The Capital Gains Treasure Chest: Rational Extension or Expedient Distortion?

Melvin G. Dakin
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I.

A study of the recent hearings of the Ways and Means Committee on the topic of capital gains and losses1 is not an exhilarating experience. One closes the volume with the feeling that there are very few, if any, taxpayers who are not being put upon in one way or another by the imposition of a tax on capital gains. However, the variety of voices raised before the committee expresses eloquently the array of interests which Congress must as best it can attempt to deal with in that handbook of Americana, the Internal Revenue Code,2 and more specifically in the sections of it devoted to capital gains.3

In the main the proponents of change in the existing law are: (1) representatives of groups having income already in part classified as capital gain and who wish to abolish the tax on such gains altogether or to ameliorate it by lowering the rate of tax; (2) representatives of groups having income from sales or exchanges of property now treated as ordinary income but which might be made eligible for capital gain treatment by appropriate amendment shortening the present holding period; or (3) representatives of groups having income from sales or exchanges of property of a kind which, though now excluded from capital gain treatment, can be rendered eligible by redefining capital asset transactions so as to include their transactions. Illustrative of the first group are long-term (six months or more)

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investors in securities and other properties.\textsuperscript{4} Illustrative of the second group are short-term (less than six months) securities and commodities speculators.\textsuperscript{5} Illustrative of the third class are those farming interests whose breeding stock has not yet been included in the definition of capital assets,\textsuperscript{6} border-line operators in real estate sales and development,\textsuperscript{7} and a miscellany of interests some of whom, such as recipients of corporate dividends,\textsuperscript{8} do not even purport to be carrying on sales or exchanges of property.

Proponents of change in the rate of tax on capital gains, or in the period for which property must be held to qualify a capital gain as "long-term" and hence subject to the reduced rate, pitch their case on the need for increasing the mobility of venture capital by eliminating a tax whose impact is felt only when an investment is turned into cash or other property at a profit.\textsuperscript{9} They argue quite plausibly that such a tax operates as a deterrent to a necessary shifting of investments if the economy is to be kept dynamic.

Congress has wrestled with the problem for decades in its two-fold aspect and has sought solutions in: (1) a holding period which will, with some semblance of plausibility, separate long-term investments from speculation; and (2) a ceiling rate which will, with some semblance of equity, reflect the fact that realized gains from property transactions may consist of the accumulated gains in the value of property over several taxable years and that consequently the tax burden should not be higher than it would have been if spread over such taxable years.\textsuperscript{10} It is, of course, the sharply progressive surtax which will otherwise be applicable to all gains "realized" in the taxable year which causes inequities.\textsuperscript{11}

\textsuperscript{4} Hearings, supra note 1, at 1006.
\textsuperscript{5} Id. at 991.
\textsuperscript{6} Id. at 1167.
\textsuperscript{7} Id. at 1028.
\textsuperscript{8} Id. at 1200.
\textsuperscript{9} Id. at 965.
\textsuperscript{10} SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, 362-63 (1938).
\textsuperscript{11} The basic provision is, of course, § 22(a) [26 U.S.C. § 22(a) (1946)] which provides in pertinent part: "Gross income includes gains, profits, and income derived from ... trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property...." (Italics supplied.) Without more, this provision subjects all included gains or profits of individuals and estates and trusts to the normal and graduated surtax rates provided in §§ 11 and 12 and all such gains and profits of corporations to the normal and ungraded surtax rates provided in §§ 13 and 15. Section 117(c), however, provides in effect a ceiling of 25 percent in such surtax rates if the property from the sale or exchange of which a gain or profit is derived qualifies as a "capital asset."
Elsewhere in the Code "bunched income" from such sources as professional fees, literary and artistic compositions, and other designated sources is dealt with by averaging devices.\textsuperscript{12} Here, however, Congress has chosen to manipulate the rate of tax in the interest of equity. That neither the rate nor the holding period can be fixed to please all the affected taxpayer interests is amply evidenced in the two hundred and fifty pages of testimony and exhibits contained in the current revenue revision hearings.

On the other hand, the third group of proponents of "change by redefining capital assets" are not necessarily concerned at all with such policy considerations as maintaining the mobility of investment. To some in this group this is merely a "low pressure" area in the Code into which they would like to move; whether their transactions are theoretically entitled to the special treatment there provided is of no matter so long as the substantial tax benefits can be attained. To these, attaining the capital gains classification is to succeed in opening the treasure chest.\textsuperscript{13} Unwisely opening the "treasure chest" to a few has introduced a corrosive into the "capital gains"--"ordinary income" classification which may destroy it and which has already created serious inequities.\textsuperscript{14}

Wherever the effect of judicial interpretation or congressional "redefinition" of capital assets has been to convert ordinary income into capital gain, there is the possibility that the sections have been distorted, either inadvertently or expediently. Whether current changes, proposed or already embodied in the Code, are expedient distortions in response to taxpayer pressure groups or rational extensions of the capital gains theory is best considered in the light of their statutory and judicial history.

The history is not as sharply drawn as one might wish, but there is enough to support some speculation. Analysis begins with Section 117(a)(1),\textsuperscript{15} which, after stating that "capital assets" means property held by the taxpayer, excludes: "(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his

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\textsuperscript{12} 26 U.S.C. § 107 (1946).
\textsuperscript{13} Hearings, supra note 1, at 1015, 1018.
\textsuperscript{14} Id. at 1167.
\textsuperscript{15} 26 U.S.C. § 117 (1946).
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trade or business”; and “(B) property [held by the taxpayer], used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (I) . . . .”

