

Date: October 23, 2008
To: Handy Corporation Tax File 2008
From: Martha Smith
Subject: Treatment of homes sold by Handy

Facts: When an executive is relocated Handy Corporation assists him/her by buying his/her home if a buyer is not found prior to the move date. Handy pays fair market value based on an appraisal. Handy then sells the home. In 2008, a home was sold at a loss.

Issue: What is the character of the homes to Handy – capital or ordinary?

Law

§1221 – This section defines “capital asset” primarily by listing eight types of assets that are not capital assets. Thus, if an asset is not included in the list of eight items, it is a capital asset. This section also notes that it is not relevant in classifying an asset whether the asset is connected to the taxpayer’s trade or business. Of the eight assets listed at §1221(a), the first two are the only ones relevant to Handy’s situation. They are:

- (1) inventory or “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business”
- (2) depreciable or real property “used in” the taxpayer’s business

Reg. §1.1221-1 – These regulations do not provide much beyond what §1221 already states. The regulations do note that how long an asset has been held is not relevant in classifying an asset as capital or not capital.

§165(f) – “Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.”

§1211(1) provides that corporations may only use losses from the sale or exchange of capital assets to the extent of gains from the sale or exchange of capital assets.

§1212 provides that a corporation must carryback a net capital loss first for three years and then forward five years if it has capital gains available for offset in such years. The loss is treated as a short-term capital loss when carried over. The loss must be carried back to the oldest year first.

Note: Regulations under §1211 and §1212 do not add much beyond what the Code states and have not been updated for many years.

Revenue Ruling 82-204 – The issue in this ruling was whether homes purchased by a company from its relocated executives was a capital asset to the corporation. If an employee to be relocated wanted the corporation to purchase his home, two appraisals would be obtained. Both the corporation and the employee selected an appraiser and the average of the two values was used as purchase price. The corporation wanted to be sure it was not paying the employee more than FMV for the home. The corporation then sold the home. The corporation never used the home or made any improvements to it.

The IRS referred to §1221(a)(1) and (2) (noted above). It also referred to *Corn Products*, 350 US 46 (1955) as a “further exception” to the types of assets that are not capital assets. In this case, if an asset is an “integral part of [the taxpayer’s] business operation” it would be excluded from capital asset treatment.

The IRS held that that the homes met no exception to the definition of a capital asset. The corporation did not hold the homes for sale to customers in the ordinary course of its business and the homes were not used in the corporation’s business. The IRS also found that the homes were not bought and sold as an integral part of the corporation’s business operations. Thus, the homes were capital assets to the corporation.

Note: This ruling has not been modified or superceded and was cited in Rev. Rul. 2005-74 and *Amdahl*, 108 TC 507 (1997). These two rulings may be relevant should Handy want us to look into planning opportunities for them for their relocation activities. Rev. Rul. 82-204 must be read in light of the 1988 Supreme Court case of *Arkansas Best*.

Azar Nut Co. v. Comm’r., 67 AFTR 2d 91-987, 91-1 USTC ¶50,257 (5th Cir.) – This case involved the issue of whether a home purchased by an employer from a terminated employee was a capital asset to the company. A was in the business of processing, packaging and selling nuts. As part of a deal to hire a CEO, A agreed that it would purchase the CEO’s home upon termination of employment. The CEO was terminated and A purchased the home. It later sold the home at a loss of about \$111,000. A made no improvements to the home and did not use it in its business. A treated the loss as an ordinary business loss. The IRS reclassified it as a capital loss and the Tax Court agreed with that determination. A appealed.

A agreed that the house met the general statutory definition of a capital asset. However, A believed that the house fell under §1221(2) in that the house was “used in” A’s business because it related to an employment contract and it does not matter that the home never played a role in A’s business operations.

The court noted that in *Arkansas Best*, 485 US 212 (1988), the Supreme Court held that the purpose of holding an asset is not relevant under §1221. Instead, one strictly looks at the definitions of the assets listed there to see if an asset is a capital asset. Thus, the court held it could not use a “business purpose” approach to determine if an asset was “used in” a business. Per the court, “an asset that has no meaningful association with the taxpayer’s business operations after it is acquired cannot reasonably fall within the plain words of the statute.”

The court also noted that in applying §1221, one must consider the role the asset plays in the business after it is acquired. Once A acquired the home, it played no role in its business.

A next argued that the loss should be an ordinary business loss under §162. The court ruled against A because the loss was not an “expense” and therefore could not be deducted under that provision.

Thus, the home was a capital asset to A and any gain or loss upon disposition would be capital.

Analysis: Handy's situation is very similar to that of Rev. Rul. 82-204 and *Azar Nut*. Handy does not hold homes for sale as part of its business so the assets do not fall under §1221(a)(1). Also, because Handy never uses the homes in its business, they do not fall under §1221(a)(2). Handy will not be helped by any argument that purchasing the homes was crucial to its business operations of enabling employees to relocate. As stressed in the *Azar Nut* case, a business purpose for purchasing an asset is not relevant under §1221. Also, the "used in" term of §1221(a)(2) is based on what the company does with an asset *after* it acquires it. Handy did not use the home in its operations. In addition, even the now defunct "Corn Products" business purpose and "integral part" theories, will not help Handy as these theories were held as not met by the corporation in Rev. Rul. 82-204 on similar facts. Just like the employers in Rev. Rul. 82-204 and *Azar Nut*, Handy must treat the homes as capital assets.

Per §1211 and §1212, Handy may only use any capital loss against capital gain income and any excess may be carried back 2 years and forward 5. It must first be carried back.

Conclusion: The homes purchased from employees are capital assets to Handy.

Next Steps:

- Review Handy's prior 3 years tax returns to determine if there is any net capital gain available for carryback of the 2008 capital loss from the sale of employee homes.
- Discuss the findings with Handy's CFO.
- Find out if Handy wants us to do additional research to determine if a different relocation plan in the future would yield a better result. For example, a third party relocation company was used by taxpayers in later rulings (Rev. Rul. 2005-74 and *Amdahl*).