

BUS 225H – Taxation of Property Transactions

Professor Annette Nellen

Week 5 Reading

- Capital Assets

In addition to the items in this file, also read on the BUS 225H website:

- IRC and Regulation Provisions Dealing with Capital Assets [for reference] - [link](#)
- *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955) - [link](#)
- *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988) - [link](#)
- IRS Information Letter [2008-0042](#) - ordinary income versus capital gain income
- 1040 [Schedule D](#) and [Instructions](#) [skim]
- The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options*, August 2010, pages 36-41 [included at end of pdf reading materials]
- Nellen, [Is It Time to Increase the Capital Loss Limitation?](#) *AICPA Tax Insider*, 2/12/09

Contents of this Reading Packet:

Item	Page
Introduction	2
Rulings on §1221(a)(1)	7
Rulings on §1221(a)(2)	20
Rulings on §1221(a)(3)	21
§1221(b)(3) - Sale or exchange of self-created musical works	25
Rulings on §1221(a)(5)	
Ruling on §1221(a)(8)	26
A Few Special Rules	28
The Capital Gains Debate	29

Introduction

Definitions: The focal point of this reading is the definition of a capital asset under §1221. This section is a bit unusual in its definitional approach in that it specifies eight types of assets that are not capital assets. Thus, if an asset falls into one of the eight categories it is not capital asset. For many years, there were only five categories (§1221(a)(1) – (5)) so some of the cases you’ll read note five items. Also subsequent to the *Corn Products* case and before the *Arkansas Best* case, it was thought that there was a sixth category of items that were not a capital asset, such as items acquired for a business purpose. Per Notice 87-68, the “Corn Products Doctrine” was “construed to permit ordinary income (or loss) treatment for certain business motivated transactions in stock and other capital assets.”

Tax Effect: Also important in the discussion of capital asset is the treatment of capital gains and losses. There are rules for corporations and for non-corporate taxpayers. Generally, non-corporate taxpayers have a lower rate for capital gains, but this has not always been the case. A variety of approaches have been used since the Revenue Act of 1921 for providing some tax benefit for capital gains. The current rate structure for non-corporate taxpayers for their net capital gains are at §1. Corporations pay tax on capital gains at the same rate as for ordinary income.

“Sale or Exchange”: In addition to the definition of “capital asset” recall from discussion of the *Citron* case in Reading 3, that to have a capital gain or loss, there must also be a “sale or exchange.”

“Property”: Also discussed in Reading 3 was the need to be sure that whatever generated income (for example, the “sales price”) was property. This issue often comes up when a taxpayer wants to label income as capital gain income rather than ordinary, such as the insurance agent in *Trantina v. U.S.*, 512 F.3d 567 (9th Cir.). The court found that there was no property but instead a payment of ordinary income. This might also come up when a lease or supply contract is cancelled and the lessor or supplier receives money. Is the money for disposition of the contract or replacement of future ordinary income (such as rent)? There are many cases and rulings that involve this type of issue.

Question 1 – Amy won \$5 million in the lottery with the winnings to be paid over 10 years. She really needs money now so she sold the right to the future lottery winnings. Has Amy sold a capital asset (the right to future lottery winnings) or did she receive ordinary income that is in essence a prepayment of future lottery winnings?¹

Relation Back Doctrine: This doctrine is from the *Arrowsmith* case (USSC 1952) and may be relevant in characterizing an expenditure or income in one year that relates back to a capital gain or loss transaction in a prior year. The following ruling provides an explanation of this doctrine.

¹ See TAM 199945008 and other rulings involving this type of fact pattern.

Rev. Rul. 78-25

Advice has been requested whether, under the circumstances described below, the taxpayer is entitled to compute tax liability under section 1341 for the restoration of an amount that was previously included in gross income.

A, an individual, owned 75 percent of the outstanding stock of X corporation. X was the common parent and owned all the stock of three domestic corporations that were engaged in the sale of real estate, the publication of periodicals pertaining to real estate, and in other related activities.

In 1976, X adopted a plan of liquidation and pursuant thereto sold for \$1,000x all of its assets, consisting primarily of the stock of its subsidiaries, to Y, an unrelated corporation. Under the terms of the purchase agreement, X placed \$150x in escrow to indemnify Y against liabilities, damages and costs incurred as the result of the failure of A or X to fulfill the conditions specified in the agreement.

In 1976, X distributed all of its assets, except the \$150x escrowed amount, to its shareholders. The liquidation of X was completed in 1976 and met the requirements of section 337 of the Code.

The amount received by A in liquidation of X resulted in a capital gain of more than \$3,000 that A included in gross income for 1976 because it appeared that A had an unrestricted right to such amount.

In 1977, a judgment was rendered against a former subsidiary of X, with respect to a transaction that occurred in 1975. As a result of this judgment, Y took legal action against X under the agreement. Later in 1977, as a result of this action, A paid Y more than \$3,000, in addition to the 150x dollars paid from the escrow account.

Section 1341 of the Code provides rules for the computation of tax where a taxpayer is entitled to a deduction in excess of \$3,000 as a result of restoring an amount included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such amount in that year.

Under section 1341(a) of the Code the tax imposed for the taxable year is the lesser of the amounts computed with such deduction, or the amount computed without such deduction but reduced by the decrease in tax for the prior taxable year attributable to the exclusion of such item.

In discussing section 1341 of the Code, the report of the Committee on Finance, *S. Rep. No. 1622*, 83rd Cong., 2d. Sess. 452 (1954), states:

The section will apply to cases of transferee liability such as *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

...

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), 1952-2 C.B. 136, two stockholders who had equal ownership in a corporation, liquidated the corporation and divided the proceeds. The stockholders reported the profits realized from the transaction as capital gains. In a subsequent year, a judgment was rendered against the former corporation. The two former stockholders were required to and did pay the judgment for the former corporation because they were transferees of the former corporation's assets. The Supreme Court of the United States held that the losses resulting from the payment of the judgment were incurred because of a legal obligation arising out of a prior liquidation. Therefore, because the transaction in the prior year resulted in capital gains, the loss in the subsequent year is a capital loss.

Accordingly, in view of *Arrowsmith*, the amount paid by A to Y is allowed as a capital loss deduction in 1977. Further, to the extent such amount was included in A's gross income for 1976, A is entitled to compute Federal income tax liability for 1977 under section 1341 of the Code.

Subchapter P: This subchapter has many definitions and special rules. We will not cover most of them, but they are listed below to give you an overview and appreciation of the nature of these rules.

Subchapter P—Capital Gains and Losses

PART I—TREATMENT OF CAPITAL GAINS

- § 1201. Alternative tax for corporations
- § 1202. Partial exclusion for gain from certain small business stock

PART II—TREATMENT OF CAPITAL LOSSES

- § 1211. Limitation on capital losses
- § 1212. Capital loss carrybacks and carryovers

PART III—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

- § 1221. Capital asset defined
- § 1222. Other terms relating to capital gains and losses
- § 1223. Holding period of property

PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

- § 1231. Property used in the trade or business and involuntary conversions
- § 1233. Gains and losses from short sales
- § 1234. Options to buy or sell
- § 1234A. Gains or losses from certain terminations
- § 1234B. Gains or losses from securities futures contracts
- § 1235. Sale or exchange of patents
- § 1236. Dealers in securities
- § 1237. Real property subdivided for sale
- § 1239. Gain from sale of depreciable property between certain related taxpayers
- § 1241. Cancellation of lease or distributor's agreement
- § 1242. Losses on small business investment company stock
- § 1243. Loss of small business investment company
- § 1244. Losses on small business stock
- § 1245. Gain from dispositions of certain depreciable property
- § 1248. Gain from certain sales or exchanges of stock in certain foreign corporations
- § 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations
- § 1250. Gain from dispositions of certain depreciable realty
- § 1252. Gain from disposition of farm land
- § 1253. Transfers of franchises, trademarks, and trade names
- § 1254. Gain from disposition of interest in oil, gas, geothermal, or other mineral properties
- § 1255. Gain from disposition of section 126 property
- § 1256. Section 1256 contracts marked to market
- § 1257. Disposition of converted wetlands or highly erodible croplands
- § 1258. Recharacterization of gain from certain financial transactions
- § 1259. Constructive sales treatment for appreciated financial positions
- § 1260. Gains from constructive ownership transactions

PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

- Subpart A—Original Issue Discount
- Subpart B—Market Discount on Bonds
- Subpart C—Discount on Short-Term Obligations
- Subpart D—Miscellaneous Provisions

PART VI—TREATMENT OF CERTAIN PASSIVE FOREIGN INVESTMENT COMPANIES

- Subpart A—Interest on Tax Deferral
- Subpart B—Treatment of Qualified Electing Funds
- Subpart C—Election of Mark to Market for Marketable Stock
- Subpart D—General Provisions

Question 2 – Review of §1221 basic capital asset definition: Which of the following assets are capital assets?

- a. 50 shares of IBM stock
- b. US government savings bond
- c. Personal auto
- d. IOU you received when you loaned your friend \$2,000
- e. Letter you received from President Obama in response to a letter you sent to him
- f. The letter from Obama in your friend's hands after you sell it to her
- g. Goodwill created by the taxpayer
- h. Goodwill acquired in a taxable business acquisition in 2001

- i. Equipment owned by ABC Company for less than one year

- j. Chemicals used by Intel in making chips

- k. Income from deposits kept by taxpayer when customer did not return the pressurized gas cylinder in which it purchased gas from the taxpayer²

- l. Congressional Record given to Congressman Smith for free

Question 3 – Capital Loss Basics: Last year, Jane and X Corporation each had \$5,000 more capital loss than capital gain. How must each report the net \$5,000 loss in that year and what other years are affected?

² *Du Pont de Nemours*, 288 F2d 904, (Ct Cls 1961).

§1221(a)(1) Rulings

Inventory? Dealer?

Sideline Business Activity: In *Guardian Industries*, 97 TC 308 (1991), aff'd 72 AFTR2d 94-1903 (6th Cir.), T was in the photo-finishing business. A by-product of its business was the extraction of silver-bearing waste materials. T sold the silver and at issue was whether the silver was a capital asset, or was precluded from such treatment under §1221(a)(1) as being an asset held primarily for sale to customers in the ordinary course of T's business. Both the Tax Court and Sixth Circuit Court agreed with the IRS that the silver as not a capital asset; thus, any gain from its sale was ordinary income.