Thus Congress leads off Section 117 (a) by including everything in the way of property held by the taxpayer as capital assets, the theory being that changes in the value of the property, as distinguished from its income, should be taxed as “long-term” investment gains and losses. But the man in trade or business who is merchandising a stock of goods is obviously realizing his ordinary annual income by turning “property” at a gross profit out of which he then deducts his charges for expenses and an allowance for capital used up by way of wear and tear. Disregarding up and down movements in the price levels, the profit on his stock of goods is no more than recompense for his entrepreneurial efforts. So the Code excludes stock in trade from long-term investment status. If the taxpayer is not merchandising a stock of goods in the grocery store sense, however, he may be building houses for sale or buying houses for resale; in that event his product is not such that he needs to resort to the conventional inventory in order to determine his profit and loss, since each unit is sufficiently important and identifiable so that the profit can be computed separately for each one. Again, however, annual gross profits on such sales should theoretically enable him to cover his expenses, return to him capital for property used up via depreciation, and leave a normal recompense for his time and the use of his capital. His houses are “property of a kind properly . . . included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” 16 Consequently, such property is excluded from investment status.

On the other hand, why exclude depreciable property used in the trade or business? Any decrease or increase in such property would seem to come within the conception of income-producing investment rather than stock in trade and ought to be eligible for the capital gains concession on the theory that such value increases are long-term increments. 17 Actually Congress excluded such property in 1938 because taxpayers were finding that in the disposition of partially depreciated assets in

order to acquire improved types of equipment they were suffer-
ing losses which as capital losses were usable to only a limited extent. But Congress might have excluded such depreciable assets for the very sound reason that depreciation allowances are not sufficiently precise so that the adjusted basis resulting can be said to be correlated with its investment or capital value for purposes of both loss and gain. Thus, if the adjusted basis had increased or decreased due to fluctuations in the price level or for other reasons, those fluctuations could be presumed to be the result of the long pull and hence eligible for investment treatment. But depreciation provisions, as we have noted, are neither precise nor immune to some degree of manipulation, and the temptation is very strong, as a consequence, to over depreci-
ate, since in so doing more of the asset cost is taken against current income and upon disposition more of the profit incident to its use is recovered as capital gain rather than ordinary income. This possibility of conversion is avoided by excluding such depreciable property from the capital gains concession. Rectification of errors in depreciation allowances is achieved by taxing any gain upon the sale of such property at ordinary income rates and allowing any loss as an ordinary loss.

Four years later, however, we were at a crucial stage in the war. A piece of equipment used in a trade or business for a number of years during which depreciation allowances were taken pursuant to Section 23(l) often had an adjusted basis of very modest proportions (in some instances, no doubt as a result of over-depreciation) compared with the fair market value it could command in the midst of the exigencies of war. As a House com-
mittee in 1942 commented: "It appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer. For example, a taxpayer sells certain trawlers used in his business to the Government. If the gain from the sale is regarded as an ordinary gain it may result in the taxpayer receiving practically nothing"

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for his property. Another example is where the proceeds of insurance on destroyed property exceed the cost of the property. The existing law treats such gain as ordinary income."

Whether such gain can be categorically labelled a long-term enhancement of investment value rather than a short-term speculative gain might perhaps be open to question, but it is in any event not the normal profit which the operator expected to realize out of the use of a depreciable asset in his trade or business. And whatever its theoretical status, if taking it as ordinary gain represented an impediment to getting equipment needed for the war effort into use, theory was apt to get only summary consideration. The obvious way of insuring that such transfers would be freely made was to move such property back into the category of capital assets with the attendant advantages in the way of gain limitations. At the same time, however, there was no disposition to take away the loss advantages enjoyed as non-capital assets in the event the amount realized was less than adjusted basis. To meet both objectives, Section 117(j) was added and Sections 117(a) (1) (A) and (B) were left untouched. The 1942 version of Section 117(j) provided:

"For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable." 22

That one of the prime purposes of Section 117(j), quoted above, was to bring depreciable property useful for war production back into an "as if" capital asset category for purposes of computing gain is evident by the way in which the draftsmen proceeded. They provided that property used in a trade or business, gainful sales and exchanges of which were to be considered as gains from the sale of capital assets, should mean "'property used in the trade or business' of a character which is

subject to the allowance for depreciation . . . held for more than 6 months . . . which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The commercial enterprise was thus carefully precluded from bringing in to the capital gains category the ordinary transactions from which it realized its normal annual profit.

Despite this legislative history, Section 117(j) has opened up a "low pressure tax area" for numerous transactions which have no flavor of long-term investment realization and which, but for this provision, would be regarded as the source of normal annual profits subject to the usual individual surtaxes.

Essentially, a number of the current distortions stem from the fact that Sections 117(a) and 117(j) were drafted to take care of conventional manufacturing, servicing, or merchandising operations in circumstances where it would be relatively simple to distinguish between the assets used for manufacturing or servicing and the services or commodity produced or purchased for sale. That fact is evidenced by the type of illustrative problem which the regulations relied upon (and still rely upon) to demonstrate the sections' application.23 Our economy is hardly as simple as the regulations would have it, however. Inevitably, and quite fairly, if a concession is to be had or largesse dispensed, the farmer, the miner, the forester, the inventor, the real estate operator, and now many others have a quite natural inclination to move from the high pressure area of surtaxes to the relatively tolerable pressures of the alternative capital gains tax. All this has occurred despite the fact that the capital gains concession still rests primarily on the notion that we are dealing with investment gains which have accumulated over a period of years; as to such gains the view has consistently been that they should not be taxed as they accrue because of our adherence to the principle that income should not be taxed until it has been realized, and when realized should not absorb the full impact of the surtax rates in one tax period. But as Judge Riddick said in Albright v. United States:24 "Nothing in the language of the Act indicates an intention on the part of Congress to deny the relief granted by the section to any taxpayers whose transactions meet the pre-

