an effective solution to problems relating to "bunching," drawing distinctions between capital and ordinary income, and the erratic nature of capital gains and losses; however, the idea provides minimal relief from the lock-in effect. *Id.*

tain economic attributes associated with the essence of the capital asset.[85] Unlike most kinds of income, capital gains accrue sporadically and without certainty[86] One generally will not consider capital gains a reliable source of income;[87] in fact, because capital losses occur with just as much irregularity, gains are commonly perceived as accretions to capital that are not available as disposable income.[88]

Furthermore, capital assets characteristically derive their worth from the income calculated to be produced by them.[89] Thus, taxing capital gains arguably amounts to double taxation in effect. An increase in the capital asset's value suggests an increase in the income the asset is expected to produce.[90] Therefore, to tax the income when received and then to tax the rise in market value that is only a reflection of expectations results in taxation times two.[91] The realization of the "expectations" upon sale, of course, replaces the promise of the increased future income related to that particular asset, but subsequent reinvestment would reinstate the income stream.[92]

Although capital gains and losses by definition are occasioned by price changes, to distinguish between independent changes in price

85. One basic concept, that capital gains represent growth in the asset and not separable income, is the *res* theory discussed *supra* notes 24-35 and accompanying text.

86. DUE & FRIEDLAENDER, *supra* note 24, at 260, 262; SELTZER, *supra* note 26, at 8, 10, 47. Of course, one might argue that all profits are uncertain, *see id.* at 79-81, but capital gains and ordinary profits differ in the extent to which one can control them. To illustrate, a factory operating to produce widgets (and ordinary profits) may exert control over management, methods, capacity, labor, and so on to impact profits. In addition, numerous influences beyond the control of management—general economic conditions, government regulation, natural disaster, competition—affect profits. The uncertainty related to capital gains is a condition of these external influences; the taxpayer has less control over capital gains than over ordinary profits.

87. Economic theory attempts to account for the "motivation, rewards, and behavior of business enterprises and consumers"; expected net income should be classified as ordinary because of its attraction of our resources and because its disposal will not reduce overall capital. SELTZER, *supra* note 26, at 47.

88. The result is that decisions to consume or save will differ according to the nature of the income. DUE & FRIEDLAENDER, *supra* note 24, at 260; SELTZER, *supra* note 26, at 10.

89. SELTZER, *supra* note 26, at 10.

90. *Id.*

91. *Id.* at 19.

92. *Id.* at 10.

and changes in the general price level[93] is very important.[94] The latter changes do not represent real changes; the increase or decrease is illusory because of inflation or deflation.[95] Thus, real capital gains and losses are only those shifts in value, excluding general price level alterations, that constitute true economic power enhancements or diminutions. In practice, real and unreal capital gains and losses generally are not distinguished.[96]

Moreover, most capital gains represent appreciation covering long periods of time, usually more than one year.[97] The treatment of such gains as income in the current year of realization creates a higher total tax burden.[98] This phenomenon, commonly known as "bunching," occurs under a graduated rate system because the incremental increases in value presumably would have been taxed at rates lower on average than the total amount taxed upon realization.[99]

A final economic consideration concerns the concept of wherewithal to pay The contention is simple: because capital gains are uncertain and irregular, they should not represent taxpaying ca-

93. The effect of inflation is an increasingly important factor in our tax system. For example, the advent of tax rate, standard deduction, and personal exemption indexation based on changes in the Consumer Price Index represented a major equitable change in the tax law, primarily during inflationary periods. *See* I.R.C. §§ 1(f), 63(c), 151(d) (1988).

Considering the disparity between low-income and high-income individuals, specifically indexing capital gains and losses is necessary for fairness because the poor suffer significantly larger capital asset changes attributable to inflation than do the wealthy. DAVIES, *supra* note 78, at 99-100 (citing a study by the National Bureau of Economic Research); *see supra* note 80 (citing capital asset incomes at various levels of wealth).

94. DAVIES, *supra* note 78, at 92, 95; SELTZER, *supra* note 26, at 51-52.

95. DUE & FRIEDLAENDER, *supra* note 24, at 262; SELTZER, *supra* note 26, at 51-52.

96. SELTZER, *supra* note 26, at 52. Given that the tax rates are now indexed, *see supra* note 93, this adjustment may not be adequate because unlike ordinary income, the essence of capital gains and losses *is* the change in price of the particular asset. DAVIES, *supra* note 78, at 95.

Although accounting for inflation and deflation related to capital assets may seem administratively difficult, the necessary information—dates of acquisition and disposition and inflation factors such as the Consumer Price Index published by the Department of Labor—appears readily available, and implementation as part of an overall revision of capital transaction taxation could not result in more problems than those currently existing.

97. SELTZER, *supra* note 26, at 10.

98. DAVIES, *supra* note 78, at 94; SELTZER, *supra* note 26, at 10.

99. DAVIES, *supra* note 78, at 94.

pacity equal to that of ordinary income, which is of a recurring, dependable nature.[100]

Basic Market Operations

Ordinary profits may be described as coming from everyday business. The manufacturer earns these profits by conversion of raw materials or semifinished goods into other semifinished goods or finished goods.[101] The wholesaler's business is the redistribution of goods to facilitate the market process; this function may include breaking up quantities into parcels that are more easily distributed, providing logistic redistribution, or simply holding goods until the market can accept them.[102] The retailer produces ordinary income by providing point-of-sale to the ultimate consumer in forms and with commensurate services that the consumer may demand.[103]

Alternatively, capital gains and losses typically result not from business profits but from price level changes within a given market applicable to capital assets.[104] Capital assets generally are income-producing assets—investment vehicles in any form[105] and, in broader language, personal and nonbusiness property at the consumer level.[106]

Obviously, then, use or purpose largely influences or controls the definition of the capital asset. As a simplistic illustration, compare the red Ferrari that you thought you could purchase after law school, which sits on the dealer's lot, to the car you owned in law school, which you continued to keep because of student loans and other real-world expenses. The former is not a capital asset; it is the essence of the dealer's business and its sale represents the expected profit of the business. The latter, however, is a capital asset;

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100. SELTZER, *supra* note 26, at 10.

101. *Id.* at 3. In the case of an individual, wages from employment are considered "business" profits. *Id.* at 4-5.

102. *Id.* at 3.

103. *Id.*

104. *Id.* at 3-4.

105. The most common are stocks, bonds, realty, and interests in partnerships, contracts, and leases. *Id.* at 4.

106. *Id.*

it is held for personal use, not for resale,[107] so when it *is* sold, the gain or loss will be capital.[108]

Legal Distinctions

This simplistic illustration, of course, does not permeate all transactions. In fact, the extent of its application is relatively limited for either economic or legal analysis.[109] The nature of profits and losses is often mixed or clouded.[110] Moreover, the legal dividing line often deviates from the general understanding. For instance, the holding period[111] of the asset may determine whether any preference will apply to a capital transaction.[112] Satisfying a one-year holding period requirement, for example, qualifies the gain or loss for preferential long-term treatment; gain or loss on an asset held for a shorter period would receive ordinary short-term treatment.[113] The cutoff between the occasional investor and one

107. Notably, if it were held for resale as an antique or vintage car, it still would be a capital asset as an "investment auto." Unlike in the case of the personal-use auto, the loss on the sale of an investment auto, if any, would be recognizable for tax purposes. *See infra* notes 108, 166 and accompanying text.

108. Unfortunately, the loss, in contrast to the gain, is not recognized for tax purposes because of its personal nature. *See* I.R.C. § 165 (1988).

109. SELTZER, *supra* note 26, at 4-5.

110. *Id.* at 67. The mixture in character of many types of income stems from the unforeseeability of all capital value changes. *Id.* For instance, an investor may anticipate a rise in a particular stock and actually go so far as to count on this eventual income. Based on expectations, if the risk-taking results in a favorable outcome, the income derived will have elements of ordinary income associated with it, in this case wages. Expectations of changes in the capital asset's value must be contrasted with expectations of income the asset will produce.

111. "Holding period" simply means the amount of time elapsed during which the taxpayer held a particular property. I.R.C. § 1223(1). In cases involving a carryover basis, such as gift transfers, the holding period of the transferor "tacks on" to the holding period of the transferee. *Id.* § 1223(2); *see id.* § 1015. Inherited property, which generally gets a "step up" in basis, is deemed to be held by the recipient for more than six months. *Id.* §§ 1014, 1223(11).

112. *Id.* §§ 1(j), 1222. Preferential treatment can arise notwithstanding the holding period requirement. *See id.* § 1231(a)(3)(A) (providing that gain on property used in a trade or business qualifies as "section 1231 gain" and thus may receive preferential treatment under §§ 1231(a)(1), 1222, and 1(j)).

113. *Id.* § 1222. This dividing line has varied among 24, 18, 12, and 6 months in the history of U.S. tax law. SELTZER, *supra* note 26, at 5. In other countries, the holding period is sometimes many years; for example, to receive capital asset treatment in Sweden, real property formerly must have been held 10 years and all other property five years. *Id.*

engaged in buying and selling to the point of engaging in a business also can become blurred.[114]

Many other statutory provisions and judicial assertions may come into play to dim any bright lines demarcating the capital asset definition. Section 1231 of the Internal Revenue Code, the so-called "best of both worlds" provision,[115] treats gains in excess of losses from dispositions of property used in a trade or business as long-term capital gain but treats the excess of losses over gains involving the same property as ordinary loss.[116] Two other Internal

114. The question is when do capital gains become ordinary income? The significance, purpose, nature, frequency, and regularity of a transaction are major indicia of where one might fall on the continuum. *See, e.g.*, Higgins v. Commissioner, 312 U.S. 212, 218 (1941) (holding that an investor for one's own account is not engaged in a trade or business); Reese v. Commissioner, 615 F.2d 226, 230-31 (5th Cir. 1980) (recognizing that a single venture without expectation of continuation in the field is not ordinarily a business); International Shoe Mach. Corp. v. United States, 491 F.2d 157, 160-61 (1st Cir.) (holding that although a taxpayer typically leased machines, had no sales support, and had tried to dissuade a customer from making a purchase, he held the machine primarily for sale in the course of business), *cert. denied*, 419 U.S. 834 (1974).