Per the Tax Court:

“Whether property is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is essentially a question of fact, which must be decided by a consideration of all the surrounding circumstances. ... Petitioners carry the burden of proving that the silver waste is a capital asset....

The controlling factor in determining the character of the silver waste is the purpose for which it is held, ... which is to be determined as of the time of sale, although we may consider events occurring prior to such time in order to identify such purpose. *Cottle v. Commissioner*, 89 T.C. at 487. See also *Suburban Realty Co. v. United States*, 615 F.2d 171, 182-184 (5th Cir. 1980) (taxpayer's purpose at time of sale to be determined with reference to primary holding purpose prior to time of decision to sell). The determination of the taxpayer's holding purpose is for the trier of fact to make, based on the taxpayer's methods of operation and the standards customary in his line of business. *Gotfredson v. United States*, 303 F.2d at 467. In deciding the holding purpose issue, more weight is given to objective evidence than to the taxpayer's own statements of intent. ...

To decide the character of the silver waste, we will consider a variety of factors which have been found useful in shedding light on the taxpayer's purpose for holding property; however, no single factor or combination of factors is dispositive. ... The factors relevant to the instant case include: (1) The frequency and regularity of sales of the silver waste; (2) the substantiality of the sales and the relative amounts of income derived by petitioners from their regular business and the sales of the silver waste; (3) the length of time the silver waste was held; (4) the nature and extent of petitioners' business and the relationship of the silver waste to that business; (5) the purpose for which the silver waste was acquired and held prior to sale; (6) the extent of petitioners' efforts to sell the property by advertising or otherwise; and (7) any improvements made to the silver waste by petitioners. ...

Under *Malat v. Riddell*, 383 U.S. at 572, in order for a sale of property to be classified as ordinary, sale to customers² in the ordinary course of business must be "of first importance," or the "principal" reason that property is held. We hold that proceeds from petitioners' sales of silver waste should be characterized as ordinary income. Our conclusion is supported by a number of considerations.”

The Tax Court relied on the following factors to conclude that the silver was not a capital asset:

- Silver was sold on a regular and frequent basis; it is not relevant that there was primarily only one customer because each sale is considered a separate sale. Under this approach, at least 228 shipments of silver occurred during the years at issue.
- Silver sales were over \$2.5 million – “the large dollar amount of the sale suggests that the property is held for the purpose described in section 1221(1)”
- It is not relevant to compare silver sales to sales of other products because the silver waste still produced substantial amounts of revenue.
- “Our conclusions that the silver-waste sales were frequent and substantial weighs heavily against petitioners, as frequency and substantiality of sales often have been held to be the most important objective indicators of whether property falls within the terms of section 1221(1).”

- “[T]he silver waste was necessarily and continuously produced in the ordinary course of petitioners' everyday business operations, and, therefore, the regular and frequent sale of the silver waste is most naturally viewed as part of those business operations.”
- “Generally, where property is placed in inventory at the time of its acquisition, positive evidence of a change in the purpose for which it is held is required to find that such property has lost its original character. ...

We do not find that any intervening event in the developing process caused the silver (that originally was contained in the paper) to be held for any purpose other than the purpose set forth in section 1221(1). Although the silver compounds in the photographic paper were transformed into silver waste by the photo-finishing process, that *physical* and *chemical* change did not cause a change in the *character* or *holding* purpose of the silver contained in the silver waste extracted from the photo-finishing solutions. The silver remained a part of petitioners' photo-finishing operation.”

- Lack of marketing efforts by T was also not relevant because market conditions did not require them to search for silver buyers.
- “While the failure to improve property sold indicates that such property is not held primarily for sale,... in the instant case such circumstance does not outweigh the other evidence, discussed above, indicating that the silver waste was held for the purpose described in section 1221(1),”

Question 4 – Is there any way where Guardian could have had capital asset treatment for the scrap silver? Explain.

Real Estate: In *US v. Winthrop*, 417 F2d 905 (5th Cir.), T subdivided and improved several tracts of land from 1945 to 1963. He sold 465 lots and about 52% of his income was from these sales. He graded, paved, installed utilities, built some houses and assisted some buyers in obtaining loans. He did not have or need an office and he had a real estate broker license. T reported the gains from the sales as capital gains. Upon audit, the IRS treated the gains as ordinary income and assessed self-employment tax upon T. After T's death, his widow filed claims for refund on the basis that the gains were capital, not ordinary.

Per the IRS, if appreciation is due to more than market conditions, then all profit should be ordinary income because the gain would then be the result of T's efforts. The court did not agree with this position because it did not follow that all income from operation of a business is ordinary income. The IRS also argued that the land was held primarily for sale in the ordinary course of business and therefore could not be a capital asset. The court agreed with this position.

To show that the property was not a capital asset, the IRS had to show that (1) the property was held primarily for sale, and (2) it was sold in the ordinary course of business. In this determination, seven tests or factors were relevant:

1. nature and purpose of acquisition of the property and duration of ownership
2. extent and nature of T's efforts to sell the property
3. number, extent, continuity and substantiality of sales
4. extent of subdividing, developing, and advertising to increase sales
5. use of a business office for the sale of the property
6. character and degree of supervision or control exercised by T over any representatives selling the property for him
7. time and effort T habitually devoted to sales.

“Held primarily for sale” – the court found that the land was held for no other purpose but to sell it. T also engaged in activities such as paving, to make the land saleable.

“Sales in the ordinary course of business” – the court also found that T was engaged in a business of selling the lots. There was continuity to his sales activities, spanning a 25 year period. The fact that T had no office, did no advertising and had n sales staff did not mans that no business existed. Such circumstances just show that T was able to sell the lots without assistance.

“The concept of normalcy requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm. History and chronology here combine to demonstrate that Winthrop did not sell his lots as an abnormal or unexpected event. He began selling shortly after he acquired the land; he never used the land for any other purpose; and he continued this course of conduct over a number of years. Thus, the sales were not only ordinary, they were the sole object of [T's] business.”

How Land Can Fall under §1221: Per Rev. Rul. 86-149, generally, real property is not considered inventory, therefore, it may not be accounted for using the LIFO method; land is unique. Thus, while land is not inventory or “stock in trade” under §1221(a)(1), it can be property held for sale to customers in the ordinary course of a trade or business (as in the *Winthrop* case).

Question 5 – Fifteen years ago, Jamie purchased 100 acres of undeveloped land in northern California. She held it for investment for ten years and then realized that if she did some basic upgrades, it would fetch a greater price from a developer. Is the land a capital asset when Jamie sells it today with water, sewer and power lines laid and residential zoning she obtained? Why or why not? Does §1237 apply to Jamie?

Dealer versus Trader versus Investor:

William G. Holsinger, et ux., TC Memo 2008-191 [excerpt]

Respondent determined deficiencies of \$54,462 and \$43,423 in petitioners' 2001 and 2002 Federal income taxes, respectively. Respondent amended his answer and increased petitioners' 2001 deficiency by \$20,278, for a total 2001 deficiency of \$74,740. After concessions by both parties, the issues for decision are: (1) Whether losses from purchases and sales of securities are deductible by petitioners as ordinary losses or are instead subject to the limitations applicable to capital losses; and (2) whether expenses attributable to those purchases and sales are deductible by petitioners as business expenses or are instead subject to the limitations applicable to itemized deductions.

FINDINGS OF FACT

William Holsinger (petitioner) retired in 1992, having worked approximately 30 years for Eli Lilly & Co. In 1999 petitioners married. In 2000 petitioners began buying and selling stocks, earning approximately \$280,000 from that source during 2000. Petitioner opened brokerage accounts in his name, using his Social Security number. Petitioners reported their trading income as capital gains in 2000.

On April 19, 2001, petitioners incorporated Alpha Trading Co. of Sarasota, L.L.C. (Alpha) under the laws of Florida. Petitioner owns 67 percent of Alpha, and petitioner Mickler owns the remaining 33 percent. On or about May 17, 2001, Alpha made a timely election pursuant to section 475(f) to use the mark-to-market method of accounting.

Petitioners maintained two trading accounts with E-Trade, two with Options Xpress, and one with Ameritrade-Comdisco. From April 19 until December 31, 2001, petitioners executed approximately 289 trades on their various trading accounts. In 2002 petitioners executed approximately 372 trades.

In 2001 petitioners claimed an ordinary loss of \$180,174 from Alpha on their 2001 Schedule E, Supplemental Income and Loss. The loss consists of trading losses of \$178,870, depreciation of \$1,284, and interest of \$40. The aggregate cost or other basis of the securities sold in 2001 was \$933,147. The sale prices in 2001 collectively were \$754,277. Also in 2001 petitioners claimed a net loss of \$80,100 on their Schedule C, Profit or Loss From Business. Respondent disallowed the \$80,100 as business expenses but allowed itemized deductions for investment interest of \$7,620 and miscellaneous deductions of \$72,480. After adjustments for gross income limitations, respondent allowed net itemized deductions of \$69,153.

In 2002 petitioners claimed an ordinary loss of \$45,521. This loss comprises \$11,227 in trading losses related to Alpha and \$34,294 in claimed business expenses related to Alpha. Respondent disallowed the \$34,294 as business expenses but allowed a net itemized deduction of \$26,181.

After petitioner incorporated Alpha, he did not switch the name on his trading accounts. Petitioner's Social Security number also remained on the trading accounts. Petitioners continued to trade stocks and options during 2001 and 2002 with the accounts they had used before the incorporation of Alpha. In December 2002 petitioners had one trading account in Alpha's name. During the years in issue petitioners used five accounts to conduct trades.

Petitioners traded from a room in their house. The room contained computers with Internet access in order for petitioners to trade and do research. Additionally, petitioner had four monitors connected to his computer because he wanted to be able to trade and track different investments and potential investments simultaneously. Petitioner purchased the computer equipment around July 1, 2000, before incorporating Alpha. None of the computer equipment was transferred to Alpha.