24. 173 F.2d 339, 344 (8th Cir. 1949).
scribed conditions.” Some of the present chaos might have been avoided, however, had Judge Riddick also reflected, as did Judge Learned Hand dissenting in *Commissioner v. Ickkelheimer*, that: “. . . the colloquial words of a statute have not the fixed and artificial content of scientific symbols; they have a penumbra, a dim fringe, a connotation . . . they express an attitude of will, into which it is our duty to penetrate and which we must enforce ungrudgingly when we can ascertain it, regardless of imprecision in its expression.”

II.

There is nothing in the legislative history to indicate that livestock sales in 1942 and prior thereto were suffering because farmers were unwilling to sell breeding and dairy stock under circumstances where the adjusted basis was such that substantial and unanticipated ordinary income would be realized. In fact, it seems relatively unlikely that, except for large farmer-operators, depreciation accounting for such stock had been resorted to widely, farm tax accounting being as simplified as it is for cash basis taxpayers.* Nonetheless, there has for a long time been provision made in the regulations for a reasonable allowance for depreciation on livestock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits. Technically and actually they thus fall within the literal words of Section 117(j) as long as the livestock involved is not properly includible in inventory or held primarily for sale to customers in the ordinary course of taxpayer’s trade or business; without the provision, however, sales of such livestock would be a source of ordinary annual profits.

The basic weakness in the drafting of Sections 117(a)(1)(A) and (B) and 117(j) thus appears to lie in a failure to distinguish adequately between property subject to depreciation which is actually being used in a manufacturing, servicing, or merchandising establishment, and hence actually being depreciated, and property which, while subject to depreciation if put to use (and hence depreciable property), is actually capable of being mer-

25. 132 F.2d 660, 662 (2d Cir. 1943).
26. One finds, for example, relatively little by way of annotations covering depreciation of dairy and breeding animals in the tax services and treatises. See 1 CCH 1952 Fed. Tax Rep. § 224 et seq.
The Treasury blurred this distinction in its initial ruling on livestock sales and was unable to bring these transactions back into focus thereafter before the policy-making had been taken over by the judiciary in the Albright litigation. Thus, if, from the beginning, sales of established draft, dairy, or breeding stock (depreciated or being depreciated) had been admitted to capital gains treatment, the analogy to ordinary depreciable physical equipment might have been maintained to some more satisfactory extent. Instead, however, the Treasury included in the "culls" which it ruled ineligible for the treatment and "held primarily for sale," "animals which had passed their state of economic usefulness." But animals in this category are presumably wholly analogous to any piece of equipment subject to depreciation during the period it was utilized in the trade or business. The basic reason for dairy and breeding herds being eligible for Section 117 (j) treatment at all was their depreciable status. Almost by definition this excluded the possibility of their being held for sale in the conventional sense—but the Treasury sought to so classify them.

When the litigation stage was reached in the livestock "breeding herd" cases, the crucial status of the animals as depreciable property was glossed over in the process of formulating issues for trial. The taxpayer in the Albright case, for example, had only the burden of showing that the animals were depreciable.

28. Depreciating an asset "used in the trade or business" necessarily implies a process of charging off each year, as part of cost of operations, the estimated portion of asset cost deemed to be used up in making and marketing that year's product. "Sale" in the sense used in the phrase "held primarily for sale" implies a holding for gainful disposition of the entire asset during an accounting period.


30. In 1944 I.T. 3666 was issued (1944 CUM. BULL. 270) providing: "The sale of animals culled from the breeding herd as feeder or slaughter animals in the regular course of business is not to be treated as the sale of a capital asset." In 1945 I.T. 3712 was issued (1945 CUM. BULL. 176) providing that "culled from the breeding herd" means: "... the normal selection for sale of those animals which, due to injury, age, disease, or for any other reason (other than that of changing the breed or the quality of the off-spring) are no longer desired by the livestock raiser for breeding purposes, and also the normal selection for sale of animals for the purpose of maintaining the herd at a regular size. The primary factor is normal practice in the case of the particular taxpayer involved." In further amplification to the Ways and Means Committee and in argument in the Albright litigation it was stated that: ""'Culls' not only represent animals sold because they had passed their state of economic usefulness or were undesirable for other purposes but also represent animals regularly sold from the breeding or dairy herd in order to keep the herd at a desirable size."

31. See note 28 supra.

He did not have to show, presumably, that allowances for depreciation as provided in Section 23(l) had been or were being taken in connection with the annual use of such animals. Such an allowance is permitted as a deduction against ordinary income only if it represents a portion of capital invested which has been used up during the taxable year in the trade or business.\textsuperscript{33} Instead, government counsel seemed to level its attack primarily at the alleged inability of taxpayer to show that the culls were “property not held . . . primarily for sale to customers in the ordinary course of . . . trade or business” as defined in the rulings of the Treasury.\textsuperscript{34}

Had issue been joined on the status of the animals as “productive plant actually being depreciated,” while the government might still have lost a part of the suit, it would have served to bring out the true objective of the relief offered under Section 117(j).\textsuperscript{35} Perhaps it would have deterred Congress from opening the capital gains “treasure chest” any wider; it might even have the effect of prompting Congress to close it at least as to sales of “animals regularly sold from the breeding or dairy herd in order to keep the herd at desirable size” and as to sales of “breeding animals which were used for the production of only one offspring or one litter of offspring.”\textsuperscript{36}

But after the Albright case\textsuperscript{37} had lighted the way, the happy enterprise of converting ordinary income into capital gain got into full swing in other circuits and in other types of transactions. A survey of the annotations to Section 117(j) in code, treatise, and tax service would indicate the Treasury fought a losing battle.\textsuperscript{38} It was fought out, not on the basis of whether the property sold or exchanged was the kind of depreciable property Congress had primarily in mind\textsuperscript{39} and whether it had or could be depreciated in accordance with Section 23(l), but on the ground of whether it was “properly includible in the inventory” or “held . . . primarily for sale to customers in the ordinary course of . . . trade or business.”