In the case of securities, generally the typical investor will hold capital assets because his sales are not usually to customers; however, dealers who do sell to customers typically hold inventory (noncapital assets) unless they hold a security for private investment. *See, e.g.*, Carl Marks & Co. v. Commissioner, 12 T.C. 1196, 1200 (1949) (holding that certain securities held by a dealer were nonetheless capital assets). *But cf.* Frank v. Commissioner, 321 F.2d 143, 148-51 (8th Cir. 1963) (ruling that certain securities, despite significant private investments, were held as by a dealer).

Considerations such as these apply to real estate transactions as well, except that taxpayer subdivision and/or improvement also operates as a deciding factor. *See, e.g.*, Hansche v. Commissioner, 457 F.2d 429, 434-35 (7th Cir. 1972) (finding ordinary income when the gain resulted from substantial subdivision and development by taxpayers).

115. *See, e.g.*, Paramont Land Co. v. United States, 556 F Supp. 815, 817 (W.D. Va. 1983), *aff'd*, 727 F.2d 322 (4th Cir. 1984).

116. I.R.C. § 1231(a)(1)-(2). However, § 1245 and § 1250 can easily diminish the impact of § 1231. Section 1245 provides generally that gains from the disposition of personalty used in a trade or business shall be treated as ordinary, notwithstanding § 1231, to the extent of previous depreciation cost recovery. *Id.* § 1245. Section 1250 provides that gains from the disposition of realty used in a trade or business shall be treated as ordinary, notwithstanding § 1231, to the extent of previous accelerated cost recovery in excess of what depreciation deduction would have applied under a straight line method. *Id.* § 1250.

Section 1231, though, has its own recapture provision that operates below the overriding control of § 1245 and § 1250. Section 1231(c) requires that § 1231 gain, otherwise eligible for capital gain treatment under the section, be treated as ordinary to the extent of the five immediately preceding years' § 1231 losses not already recaptured under § 1231(c). *Id.* § 1231(c). The losses are considered recaptured in chronological order (on a first-in-first-out basis). *See* H.R. REP. No. 861, 98th Cong., 2d Sess. 1034 (1984), *reprinted in* 1984 U.S.C.C.A.N. 494.

Revenue Code provisions, sections 1234 and 1234A, specify that the nature of the gain or loss related to certain options to buy property is to be determined by looking to the character of the property underlying the option if in the "hands of the taxpayer."[117]

Some of the noteworthy judicial glosses placed on the capital asset definition relate to the meaning of "property" contained in the statutory definition, the "substitute" theory, and the evolution of the *Corn Products* doctrine.[118] The courts' revelations regarding the scope of the term "property" in section 1221 alone have created a quagmire in the definition of the capital asset. The Supreme Court, for instance, has held that property compensable under the Takings Clause[119] is not necessarily property under section 1221.[120] Another salient issue in this area is whether any property rights even exist to receive capital gains treatment. A leading Second Circuit opinion determined that payment to the taxpayer for certain privacy rights—name, image, reputation—was ordinary income instead of capital gain because local law did not recognize these rights under the particular facts.[121]

The "substitution" theory concerns the characterization of a payment received in disposition of a right to receive future ordinary income. A typical case is *Hort v. Commissioner*,[122] which involved a financially strained tenant who made a lump-sum payment in satisfaction of and release from a long-term lease.[123] The Court held simply that the payment was in substitution of future

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117. I.R.C. §§ 1234, 1234A.

118. See *infra* notes 180-90 and accompanying text for a discussion of the *Corn Products* doctrine.

119. U.S. CONST. amend. V ("[P]rivate property [shall not] be taken for public use, without just compensation.").

120. Commissioner v. Gillette Motor Co., 364 U.S. 130 (1960). The Court stated that it would construe the definition of capital asset narrowly

> to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time. [R]espondent's right to use its facilities was held to be a valuable property right compensable under the Fifth Amendment. However, that right was simply an incident of the underlying physical property

Id. at 134-36.

121. Miller v. Commissioner, 299 F.2d 706, 707, 711 (2d Cir.) (involving payment to Glenn Miller's widow for her "property rights" in her deceased husband's name, image, and likeness), *cert. denied*, 370 U.S. 923 (1962).

122. 313 U.S. 28 (1941).

123. *Id.* at 28-29.

rentals, which are ordinary income, and therefore should likewise be characterized as ordinary[124] However, if Hort had sold the entire building including the remaining lease term, the entire transaction would have received capital gain treatment even though some of the payment received presumably would have been attributable to the lease.[125]

Impact of Capital Gains Taxation

One of the basic tenets of taxation is that differing resource allocations and institutional frameworks will result from differing approaches to taxation.[126] Varying tax formulas for capital gains and losses are no exception. The tax structure can effect changes in the allocation of labor, capital, and product markets.[127] Primary public policy considerations when dealing with capital gains are economic growth, efficient resource utilization, and economic stabilization at full employment.[128]

The taxation of capital gains impacts economic growth by way of its effect on real investment—both the demand for and supply of financial securities.[129] From the demand side of the equation, the desire for capital assets is directly proportionate to the preferential treatment applied to these assets.[130] More simply, capital assets accorded a greater tax preference will see a higher real rate of return and thus a greater demand. The extent to which this chain of

124. *Id.* at 32.

125. This situation is analogous to that in McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947), which involved a life-income beneficiary's transfer of her entire interest to the remainderman. The court distinguished between the "anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate." *Id.* at 237.

Compare this treatment to the sale of an entire concern that is required to be "broken up" into its component assets for characterization of gain and loss. *See, e.g.*, Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945) (requiring separate application of the capital asset definition to each asset of a sole proprietorship upon sale, denying treatment as one giant "capital asset").

126. For a succinct summary of the economic effects, see George F Break, *The Perception of Power: The Capital Gains Story*, 52 TAX NOTES 229, 229 (1991); MARTIN DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 2 (1968).

127. DAVID, *supra* note 126, at 2.

128. *Id.*

129. *Id.*

130. *Id.* at 3; DUE & FRIEDLAENDER, *supra* note 24, at 263.

events affects the economy depends on whether the additional capital created enters a capital market in need of more supply.[131]

Concerning the supply side, many consequences are possible. Generally, the increased return to the investor from capital gains will allow corporations to lower the dividends they pay and thereby increase internal earnings available.[132] This increase in retained earnings will reduce the need for capital raised through issuing additional stock.[133] Depending on the balance between upward effects of increased retained earnings and the downward effects of a lower dividend payout,[134] corporate stock prices too would be adjusted by the market. Of course, stock prices will move according to the new equilibrium established by these supply and demand effects as well.[135]

The economic effect of capital asset taxation on the efficient allocation of resources is also important. The increased attractiveness of investments that receive preferences skews the comparative yields away from alternative investments.[136] The allocation of the

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131. DAVID, *supra* note 126, at 3. Increased capital presumably would result because savings would rise in two related ways. First, the advantage of saving would be greater, and second, the resulting increased return (or "income") ultimately would be partly disposed of and partly saved. DAVIES, *supra* note 78, at 109-10. The attractiveness of aggrandizement of saving occurs because higher returns will influence one's decision where to place discretionary funds. Assuming the appeal of increased returns does increase rates of saving, the returns flowing from larger aggregate investments create additional discretionary funds that may again enter the cycle. *See id.* at 109-11. The economist's terms for measuring the marginal changes in disposable income that one chooses to spend and that one chooses to save are the "marginal propensity to consume" and the "marginal propensity to save." *See id.* at 110.

132. DAVID, *supra* note 126, at 3; DAVIES, *supra* note 78, at 110. This situation would function less effectively in periods of rising or high inflation. *Id.* at 110. Several generalizations regarding times of elevated inflation account for this fact: these periods are poor times to retain cash, good times to be a debtor, and perhaps good times to purchase assets such as plant and equipment.

133. DAVID, *supra* note 126, at 3. The need for borrowing presumably would fall also. *Id.* Because of the new level of capital available through savings and the reduced corporate need for borrowing, a drop in interest rates would likely occur. *Id.*

134. On balance, a rising capital gain that is preferentially treated, offset with equally falling dividends taxed at ordinary rates, will produce rising stock prices, all other things being equal. *See* DAVIES, *supra* note 78, at 107 (attributing the expected stock price increases in such situations to improved after-tax rates of return).

135. Whether the new equilibrium is an improvement in the level of real investment will depend greatly on the transaction costs associated with fewer equity issuances and a less fluid market source of funds. DAVID, *supra* note 126, at 3.