OPINION***I. Mark-to-Market Election***

Respondent concedes that Alpha made a timely mark-to-market election pursuant to section 475(f). Section 475(f) applies only to those engaged in a trade or business as traders in securities. Having made a timely election, if Alpha were a trader in securities, it would be eligible to recognize gain or loss on any

security held in connection with such a trade or business at the close of any taxable year as if the security were sold at its fair market value on the last business day of the taxable year. See sec. 475(f)(1)(A)(I). In general any gains or losses with respect to the securities, whether deemed sold at yearend under the mark-to-market method of accounting or actually sold during the taxable year, shall be treated as ordinary income or loss. Sec. 475(d)(3)(A)(I). If Alpha is considered an investor in securities, the 2001 and 2002 net losses from the purchases and sales of securities would be capital losses and only partially deductible to petitioners.

II. *Trade or Business*

The Internal Revenue Code does not define the term “trade or business” for purposes of section 162. *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987); ... Whether activities constitute a trade or business is a question of fact. ...

Petitioners argue that they were traders, trading as agents of Alpha. With the incorporation of Alpha, petitioners argue they became traders. In determining whether a taxpayer's trading activity constituted a trade or business, courts have distinguished between “traders” and “investors”. ...

In determining whether a taxpayer is a trader, nonexclusive factors to consider are: (1) The taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. ... For a taxpayer to be a trader the trading activity must be substantial, which means “frequent, regular, and continuous enough to constitute a trade or business” as opposed to sporadic trading. ... A taxpayer's activities constitute a trade or business where both of the following requirements are met: (1) The taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. ...

As to the first requirement, we find petitioners' trading was not substantial. Courts consider the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's trading activities were substantial... In *Paoli*, the Court held trading activities were substantial when the taxpayers traded stocks or options worth approximately \$9 million. In *Mayer*, the Court considered over 1,100 executed sales and purchases in each of the years at issue therein to be substantial trading activity. Trading activity was found to be insubstantial when a taxpayer executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year. ... In 2001 petitioners executed approximately 289 trades. An analysis of petitioners' trading activity reveals that in 2001 they traded on 63 days. This total represents less than 40 percent of the trading days from April 19, 2001, the day petitioners incorporated Alpha, until December 31, 2001. In 2002 petitioners traded on 110 days and executed approximately 372 trades. This total represents less than 45 percent of the trading days in 2002. We find it doubtful whether the trades were conducted with the frequency, continuity, and regularity indicative of a business.

As to the second requirement, petitioners have failed to prove that they sought to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. Petitioner testified that his goal in forming Alpha was to profit from short-term swings in the market. Additionally, petitioner testified that he usually closed his account at the end of the day and tried to avoid holding stocks and options overnight. The documentary evidence, however, paints a different picture. A list of petitioners' trades shows they rarely bought and sold on the same day. Furthermore, a significant amount of petitioners' holdings was held for more than 31 days. As a result, we find that petitioners have not demonstrated that they sought to capture the daily swings in the market. We find that they were not traders, but investors. Petitioners' trading pattern is consistent with that of an investor, not of a trader.

III. *Business Expenses*

Deductions are a matter of legislative grace, and the taxpayer has the burden of showing entitlement to any deduction claimed. ... Taxpayers must substantiate amounts claimed as deductions by maintaining the records necessary to establish such entitlement. ...

Petitioners claimed business deductions for 2001 and 2002. Petitioners argue that their trading activity was on behalf of Alpha, not for themselves as individuals. Petitioners claim they were Alpha's agents and therefore had the authority to conduct trades on its behalf. Even if petitioners acted on Alpha's behalf, because their activity, as we have already found, did not rise to the level of a business (the business of trading securities), the expenses petitioners attributed to that activity, even if incurred on Alpha's behalf, are not deductible as business expenses.

In reaching all of our holdings herein, we have considered all arguments made by the parties, and to the extent not mentioned above, we find them to be irrelevant or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

King, 89 TC 445 (1987) [excerpt]

Official Tax Court Syllabus

Petitioner was engaged in the trade or business of commodities futures trading. In 1978, petitioner took delivery of 10,000 ounces of gold pursuant to the terms of 100 long gold futures contracts. In 1980, petitioner disposed of the gold pursuant to 100 short gold futures contracts. Petitioner realized a long-term capital gain with respect to his disposition of the gold. During the years 1979 and 1980, petitioner deducted interest expenses resulting from carrying the physical gold. Held, to the extent a trader has incurred debt in order to carry on ordinary trading activities as part of his trade or business of trading, the interest paid thereon is not subject to the investment interest limitations of sec. 163(d), I.R.C. 1954. Held, further, the carrying of the physical gold by petitioner was part of his trade or business of trading commodity futures and sec. 163(d), I.R.C. 1954, is therefore not applicable to the interest incurred thereon.

Background

Petitioner is a registered member of the Chicago Mercantile Exchange (CME), a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission. Petitioner is also a member of the International Monetary Market (IMM), a division of the CME, and has been a member of the IMM since its establishment in 1972. From approximately 1954 through 1985, petitioner was also a member of the Chicago Board of Trade (CBOT).

...

Petitioner's Daily Exchange Activities

Petitioner monitors the trading on the CME and IMM on a regular basis on most days that the exchanges are open for trading. Since 1975, petitioner has not conducted his trading activity on the trading floor. Rather, he monitors trading through television screens in his offices and Highland Park home, and telephones instructions to King & King for execution by floor brokers. During the years in issue, petitioner had an office in Palm Springs, California and an office in King & King's offices in Riverside Plaza in Chicago.

Petitioner normally spends approximately 6 hours per day on trading and activities related to his trading. Petitioner normally arrives in his office 1 hour before the opening of the futures markets. He ordinarily calls a consultant to discuss information on the cash markets for the commodities he is trading. Petitioner also customarily consults with a clerk on the CME floor to obtain any statistics published by the CME. Petitioner also, if possible prior to the opening of the markets, calls to consult other traders around the country with whom petitioner is acquainted and who, like petitioner, trade on the basis of supply and demand. ...

OPINION

Our only issue for decision is whether the amounts of \$231,499.84 and \$124,591.92 paid by petitioner as interest in 1979 and 1980, respectively, are subject to the limitations of section 163(d).

As relevant to this case, section 163(d) restricts the deduction of "investment interest" otherwise allowable as a deduction to the amount of \$10,000 plus the amount of net investment income. Investment interest is defined as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." Sec. 163(d)(3)(D) (emphasis added). Petitioner argues that he was engaged in the trade or business of commodities trading and that the gold transaction here in issue was a part of that trade or business. Petitioner concludes that because the gold was held as a part of his trade or business, it was not held for investment within the meaning of section 163(d).

Respondent has not contested that petitioner's futures trading activities qualify as a trade or business. On the other hand, respondent argues that petitioner was not in the trade or business of trading physical commodities and that such trading, or at least the gold transaction here in issue, was not a part of his trade or business of trading futures.

One who regularly buys and sells on an exchange may be either a dealer or a trader. In this regard, we have stated,

Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. *** Such sellers are known as "dealers."

Contrasted to "dealers" are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as "traders."

[Kemon v. Commissioner, 16 T.C. 1026, 1032-1033 (1951); citations omitted.]

As a result of Congress' amending the predecessor of section 1221, traders, as opposed to dealers, occupy an unusual position with respect to the tax laws. Traders may engage in a trade or business which produces capital gains and losses rather than ordinary income and losses. The history behind this anomaly was explained in *Wood v. Commissioner*, 16 T.C. 213, 219-220 (1951),

Prior to 1934, a trader, as distinguished from a dealer, in securities was taxable on the gains derived from his trading activities in the same manner as the gains of dealers in securities, namely, as ordinary income. Such gains were excluded from the operation of the capital gains provisions of the statute because "capital assets" were defined as not including "property held by the taxpayer primarily for sale in the course of his trade or business." In 1934 Congress amended section 117 for the purpose of treating certain transactions in securities as transactions in capital assets in order that losses incurred in these transactions could not be deducted in full. *** In the Revenue Act of 1934 Congress sought to accomplish this *** result by amending the definition of "capital asset" in the new section 117 so as to exclude, not all property held primarily for sale in the course of business, but only such property as was held primarily for sale "to customers" in the "ordinary" course of business. Since the sale on a securities exchange is not usually considered to be a sale "to customers," it was asserted that this amendment made it "impossible to contend that a stock speculator trading on his own account is not

subject to the provisions of Section 117" [H. Conf. Rept. 1385, 73d Cong., 2d Sess. 22 (1934)]—or, to state it in the positive, that a stock speculator trading on his own account would be subject to capital gain and loss treatment under section 117, as so amended. ...

As a result, a primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, where as a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business.⁵ A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.

The distinction between a "trader" and an "investor" also turns on the nature of the activity in which the taxpayer is involved. A trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. ... Further, a trader will be deemed to be engaged in a trade or business if his trading is frequent and substantial. [Groetzinger] ... An investor, on the other hand, makes purchases for capital appreciation and income, usually without regard to short-term developments that would influence prices on the daily market. G...No matter how extensive his activities might be, an investor is never considered to be engaged in a trade or business with respect to his investment activities. ...

Petitioner clearly was in the trade or business of trading commodity futures during the years in issue. Petitioner's trading was frequent and substantial but he traded solely for his own account during the years in issue and neither had customers nor performed services analogous to those performed by a merchant. The parties appear to agree that petitioner was in the trade or business of trading commodities futures.

Based on the above, we are faced with the unusual situation of a taxpayer engaged in a trade or business which produces capital gains and losses. The application of section 163(d) to such a taxpayer has been presented by the parties as a novel issue.

Initially, respondent argues that petitioner's holding of the physical gold was subject to the provisions of section 163(d) whether or not such property was held in connection with petitioner's trade or business. Respondent argues that this conclusion necessarily follows from both the legislative history of section 163(d), as well as from this Court's opinion in *Miller v. Commissioner*, 70 T.C. 448 (1978).

The legislative history of section 163(d) describes the abuse which Congress intended to curb by the enactment of section 163(d):

The itemized deduction presently allowed individuals for interest, makes it possible for taxpayers to voluntarily incur substantial interest expenses on funds borrowed to acquire or carry investment assets. Where the interest expense exceeds the taxpayer's investment income, it, in effect, is used to insulate other income from taxation. For example, a taxpayer may borrow substantial amounts to purchase stocks which have growth potential but which return small dividends currently. Despite the fact that the receipt of the income from the investment may be postponed (and may be capital), the taxpayer will receive a current deduction for the interest expense even though it is substantially in excess of the income from the investment. [H. Rept. 91-413 (Part 1)(1969), 1969-3 C.B. 200, 245.]