\textsuperscript{33} U.S. Treas. Reg. 118, § 39.23(1)-1 (1953).
\textsuperscript{34} See note 30 supra.
\textsuperscript{35} I find Judge Delehant’s opinion in Laflin v. United States, 100 F. Supp. 353 (D. Neb. 1951), one of the most thoughtful on the proper role of § 117(j) in livestock transactions; it bears comparison with the opinion in Albright v. United States, 173 F.2d 339 (8th Cir. 1949).
\textsuperscript{36} Compare MIMEO. 6660, 1951 CUM. BULL. 60 with U.S. Treas. Reg. 118, § 39.117(j)-2(b) and (c), Example (3) (1953).
\textsuperscript{37} 173 F.2d 339 (8th Cir. 1949).
\textsuperscript{38} See, e.g., 3 MERTENS, THE LAW OF FEDERAL INCOME TAXATION §§ 22.10, 22.11a (Supp. 1953).
\textsuperscript{39} 26 U.S.C. §§ 22(a), 22(e) (1946).
The Fifth Circuit accepted this latter as the issue in *United States v. Bennett* and arrived at a result, with respect to "culls from a breeding herd," in agreement with that reached by the Eighth Circuit in the *Albright* case. The government was here contending that "primarily held for sale" as used in the statute meant "ultimately held for sale." The taxpayer was contending that "first" or "initially held for sale" was the appropriate synonym. The Court, however, found the taxpayer's argument wholly reasonable "that when the business of the cattleman is to breed and sell calves, and his breeding herd, though obtained from the cattle he raised, is kept and maintained for that purpose, there is no more reason to say of these cattle that they are kept primarily for sale than to say it of cattle which are bought for breeding and sold when and because their breeding uses are over." And the Court expressed "complete disagreement . . . with the Collector's point that since it was known before the calves were dropped that each would certainly be sold, either while still a calf or after its usefulness as a breeder was past, it ought to be held that all of the stock bred and raised on the ranch was kept primarily for sale." Such a view was deemed by the Court to be "a severely narrow and restricted point of view wholly unreasonable, impractical and unsound.

It is hardly "impractical and unsound" to point out, however, that the capital gains treatment was intended by Congress to alleviate hardship incident to realizing in one year enhancements in value accruing over several tax periods. Such a case is hardly presented where each year's livestock operations result in the sale of "culls" at market prices and there is no "bunching" of gains. The Treasury is merely attempting, within the confines of almost unworkable legislation, to prevent the conversion of what are pretty clearly ordinary, and probably not abnormal, annual profits into capital gains.

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40. 186 F.2d 407 (5th Cir. 1951).
41. *Id.* at 409, 410.
42. *Id.* at 410.
44. In the case of the cash basis cattleman, the inequitable aspects of the transaction do not end with the advantage of a cut rate tax applied to ordinary profits; if a "cull" is one which he has raised himself he may already have deducted the costs incident thereto against the ordinary income of a prior year. Thus, to cite an example used by the Secretary of the Treasury in a letter to Congress: "A cash-basis farmer spends $100 in raising to maturity a dairy animal which is later culled from the herd and sold for $150. The $100 is deductible in full as a business expense and the gain on sale is $150, the basis of the animal being regarded as zero. Of
Incidentally, another use of Section 117(j) as a cut rate tax device was uncovered by agricultural interests almost concurrently with its use in connection with livestock sales. This was its use in connection with the sale of land with a growing crop thereon. Thus in 1942, when Section 117(j) was added, dispositions of “real property used in the trade or business of the taxpayer” were still “capital assets” although depreciable equipment thereon (or therein) had been excluded, as has been noted. Presumably to qualify the disposition of an entire plant (real estate and plant equipment) for capital gains treatment if it resulted in a gain, and to give all of it ordinary loss status if the disposition resulted in a loss, such real estate was in 1942 excluded from the definition of capital assets in Section 117(a)(1) and included in the “as if” capital assets treatment in Section 117(j). As in the case of depreciable property, the real estate must not be “property of a kind which would properly be included in the inventory if on hand at the close of the taxable year” nor “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” Thus there was again a careful attempt on the part of Congress to preclude transactions which would be a source of ordinary annual profits from enjoying capital gains treatment. As a corollary, it seems quite unlikely that the draftsmen envisaged sales of unharvested crops in connection with a sale of land as transactions involving sudden sharp enhancement of capital values which it would be a hardship to subject to ordinary surtaxes. But here again, “growing crops” are, for many purposes of local