136. *Id.* at 4; DUE & FRIEDLAENDER, *supra* note 24, at 263.

investment dollar (risk capital) very well may shift away from more optimal uses for the capital as a result of the preference.[137]

WHERE WE HAVE BEEN: A HISTORICAL BACKGROUND

The Internal Revenue Laws

The Evolution

During the period from 1913 to 1921, the tax laws made no distinction between capital assets and other kinds of property[138] All gains from the sales of property were taxable in full as ordinary income, whereas losses were deductible only if the taxpayer used the property in a trade or business.[139] Congress, however, relaxed this loss rule somewhat in 1916 to provide that losses from property sales would be deductible if related to a transaction entered into for profit.[140]

The Revenue Act of 1921[141] contained the first specified capital asset definition[142] and also provided for the application of special

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137. DAVID, *supra* note 126, at 4. Considering the tax preference on capital asset appreciation and the effect of reducing corporate dividends, the more venture-oriented enterprises will attract capital. Stable companies, however, which are typically large manufacturing concerns with more constant stock prices and higher dividend payouts, may suffer. *See supra* notes 126-35 and accompanying text.

Conversely, the increased risk-taking may prove to be beneficial. Because the corporate form will be encouraged and capital gains may be realized at a pace rivaling ordinary income, start-up businesses will increase. DUE & FRIEDLAENDER, *supra* note 24, at 263. *But see* I.R.C. § 341 (1988) (discouraging and limiting the use of "collapsible corporations" to transform ordinary income into capital gain by purposeful liquidation).

138. The essence of the income definition in the Revenue Act of 1913, ch. 16, § II.B, 38 Stat. 114, 166, was maintained until 1921; net income during this interim was defined as including gains, profits, and income derived from sales and dealings in real and personal property and, generally, gains, profits, and income from any source.

139. SELTZER, *supra* note 26, at 20.

140. *Id.*

141. Revenue Act of 1921, ch. 136, 42 Stat. 227.

142. According to the definition, property held more than two years generally attained capital asset status; inventory and personal-use property were not capital assets. *Id.* § 206(a)(6), 42 Stat. at 233. Recognition of the lock-in effect was at least part of the reason for this first distinction between capital and ordinary assets. *See supra* notes 67-84 and accompanying text. The House Ways and Means Committee stated that sales of capital assets were being inhibited because "gains and profits earned over a series of years are under the present law taxed as a lump sum in the year in which the profit is realized." H.R. REP. No. 350, 67th Cong., 1st Sess. 10-11 (1921).

treatment to capital gains recognized by individuals.[143] Such special treatment did not yet apply to corporations; corporate capital gains continued to receive ordinary income treatment until 1942.[144]

This "original" statutory definition was that property acquired and held by a taxpayer—either for profit or investment—for more than two years was a capital asset.[145] This definition was unaffected by whether the taxpayer used assets in trade or business, but it did exclude personal-use assets and stock-in-trade or other inventoried property.[146]

In 1924, Congress modified the 1921 Act's definition.[147] By eliminating the requirement of profit or investment and the exclusion of personal property, individuals were able to benefit from the preferential rates on sales of homes and other property not acquired for profit.[148] This alteration applied until the Revenue Act of 1934,[149] which further constrained the definitional exclusions.[150]

143. SEIDMAN, *supra* note 65, at 810-13. Section 206(b) of the Act provided that the taxpayer could elect a separate capital gains rate of 12.5% to apply only to capital gains. Ch. 136, § 206(b), 42 Stat. at 233. If the taxpayer's effective rate on all income was below 12.5%, no benefit arose from this provision. SEIDMAN, *supra* note 65, at 813.

144. SELTZER, *supra* note 26, at 20-21.

145. SEIDMAN, *supra* note 65, at 811. The two-year holding period requirement was proposed by Senators Walsh and McCumber because the Senate Finance Committee had proposed a capital gains preference to the effect that only 40% of such gains would be taxable. *Id.* at 812-13. The Senators perceived an unfairness in taxing current wages in full while taxing only 40% of a sudden capital gain windfall. *Id.* The lawmakers changed the capital gains tax preference from the proposed reduction in the percentage of gain taxed to a lower rate applied to the full amount of capital gains; however, they retained the holding period requirement because the change did not eliminate the element of unfairness. *Id.*

146. *Id.* at 811. Senator Lenroot proposed an additional exclusion for corporate stock because he believed that stock dividends would become preferred to cash dividends in light of the capital gains tax preference; the Conference Committee, however, deleted the addition. *Id.*

147. Act of June 2, 1924, ch. 234, § 208(a)(8), 43 Stat. 253, 263.

148. The attempt by the House to exclude stock dividends from capital assets was rejected because "[t]here is no logical reason why such stock does not constitute a capital asset, as well as other stock." SEIDMAN, *supra* note 65, at 717 (quoting S. REP. No. 398, 68th Cong., 1st Sess. (1924)). The attempt at exclusion was apparently related to the Supreme Court's decision that stock dividends did not constitute income. *See supra* notes 65-66.

149. Revenue Act of 1934, ch. 277, 48 Stat. 680.

150. The only significant provision created in the interim was contained in the Act of 1926, ch. 27, § 208(a)(8), 44 Stat. 9, 19-20, which contained a tacking provision for taxpayers receiving property with a transferred basis. In the provision's current form, "tacking" refers to a continuation in holding period, usually from transferor to transferee. I.R.C. § 1223 (1988).

Congress' broadening of the definition of capital assets by narrowing the exclusions from capital assets in 1934 was motivated by a desire to prevent ordinary loss deductions previously taken by professional traders in stocks and commodities.[151] To effect the change, Congress replaced the exclusion of "property held by the taxpayer primarily for sale in the course of his trade or business" with an exclusion of "property held by the taxpayer primarily for sale *to customers* in the ordinary course of his business."[152] Further, the legislature removed the exclusion of assets held by the taxpayer for less than two years.[153]

The Revenue Act of 1934 also placed limitations on the deductibility of capital losses. Before 1934, any losses on the sale of business equipment or buildings could be deducted fully against corporate income.[154] Congress limited these losses on depreciable property to capital gains plus $2,000, prompting an outcry of unfairness.[155] Taxpayers who chose to deduct limited amounts of depreciation during their use of the property would be penalized upon selling it.[156] Congress responded in the Revenue Act of 1938[157] by excluding depreciable property used in a trade or business from capital asset status.[158] Consequently, both corporate and individual taxpayers were permitted to deduct fully losses arising from the sale of depreciable business property.[159] The provisions

151. H.R. REP. No. 1385, 73rd Cong., 2d Sess. 22 (1934).

152. SEIDMAN, *supra* note 65, at 364.

153. *See id.*

154. SELTZER, *supra* note 26, at 21-22.

155. SEIDMAN, *supra* note 65, at 365; SELTZER, *supra* note 26, at 21-22.

156. SELTZER, *supra* note 26, at 21. Under these limitations, property depreciated in a conservative manner had a higher basis upon sale than property depreciated in an aggressive manner. A sale of the former, therefore, would more likely result in nondeductible losses than a sale of the latter. Alternatively, the taxpayer could have held the property instead of selling it and continued to take depreciation deductions until the basis reached zero.

157. Revenue Act of 1938, ch. 289, 52 Stat. 447.

158. *Id.* § 117(a)(1), 52 Stat. at 500.

159. SELTZER, *supra* note 26, at 22. This change allowed full deduction of losses from the sale of under-depreciated assets instead of limiting the deduction to capital gains plus a nominal additional amount. *See* H.R. REP. No. 1860, 75th Cong., 3d Sess. 34 (1938). The House Ways and Means Committee Report stated:

> This important change [recognizes] that gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses and, as such, directly affect the volume of the business profits which

affecting depreciable property, of course, still did not apply to inventories.[160] Additionally, to qualify as depreciable business property, the property must have been in such use at the time of disposition.[161] The use, however, did not have to be active. If the property was being held in reserve for business use, its idleness was not detrimental, but if its intended use had changed, the property would not be excluded from capital asset status.[162]

Current Definition and Treatment[163]

The statutory definition of the capital asset has changed very little since 1938, except for the addition of some very narrow ex-

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> should be subjected to tax in the years in which such transactions occur. [The change] is limited to property used by the taxpayer in his trade or business at the time of the sale or exchange, of a character which is subject to the allowance for depreciation It therefore has no application to gains or losses allocable to the land

Id., *see* SEIDMAN, *supra* note 65, at 65-66.

However, land was often difficult to separate from its attachments in calculating gains and losses, and World War II caused a huge turnover of realty. SELTZER, *supra* note 26, at 22-23. To insure that all losses would be fairly deducted, Congress responded with the Revenue Act of 1942, ch. 619, § 151, 56 Stat. 798, 846, which provided that no depreciable or real property used in a trade or business was a capital asset. Nevertheless, the statute applied capital gains treatment to the same property sold at a gain if the property had been held at least six months. *Id.*, *see supra* note 116 and accompanying text.

160. SELTZER, *supra* note 26, at 23.

161. *Id.*

162. *Id.* at 24. At the time, "trade or business" had not yet been defined by statute or by Bureau of Internal Revenue regulation. *Id.* In Schwinn v. Commissioner, 9 B.T.A. 1304 (1928), the Board of Tax Appeals stated that "trade or business refer[red] to a regular occupation or calling of the taxpayer, for the purpose of livelihood or profit." *Id.* at 1308.

163. At the time of this Note's publication, President Clinton has proposed numerous changes in the tax law as part of his economic program. Provisions affecting capital gains taxation involve a widened tax rate differential and a targeted capital gains tax preference.