The House report also adds, however, that "interest on funds borrowed in connection with a trade or business would not be affected by the limitation."

Respondent argues that a trader such as petitioner makes purchases and incurs debt in order to earn income which will be postponed and capital, and that the assets purchased by petitioner, unlike stock, produce no income of any type prior to disposition. Respondent concludes that petitioner's trading activities fall within the scope of the abuse described in the legislative history. As we previously stated, however, the primary characteristic which differentiates the activities of a trader from those of an investor is that a trader seeks short-swing gains while an investor seeks long-term appreciation. ... As such, the general activities of a trader do not fit the description of the abuse described in the legislative history of

section 163(d), i.e., investing for postponed income and current interest deductions. Further, the case law cited above distinguishes traders and investors. To the extent a trader is holding assets as part of his trading activities, he is not an investor and therefore does not hold property for investment. The statement in the legislative history that the limitations of section 163(d) are not to apply to "interest on funds borrowed in connection with a trade or business" is clear and unambiguous. From the above we conclude that section 163(d) does not apply to the extent a trader has incurred indebtedness in order to carry on ordinary trading activities as part of his trade or business.

Nonetheless, respondent argues that this Court's holding in *Miller v. Commissioner*, supra, is controlling with respect to the application of section 163(d). In *Miller*, a partnership borrowed money to purchase a controlling interest in the stock of a bank. The taxpayer therein, a partner in the partnership and president of the bank, deducted his proportionate share of the interest incurred by the partnership on the loan used to purchase the bank's stock. Respondent determined that the interest should be treated as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." The partnership reported the gains on sale of the bank stock as capital gains. In holding that the partnership's interest payments were made on indebtedness incurred or continued to purchase or carry property held for investment, we stated that—

section 57, like section 163(d), attempts to deal with an abuse which is present whenever interest is incurred to obtain or maintain property held with sufficient investment intent for the gain on its disposition to constitute capital gain. Such property is investment property and the interest on funds borrowed to finance its purchase is investment interest. We, therefore, must look to the stock purchased by [the partnership] with the borrowed funds to determine whether the stock was held with sufficient investment intent to make it a capital asset. [70 T.C. at 455.]

Our *Miller* decision neither involved nor considered the unusual situation of a trader of securities or commodities. Rather, our opinion therein dealt with a factual pattern in which the taxpayer attempted to argue the applicability of the doctrine put forth in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). In reaching our conclusion in *Miller*, we noted statements made by this Court in *W.W. Windle Co. v. Commissioner*, 65 T.C. 694, 714 n. 15 (1976), that "stock is normally a capital asset" held for investment, and that only where the "original purpose of [the] acquisition and the reason for continued retention are both devoid of substantial investment intent should the stock be treated otherwise." *Miller v. Commissioner*, supra at 455.

Under the factual scenario in *Miller*, whether the taxpayer therein could properly claim capital gains treatment was synonymous with whether the taxpayer held the property for investment. ... A trader, on the other hand, receives capital gains treatment whether or not the property is held for investment or held in connection with his trade or business. As discussed supra, to the extent a trader holds property as part of his trade or business of trading, he receives capital gains treatment even though such property is not held for investment. Our holding in *Miller* is limited to the factual situation involved therein, i.e., a taxpayer attempting to prove that stock is not held for investment due to the application of the doctrine set forth in *Corn Products Refining Co. v. Commissioner*, supra.

Accordingly, we find that to the extent a trader has incurred debt in order to carry on ordinary trading activities as part of his trade or business of trading, the interest paid thereon is not subject to the limitations of section 163(d).

We next consider whether the holding of the gold by petitioner should nonetheless be treated as the holding of property for investment either because petitioner was not engaged in the business of trading physical commodities or because this particular transaction was not a part of petitioner's trade or business.

Petitioner acquired the 10,000 ounces of gold on December 4, 1978, by taking delivery of warehouse receipts representing ownership of gold under 100 long gold futures contracts, which called for delivery in December 1978. On May 5, 1980, petitioner disposed of the 10,000 ounces of gold by delivering the warehouse receipts to the CME Clearing House in satisfaction of his delivery obligation under 100 short gold futures contracts which called for May 1980 delivery. On the date petitioner took delivery of the

gold, he executed a note to the King & King, Inc. Profit Sharing Plan and Trust. This note was due on December 4, 1979, one year after its execution. On December 4, 1979, petitioner executed a second note with a due date of December 4, 1980.

In addition to the delivery of gold here in issue, petitioner took delivery during the years 1979 and 1980 under 34 futures contracts and held these commodities for varying periods of time ranging from a few hours to 26 days. In some cases, petitioner affected disposition of these commodities by redelivering them in satisfaction of a short CME futures contract for the current delivery month, and, in other cases, disposition was affected by selling the commodity to a purchaser in a transaction off the exchange. Petitioner also made off-exchange purchases of various commodities during the year 1978 and held these physical commodities for periods as long as 8 months. Petitioner made no off-exchange purchases during 1979 or 1980. Other than the one gold acquisition at issue in this case, petitioner never took delivery of or purchased gold, silver, or any other precious metal.

Respondent directs our attention to statements of the Supreme Court in *Higgins v. Commissioner*, supra, in arguing that petitioner's dealings in physical commodities, or at least the gold transaction here in issue, can be separated out from petitioner's trade or business of trading in commodities futures. In *Higgins*, the taxpayer had extensive investment in real estate, bonds, and stocks, and devoted a considerable portion of his time to the oversight of his interests. He hired others to assist him with his investments, in offices rented for that purpose, and claimed that the salaries and expenses incident to looking after his properties were deductible under section 23(a) of the Revenue Act of 1932, the predecessor of section 162(a). The Supreme Court held that the taxpayer's expenses attributable to investment in securities were not deductible notwithstanding that the taxpayer was engaged in another trade or business, i.e., real estate. The taxpayer therein argued that—

his activities in managing his estate, both realty and personalty, were a unified business. Since it was admittedly a business in so far as the realty is concerned, he urges, there is no statutory authority to sever expenses allocable to the securities. *** [312 U.S. at 218.]

The Court rejected this argument stating "we see no reason why expenses not attributable, as we have just held these are not, to carrying on business cannot be apportioned." 312 U.S. at 218.

As we have stated, petitioner herein was clearly in the trade or business of trading commodities futures. Petitioner acquired the gold in issue pursuant to delivery on long gold futures contracts which he acquired in the regular course of his business. Petitioner also disposed of the gold pursuant to short gold futures contracts. While petitioner had not regularly held physical commodities for extended periods of time, petitioner did periodically, in the course of his business, take delivery of physical commodities. Further, petitioner took no affirmative action to set apart or distinguish this transaction from other transactions which were entered into in the normal course of his business. These factors strongly suggest that petitioner's gold transaction was part of his trade or business of trading commodity futures.

This case is not factually similar to *Higgins* in that the transaction here in issue was integrally related to transactions which were indisputably part of petitioner's trade or business, i.e., the closing of the futures contracts by which the gold was acquired and disposed. In *Higgins*, the only relationship between the taxpayer's investment activities and real estate activities was that they were directed through the same office. *Higgins* does not lead us to the conclusion that the transaction here in issue should be separated out from petitioner's trade or business.

We are not aware of any case which has held that a taxpayer may hold property both as a trader of commodity futures and as an investor in commodities. Past cases have held that a taxpayer may be both a trader and a dealer with respect to securities, but these cases have not dealt with the issue of whether the taxpayer therein was a trader or investor....

In *Reinach v. Commissioner*, 373 F.2d 900 (2d Cir. 1967), affg. a Memorandum Opinion of this Court, a self-employed writer of put and call options sold such options through the services of a broker. In every case of an exercised put option, i.e., when the option holder exercised the option to sell stock to the taxpayer, the taxpayer disposed of the put stock immediately. In every case of an exercised call option,

i.e., when the option holder exercised the option to buy stock from the taxpayer, the taxpayer never owned (nor was long) the stock. At the time a call option was exercised the taxpayer would, through the services of his broker, purchase the stock to deliver to the optionee. At issue were seven transactions in which a call option was exercised and the taxpayer's broker covered the call but the taxpayer did not immediately replace the stock that the broker delivered to the optionee. As to these seven transactions, the taxpayer maintained short positions for periods ranging from 1 1/2 years to 3 1/2 years.

There was no dispute in Reinach that the taxpayer therein was in the trade or business of writing options, and that the profits and losses resulting from his option writing business were ordinary in nature. The taxpayer argued that losses resulting from the seven short positions should also be treated as ordinary losses because his intent was not to "buy or sell stock except as required to fulfill options which he wrote." 373 F.2d at 904. The Court of Appeals concluded,

Whatever we might think about stock bought to honor a call or disposed of following a put within a few days after their exercise, we do not consider stock borrowed for one and one-half to three and one-half years thereafter to have been "held by the taxpayer primarily for sale to customers ***."

When [the taxpayer] persisted in his decision to go short for such lengthy periods of time rather than covering immediately, it could not [sic] longer be said that the stock he sold short was held primarily for sale to any alleged customer. [The taxpayer] made his choice to keep the transaction open; that implied a parallel choice to transform this transaction from the ordinary exercise of an option into a short sale extending over a period of many months or even years.

[373 F.2d at 904; emphasis in original; fn. ref. omitted.]

The Court in Reinach did not consider whether the taxpayer therein was a trader or investor with respect to the seven short sales in issue.¹² Further, the opinion in Reinach does not furnish us with a basis for determining when a given commodities transaction can be separated out from the trade or business of a commodity futures trader. Even if we were to assume that the gold transaction here in issue could be examined on the same basis as the transaction in Reinach, we do not believe that it would lead to the conclusion advocated by respondent. The seven short positions there in issue were held for periods from 1 1/2 to 3 1/2 years. The very fact that the taxpayer therein entered into seven such transactions suggests that he intended to depart from his normal business practices, and the Court therein found that he "went short for a purpose entirely divorced from his put and call writing." 373 F.2d at 904. The gold here in issue was held for less than 1 1/2 years and was not part of a series of transactions suggesting an intent on the part of petitioner to depart from his regular business practices.