this $150, only $75 is recognized for tax purposes, so that in effect the farmer has $25 excess deductions over income. An accrual-basis farmer, on the other hand, in accordance with general practice, inventories his dairy animals at round figures representing the estimated costs normally incurred in raising animals of this class. The average cost is $100. He sells one of the animals for $150. His gain is $50, of which $25 is recognizable for tax purposes. Thus he is taxed on $50 more than the cash-basis farmer.” But an accrual-basis farmer may not change to cash basis without the consent of the Commissioner and the consent would hardly be forthcoming where the method pursued is unquestionably more accurate even though now more onerous taxwise. If Omar Khayyam were on the scene today, he might well be tempted to give his old couplet a new twist and ask, “One wonders what the ‘cash-basis farmer’ sells one half so precious as the stuff he buys.” The anomalousness of according routine capital gain treatment to transactions in which the adjusted basis is zero seems not to have troubled the courts. The anchor section of the procedure, § 111(a), provides: “The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in such section for determining loss over the amount realized.” 45. Sen. Rep. No. 1631, 77th Cong., 2d Sess. 50 (1942).
land law, realty until severed. And literalists, unconcerned with resulting distortion of legislative intent, seized the opportunity. Thus in a case where a taxpayer had sold a fully equipped orange grove with mature and almost mature fruit unpicked, reliance upon local land law notions of the scope of "realty" netted a handsome tax saving.\(^7\) The taxpayer here claimed capital gains treatment for the gain on the crop because it had been sold with the land, the latter being, of course, clearly entitled to such treatment. The Fifth Circuit held that, under Florida law, unsevered fruit is part of the land and follows it upon conveyance unless in terms reserved. Thus, while the crop was intended to be eventually sold, the court decided it was not "primarily held for sale" until it became personal property by actual or constructive severance from the trees.\(^8\) While it was in the process of being grown it could only be held for a potential future sale. In effect, because the fruit was real estate under local law it could not be held "primarily for sale" to customers in the ordinary course of trade. This decision was reached despite the established Florida practice of agreeing to sell a crop while still on the trees in the ordinary course of business and reporting gain or loss as ordinary income or business deductions.\(^9\) It was also reached despite the fact that the taxpayer had taken the expense of raising this crop as an ordinary deduction against other ordinary income.\(^10\) And even as real estate the crop, as distinguished from the trees, had probably not been held for the requisite six months under Section 117(j). Nonetheless, the Tax Court was reversed and the entire proceeds allowed to qualify "as if" a sale of "capital assets."

A similar result was reached by the Tenth Circuit in a case\(^51\) involving the sale of a section of land with a partially matured crop of wheat thereon. On the other hand, the Ninth Circuit, without entangling itself in irrelevant questions of conveyancing and security devices, concluded that the only purpose of a taxpayer in "holding" the crop portion of an orange grove was to carry on her business of selling oranges to customers.\(^52\) It was refreshing, in the light of other decisions, to have the court point out that Section 117(j) was for the purpose of relieving from ordinary taxation the realization of values which had accumu-

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\(^{47}\) Owen v. Commissioner, 192 F.2d 1006 (5th Cir. 1951).
\(^{48}\) Id. at 1009.
\(^{49}\) Id. at 1007.
\(^{50}\) Id. at 1009.
\(^{51}\) McCoy v. Commissioner, 192 F.2d 486 (10th Cir. 1951).
\(^{52}\) Watson v. Commissioner, 197 F.2d 56 (9th Cir. 1952).
lated over a long period of time and that a crop which was largely the product of effort within the tax year was hardly entitled to such relief.53

But even though the Treasury won a few battles here and there, it lost the war, as witness the addition, in 1951, of Section 117(j)(3) and the amendment of Section 117(j)(1). The 1951 amendment54 bluntly includes a sale of growing crops in the definition of a sale, exchange, or involuntary conversion of “property used in the trade or business,” thus overriding the Treasury and those court decisions which required demonstration that such property was not held “primarily for sale to customers in the ordinary course of trade or business.” Livestock, except poultry, held for twelve months or more for draft, breeding, or dairy purposes is given similar treatment by the addition of a sentence of similar import at the end of Section 117(j)(1).55 However, one might say that the growing crop sales are unfairly penalized, since expenses incident to raising a crop so sold are disallowed as deductions under Section 2456 and required to be added to basis under Section 113.56

53. Id. at 58. Even though the crop is “real property used in the trade or business,” thought the court, the taxpayer has the burden of proving that it is real property held for more than six months which is not held primarily for sale to customers in the ordinary course of business.


55. Ibid. What are “livestock . . . held . . . for draft, breeding or dairy purposes” is still left to Treasury to define, however, and new Regulations proceed at § 39.117(j)-2(b) thusly: “The determination whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present in a case where the animal is disposed of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance. An animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may, depending upon the circumstances, be considered held for a draft, breeding, or dairy purpose. An animal is not held by the taxpayer for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held by the taxpayer for sale to other persons for use by them for such purpose. Furthermore, an animal held by the taxpayer for other purposes is not considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use of the animal for such purpose as an ordinary or necessary incident to the purpose for which the animal is held.” Six detailed examples follow; culls are exemplified specifically only in the case of animals discovered to be sterile.

The statutory solution in the case of unharvested crops seems a clear distortion which almost necessarily runs counter to the underlying theory of the section of affording capital gains treatment only to realized long-term enhancements of capital value. It seems unlikely that the gain on the sale or exchange of either livestock or annual crops could normally qualify as such an enhancement.

III.