For individual taxpayers, Clinton advocates a new top marginal income tax rate of 36% coupled with a 10% "surtax" on certain wealthy taxpayers. *Draft Explanation of Clinton Tax Proposals Available*, TAX NOTES TODAY, Feb. 23, 1993, *available in* LEXIS, Taxana Library, TNT File (93 TNT 43-1) (authored by the U.S. Treasury Department) [hereinafter *Clinton Tax Proposals*]. Neither rate increase applies to the taxation of capital gains, which would remain subject to the current maximum rate of 28%. *See infra* note 169. Thus, the structural capital gains rate preference under Clinton's proposal would reach a maximum of 11.6% [(36% x 110%) - 28%] as compared to the current 3% (31% - 28%).

In the case of the proposed targeted capital gains exclusion, Clinton's plan would benefit *all* taxpayer investors *except* subchapter C corporations. Under this change, investors holding "qualified small business stock" would be allowed to exclude 50% of the gains realized on disposition of the stock if they have held the stock at least five years prior to disposition.

ceptions.[164] Located at section 1221 of the Internal Revenue Code, they state:

> [T]he term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> (1) stock in trade of the taxpayer or inventory of the taxpayer , or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

Clinton Tax Proposals, *supra*. Also, several definitional limitations are relevant to the application of the proposal. To qualify as "qualified small business stock": 1) the investor would have to acquire the stock after December 31, 1992; 2) the stock would have to be "original issue" stock; 3) the issuing business must be a subchapter C corporation with less than $25 million of aggregate capitalization from January 1, 1993 through the date the taxpayer acquires the stock; and 4) the issuing corporation must use substantially all of its assets in the active conduct of a trade or business during the investor's holding period. *Id.* Lastly, certain business activities—services, banking, leasing, real estate, farming, mineral extraction, and hospitality—specifically would be excluded from qualification. *Id.*

Two further limitations applicable to the targeted capital gains exclusion would prevent *unlimited* gains from escaping taxation. First, the amount of gain excluded could not exceed the greater of 10 times the taxpayer's basis in the stock or $1 million; this limit would be applied separately to each qualified small business investment. *Id.* Second, one half of any exclusion claimed would be treated as a tax preference item by individual taxpayers under the alternative minimum tax system. *Id.*, *see* I.R.C. §§ 55-59 (1988).

Concerning corporate taxpayers, whether Clinton's plan as currently formulated involves any capital gains taxation preferences is unclear. Although his plan includes an increase in the corporate top marginal tax rate from 34% to 36%, preliminary information on Clinton's proposals makes no mention of whether the legislation will tamper with the currently "nonbeneficial" corporate capital gains rate ceiling of 34%, which is located at I.R.C. § 1201. *See Clinton Tax Proposals*, *supra*; *infra* note 171 and accompanying text. If § 1201 is left intact, a nominal rate preference of 2% (36% - 34%) would benefit those corporations whose income level invokes the top marginal tax rates and who have capital gains income. If, however, Clinton's exclusion of subchapter C corporations from the benefit of the targeted capital gains proposal mentioned above is an indication that he intends not to provide any benefit to corporations in the area of capital gains, corporations may ultimately be subject to a top marginal tax rate of 36% on *all* income. Of course, Clinton's entire economic plan has yet to experience the mutilation of the legislative process. Already, Senator Bumpers from Clinton's home state of Arkansas has proposed that a targeted capital gains preference, similar to the exclusion discussed above, apply to both individual and corporate taxpayers. *Bumpers Bill Would Cut Capital Gains Rate*, TAX NOTES TODAY, Feb. 26, 1993, *available in* LEXIS, Taxana Library, TNT File (93 TNT 46-79) (discussing S. 368, 103d Cong., 1st Sess. (1993) (introduced by Sen. Dale Bumpers, D-Ark)).

164. The copyright exclusion, trade receivables exclusion, and letters exclusion were added by the Acts of 1950, 1954, and 1969, respectively. Revenue Act of 1950, ch. 994, § 210(a), 64 Stat. 906, 933; Internal Revenue Code of 1954, ch. 736, § 1221(4), 68A Stat. 321, 322; Tax Reform Act of 1969, Pub. L. No. 91-172, § 514, 83 Stat. 487, 643.

> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation , or real property used in his trade or business;
> (3) [certain copyrights, compositions, or similar creations held by the creator] ,
> (4) accounts or notes receivable acquired in the ordinary course of trade or business ,
> (5) [certain government publications].[165]

In addition to being classified as a capital asset, the asset must be sold or exchanged to qualify for capital gain treatment.[166] Whether an event qualifies as a sale or exchange is not always straightforward. For example, both the abandonment of an asset[167] and the cancellation of a contract right[168] have failed to qualify as a sale or exchange.

Once the definitional and sale/exchange prerequisites have been met, the taxpayer typically receives the tax benefit. Currently, in the case of individual taxpayers, a nominal capital gains tax rate preference is applicable,[169] but the deductibility of capital losses is limited to capital gains plus $3,000.[170] For corporations, no tax rate

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165. I.R.C. § 1221.

166. *Id.* § 1222. Note, however, that the gain or loss "from the sale or *other disposition* of property" is recognized unless otherwise disallowed or denied. *Id.* § 1001(a), (c) (emphasis added).

167. *See, e.g.*, Rev. Rul. 57-503, 1957-2 C.B. 139. A sale or exchange does occur, however, if cancellation or diminution in indebtedness is present. *See, e.g.*, O'Brien v. Commissioner, 77 T.C. 113 (1981) (involving the abandonment of a partnership interest); Freeland v. Commissioner, 74 T.C. 970 (1980) (involving the abandonment of an encumbered property interest).

168. *See, e.g.*, Hoover Co. v. Commissioner, 72 T.C. 206 (1979), *nonacq.*, 1980-2 C.B. 2.

169. The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101(a), (c), 104 Stat. 1388-400, 1388-403 to -405 (codified as amended at I.R.C. § 1(h) (1992)), reinstituted the tax rate preference removed by the Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101, 302, 100 Stat. 2085, 2096, 2218 (codified as amended at I.R.C. § 1 (1988)). Section 1(h) now provides a maximum 28% tax rate for capital gains, whereas ordinary income is taxed at a maximum rate of 31%. I.R.C. § 1(a)-(e), (h) (1992).

170. I.R.C. § 1211(b) (1988). Before reaching the deductibility limitations of capital losses, both gains and losses are subject to a netting process. *Id.* § 1222. First, short-term gains and losses are netted separately from long-term gains and losses. *Id.*, *see supra* notes 111-13 and accompanying text (describing short-term and long-term holding periods). Only losses that are deductible for tax purposes—those "taken into account in computing taxable income"—are considered in the netting process; for individuals, these losses are generally only business, investment, and casualty losses. I.R.C. § 1222. The net "shorts" are then combined with the net "longs." *Id.* Both net long-term gains in excess of net short-term losses and the

preference is currently in effect[171] and deductible capital losses are limited to capital gains.[172]

The Legislative Purpose

The statutory exclusions in the capital asset definition allude to an intent to restrict capital asset treatment to those transactions realizing gain or loss that do not indicate recurrent and normally expected returns from wealth (capital), management and entrepreneurship, or plain labor in the context of a business enterprise.[173] The examples of such expected returns are explicit in the statute—inventories, depreciable and other realty used in the business,

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whole of net long-term gains in the absence of net short-term losses generally will receive capital gains treatment. *Id.* §§ 1(j), 1222. If net short-term gains exceed net long-term losses, or if net short-term gains exist along with net long-term gains, the excess of net short-term gain in the former case and the whole of the net short-term gain in the latter case are simply treated as ordinary income. *See id.*

In the case of either net short-term or long-term capital losses exceeding or equaling net short-term or long-term capital gains, the losses offset the gains dollar-for-dollar; additionally, any remaining losses offset up to $3,000 of an individual taxpayer's ordinary income. *Id.* § 1211(b). Remaining capital losses are carried forward indefinitely for future use in the case of individuals. *Id.* § 1212(b). The character of the loss carryover, short term or long term, extends into the future, but a statutory twist applies to determine the carryover character when the loss consists of both long-term and short-term loss. *Id.* By creating artificial short-term gain in the year in which the carryover arises, the provision effectively consumes net short-term loss *first* during the offset of up to $3,000 of ordinary income. *See id.* § 1212(b)(2). The result is always the lowest amount of short-term loss carryover possible. This method reduces the future short-term loss available to offset short-term gain. Short-term gain surviving the § 1222 netting process otherwise would receive ordinary-income treatment. The taxpayer would prefer the opposite approach, which would increase the chances for creating net long-term gains that receive all available preferential treatment.

171. Corporate taxpayers still are not afforded any capital gains concessions. The Tax Reform Act of 1986 removed the prior flat 28% rate preference applicable to corporations. § 311, 100 Stat. at 2219. The present corporate maximum tax rate of 34% under § 11 of the Internal Revenue Code also applies to capital gains; as part of the 1986 Act, however, Congress included a 34% rate ceiling on capital gains in anticipation of future corporate rate increases applicable to ordinary income. *Id.*, I.R.C. §§ 11, 1201; *see* H.R. CONF. REP. No. 841, 99th Cong., 2d Sess., II-106 to -107 (1986). Of course, should corporate rates increase, the resultant benefit of § 1201 can easily disappear with additional legislation.