Based on the above, we find that the gold here in issue was not property held for investment within the meaning of section 163(d) and that the investment interest limitations do not apply to petitioner's 1979 and 1980 interest payments made with respect to the holding of such property.

Question 6 – What is the difference between a dealer, trader and investor and what is the relevance under §1221 and §163?

Corn Products and Arkansas Best:

[see links on 225H website]

The *Arkansas Best* case clarified the earlier *Corn Products* case. Basically, *Corn Products* means that if an asset is similar to one of the eight types of assets listed at §1221, it is not a capital asset. Per the Court's summary: "Corn Products must instead be interpreted as standing for the narrow proposition that "hedging" transactions that are an integral part of a business' inventory-purchase system fall within §1221's first exception for "property ... which would properly be included in the [taxpayer's] inventory.""

This technique for interpreting §1221 is not limited to §1221(a)(1). In *Federal National Mortgage Association*, 100 TC 541(1993), it was used to find that the taxpayer's hedging transactions fell under §1221(a)(4).

"For the hedging positions to come within section 1221(4) and obtain ordinary treatment, they must have been integrally related to FNMA's purchasing and holding of mortgages. *Arkansas Best v. Commissioner*, supra. Since we have concluded that the futures and short sales transactions were hedges of both FNMA's mortgage commitments and the debentures it issued, we believe that they were integrally related to both the purchasing and holding by petitioner of its mortgage portfolio. The hedging positions, like FNMA's commitments, were contracts for the purchase and sale of debt instruments. As regards the commitment hedges, the conclusion of integral relationships easily follows because the futures contracts were designed to offset the decline in value of the mortgages subject to the commitments prior to their acquisition."

"The hedging positions that FNMA took in the securities market in order to protect its interest position made these hedging securities the "surrogates" for the mortgages it was committed to buy, and the interest it would have to pay on the money it borrowed to acquire those mortgages in the same sense that corn futures were surrogates for corn in *Corn Products*. The transactions were surrogates and the income or loss from each transaction should have the same character. Thus, we conclude that petitioner's hedging transactions bear a close enough connection to its section 1221(4) mortgages to be excluded from the definition of capital asset."

Question 7 – As a condition of his employment, Henry must buy 50,000 shares of his employer's stock (5%). Upon quitting his job, Henry sold the stock at a \$13,000 loss. What is the character of Henry's loss – capital or ordinary? Why? If Henry had borrowed money to buy the stock, what type of interest expense would he have?

§1221(a)(2)

Depreciable or Real Property Used in a Trade or Business

“Used in”: *Azar Nut*, 87 AFTR2d 997 (5th Cir. 1991) – In hiring a new CEO, Azar entered into an agreement with the executive that Azar would buy his house upon termination of his employment. Executive was fired after two years and Azar bought his home. Azar immediately listed the home for sale, but was not able to sell it until about two years later. The sale resulted in a loss of about \$111,000 which Azar deducted as an ordinary and necessary business expense. The IRS disallowed this treatment arguing that the loss was a capital loss. The Tax Court and 5th Circuit both agreed with the IRS.

Azar argued that the house was excluded from capital asset treatment under §1221(2) – depreciable property or real property used in the taxpayer’s trade or business. Azar stated “this “used in” exception includes any asset acquired by a taxpayer under the terms of a contract or similar agreement that is an integral part of the taxpayer’s business, even if the asset never plays a role in business operations after its acquisition.”

The court disagreed with this position because it would make “used in” mean that assets bought with a business purpose not be capital assets, which would be contrary to *Arkansas Best*. The court stated: “§1221(2) required us to consider an asset’s post-acquisition role in the taxpayer’s business. The Taxpayer’s purpose for acquiring the asset and the method of acquisition are irrelevant to this inquiry.” The court noted that the house played no role in Azar’s business. Azar’s alternative argument that the “loss” was allowable as a business expense under §162(a) was not accepted by the court because it was not an “expense.”

§1221(a)(3)

Certain copyright, literary, musical, or artistic composition, letter or memorandum, or similar property

In *Levy v. Commissioner*, T.C. Memo 1992-471, the court held that software sold to a third party by its two individual developers was copyrightable and thus, not a capital asset. The taxpayer was not successful in arguing that the item transferred was an idea and thus not eligible for copyright protection.

Reg. Section 1.1221-1(c), further clarifies the meaning of the third category above by providing that it “does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.” Thus, it would appear that a patent is a capital asset. However, the analysis is not that simple. Instead, to determine the tax consequences of a transfer or disposition of a patent, the facts surrounding the transaction must be carefully examined. Relevant facts include whether the taxpayer is an individual or corporation, whether the taxpayer created or purchased the patent, and whether the patent was sold or licensed.

For example, if a patent is licensed rather than sold, the royalties are ordinary income to the patent holder (there is no sale to generate a gain). If the patent holder is a corporation that regularly creates and sells patents, the patents most likely fall into the first category listed above and would not be capital assets. If instead the patent holder is an individual, they may qualify for the special treatment under Section 1235.

Special rule for patent sales: Section 1235, *Sale or exchanges of patents*, provides a beneficial rule for patent holders that dispose of all substantial rights in their patent. Section 1235 allows for certain transfers of patents to be treated as if a capital asset were sold or exchanged. Thus, if the transferor is an individual, they obtain the benefit of the lower capital gains tax rates. Section 1235 applies to professional as well as amateur inventors. Capital gain treatment is available even if payments by the transferee are payable periodically or contingent on the productivity or use of the patent. Regardless of how long the patent was held, if §1235 applies, the gain is treated as long-term capital gain.

To qualify for the beneficial treatment, the transfer must be of all substantial rights to the patent, or an undivided interest which includes a part of all such rights. In addition, the transfer must be by the “holder.” A “holder” is any individual whose efforts created the patent, or any other individual who acquired his interest in the patent in exchange for consideration in money or money’s worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither a) the creator’s employer, nor b) related to the creator (per §1235(d)).

Relevance of capital asset definition for charitable contribution purposes: There have been several cases where the question of whether an asset was a capital asset was not for purposes of determining the character of gain or loss, but to determine the allowable deduction under §170 for charitable contribution purposes. Issues have involved donation of an antique violin by a professional musician (PLR 9147049), donation of President Nixon’s “papers” (which led to a law change under §1221(5), and below, the donation of the clippings of the SF Chronicle.

Chronicle Publishing Co, 97 TC 445 (1991) [excerpt]

Petitioner’s principal place of business is in San Francisco, California. Included within petitioner’s numerous media-related interests is a daily newspaper, the San Francisco Chronicle (Chronicle).

During 1983 and 1984, petitioner contributed its clippings library to the California Historical Society, a qualifying charitable organization under section 170(c)(2).

The clippings library, which contained approximately 7,800,000 clippings, was compiled from all editions of the Chronicle newspaper dating as far back as 1906. Clippings collected prior to 1906 were destroyed in an earthquake. The library also contained materials from other newspapers, magazines, press releases, brochures, and unpublished materials. Non-Chronicle clippings and materials constituted approximately 20 percent of the library's total content.

All clippings and other materials were mounted on a paper backing for protection and cataloged by subject matter in over 200,000 file envelopes which were arranged in alphabetical order.

Most clippings were cataloged in several envelopes. For example, a newspaper story covering an election would be filed under the particular election, the office, and the candidates' names. Access to clippings contained in the library was facilitated by a master-card file which listed all the envelopes alphabetically by subject matter.

The Chronicle clippings library was open to the general public through the late 1960s, at which time physical access to the library was strictly limited to curtail the volume of public traffic and occasional loss of clippings. Physical access to the library continued to be available for persons demonstrating "significant research needs" such as authors, professors, graduate students, and journalists. At all times since the clippings library's inception, the library staff answered requests for information that could be obtained from information contained in the library, both over the phone and through written correspondence. In addition to public use of the library, Chronicle writers and reporters utilized the clippings library to conduct research and to verify facts for Chronicle newspaper stories.

In addition to the clippings library, petitioner has maintained a complete collection of the final editions of each daily paper published by the Chronicle dating back to 1865. This collection of final editions was at all relevant times located in a separate storage facility from that housing the clippings library and was not included in the contribution to the California Historical Society.

The entire clippings library was reproduced on approximately 80,000 microfiche before the donation was made to the California Historical Society. This microfiche has been retained by the Chronicle.

Petitioner expended in excess of \$10 million creating the clippings library. These costs were deducted by petitioner as ordinary and necessary business expenses during the years petitioner operated the library. Petitioner's basis in the clippings library at the time of contribution was zero.

Petitioner claimed a charitable deduction in respect of its contributions of the clippings library for the years 1983, 1984, and 1985 in the amounts \$1,503,988, \$458,957, and \$891,873. Respondent, in a notice of deficiency dated May 31, 1990, disallowed the claimed deductions in their entirety.

Section 170(a) allows a deduction for charitable contributions to organizations described in section 170(c)(2). Where the charitable contribution consists of property other than money, the amount of the gift is governed by section 170(e)(1)(A). [Chronicle could only deduct at FMV under §170 if it was a long-term capital asset] ...

Petitioner asserts that: (1) The clippings library is not an asset described in section 1221(3) and (2) even if it is such an asset, section 1221(3) does not apply to a corporate taxpayer. Respondent disputes both assertions. For the reasons hereinafter set forth, we disagree with petitioner and sustain respondent's determination that petitioner is not entitled to any deduction for its contribution of the clippings library to the California Historical Society.

We deal first with the question of the proper characterization of the clippings library. Clearly, it is not, in and of itself, a copyright, literary, musical, or artistic composition, and respondent does not argue that it is. Thus the characterization of the library depends upon whether it falls within the category of a "letter or memorandum, or similar property." The regulations state that the phrase "similar property":

includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or

property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. *** [Sec. 1.1221-1(c)(2), Income Tax Regs.]