In the “sale of war-rental housing” cases there is perhaps more real possibility of “bunched” income since large numbers of units may be sold after several years of rental status. On the other hand, the projects have frequently been part of a larger operation devoted to building and sale of housing units and sales from the unit have taken place routinely along with other sales distinguished only perhaps by a lesser sales effort devoted to the rental units. Such was the situation in the Rollingwood Corporation case.58

In this case, involving the sale of houses from a war workers’ rental housing development, the issue was deemed to be whether or not the houses were held primarily for sale or primarily for rent.59 The houses were all originally rented, and they unquestionably qualified for depreciation allowances under Section 23 (l) since they were the physical equipment from which the owner produced and sold housing service. The sale or exchange basis for the property would accordingly have been adjusted to the extent of such allowances. Upon their disposition they represented the retirement of equipment and, if by sale or exchange, clearly qualified for the concession contained in Section 117 (j), at least by analogy to the transactions for which the provision was probably originally drafted. Here again, however, the same basic unit was “stock in trade” as well as “depreciable property,” and the Commissioner contended that the houses were held “primarily” for sale if “primarily” is taken to mean “essentially” or “substantially” rather than “principally” or “chiefly.”60

as a capital gain. Actually, of course, the true gain in such cases is the difference between that part of the selling price attributable to the crop or fruit and the expenses attributable to its production. Therefore, your committee’s bill provides that no deduction shall be allowed which is attributable to the production of such crops or fruit, but that the deductions so disallowed shall be included in the basis of the property for the purpose of computing the capital gain.” Sen. Rep. No. 781, 82d Cong., 1st Sess. 47 (1951).

58. Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951).
59. Id. at 265.
60. Id. at 266.
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The court noted that the taxpayer might well have intended to pursue whichever of the activities of selling or renting proved to be the most profitable and that it was consequently fair to say that one of the essential purposes in acquiring or holding the houses was that of sale. It noted that Section 117(j) is "intended to alleviate the burden on a taxpayer whose property has increased in value over a long period of time from having the profits from sales taxed at graduated tax rates designed for a single year's income" and that its "purpose is to protect investment property as distinguished from stock in trade or property bought and sold for a profit." It found, consequently, that it was not within the legislative purpose that the profits from these sales be treated as capital gains. But the result was achieved only with difficulty under a statute which was not precisely enough drafted to deal with identical units of property playing both the roles of depreciable physical plant and stock in trade. For example, a "housing" decision of the Fifth Circuit shows no disposition on the part of that court to interpret the statute so as to prevent the conversion of ordinary income into capital gain. In this case the rental housing development was only a small part of a larger house construction and selling enterprise. The houses were built on the basis of a financing application that specified for sale or rent, subject, however, to a limitation that for some months after their construction not more than one-third of the development could be sold. The houses were depreciated as commercial property and, when sold, the services of a real estate agent were not utilized as was the taxpayer's practice generally. The court found no "permissible" basis for a determination that the sales of the houses constituted a disposition of "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The legislative history of Section 117(j) was not mentioned.

IV.

In the main, Section 117(j) has opened up no new opportunities for cut rate taxes for ordinary annual profits in the securities field. Since 1942, when the six months holding period was adopted, the short-term trader (who is not a dealer) has enjoyed capital gains treatment for his profits and losses along with the

61. Id. at 266, 267.
62. Delsing v. United States, 186 F.2d 59 (5th Cir. 1951).
63. Id. at 61.
investor, so long as he satisfies this relatively modest holding requirement. Yet one searches the current hearings almost in vain for any suggestion from securities interests that the short-term speculator should be distinguished from the long-term investor and that the present holding period might, after all, be a rather adequate device with which to do it. The insistent plea is rather to shorten the holding period to three months so as to add "greater mobility to venture capital." There is, of course, no intimation that Congress will not stand firm on the present holding period since any further shortening would serve to sharpen the anomaly of speculative gains realized on relatively short-term market changes enjoying the same tax benefits as clear long-term investment enhancements if the holding of the property has been six months or more. The gains of such a trader are presently distinguishable from those of a securities dealer since the trader does not sell "to customers."

Incidentally, the phrase "to customers" was added to Section 117(a) (1) (A) in 1934 in order to prevent traders, as distinguished from securities dealers, from taking 100 percent of their market losses as deductions against ordinary income. The interpretation of the section prior to the addition of this phrase was such as to preclude transactions of such traders from the capital asset category since their securities or commodities were obviously held "primarily for sale in the course of trade." They were not, however, held for sale "to customers" in the conventional merchandising sense, and the amendment made it clear that Congress intended to exclude only the latter trading. The intended result, of course, was that the transactions of such a trader would be treated as "sales or exchanges of capital assets" subject to loss limitations if held the requisite period. The corollary, not sufficiently important in 1934 to merit consideration, was that gains of such traders would also be subject to the treatment accorded long-term gains whenever the holding requirement had been satisfied. In addition, until 1950 such standard

65. E.g., the statement of G. Keith Funston, President, New York Stock Exchange, Hearings, supra note 1, at 963.
66. H.R. Rep. No. 1860, 75th Cong., 3d Sess. 36 (1938). "The short-term category includes, in the main, speculative gains which it has been the long-settled policy of Congress to tax in the same manner and to the same extent as earned income and business profits. This policy is adhered to in the present bill, and the full amount of an individual's 'short-term' capital net gains will be included in the computation of his net income."
market devices as selling "against the box" were available to convert short-term gains into long-term gains and to turn long-term losses into more useful short-term losses.69 The profits derived from such transactions certainly deserve no different treatment than the annual profits of a used car dealer—certainly they are hardly to be distinguished in terms of availability for the purchase of the necessities of life and for income taxes. These are hardly the increments of many tax periods which it would be inequitable to tax in full in the year of their realization.70

V.