172. The netting process described *supra* note 170 also applies to corporations, except no provisions such as § 1212(b)(2) apply because corporations are not allowed to deduct any capital losses in excess of capital gains. Regarding corporate capital losses not used in a taxable year, a carryback period of three years is required; any unused losses are then carried forward for up to five years. I.R.C. § 1212(a). Also, the character of all corporate capital loss carrybacks and carryforwards is deemed to be short term. *Id.*

173. DAVID, *supra* note 126, at 21-22.

and receivables.[174] Unfortunately, neither the format of the definition, nor additional revenue statutes, nor inconsistent judicial opinions has made this simplistic intent effective.[175]

Economic parallels help to describe several purposes that justify special treatment of capital assets. Preferences for capital transactions may:

> (1) secur[e] more equitable tax treatment for investment gains which have accrued over long periods of time and which would be assessed in a single year under progressive income tax rates; (2) reduc[e] the inequitable taxation of increments to capital that arise from illusory revaluations, such as inflation; and (3) minimiz[e] interference with the operation of assets markets, which, in many cases, are characterized by a limited number of buyers and sellers.[176]

Additionally, reducing the progressive tax effects on capital transactions is warranted to mitigate applying the usual tax treatment to unusual situations. Total income realized from an asset transaction may have accrued over many years and may represent a *sui generis* occasion to the investor, or an ultimate or attendant transaction may bear an intimate relation to another transaction that would be or is eligible for capital asset treatment.[177] Regarding this latter circumstance, the reverse relation should also be true. That is, a transaction sufficiently related to a noncapital asset transaction should not merit capital asset treatment.[178]

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174. I.R.C. § 1221.

175. *See supra* notes 19-22, 109-25 and accompanying text (discussing statutory constructions and judicial glosses applicable to the capital asset definition).

176. DAVID, *supra* note 126, at 37; *see supra* notes 85-137 and accompanying text (discussing the economic foundation of the capital asset).

177. DAVID, *supra* note 126, at 37-38; *cf. infra* notes 180-263 and accompanying text (discussing courts' determinations of legislative purpose).

178. *But see* Azar Nut Co. v. Commissioner, 931 F.2d 314 (1991) (coming to an opposite conclusion); *infra* notes 212-38 and accompanying text.

Doctrinal Cases[179]

Corn Products Refining Co. v. Commissioner

Corn Products Refining Co. v. Commissioner[180] involved a grain product manufacturer who purchased corn futures contracts[181] to ensure an adequate supply of raw corn.[182] Having incurred a gain of $680,587 and a loss of $109,969 on the contracts during tax years 1940 and 1942, respectively, the taxpayer sought a ruling that the futures contracts were capital assets.[183] Finding the transactions vitally important to maintaining a source of supply, the Supreme Court disagreed with the contention that the assets were "property" distinct from the manufacturing business.[184]

Upon deciding that the futures contracts did not fall into a specific statutory exception, the Court stated that the definition of capital assets "must not be so broadly applied as to defeat rather then [sic] further the purpose of Congress."[185] In the Court's opinion, "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."[186] The Court reasoned further that to effect congressional purpose regarding such an excep-

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179. For an in-depth development of earlier capital gains cases, see Kornhauser, *supra* note 23 (focusing on historical dialogue).

180. 350 U.S. 46 (1955).

181. A commodity futures contract obligates the seller of the contract to deliver the commodity to the buyer on the indicated date at the indicated price; the price of the contract is determined by reference to the current commodity price and the perception of likely increases or decreases in price. DAVID L. RATNER & THOMAS L. HAZEN, SECURITIES REGULATION 273 (4th ed. 1991).

182. *Corn Products*, 350 U.S. at 48.

183. *Id.* at 49.

184. *Id.* at 50.

185. *Id.* at 51-52. This was not the first time that an understood congressional intent and purpose was used to carve out special treatment for capital assets. A Supreme Court interpretation of the Act of 1924, which reflected the original capital asset treatment provisions of the Act of 1921 without change, held that an oil and gas royalty system passing actual title to the lessee resulted in ordinary income even though no specific capital asset exception of this kind was in place. Burnet v. Harmel, 287 U.S. 103, 106 (1932). The Court stated that the special capital gains enactment was "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." *Id.* To allow capital treatment in this case "would have tended to defeat rather than further the purpose of the Act." *Id.* at 106-08.

186. *Corn Products*, 350 U.S. at 52. The Court further stated that the statute "was intended 'to relieve the taxpayer from excessive tax burdens on gains resulting from a

tion to "normal tax requirements, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly"[187] The Court also remarked that it would create a loophole if it held that the sale of a futures contract was a capital transaction while actual delivery under the contract was not.[188]

This latter reasoning is in the vein of the substitution approach,[189] in the sense that the court examines the underlying transaction, or in this case, the underlying purpose, in order to characterize the asset. In terms of economic principles, the reason for holding an asset is a fundamental indicator of its character. Although surrounding facts and circumstances should not be ignored,[190] an asset's instant purpose in fact should be almost determinative.

In *Corn Products*, the connection of the stock to the taxpayer's main business was relatively clear and straightforward. The underlying purpose might have been a more determinative factor if Corn Products had bought the stock as an investment also, or, still further, if it actually had bought the stock with the *sole* intent of speculation, notwithstanding any relation to its business.

Arkansas Best Corp. v. Commissioner

In *Arkansas Best Corp. v. Commissioner*,[191] a holding company acquired bank stock for investment purposes but later acquired additional stock, not to increase its investment, but to provide capital to the failing enterprise in an effort to maintain the value of

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conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.'" *Id.* (quoting *Burnet*, 287 U.S. at 106).

187. *Id.*

188. *Id.* at 54. Compare this reasoning to the lease cancellation scenario in Hort v. Commissioner, 313 U.S. 28 (1941). *See supra* notes 122-25 and accompanying text.

189. *See supra* notes 122-25 and accompanying text (discussing the substitution approach). In Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222-23 (1988), the Court was concerned with taxpayer influence over the transaction's character under a "substitution" approach coupled with intent. It pointed out that although allowing capital treatment for a transaction of a truly ordinary nature would defeat the tax laws, to allow the taxpayer to control character via assertion of motive would seem unchallengeable. *Id.*

190. For instance, someone asserting status as an investor in a plot of land should be defeated by a past history of buying and selling numerous pieces of similar real estate. *See supra* note 112.

191. 485 U.S. 212.

the entire investment.[192] Petitioner eventually sold the shares at a loss of almost $10 million.[193] The Tax Court determined that the loss attributable to those shares purchased as an initial investment was capital and that the loss attributable to the subsequent purchase was ordinary.[194] The court based its reasoning on a broad reading of *Corn Products* creating a dichotomy between assets "purchased with a substantial investment purpose" and those "held for a business purpose."[195]

The Supreme Court, however, agreed with the Eighth Circuit's determination that stock clearly fell within the general definition of "capital asset" and was "outside the classes of property excluded from capital-asset status."[196] Arkansas Best agreed with the Supreme Court's definitional assertions but contended that the Court in *Corn Products* had "rejected a literal reading" of the definition in holding that "assets acquired and sold for ordinary business purposes rather than for investment purposes should be given ordinary-asset treatment."[197] The Court acknowledged this interpretation but stated that such a "broad reading finds no support"[198] in the statute.

Turning to the statutory language, the Court discounted the use of any "motive test" for determining the status of an asset because the phrasing of section 1221, that capital assets include all property " 'whether or not connected with [the taxpayer's] trade or business' . . . , makes irrelevant any consideration of the property's connection with the taxpayer's business."[199] The Court explained that the statute's enumeration of specific assets excluded from the capital asset definition was meant as an exhaustive, not illustrative, list. Thus, the Court was unwilling to "make[ ] surplusage of these statutory exclusions"[200] without congressional direction.

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192. *Id.* at 213-14.
193. *Id.* at 214.
194. Arkansas Best Corp. v. Commissioner, 83 T.C. 640, 657 (1984), *aff'd in part and rev'd in part*, 800 F.2d 215 (8th Cir. 1986), *aff'd*, 485 U.S. 212 (1988).
195. *Id.*
196. *Arkansas Best*, 485 U.S. at 223.
197. *Id.* at 216.
198. *Id.*
199. *Id.* at 217 (quoting I.R.C. § 1221 (1988)).
200. *Id.* at 218.

In concluding that "motivation in purchasing an asset is irrelevant"[201] to whether an asset is a capital asset and that the stock in the instant case therefore retained its capital nature,[202] the Court again offered its interpretation of *Corn Products*.[203] Because corn futures can be viewed as surrogates for the actual raw material, the Court held "that *Corn Products* is properly interpreted as involving an application of [the] inventory exception."[204] Concerning the use of a "business connection" test, the Court stated, "[A]lthough irrelevant to the initial determination whether an item is a capital asset, [it] is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception."[205] The relation between the futures contracts and the taxpayer's business in *Corn Products* was therefore important in considering the inventory exception.[206]

Interestingly, the Court acknowledged that it was turning its back on twenty-five years of a doctrine to which Congress had acquiesced by its "inaction."[207] The language it used in deflating the *Corn Products* doctrine maintained a definite, strict interpretation of the statute;[208] in contrast to this view, the Supreme Court in fact has used nonliteral interpretations of the Tax Code on numerous occasions in an effort to effect Congress' purpose.[209] This trend

201. *Id.* at 223.

202. *Id.*

203. *Id.* at 220-21.

204. *Id.* at 220.

205. *Id.* at 221.

206. *Id.*

207. Although congressional inaction is generally a poor measure of congressional intent, we are given some pause by the fact that over 25 years have passed since *Corn Products* without any sign of disfavor from Congress. We cannot ignore the unambiguous language of § 1221, however, no matter how reticent Congress has been. If a broad exclusion from capital-asset status is to be created for assets acquired for business purposes, it must come from congressional action, not silence.