...[I]n *Glen v. Commissioner*, 79 T.C. 208 (1982), we held that tapes of interviews conducted by the taxpayer constituted "similar property" because they fell within the characterization of "an oral recording" set forth in the regulation. See 79 TC at 214. Similarly, in *Morrison v. Commissioner*, 71 T.C. 683 (1979), affd. per curiam 611 F.2d 98 (5th Cir. 1980), we held that letters, copies of letters to or from a taxpayer and third person, and memoranda dealing with problems associated with his service as a Congressman fell within the proscription of section 1221(3) and the foregoing regulation.

The parties have focused their arguments primarily on the categories of "corporate archive," "log or journal," or "office correspondence" embodied in the regulation. Petitioner seeks to confine the meaning of the phrase "corporate archive" to corporate records such as minutes, financial statements, and possibly a chronological file of the newspaper and points to the fact that such a file is separately maintained.

"Archive" is defined in Webster's Third New International Dictionary 113 (1981) as follows:

1 *** a: a place in which public or institutional records (as minutes, correspondence, reports, accounts) are systematically preserved b: a repository for any documents or other materials esp. of historical value (as diaries, photographs, private correspondence) *** c: any repository or *collection* esp. of information
 *** 2: *public or institutional records, historic documents and other materials that have been preserved.*
 *** [Emphasis added.]

While the first category of this definition is limited as petitioner suggests, there is no such limitation in the remaining portions of the definition nor is there any indication that the definition is limited to materials presented in chronological sequence or that an institution can have only one form of archive. Clearly, the clippings library is a "collection of information" as well as an "institutional record" that has been preserved. Furthermore, we think it significant that "archive" is considered to include "library." ... Our examination of the legislative history ... reveals nothing which would cause us to conclude that the use of the word "archive" in the regulation constitutes an unwarranted extension of section 1221(3)(B) nor does petitioner advance any such contention. We are satisfied that copies of petitioner's newspaper maintained in topical, as well as chronological, form fall within the scope of the ordinary meaning of "archive." We also note that the phrase "similar property" is not limited in any way by the statute and that the regulations state that the specific categories set forth therein are merely examples of some types of materials which are included within this phrase.

We now turn to petitioner's second argument, namely, that section 1221(3) does not apply to corporations. Petitioner's argument rests almost entirely on the fact that the legislative history of section 1221(3) and its predecessor section 117(a)(1)(C) of the Internal Revenue Code of 1939, added by section 210(a) of the Revenue Act of 1950, ch. 994, tit. II, 64 Stat. 932, speaks of individuals and does not once mention a corporation as falling within the "taxpayer" category.

Concededly, the objective of these statutory provisions was to insure that individuals who disposed of the product of their personal efforts should be treated as having realized ordinary income and not capital gain. This objective is clearly revealed by the legislative history of section 514(a) of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 643, which amended section 1221(3) to exclude a letter, memorandum, or similar property whether held by the taxpayer whose personal efforts created such property or a taxpayer for whom such property was prepared or produced. The report of the House Ways and Means Committee dealing with this amendment reveals its thrust as well as the thrust of the earlier provision:

Present law.—Under present law, copyrights and literary, musical or artistic compositions (or similar property) are not treated as capital assets if they are held by the person whose personal efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, any gain arising from the sale of such a book, artistic work or similar property is treated as ordinary income, rather than as capital gain. Collections of papers and letters prepared and collected by an *individual* (including papers prepared for the *individual*), however, are treated as capital assets. Therefore, a gain from the sale of papers of this nature is treated as a capital gain, rather than as ordinary income.

General reasons for change.—

Your committee believes that collections of papers and letters are essentially similar to a literary or artistic composition which is created by the personal effort of the taxpayer and should be classified for purposes of the tax law in the same manner. In the one case, a person who writes a book and then sells it is treated as receiving ordinary income on the sale of the product of *his* personal efforts (i.e., compensation for personal services rendered). On the other hand, one who sells a paper or memorandum written by or for *him* is treated as receiving capital gain on the sale, even though the product *he* is selling is, in effect, the result of *his* personal efforts.

Explanation of provision.— Your committee's bill provides that letters, memorandums, and similar property (or collections thereof) are not to be treated as capital assets, if they are held by a taxpayer whose personal efforts created the property or for whom the property was prepared or produced (or by a person who received the property as a gift from such taxpayer). For this purpose, letters and memorandums addressed to an *individual* are considered as prepared for *him*. Gains from the sale of these letters and memorandums, accordingly, are to be taxed as ordinary income, rather than as capital gains.

...

We are not disposed to adopt petitioner's position. The structure and language of section 1221(3), ... belies any such restrictive interpretation. Thus, subparagraph (A) is clearly limited to a taxpayer "whose personal efforts created such property." However, subparagraph (B) is not so limited and equally clearly covers a taxpayer who did not create the property. Similarly, subparagraph (C) is also not limited, covering any taxpayer whose basis is determined by reference to the basis of the property in the hands of a taxpayer described in subparagraph (A) or (B). In light of the foregoing and the fact that the word "taxpayer" is broadly defined by section 7701(a)(14) as "any person subject to any internal revenue tax" and "person" is defined by section 7701(a)(1) to include a corporation, we have no hesitancy in concluding that petitioner's corporate status does not preclude it from being covered by section 1221(3).

...

It may well be that a library of the clippings of a newspaper's articles in the hands of the publisher of the newspaper ought not to be included within the scope of section 1221(3) and ought to be considered a capital asset. But this involves a question of policy and is not for us to decide given the ordinary meaning of the language used in section 1221(3)(B). ...

We conclude that, by virtue of section 1221(3)(B) and the regulation thereunder (see *supra* p. 448), the clippings library was not a capital asset and that, consequently, section 170(e) prevents petitioner from obtaining a charitable deduction for its contribution to the California Historical Society.

§1221(b)(3) - Sale or exchange of self-created musical works

Tax Relief and Health Care Act of 2006, 109-432, 12/20/2006

Capital gains treatment for certain self-created musical works made permanent

Joint Committee on Taxation Report — JCX-50-06

Present Law

Capital gains

The maximum tax rate on the net capital gain income of an individual is 15 percent for taxable years beginning in 2006. By contrast, the maximum tax rate on an individual's ordinary income is 35 percent. The reduced 15-percent rate generally is available for gain from the sale or exchange of a capital asset for which the taxpayer has satisfied a holding-period requirement. Capital assets generally include all property held by a taxpayer with certain specified exclusions.

An exclusion from the definition of a capital asset applies to inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.¹⁰² Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property).¹⁰³ Under a provision included in the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"),¹⁰⁴ at the election of a taxpayer, the section 1221(a)(1) and (a)(3) exclusions from capital asset status do not apply to musical compositions or copyrights in musical works sold or exchanged before January 1, 2011 by a taxpayer described in section 1221(a)(3).¹⁰⁵ Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.

¹⁰² Sec. 1221(a)(1) .

¹⁰³ Sec. 1221(a)(3) .

¹⁰⁴ Pub. L. No. 109-222, sec. 204(a) (2006).

¹⁰⁵ Sec. 1221(b)(3) .

Charitable contributions

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.¹⁰⁶ The determination whether property would have generated ordinary income (or short-term capital gain) is made without regard to new section 1221(b)(3) described above.¹⁰⁷

¹⁰⁶ Sec. 170(e)(1)(A) .

¹⁰⁷ Sec. 170(e)(1)(A) , as modified by TIPRA, Pub. L. No. 109-222, sec. 204(b) (2006).

Explanation of Provision

The provision makes permanent the availability of the section 1221(b)(3) election to treat certain sales of musical compositions or copyrights in musical works as being sales of capital assets (and therefore as generating capital gain). The provision also makes permanent the accompanying rule limiting to adjusted basis the amount of a charitable contribution deduction allowed for musical compositions or copyrights in musical works to which a taxpayer has elected the application of section 1221(b)(3) .

Effective Date

The provision is effective as if included in section 204 of the Tax Increase Prevention and Reconciliation Act of 2005.

§1221(a)(5)**Certain Publications of the US Government****Rev. Rul. 75-342**

A taxpayer, a member of the United States Congress, has accumulated numerous bound volumes of the Congressional Record during his tenure in office. The taxpayer is now considering the disposition of these volumes and desires to ascertain whether they are literary compositions, letters or memorandums, or similar property, within the meaning of section 1221(3).

Held, the bound volumes of the Congressional Record accumulated by the taxpayer are not literary compositions, letters or memorandums, or similar property, within the meaning of section 1221(3).

§1221(a)(8)

Supplies

PLR 200728032

This is in reply to your letter dated October 18, 2006, requesting a ruling regarding the federal income tax characterization of certain sulfur dioxide emission allowances granted to or acquired by Taxpayer for use in its trade or business. Specifically, Taxpayer requests a ruling that the emission allowances it uses in its business are not supplies within the meaning of Internal Revenue Code section 1221(a)(8).

FACTS

Parent is primarily engaged through Taxpayer, a subsidiary, in the generation and sale of electricity at wholesale and retail. Taxpayer owns sulfur dioxide emission allowances created under the air allowance program which is a part of the Clean Air Act Amendments of 1990, ... The purpose of the Act was to reduce acid rain through allocations of sulfur dioxide emissions to fossil fuel-powered combustion devices owned by electricity generating companies. The air allowance program is administered by the Environmental Protection Agency (EPA).

...

In general, an emission allowance may be applied against emissions occurring in the year to which it has been allocated by EPA; transferred; sold or exchanged; or held for h and applied against emissions occurring in a future year. It may not, however, be applied against emissions occurring in a year prior to the year to which it has been allocated by EPA. For instance, 2007 allowances cannot be used for compliance in a 2006.

Under the Act, the owner or operator of a fossil fuel-powered combustion device must account to EPA for the total of emissions from combustion devices during a calendar year. The owner or operator of a combustion device has until the emission allowance transfer deadline to acquire and record with EPA emission allowances sufficient to equal emissions during that calendar year.

The Act prohibits the operation of any combustion device in a manner that causes the combustion device to exceed its emission limitation. A combustion device's emission limitation equals the number of emission allowances in the combustion device's emission allowance account that may be applied against emissions of that combustion device during that calendar year. Each measurement of emissions in excess of a device's emission limitation is a separate violation of the Act. The owner or operator must pay a \$2,000 penalty to EPA for each excess ton produced.

Taxpayer buys and sells emission allowances periodically as needed with the intent to maintain a portfolio of emission allowances to satisfy the requirements of the Act.