Among the loophole plugging (or unplugging) amendments to Section 117 which constantly engage the attention of Congress one frequently finds notions which seem so theoretically sound that it is puzzling that wider use is not made of them. For example, Congress has evolved a statutory device for dealing with long-term value enhancements of property such as timber which has both "investment" and "stock in trade" characteristics which might well be useful elsewhere. Presently the timber owner may elect to report as capital gain the difference between the adjusted basis for depletion of his timber and the fair market

69. This loophole was plugged in 1950 by the addition of Section 117(1), 64 STAT. 932-34 (1950), 26 U.S.C.A. § 117(1) (Supp. 1953). 70. Professor Seltzer, in his penetrating study [THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 318 (1951)] comments: "The prominence of capital gains as a source of private wealth in the United States, and the origin of considerable amounts of them, though far from all, in reinvested corporate profits, early led this country to treat them as ordinary constituents of income. . . . On the one hand, capital gains add to the economic power of individuals no less than ordinary kinds of income. On the other hand, to treat capital gains as such under a graduated income tax raises questions of equity and of adverse operational effects upon transactions in capital assets." England ignores such gains entirely for tax purposes. If a recent "Time" story (Feb. 1, 1954, p. 20, col. 3) is to be credited, or rather the Inland Revenue man's comments to a "Time" reporter, reported taxable income is not a criterion by which England's well-to-do can be determined. Untaxed capital gains, according to the "Time" story, provide the basis on which much lavish living is maintained. Compare the following paragraph from a customer letter circulated by Merrill, Lynch, Pierce, Fenner & Beane and prompted by a recommendation from the Secretary of the Treasury on February 23, 1951, that the rate on long-term gains (property held 6 months or more) be increased from 25 percent to 37½ percent: "Every owner of property, including farmers, home owners and investors, should be vitally interested in this proposed tax because it is the owner who will pay it—pay it not out of income, but out of capital. . . . None of the leading commercial countries of Europe has a capital gains tax, not even socialist Britain. They don't have it because it does not make economic sense. In the last analysis taxes can only be paid from production—from wealth created day-by-day. A capital gains tax attempts to funnel into the government existing capital. Such transfers do not represent new production and to attempt to levy such a tax tends to dam the flow of capital. Business as a whole is retarded."
value of such timber on the first day of the taxable year in which it was cut. Thereafter, such fair market value is considered as the cost of such timber for ordinary merchandising purposes, and profits over such fair market value are taxed as ordinary income.\textsuperscript{71} The effect is to recognize that a portion of the difference between adjusted basis and the selling price of cut timber may be a long-term enhancement of capital value which it would be inequitable to subject to surtax rates in the year of its realization. It would seem completely applicable, for example, to land held for investment or for other long-term reasons and then subdivided by the original owner. Such transactions under the existing statute and interpretations thereof have been decided by applying the criterion of whether or not held by the taxpayer "primarily for sale to customers in the ordinary course of trade or business."\textsuperscript{72} The results have often been to distort the incidence of tax, in some transactions by taxing as capital gain what was in part the ordinary annual profit of a subdivider and in other transactions by taxing as ordinary income what was in part long-term investment enhancement. The Section 112(k) procedure would seem applicable as well to many of the "livestock" and "housing development" transactions where there may be, as has been noted, a mixture of ordinary annual profit and long-term investment enhancement. In fact, it would seem usable to minimize distortion in any situation where identical units of property may be either a long-term, income-producing investment which, however, fluctuates in capital value and thus gives rise to capital gains or losses, or stock in trade subject to normal merchandising which thus gives rise to ordinary income or business loss deductions.

Another device worked out for securities dealers might possibly be useful in the field of real estate operations in order to assure a dealer of the possibility of making long-term investments out of some of his holdings which would otherwise be regarded as stock in trade. Thus, a securities dealer, since a 1951 amendment,\textsuperscript{73} is able to set aside for long-term investment securities out of current trading, providing he identifies them in his records

\textsuperscript{71} 26 U.S.C. § 117(k) (1946).
\textsuperscript{72} An excellent conception of the variety of judicial results being arrived at on the basis of available criteria may be obtained by noting the annotations in, for example, 3 MERTENS, LAW OF FEDERAL INCOME TAXATION 394 et seq. (Supp. 1953). And see also an excellent article on inadequacies of present criteria generally in Miller, The "Capital Asset" Concept: A Critique of Capital Gains Taxation, 59 YALE L.J. 837, 1057 (1950).
\textsuperscript{73} 65 STAT. 503 (1951), 26 U.S.C.A. § 117(n) (Supp. 1953).
as such within thirty days of acquisition and does not after such period hold them “primarily for sale to customers in the ordinary course of his trade or business.”

A number of proposals made at the current hearing may prove fruitful of further general improvement in Section 117. In the main, however, the voices raised at the hearing table in Washington were concerned with special interests which it was felt were not being dealt with fairly in the present capital gains provisions and their application. In a number of instances it is true that even the present liberalized version can be applied in such a way as to exclude some qualified long-term investment enhancements; objections from those so affected will presumably be given careful consideration by Congress. But there were also many proposals made which would simply open the “treasure chest” further to those baldly seeking a cut-rate tax on ordinary annual profits. A sympathetic ear lent to such proposals certainly augurs for little but complete chaos in this field.

One excellent suggestion is contained in the hearings for alleviating and perhaps eliminating the myriad of cross-currents in this troubled area although probably so radical as to gain very little attention from a harassed but not yet desperate committee. It was proposed that a more careful classification of capital transactions be combined with some method of averaging both capital gains and ordinary income over an appropriate period, thus eliminating the necessity for a differential in the tax rate. Proposals for averaging, of course, are not new. Professor Simons of the University of Chicago advocated such an approach for a number of years before his untimely death. Professor Seltzer of Wayne University includes a fairly lengthy discussion of

74. As witness the statement of Edward J. Grassman, a casual real estate owner, faced with the prospect of paying a tax on $460,000 as ordinary gain after holding property for some 30 years. Hearings, supra note 1, at 1029.