Id. at 222 n.7 (citation omitted).

208. *See id.*

209. *See, e.g.*, Bob Jones Univ. v. United States, 461 U.S. 574, 586 (1983) (concluding that an educational entity meeting all statutory requirements of exempt status must also be charitable in the common law sense to qualify as tax exempt); Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 399 (1983) (requiring income recognition under the tax benefit rule notwithstanding an express statutory provision allowing nonrecognition); Helvering v. Morgan's, Inc., 293 U.S. 121, 126 (1934) ("[T]he true meaning of a single section of a statute

of broad, "purpose" interpretations of the tax laws was even recognized by the Internal Revenue Service (IRS) in a 1979 ruling.[210]

Ironically, the Court in *Arkansas Best* used its strict-interpretation-until-Congress-acts approach *after* Congress already had indicated its acceptance of the *Corn Products* doctrine. Although they did not convey the view in the form of statute, both Houses had stated in congressional reports that under *Corn Products*, property otherwise satisfying the literal language of section 1221 would not be considered a capital asset if it was used "as an integral part of a trade or business."[211]

WHERE WE ARE GOING: NOWHERE

Azar Nut Co. v. Commissioner

Azar Nut Co. v. Commissioner[212] involved a nut packaging and marketing company in need of a high-level executive to replace retiring owners.[213] To attract a qualified person, Azar found that a residence purchase agreement—a contract to purchase the executive's home in the event of termination—was a necessary part of employment offers of this nature and level.[214] Azar released the executive after two years of employment and purchased his home in accordance with the contract.[215] Although Azar immediately listed the house, almost two years passed before Azar sold the house at a loss of $111,366.[216] Azar had no capital gains during the tax year so the loss, if characterized as capital, represented no tax benefit for that year.[217] The company argued that the house fell into section

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however precise its language, cannot be ascertained if the mind be isolated from the history of the income tax legislation of which it is an integral part.") (citation omitted).

210. Rev. Rul. 79-404, 1979-2 C.B. 382.

211. S. REP. No. 313, 99th Cong., 2d Sess. 434 n.5 (1986); H.R. REP. No. 426, 99th Cong., 1st Sess. 450 n.19 (1985). Additionally, Congress earlier declined an opportunity to adopt a Treasury recommendation classifying securities as capital assets in all situations. STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., DESCRIPTION OF TECHNICAL AND MINOR BILLS LISTED FOR A HEARING BY THE COMMITTEE ON WAYS AND MEANS ON DECEMBER 10, at 56 (Comm. Print 1975).

212. 931 F.2d 314 (5th Cir. 1991).

213. *Id.* at 315.

214. *Id.* at 315-16.

215. *Id.* at 316.

216. *Id.*

217. *Id.*

1221's second capital asset exception, which concerned property used in the taxpayer's trade or business.[218]

The Fifth Circuit held that only a broad reading of "used in" would encompass an asset purchased with a "business purpose," as the term evolved under the *Corn Products* doctrine.[219] In accordance with the Supreme Court's narrow reading of *Corn Products* in *Arkansas Best*, the court concluded that business purpose generally is irrelevant to whether an asset meets one of the capital asset exceptions.[220] The court further noted that the words "used in" required that property play a role in business operations to satisfy the exception.[221] Finally, in holding that Azar's loss was capital, the court distinguished an earlier case in which it held that the sale of foreclosed homes by a building financier resulted in ordinary loss.[222] The court stated that the key to meeting the "used in" exception was that the property represent an " 'essential ingredient of the business' "[223] and be "*used* to protect the taxpayer's capital."[224] The court easily could have drawn a direct parallel to this earlier ruling. Azar's hiring of the executive was contingent upon its agreeing to purchase the house in the event of termination, hence an "essential ingredient." Azar's view thus considers "essential" to mean "necessary." Second, although the house itself was not "used to protect" its capital, Azar's hiring of a qualified executive indeed was. Neither analogy is too attenuated; the court merely colored the facts as an expedient to reaching a desired outcome.

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218. *Id.*

219. *Id.*

220. *Id.* at 317.

221. *Id.*

222. *Id.* at 318 (quoting A.L. Carter Co. v. Commissioner, 143 F.2d 296, 297 (5th Cir. 1944)). The case Azar used in its argument, *A.L. Carter*, involved a taxpayer who supplied building materials and financed home construction. *A.L. Carter*, 143 F.2d at 297. Forced to foreclose on several hundred homes after the Depression, the taxpayer resold the houses at a gain or loss computed by using the cost of the houses because the taxpayer had taken no depreciation deductions. *Id.* The IRS's challenge related to this cost basis because depreciation is allowed on property "used in" a trade or business regardless of whether the taxpayer takes it. *Id.* The court in *A.L. Carter* agreed with the IRS upon concluding that the management and administration of foreclosed property was an essential part of financing. *Id.* at 297-98.

223. *Azar Nut*, 931 F.2d at 318 (quoting *A.L. Carter*, 143 F.2d at 297).

224. *Id.*

As one commentator noted, "What is interesting about this case is not the rather obvious result but the determination to ignore it on the part of large employers, who consistently take the return position that [such] losses are ordinary"[225] In fact, approximately one half of large employers employ sizeable staffs to execute the buying and selling of employees' houses while the other half engage third-party relocation specialists; "whether the houses are capital or ordinary assets can be worth several million dollars annually"[226]

The IRS, meanwhile, continues to assert that the transactions are capital.[227] Lobbyists for the large corporations, though, assert that the real estate operations are ordinary because each employer deals with "so many houses that it qualifie[s] as a dealer, making the houses inventory,"[228] or alternatively, because continual employee relocation is an obvious ordinary and necessary business involvement so that losses on the houses are ordinary and necessary business expenses of that involvement.[229] The IRS's response effectually rejected both of these arguments.[230]

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225. Lee A. Sheppard, *Losses on Sales of Employees' Houses After* Azar Nut, 51 TAX NOTES 1233, 1233-34 (1991).

226. *Id.* at 1234.

227. *See* Rev. Rul. 82-204, 1982-2 C.B. 192 (stating an employer's in-house program of handling transferred employees' houses resulted in capital transactions because neither the inventory nor the depreciable business property exception applied).

228. Sheppard, *supra* note 225, at 1235.

229. *Id., see also* I.R.C. § 162(a) (1988) (allowing the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business").

230. Tech. Adv. Mem. 90-36-003 (Sept. 7, 1990). The transaction involved a contract with a relocation company to sell employees' houses for a fee that was adjusted upward or downward to account for any loss or gain, respectively. *Id.* Title did not pass until the sale was made. The IRS held that the transaction fell within the ambit of Rev. Rul. 82-204, even though the form was more attenuated. *Id.* The holding focused on retention of risk/benefit and application of substance over form but ignored whether an agency relation existed. *Id.*

Although the Technical Advice Memorandum is limited to its facts, it does leave open other possibilities. For example, what if a corporation entered a contract to transfer title at cost to a relocation service and paid a standard fee based on the value of the house, instead of explicitly relating the gain or loss on the house back to the corporation? Of course, this practice would deny the corporation the benefit of any gain.

Alternatively, as an analogy to certain insurance arrangements, consider an agreement with such a service under which the service took title to the houses from the outset, sold them at a gain or loss, and charged the corporation a fee for the service, but adjusted the fee annually according to its gain or loss "experience." The corporation, then, would benefit

The IRS's defeat may come from the one-versus-many argument that it has used in previous real estate dealer cases.[231] To qualify for the inventory exception, the property must be either typical inventory or property held "primarily for sale to customers in the ordinary course" of business.[232] An employer should be able to satisfy the "primarily"[233] portion of the statute because its only intention in holding an employee's house is to resell it.

The "to customers" and "ordinary course" mandates, however, may prove more troublesome. If the employer can convince the court simply to follow the legislative intent in attaching these words, the taxpayer seemingly still would prevail. Congress appended the language in 1934 solely to estop traders in securities from asserting dealer status.[234] Attention to the statute, instead, might prove fatal; it contains no language limiting application of the words to securities traders.[235] Considering the housing transaction further, the employer has no "customers" in the conventional sense and does not expect ordinary profits from the sale of employees' houses. The employer's purpose, then, would be speculation—to minimize its losses—which certainly would warrant capital treatment.[236]

To come full circle, the big picture reveals that the employer holds the house not for speculation, but for meeting the business need of providing such "compensation" in order to attract qualified employees.[237] This last justification for ordinary treatment appears to make perfect sense in this case; however, the Court cut off any such reasoning four years ago in its *Arkansas Best* decision,

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indirectly from any gains, possibly even in the form of "rebates" that would also be ordinary.

The beneficial part of either approach is that losses represented by fees would receive ordinary treatment and therefore would not be limited under the capital loss provisions. *See* I.R.C. § 1211.

231. *See supra* note 114 (describing the variability of classification of an asset in differing hands and the factors influencing this variability).

232. I.R.C. § 1221(1).

233. In Malat v. Riddell, 383 U.S. 569 (1966), the Supreme Court defined "primarily" in the context of I.R.C. § 1221(1) to mean " 'of first importance' or 'principally.' " *Id.* at 572.

234. *See supra* notes 152-53 and accompanying text.

235. *See* I.R.C. § 1221.