...

LAW and ANALYSIS

Section 1221(a) (8) provides that the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include— (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Section 41(b)(2)(C) provides that the term “supplies” means any tangible property other than—

- (i) land or improvements to land, and
- (ii) property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.162-3 provides that:

Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

Treas. Reg. § 1.471-1 provides that:

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer.

Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

(But see § 1.472-1).

Taxpayer argues that it would be inappropriate to treat the emission allowances at issue as supplies within the meaning of section 1221(a)(8) because they are not tangible property as envisioned by the authorities cited above. FERC accounting rules treat the emission allowances separate from, and in a different manner than, supplies. Section 41(b)(2)(C) explicitly provides that supplies, for purposes of determining a research credit, only includes certain tangible property. Both Treas. Reg. § 1.162-3 and §1.471-1 arguably refer to only tangible property when describing supplies.

For the reasons set forth by Taxpayer, the emission allowances at issue are not supplies for purposes of section 1221(a)(8).

A Few Special Rules

Question 8 – Mr. and Mrs. Markham sold stock in AB Corporation, realizing a \$90,000 loss. Are there any circumstances under which they may treat this as an ordinary loss rather than a capital loss?

Question 9 – Provide an example of a taxpayer who might benefit from §1202.

Capital Gains Debate

The typical rationale for a lower capital gains tax rate was well explained in the legislative history to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27; 5/28/03) which lowered the 10% and 20% capital gains rates to 5% and 15%.

House Committee Report for the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27; 5/28/03):

“Reasons for Change

The Committee believes it is important that tax policy be conducive to economic growth. The Committee believes that reducing the capital gains tax lowers the cost of capital and will lead to economic growth and the creation of jobs. Economic growth cannot occur without savings, investment, and the willingness

of individuals to take risks. The greater the pool of savings, the greater will be the monies available for business investment. It is through such investment that the United States' economy can increase output, productivity, and employment. It is through increases in productivity that workers earn higher real wages. Increases in investment create more employment opportunities. Hence, a greater saving rate is necessary for all Americans to benefit from a higher standard of living.

The Committee believes that, by reducing the effective tax rates on capital gains, American households will respond by increasing savings. The Committee believes it is important to encourage risk-taking and believes a reduction in the taxation of capital gains will have that effect. The Committee also believes that a reduction in the taxation of capital gains will improve the efficiency of the markets, because the taxation of capital gains upon realization encourages investors who have accrued past gains to keep their monies “locked in” to such investments even when better investment opportunities present themselves. A reduction in the taxation of capital gains should reduce this “lock in” effect.”

Question 10 – Provide reasons both for and against having a lower capital gains tax rate.

Question 11 – Provide arguments both for and against the limitation on the use of capital losses by individuals.

Excerpt on capital gains
full text of report available at
http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf

The President's
ECONOMIC RECOVERY ADVISORY BOARD



The Report on Tax
Reform Options:
*Simplification, Compliance,
and Corporate Taxation*

AUGUST 2010

PREFACE

What follows is a report of the President’s Economic Recovery Advisory Board (PERAB) on options for changes in the current tax system to achieve three broad goals: simplifying the tax system, improving taxpayer compliance with existing tax laws, and reforming the corporate tax system.

The Board was asked to consider various options for achieving these goals but was asked to exclude options that would raise taxes for families with incomes less than \$250,000 a year. We interpreted this mandate not to mean that every option we considered must avoid a tax increase on such families, but rather that the options taken together should be revenue neutral for each income class with annual incomes less than \$250,000. A similar principle of revenue neutrality was used in the 1986 tax reform legislation in which changes that raised revenue were combined with cuts in personal income tax rates. The specific changes we considered can either raise or lower revenue. We realize that revenue neutrality by income class might result in increases or decreases in tax liability for subgroups or individual taxpayers within each income class – that is, revenue neutrality might result in “winners” and “losers.” We hope that the Administration and the Congress will select changes that are desirable on their merits and not worry about the distributional effects of each of them individually. The entire package of options selected should be evaluated by the Treasury or the Joint Committee on Taxation (JCT) to see what impact it has on tax liability by income class. If, as seems likely, the package raises taxes for some income groups and lowers them for others, this could be offset by adjustments to the standard deduction, tax rates or other provisions. Of course, even if the rates are adjusted to be revenue neutral in each income class, there will be individual taxpayers who gain and lose. We did not try to hold all taxpayers harmless in the options we evaluated, and we were not asked to do so by the President. It would be impossible to do so without substantial costs in terms of lost revenues.

The Board gathered information from business leaders, policy makers, academics, individual citizens, labor leaders, and many others. Our findings are the result of months of input from many people, and we thank them for their advice. In addition, over the years there have been many reports on tax reform options by both government agencies and private entities. There has also been substantial academic research on these issues. We have benefited greatly from studying these previous reports and materials.

The Board was not asked to recommend a major overarching tax reform, such as the 1986 tax reform, the tax plans proposed by the 2005 Tax Reform Panel, or proposals for introducing a value-added tax in addition to or in lieu of the current income tax system. We received many suggestions for broad tax reform, and some members of the PERAB believe that such reform will be an essential component of a strategy to reduce the long-term deficit of the federal government. But consistent with our limited mandate, we did not evaluate competing proposals for overarching tax reform in this report.

Finally, it is important to emphasize at the outset that the PERAB is an outside advisory panel and is not part of the Obama Administration. We have heard the views of experts in the government in the same way that we have heard the views of outside experts and interest groups. We have attempted to distill these views in this report to provide an overview of the advantages and disadvan-

tages of tax reform options that achieve the three goals of our mandate: tax simplification, greater tax compliance, and corporate tax reform. Our report is meant to provide helpful advice to the Administration as it considers options for tax reform in the future. The report does not represent Administration policy.

rates. This policy would create winners and losers. For example, people with high Social Security income but low non-Social Security income would pay more in taxes. Indeed, individuals with the same total income—like those in columns 2-4—would be affected slightly differently, and some would pay slightly more and some slightly less. To maintain revenue while lowering the phase-in rate to 40 percent, the phase-in threshold would need to be lower—while some low-income taxpayers would pay less in taxes, others would pay more. An adjustment to the additional standard deduction for taxpayers age 65 and over could be used to offset these distributional effects.

c. Option Group C: Simplify Taxation of Capital Gains

Capital gains are taxed at the individual level at special rates which depend on factors like the type of income or type of asset, the holding period of the asset, and other accounting rules. Long-term capital gains and qualified stock dividends are taxed separately from other income at rates of 0 percent or 15 percent. The capital gains rules slated to return in 2011 include 10 and 20 percent basic rates and 8 and 18 percent rates for gains on assets held over 5 years. The Administration's Budget calls for a 20 percent tax rate on long-run capital gains and dividends starting in 2011. In addition, starting in 2013, the recently enacted Patient Protection and Affordable Care Act imposes a new 3.8 percent Medicare contribution on capital gains and other investment income of married taxpayers with AGI over \$250,000 (\$200,000 for single taxpayers).³ This increases the top statutory rate on capital gains to 23.8 percent. The capital gains rate of most high-income taxpayers is also affected by the "Pease" 3-percent phase-out of itemized deductions, which adds 1.19 percentage points to the effective rate.

The system of capital gains also includes special rates for certain types of investment. Long-term gains on collectibles—for example, gold, jewelry, or art—are taxed at ordinary tax rates up to a 28 percent maximum rate. Gains from the sale of certain small business stock are taxed at ordinary rates up to a maximum of 28 percent but with exclusions of 50, 60, 75 or 100 percent depending on when the stock was initially issued and whether the corporation is located in an enterprise zone. The taxation of the gain on certain real estate (Section 1250 real property) is particularly complex, and proceeds from a single transaction may be taxed partially at ordinary rates, partially as "unrecaptured Section 1250 gain" subject to ordinary rates up to a 25 percent maximum, and partially at the capital gains rate. (Moreover, the maximum rate of 25 percent on "unrecaptured Section 1250 gain" applies to the portion of the gain attributable to depreciation deducted at potentially higher ordinary tax rates.) In the case of "carried interest," capital gains treatment is applied to certain income that does not represent a return on invested capital.

Because capital gains are taxed separately from other income, taxpayers must compute the tax on capital gains and dividends on an alternative schedule. Further, because there is not enough room on Schedule D for all of the special rates and provisions, many of these are now included in separate schedules in the instructions. Having separate schedules increases taxpayer burden and makes it more difficult to check whether taxpayers are properly computing their tax because these schedules

3 The tax applies to the lesser of the taxpayer's net investment income and modified AGI in excess of the \$250,000 or \$200,000 income thresholds. The new definition of modified AGI adds back any foreign income exclusion in excess of any deductions and exclusions disallowed with respect to that income.

are not sent to the IRS. This may increase the likelihood that taxpayers will claim tax benefits to which they are not entitled and thus increase noncompliance. In addition to contributing pages of instructions and worksheets, having multiple tax rates for different types of capital gains affects the after-tax rate of return on different assets, distorting investment decisions.

Another source of complexity arises when a capital gain has occurred and thus when taxes are due. An exchange of property, such as a sale, generally is a taxable transaction—i.e., you pay the tax when you sell an asset. However, several provisions allow taxes on capital gains income to be deferred or for the gain to be calculated differently, adding complexity and providing incentives for socially unproductive tax planning. For example, present law provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment purposes is exchanged for like-kind property (a Section 1031 exchange). Although traditional like-kind exchanges typically involve two persons trading real property with each other, this form of exchange has given way over time to exchanges intermediated by a third party market maker. Most transactions that occur under Section 1031 only loosely resemble an exchange and instead effectively confer rollover treatment on a wide range of business property and investments. Rollover treatment is conferred only if the taxpayer complies with a series of complicated rules, and there is much uncertainty surrounding these transactions.

Another area of concern is the taxation of carried interest. The manager or “general partner” of an investment fund typically receives two types of compensation: a management fee and a percentage of profits generated by the investments called a “carried interest.” The management fee is taxed as ordinary income, but the carried interest is generally taxed at the lower capital gains tax rate to the extent that the underlying investment has generated long-term capital gains eligible for the lower rate. Many tax experts consider some or all of the carried interest as compensation for managers’ services, and therefore argue that some or all of this compensation should be taxed as ordinary earned income, as is performance-based pay in other professions.