75. See, for example, the arguments for treating the income from patents as “capital gains,” (Hearings, supra note 1, at 1188); and for treating ordinary corporate dividends as “capital gains,” (Hearings, supra note 1, at 1200). A nice juxtaposition was fortuitously achieved in the hearings by virtue of the following statement being received into the record immediately after the plea for capital gains status for corporate dividends: “The American Federation of Labor believes the present 26 percent rate on capital gains is too low. This low rate has operated as a spur to move more and more taxpayers to take advantage of the capital-gains section of the revenue law to escape the regular personal-income-tax rate. The law itself has been weakened to permit such escape to types of income which should not be given the preferential treatment given to capital-gains income.”

76. Hearings, supra note 1, at 1146.

77. SIMONS, PERSONAL INCOME TAXATION 154 (1938).
income averaging proposals in his recent penetrating study of the subject. However, the current proposal to be found in the hearings of the Ways and Means Committee combines with averaging other procedures which have been very carefully thought out, and indicates penetrating insights into the problems involved.

The proposal would set to one side physical property acquired and held for the consumption and use of the individual and his family and would ignore both gains and losses thereon (with certain safeguards) on the theory that such property was not acquired and held for either profit or investment. In the second class would be put all physical property used in a trade, business, or profession classifiable as income and profit producing equipment. Applying present Sections 112 and 113 procedures, it is suggested that the proceeds from the sale or exchange of such property be usable within an appropriate period for the acquisition of other physical assets of the same kind, undiminished by income taxes. New assets thus acquired would have their basis reduced by the amount of the profits thus absorbed, and over the years the reduced allowances for depreciation resulting would subject ordinary income to tax in an amount equivalent to the original basis reduction. As now under Section 112, if the entire profit was not absorbed in the new asset it would be included in income. In a third class would be placed depreciable property held for the production of income, and here again Sections 112 and 113 procedures would be relied upon to accomplish the postponement and proration of surtax impacts by reducing basis (and consequently future depreciation allowances) in the event of sale or exchange and reinvestment in other similar property. Stocks and bonds would comprise a fourth class, and some present notions contained in Section 115 would be relied upon to deal with the special problems relating to corporate stocks and undistributed profits. It is, of course, apparent that a Section 112 postponement of tax, without other safeguards, would enable a taxpayer to pursue for an indefinite period a program of reinvestment in stocks whose values represented in part undistributed profits. However, it would be quite possible, as now in some instances, to allow a taxpayer to separate from the proceeds of

79. Hearings, supra note 1, at 1161-63; Bravman, Integration of Taxes on Capital Gains and Income, 37 Va. L. Rev. 527 (1951); Bravman, Equalization of Tax on All Individuals with the Same Aggregate Income over Same Number of Years, 50 Col. L. Rev. 1 (1950).
a sale the undistributed earnings for the period held and report them as ordinary income. If there remained any excess over basis, taxpayer would then be permitted to postpone taxation thereon providing that he reinvested in other property held for the production of income or used in the trade or business. All other property, including property held for speculation, would get no special treatment, on the theory that such property would be held for short periods of time and would be analogous to stock in trade turned for an annual profit. Any inequities resulting from the taxing of gains thereon in one period would be ameliorated by an averaging process.80

On the question of the length of a desirable averaging period, Professor Seltzer of Wayne University notes that:

“If capital gains alone are considered, the averaging period necessary to overcome tolerably well the inequitable consequences of applying graduated rates to bunched realizations is much shorter ... than might be imagined. ... [A]n averaging period as short as 5 or even 3 years would be sufficient in most instances to eliminate any sizeable tax penalties otherwise created by a concentration of capital gains in a single year. If the sole object of the present preferential tax rates on capital gains is to offset the over-taxation of bunched gains under a graduated rate schedule, the offset is excessive. The present rates are materially lower than those that would prevail even under an averaging period as long as 20 years.”81

Under a carefully worked out averaging system the individual taxpayer would have nothing to gain by deferring the taking of a profit or accelerating the realization of a loss, because the ultimate tax would be the same whether the transactions take place at the beginning or at the end of the averaging period or in any year in between. Individuals could dispose of their property whenever the opportunity to make a profit presented itself. Assuming a relatively long averaging period, they could earn as much income as they were able, when they were able, and yet not be penalized for concentrating such profit or income in their most productive years. Also, as Professor Simons has colorfully pointed out, it would eliminate the “now or never,”

80. Hearings, supra note 1, at 1163.
“grab all you can” attitude among enforcement officers which the present system cultivates. As Simons comments:

“If we had a law under which the Treasury could bide its time—could calmly let taxpayers overcharge here and there, circumvent realizations, futilely conduct tax reorganizations to their hearts’ content, and convert ordinary income into capital gains, confident always of a final, complete reckoning—there would perhaps be little occasion to worry much about reasonableness and flexibility in administrative practice.”

Within a framework of classification and averaging, a scheme of income taxation is surely possible which would enable us to keep productive capital at work unimpaired as long as it was not converted to personal uses. We can surely find a way “so to arrange matters that precisely the same tax liability will arise no matter when the taxpayer carries through his transaction and no matter what form he causes the transaction to assume,” and we can also “evolve a method of purchasing mobility [of capital] at a lower cost in terms of equity.”