236. Sheppard, *supra* note 225, at 1237.

237. Consider a "but for" type analysis: the employer would not be buying and selling the house *but for* its relation to providing the benefit to employees.

which severely limited the effect of business motivation on tax character determinations.[238]

Circle K Corp. v. United States

In *Circle K Corp. v. United States*,[239] a convenience store chain purchased stock in an oil development company.[240] The majority of its convenience stores sold gasoline, which comprised thirty-five percent of its total sales.[241] Although the substance of the stock purchase was to guarantee a gasoline supply, Circle K on more than one occasion represented the purchase in filings with the Securities and Exchange Commission as only an investment or as a transaction primarily for investment.[242] The company made this representation chiefly to obtain available tax benefits.[243] Ultimately, plaintiff sold the stock after determining that the investment would not serve as a viable solution to its gasoline problem.[244] Circle K claimed a $27,824,296 ordinary loss deduction attributable to the sale.[245] As a basis for its claim, the company argued that the stock qualified under the first capital asset exception exempting "stock in trade . . . or other property . . . included in the inventory of the taxpayer."[246]

The Claims Court analyzed Circle K's claim according to Supreme Court holdings in *Corn Products Refining Co. v. Commissioner*[247] and *Arkansas Best Corp. v. Commissioner*.[248] Recognizing that under the expanded *Corn Products* doctrine, "ordinary asset treatment" applied to all "assets acquired and sold for regular business purposes," the Claims Court held that judicial determination

238. *See supra* notes 191-211 and accompanying text.
239. 23 Cl. Ct. 665 (1991).
240. *Id.* at 666-67.
241. *Id.* at 666.
242. *Id.* at 667.
243. *Id.* Oil and gas producers are allowed percentage depletion deductions from each producing property, but the deduction is not available to gasoline retailers or to producers who sell their product to owners of more than five percent of the producer's stock. I.R.C. § 613 (1988); *Circle K*, 23 Cl. Ct. at 667.
244. *Circle K*, 23 Cl. Ct. at 669.
245. *Id.*
246. *Id.* (citing I.R.C. § 1221(1)).
247. 350 U.S. 46 (1955).
248. 485 U.S. 212 (1988).

of motive was dispositive.[249] Next, the court noted that the Supreme Court in *Arkansas Best* had repudiated the motive test, trimming the *Corn Products* holding to mean that only "hedging transactions that are an integral part of a business' inventory-purchase system" qualify for the inventory exception.[250] Thus, after *Arkansas Best*, motive has no bearing;[251] instead, the question is whether the inventory item and the taxpayer's business are closely connected.[252] Although Circle K at times professed that it purchased its stock for other purposes, the court held that the purchase qualified in substance as a hedging transaction, and the loss was therefore ordinary.[253] The "substance" argument was that Circle K's controlling or influential ownership investment could guarantee supply at a reasonable price in the event that market prices became cost prohibitive.[254]

In light of *Arkansas Best*, the court arguably wrongly decided *Circle K*. The Claims Court, in effect, wedged open the door for using "purpose" testing to determine capital versus ordinary status, a door that the Supreme Court had all but closed in *Arkansas Best*.[255] Nonetheless, the court's reasoning does mesh with *Arkansas Best* in the sense that the taxpayer's motive is unimportant except in establishing a surrogate for one of the statutory exceptions. The substitute for inventory in the case, however, was not a

249. *Circle K*, 23 Cl. Ct. at 670.

250. *Id.* at 671 (citing *Arkansas Best*, 485 U.S. at 217).

251. *Id.* at 672.

252. *Id.*

253. *Id.* at 673.

254. *Id.*

255. *See* Lee A. Sheppard, Circle K. *How Taxpayer Choice Survives* Arkansas Best, 51 TAX NOTES 1359, 1359-60 (1991). Although the Supreme Court did not say explicitly that capital stock not in the hands of a dealer could not be ordinary, it did argue that to allow the application of a business-motive test to stock would be to allow the taxpayer significant influence over the asset's characterization. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222 (1988). The Court stated that "stock is most naturally viewed as a capital asset [and] we are unaware of a single decision that has applied the business-motive test so as to require a taxpayer to report a gain from the sale of stock as an ordinary gain." *Id.* at 222-23. Ironically, *Circle K* involved a taxpayer *seeking* ordinary treatment for the sale of stock and winning.

commodity futures hedge, but the quintessential capital asset, capital stock.[256]

Addressing the underlying concern that a taxpayer might attempt to recharacterize assets at or near the time of sale to benefit himself most, commentators after *Corn Products* called for identification upon acquisition of an asset.[257] Although the IRS did not enact any such regulation, in litigating cases such as *Circle K* the government nevertheless took the position that each taxpayer should preidentify the purpose of its asset acquisition.[258] After hearing the government's argument that Circle K had disavowed any intent to utilize the stock purchase as a source of supply,[259] the court seemed to recognize the oddity of ignoring motive for one purpose and effectively recognizing it for another. "[Such] evidence to that effect is entirely irrelevant here Instead, [we] must determine whether the stock purchase, solely on its face, had a substantially close connection to plaintiff's inventory-purchase system."[260]

Admittedly, if the government had centered more of its efforts on arguing the absence of a valid hedge,[261] it may have persuaded the court that the stock purchase at issue was not an inventory

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256. This statement is not meant to imply that stock can never be an inventory hedge; however, such a finding would be "starting over," considering the constraints that the *Arkansas Best* decision placed on the *Corn Products* doctrine.

Cases such as Campbell Taggart, Inc. v. United States, 744 F.2d 442 (5th Cir. 1984) (holding that overpriced stock purchased to maintain business reputation and subsequently sold at a loss qualified for ordinary loss treatment) and Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (holding that a taxpayer's stock "investment" to insure a supply of newsprint vital to its business was ordinary in nature and qualified for ordinary loss treatment upon disposition) are implicitly overruled by language in *Arkansas Best*. In fact, the Court in *Arkansas Best* cited these cases as support for the former broad application of *Corn Products* but immediately rebuked that broad application as having no statutory support. *Arkansas Best*, 485 U.S. at 216.

257. Sheppard, *supra* note 255, at 1360.

258. *Circle K*, 23 Cl. Ct. at 672; Sheppard, *supra* note 255, at 1360.

259. *Circle K*, 23 Cl. Ct. at 672.

260. *Id.*

261. A valid hedge meriting ordinary loss treatment arguably did not exist for two reasons. First, the "hedge" was to obtain supply, not to ward against price fluctuations. Although *Corn Products* would have recognized source of supply as an exception to the statutory definition of capital assets, *Arkansas Best* effectively overruled such exceptions. *See* Sheppard, *supra* note 255, at 1361; *supra* notes 195-200, 250-56 and accompanying text. Second, considering the nature of a hedge as a legitimate guarantee to counterbalance future uncertainty, a stock investment in a risky wildcat oil venture is certainly not a palpable

substitute comporting with *Arkansas Best.* Indeed, even given this Note's recommendations,[262] *Circle K* is a poor decision on the merits. Characterizing a purely uncertain investment as an attempt to secure a future inventory is illogical.[263]

WHAT SHOULD BE DONE

Reconciling the Cases

From a broad definitional standpoint, *Azar Nut* and *Circle K* are reconcilable on one obvious point: the courts have consistently been deferential to taxpayer treatment of assets related to inventory, but not to treatment based on equally valid business circumstances unrelated to inventory.[264]

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solution given many, much safer means of insuring supply. Sheppard, *supra* note 255, at 1361.

262. *See infra* notes 264-74 and accompanying text.

263. Of course, a business may take whatever risks it determines worthwhile in its judgment. However, for tax purposes, the goal of some reciprocal fairness between the taxpayer and the government would dictate the need of some guidelines in such instances. In *Circle K*, a purely chance venture, an investment in a wildcat oil venture (even when coupled with the importance of gasoline to the company), a prior history of shortages, and the assertion of a hedge, should not rise to a determination of ordinary asset treatment under any analysis. Recognizing such attenuated positions would allow the taxpayer to assert that almost any investment with a relation to its business is an inventory hedge or business necessity. *See supra* notes 189-90.

264. The statutory inventory exception of course may be the general reason for these outcomes. However, § 162, the stalwart business-expense provision, has apparently been ignored. *See* I.R.C. § 162 (1988) (providing deductibility for all "ordinary and necessary" business expenses).

In a sense, the courts have come full circle as illustrated by a comparison between pre-*Corn Products* decisions. In Exposition Souvenir Corp. v. Commissioner, 163 F.2d 283 (2d Cir. 1947), a company was required to buy World's Fair bonds to operate a souvenir concession stand at the Fair. *Id.* at 284. Agreeing that the motivation was purely business oriented, but finding no statutory exclusion, the court denied ordinary loss treatment. *Id.* at 285-86. A second case also dealt with purchase of securities for a business reason, but this reason was related to inventory needs. In Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1090 (1952), *acq.*, 1958-1 C.B. 6, *acq. appeal dismissed*, 205 F.2d 420 (8th Cir. 1953), a whiskey wholesaler purchased stock in a distilling company to offset whiskey shortages in the market. *Id.* at 1092. The tax court found that the purchase was incident to the company's business but allowed ordinary loss treatment. *Id.* at 1099. Although both courts classified the motive driving the purchase as business purposes, the clear distinction was the latter's inventory relation.