We discuss four options for simplifying the taxation of capital gains.

i. Option 1: Harmonize Rules and Tax Rates for Long-Term Capital Gains

1. Harmonize 25 and 28 Percent Rates on Capital Gains

When a taxpayer deducts depreciation expense, the taxpayer’s cost basis is reduced by the amount of depreciation claimed. Thus, when the taxpayer later goes to sell the asset, he may have a gain as a result of claiming the previous deduction. Since the depreciation was deducted at ordinary income tax rates, it makes sense that any gain due to the deduction should be taxed (“recaptured”) at ordinary rates, and this is how most assets are treated. However, gains on certain real estate sales (so-called Section 1250 gains) are taxed at ordinary rates only up to 25 percent. Similarly, collectibles are taxed at ordinary rates, but up to a maximum rate of 28 percent.

The proposal and its advantages:

Since the separate capital gains rate adds complexity to forms and tax planning and the rationale for a preferential rate is weak in both cases, one reform option would be to tax Section 1250 recapture and collectibles at ordinary tax rates. A smaller simplification would use the same rate for both provisions: 25 percent, 28 percent or an intermediate rate such as 27 percent.

Disadvantages:

Real estate held for investment (non-owner occupied) and collectibles investors would be adversely affected by eliminating or raising these preferential rates.

2. Simplify Capital Gains Taxes on Mutual Funds

Investors in mutual funds currently have the choice of using several different methods of computing their basis for purposes of computing capital gain. They can choose the average cost basis method, the first-in, first-out method or the specific identification of shares method. Specific identification is the most taxpayer friendly as it allows selling those shares that have the highest cost and thus the lowest capital gain first. First-in, first-out is generally least taxpayer friendly as the oldest shares are more likely to have been purchased when stock prices were lower, resulting in a larger taxable gain. The average cost method would generally be in between these two methods. With new reporting of basis requirements in effect, however, this creates the potential for confusion and errors if taxpayers use a different method than used by the mutual fund.

The proposal and its advantages:

Requiring standardization using the average cost method for all shares in a particular mutual fund account would provide the greatest simplification and be a compromise among the methods available. Taxpayers would still have some flexibility as separate accounts would be treated separately. As a transition measure, this could be mandatory only for new shares purchased after date of enactment (or alternatively starting at the beginning of that calendar year). This option would also help improve compliance as over time all mutual-fund gain information would be computed and reported by mutual funds.

Disadvantages:

Some mutual fund investors would face higher effective tax rates on their mutual fund investments.

3. Small Business Stock

The small business stock exclusion (Section 1202) has a highly complex set of requirements that must be met throughout the holding period of a shareholder who hopes to benefit from the exclusion. The complex requirements are designed to prevent abuse of this generous provision. In addition, the Small Business Investment Act has been repealed, and there are now only a few small grandfathered Specialized Small Business Investment Companies (SSBICs). Because capital gains tax rates have declined substantially and the excluded gains are taxed as a preference under the AMT, there is almost no benefit from these exclusions. Both the small business stock exclusion and

the rollover of qualified small business stock gains have suffered from compliance issues because of limited reporting requirements and enforcement by the IRS. The IRS does not receive third-party information on eligibility of stock owners of potentially qualified small business stock, making the provision difficult to enforce. The rollover provision has also been criticized because of the short 6-month holding period, which mainly benefits insiders and traders rather than long-term investors. This provision has been described as a tax benefit allowing a zero capital gains tax, but some small business investors do not re-invest their gains in replacement-qualified small business stock. The President proposed a zero percent capital gains rate on equity investments (stock) in small businesses and a 75 percent exclusion was enacted for investments in 2009 and 2010 as part of ARRA.

The proposal and its advantages:

Some simplification could be achieved by allowing the 100 percent exclusion for stock purchases starting in 2009 and changing the prior 50 percent exclusion off ordinary income tax rates to a 25 percent exclusion off capital gains rates. This simplification would retain the extra incentive for qualifying small business investments and result in similar effective tax rates while greatly simplifying the tax calculations. The alternative of repealing these special small business provisions for pre-2009 investments would still provide these investments with the benefits of the general preferential rate for long-term capital gains. Whatever option is chosen, improved reporting is required to help prevent abuse of this provision.

The rollover of gains from qualified small business stock (Section 1044) into an investment in another qualified small business stock could be repealed or reformed by lengthening the holding period from 6 months to at least one year. The short 6-month holding period requirement is inconsistent with the “patient capital” rationale for special small business stock incentives.

Disadvantages:

Eliminating the small business stock exclusion would raise the tax rate on investments in small businesses. However, few businesses actually make use of these provisions, so the effect would be limited.

ii. Option 2: Simplify Capital Gains Tax Rate Structure

The combination of the expiration of the zero and 15 percent capital gains tax rates in 2011, the President’s proposal for a 20 percent rate on capital gains of taxpayers with incomes over \$250,000 and the 3.8 percent Medicare tax on capital gains of high-income taxpayers in the recently enacted health care bill, suggests that it is timely to review the taxation of capital gains.

The basic 10 and 20 percent rates enacted in 1997 (along with the depreciation recapture provision discussed above) were thought to allow reduction of the top capital gains rate without loss of tax revenue because of the revenue efficiency of the design of the proposal. The zero percent rate under current law raises little revenue (only through the effect of including the full capital gain on income-based phase-out provisions). The zero rate also raises questions about whether even middle-income taxpayers should pay some capital gains tax on their capital gains income.

The proposal and its advantages:

One option would be to convert the separate rates into a 50 percent exclusion. A 50 percent exclusion would result in approximately the same top income tax rate (19.6 percent vs. 20 percent) while imposing rates of 5 and 7.5 percent on gains of taxpayers in the 10 and 15 percent tax brackets. Such a percentage exclusion would simplify the computation of the tax on capital gains, especially if other capital gains provisions were also converted into percentage exclusions. The same percentage exclusion would apply to net capital losses to make the tax treatment symmetric and reduce any revenue losses. While the separate calculation of the tax on capital gains is slightly more complicated than an exclusion, simplification benefits would come from cleaning up the other provisions on special types of capital gains.

A more modest option would be to replace the zero percent rate with the 5 percent capital gains rate in effect from 2001 through 2007 for taxpayers with taxable income placing them in the 10 or 15 percent rate brackets. While this would increase taxes for some middle-income individuals, capital gains are infrequent and tend to be relatively small in this income range. As a result, the overall income tax of these households would stay roughly the same because of changes to other provisions in the simplification package. The 5 percent rate would raise capital gains taxes on higher-income taxpayers without distorting their decisions about stock sales because those decisions would be affected only by the maximum rate that applied to their gains.

Disadvantages:

A significant drawback of such an exclusion is that the basic income measure (AGI) would be distorted, especially for taxpayers whose income consists primarily of capital gains. This distortion would affect the starting points for income phase-outs and published tables that use AGI to show the distribution of income. However, this might be an appropriate treatment for individuals for whom a large capital gain is a one-time or infrequent event.

iii. Option 3: Limit or Repeal Section 1031 Like-Kind Exchanges**The proposal and its advantages:**

One simplification option is to tighten the eligibility for this treatment to better align the operation of Section 1031 with the justifications for tax deferral treatment. An alternative option would be to disallow deferral of gain on like-kind exchanges. Other proposals would limit the rollover to property in certain cases. For example, some proposals would make developed property and structures a separate category from undeveloped land. Some developers are able to defer taxation continually by rolling over gains from the sale of developed properties into new investment in increasing amounts of land.

Disadvantages:

The proposal would raise tax rates on real property. The Section 1031 provision interacts with and is an escape valve for capital gains tax rates. Thus, it is most important for corporations as they face a 35 percent corporate capital gains tax rate. Substantial limitation of like-kind exchange rules would increase the pressure to reduce the corporate capital gains rate (or the overall corpo-

rate rate). On the other hand, limiting the like-kind exchange rules could partially fund a lower corporate rate.

iv. Option 4: Capital Gains on Principal Residences

Homeowners may exclude up to \$500,000 (\$250,000 for a single individual) of capital gain from the sale of principal residences provided the home was their principal residence in two of the last five years. This provision was enacted as a simplification measure—at the time of enactment over 95 percent of home sales produced capital gains below the exclusion amount and even fewer sales were subject to tax if they met the holding period requirement—and as a middle-class tax break. With the passage of time, the real value of the exclusion has been eroded, limiting simplification benefits.⁴

Calculating the capital gain is itself a complex procedure because the tax basis of the home—the adjusted purchase price against which to compare the sales price—includes transaction costs, fees, investments, and renovations (but not routine maintenance) that occurred since purchase. Records documenting all of those expenditures (often covering many years of expenditures) are required.

The proposal and its advantages:

These issues suggest indexing the exclusion for inflation. A higher threshold would prevent the erosion of the simplification benefits of this provision and prevent increasing numbers of homeowners from paying taxes on appreciated residences.

Disadvantages:

Indexing the threshold for inflation would expand the already very favorable treatment afforded to owner-occupied housing and would benefit those with the largest capital gains.

d. Option Group D: Simplifying Tax Filing

Based on IRS research, on average individual tax filers spend more than 17 hours on tax-related matters each year. Overall, that means that the roughly 140 million filers expend almost 2.5 billion hours devoted to federal income taxes. In addition to the time cost, taxpayers spend \$32 billion paying accountants, lawyers, and tax preparers or purchasing tax software. All told, the monetized cost (at \$25 per hour) of this compliance burden for individual taxpayers is about \$92 billion. Of course, these calculations ignore the hard-to-monetize costs of frustration and anxiety.

About 30 percent of the time is spent actually preparing and submitting a tax return, and the remaining 70 percent is spent on recordkeeping, tax planning, and other tax-related items. Recordkeeping alone is nearly half of the total time burden. Much of that is devoted to documenting

⁴ The relatively short holding period requirement of two years and allowing repeat use every two years is thought to invite abuse of the provision by homebuilders living in a house they built for two years to get tax-free earnings from their profit on the house, by conversion of rental or vacation properties into principal residences, and by serial fixer-upper specialists who also get tax-free income on their labor on the house. An option in the compliance section addresses this issue.