These cases are analogous to *Corn Products* and *Arkansas Best.* The Supreme Court in *Corn Products* recognized the business purpose behind an inventory-related asset purchase. Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 50 (1955). Of course, the significance of

The Court in *Corn Products* was attempting to recognize, as best it could, the true meaning of capital asset.[265] Its attempt generally comports with both early notions of the meaning of capital assets at the inception of our tax laws and the more academic economic theories. The *Arkansas Best* decision represented the Court's concern that judicial decisions might go too far beyond the statute, supported by little more than unbounded conjecture. The Court's solution was to return to the statute.

The Claims Court at least believed that *Arkansas Best* left open the possibility that stock purchases closely tied to inventory needs could be ordinary transactions.[266] Whether the Supreme Court intended to allow this result is uncertain, but clearly the Court in *Arkansas Best* did not approve of the possibility for taxpayer and IRS manipulation that *Corn Products* allowed.[267] Therefore, the Court chose not to use its interpretive powers to support a departure from the statute.

A common acceptance of *Arkansas Best* states that although the Court "side-stepped its role in the law making process and [went] against its own tradition of interpreting the laws to further the intent of Congress," it justifiably did so to "narrow[] the

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this case rests in its precedential value and its language framing the holding in terms of business motive. The emphasis on business purpose was so strong that the *Corn Products* doctrine resulted in 33 years of subjectively determined cases based on the asset's purpose. *Arkansas Best* represented the retreat from *Western Wine* thinking to *Exposition Souvenir* reasoning.

265. For example, in Malat v. Riddell, 383 U.S. 569 (1966), the Court stated that the purpose of the inventory exception was "to differentiate between the 'profits and losses arising from the everyday operation of a business' and 'the realization of appreciation in value accrued over a substantial period of time.' " *Id.* at 572 (citations omitted) (quoting *Corn Products*, 350 U.S. at 52; Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960)).

266. The Court in *Arkansas Best* did not specifically foreclose this possibility, but it did affirm the Eighth Circuit Court, which stated:

> We do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221. *Corn Products* and its progeny [are] misbegotten [and have led] to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock.

Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 221 (8th Cir. 1986), *aff'd*, 485 U.S. 212 (1988).

267. Maria E. O'Neill, Note, Arkansas Best Corporation v. Commissioner—*The Demise of the* Corn Products *Doctrine?*, 35 WAYNE L. REV. 1481, 1490 (1989).

range of litigable issues."[268] Ironically, an earlier Supreme Court touted the motive test as workable and providing certainty.[269]

A Sixth Exception

One conclusion is inescapable: Congress is overdue in exercising its "necessary and proper"[270] power in this area. The courts clearly have been troubled by common principles of economics as applied to the current statutory definition of capital assets. Their uncertainty is justified because the statute is structured inversely and fails to account for economic realities.

Perhaps Congress has failed to act for reasons that were the cause of the statute's current structure. Both capital and ordinary assets are innumerable and the character of a given asset is not fixed; therefore, a workable statutory definition, whether inclusive or exclusive, is difficult to construct. Because the nature of the property itself is at issue, its economic substance should be the most important definitional concern.

One possible solution would be to leave the definition in its current state—explicitly recognizing "everyday" ordinary asset exclusions—and append a sixth exclusion. This addition necessarily would be variable in nature to recognize both the realities of a complex economic system and the economic essence of the capital asset. The effect would be to mitigate judicial manipulation of the current definition.

Of course, the administrative fears must be addressed. Adoption of a form of predetermination could solve, as has been proposed in the past, the burden of analyzing taxpayers' motives under the sixth exception. The form of predetermination would have to pro-

268. M. Kevin Bryant, Comment, *The* Corn Products *Doctrine After* Arkansas Best, 14 OKLA. CITY U. L. REV. 131, 157 (1989). *But see* Shrader, *supra* note 21, at 420 (concluding that although *Arkansas Best* may have reduced complexity, it frustrated general tax policy treatment of ordinary business operations and denial of preferences to property related to normal business income).

269. United States v. Generes, 405 U.S. 93, 104 (1972) (stating that the motivation test has "the attribute of workability" and provides "a guideline of certainty"); *see also* Shrader, *supra* note 21, at 366-69 (arguing against the wisdom of *Arkansas Best*); *cf. Arkansas Best*, 485 U.S. at 222-23 (speaking of the taxpayer's significant influence in determining the character of an asset under a motive test).

270. U.S. CONST. art. I, § 8 (providing that "Congress shall have Power To lay and collect Taxes" and "make all Laws which shall be necessary and proper" to execute such power).

vide an opportunity for scrutiny by the IRS before the "sell or exchange" transaction.

A test similar to that expounded in *Booth Newspapers, Inc. v. United States*[271] is perhaps descriptive of this proposal. The court in *Booth* stated the "business motive test" as follows:

> [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.[272]

Both the government and the taxpayer could use such a test to evaluate any assets that might fall within the sixth exception. A taxpayer wishing to assert this new exclusion from the capital asset "presumption" would file with the IRS a statement of its position upon acquisition or upon changed circumstances thereafter.[273] The

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271. 303 F.2d 916 (Ct. Cl. 1962).

272. *Id.* at 921; *see* O'Neill, *supra* note 267, at 1486. A similar test adopted by the Tax Court in W W. Windle Co. v. Commissioner, 65 T.C. 694 (1976), *appeal dismissed*, 550 F.2d 43 (1st Cir.), *cert. denied*, 431 U.S. 966 (1977), provided that, in the case of stock, the existence of a substantial investment motive (SIM) resulted in capital asset classification notwithstanding a coexisting or overriding business purpose. *Id.* at 712. This test recognizes instances that involve "mixed" motives. On its face, the test appears equitable because any significant investment motive legitimately could be considered to taint the classification of an asset. The problem apparent upon practical analysis, however, is that the test seems to be a breeding ground of argument between the IRS and the taxpayer. The parties might argue for example, over what is "significant" and how the subjective nature of motive might be resolved. This Note's proposal would remedy such problems.

The IRS indicated that it would follow the SIM test in Rev. Rul. 78-94, 1978-1 C.B. 58, but suspended this ruling in I.R.S. Notice 87-68, 1987-2 C.B. 378, just prior to the *Arkansas Best* decision.

One reason cited for favoring the SIM test over the business-motive test is that the latter is too susceptible to taxpayer manipulation. O'Neill, *supra* note 267, at 1486. The same criticism, however, is readily apparent in the SIM test. Particularly with regard to stock, the IRS could attempt to deny ordinary treatment at will by asserting a substantial investment motive.

273. In 1976, both Houses of Congress passed similar bills but did not enact them; the proposed procedures required the taxpayer acquiring securities to notify the IRS if he contemplated ordinary treatment. H.R. 10902, 94th Cong., 2d Sess. (1976); *see also* 122 CONG. REC. 27,499, 34,589 (1976) (discussing H.R. 10902).

IRS would then either acquiesce or deny the petition, in which case the taxpayer would be afforded an appeal.[274] If the petition were successful, the status would remain in effect while in the taxpayer's hands, absent a compelling change in circumstances. Such a compelling change might effect a change in status and would be reviewed by the Service. Again, an appeal would be provided to the taxpayer.

Although costs of administering the sixth exception might be significant at the IRS/taxpayer level, a commensurate savings at the judiciary level should result and offset those costs. More importantly, the capital assets' economic substance would be restored. Furthermore, given a statutory provision *intended* to be subject to "facts and circumstances," Treasury regulations providing examples and guidance as to indicia of business versus investment purposes, followed by judicial development of a consistent body of precedent, would soon provide certainty as well.

CONCLUSION

In choosing the statutory form of the capital asset definition, Congress long ago fashioned the infamous "inverted" definition by exception. The awkward form appears objectionable at first, but becomes more sensible upon realizing that no finite list of capital assets is possible or that no tell-tale description absolutely delineates the possibilities. The language, in fact, serves well to truncate those most basic ordinary assets from capital characterization.

The problem, however, is that the definition describes only literal "exceptions," while commercial and economic realities demand a definition capable of recognizing the characteristic economic nature and use of an asset at a point in time. Economic substance and state are not fixed; instead, they are indicated by the asset's position in the economic chain, the operations of the asset holder, and the actual or intended use of the asset. The historical origins

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Other proposals in the nature of taxpayer elections surfaced after *Corn Products*. *See, e.g.*, Note, *Judicial Treatment of Capital Assets Acquired for Business: The New Criterion*, 65 YALE L.J. 401 (1956).

274. The appeal would be within the IRS. To prevent one-sided IRS denials from defeating the provision, however, the taxpayer would still be able to resort to the courts once the recognition transaction had been reported, based on the facts and circumstances. Acquiescence by the IRS would always serve as a safe harbor for the taxpayer.

of income classification and economic principles that guide the distinction between capital and ordinary assets, however, are relatively fixed and thereby allow for economically substantive, predictable determinations of asset characterization.

The courts nevertheless have been in a quandary over such determinations for nearly a century. Some read intent and economic reality into the present statute and others, offended by judicial legislating and fearful of overly broad interpretations, interpreted the statute narrowly. They have left the taxpayer unable to ascertain the nature of his assets and predict the tax consequences of certain transactions. Congress must respond to the statute's failure to recognize economic realities and provide a statutory definition that accommodates the intrinsic economic basis of the capital asset. The present statute's listing of fundamental capital asset exceptions should be maintained given their presumptively ordinary character; an additional provision allowing taxpayer declaration of ordinary character based on the "facts and circumstances"—subject to IRS scrutiny and ultimately to judicial review—will encourage more proper economic characterization. Adding mindful variability to the definition will also quell the sometimes mindless variability of the courts' past decisions.

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