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**Retention of Control Over Stock Constitutes
"Ownership" Under Section 1239 of
the Internal Revenue Code—Harry Trotz***

Petitioner set up a corporation, retaining seventy-nine per cent of the stock and distributing the remainder to a third party. The third party borrowed from petitioner, pledging his stock as security and executing an option agreement under which the petitioner could recover the stock at any time.¹ Subsequently, the newly organized corporation purchased all the depreciable assets of petitioner's proprietorship at a price in excess of their adjusted basis; petitioner reported the difference as a capital gain. The Commissioner declared a deficiency, relying on section 1239² of the Internal Revenue Code, which treats as ordinary income the gain recognized from a sale by an individual to a corporation of which he is at least an eighty per cent owner. The Tax Court sustained the Commissioner's position,³ holding that although the petitioner had legal title to only seventy-nine per cent of the stock, his degree of control over the remaining twenty-one per cent amounted to "ownership" under section 1239.

Section 167 of the Internal Revenue Code provides for a deduction from ordinary income of a reasonable allowance for depreciation.⁴ Section 1231 permits the gain from a sale of certain depreciable property to be taxed at capital gains rates.⁵ Prior to the enactment of sections 1239,⁶ 1245,⁷ and 1250,⁸ a significant tax saving could be realized by depreciating property, selling it at a gain to a related taxpayer, and depreciating it a second time.⁹ Section 1239 attempts to prevent this saving by providing that gains

* 43 T.C. 127 (1964).

1. The option agreement provided that petitioner could purchase the stock at its book value without considering good will whenever the third party ceased to be an officer of the corporation; the corporate by-laws provided that an officer could be removed at any time, without cause, by a majority vote of the stockholders.

2. INT. REV. CODE OF 1954, § 1239.

3. One judge dissented on the issue of ownership, and three judges dissented on the collateral issue of permitting a depreciation deduction in the year of sale.

4. INT. REV. CODE OF 1954, § 167(a).

5. INT. REV. CODE OF 1954, § 1231(a). However, if total losses on § 1231 property exceed total gains, the individual gains will be treated as ordinary income and the individual losses will be treated as deductions from ordinary income. *Ibid.*

6. INT. REV. CODE OF 1954, § 1239 (formerly Int. Rev. Code of 1939, § 117(o)). Section 1239 was enacted in 1951. See Revenue Act of 1951, § 328.

7. INT. REV. CODE OF 1954, § 1245, enacted in 1962. See Revenue Act of 1962, § 13, 76 Stat. 960.

8. INT. REV. CODE OF 1954, § 1250, enacted in 1964. See Revenue Act of 1964, § 231, 78 Stat. 19.

9. H.R. REP. NO. 586, 82d Cong., 1st Sess. 26 (1951). "Thus, in effect, the immediate payment of a capital gains tax has been substituted for the elimination, over a period of years, of the corporate income taxes on an equivalent amount. The substantial differential between the capital gains rate and the ordinary rates makes such a substitution highly advantageous when the sale may be carried out without loss of control over the asset"

recognized from a sale or exchange of depreciable property between an individual and his controlled corporation are taxable as ordinary income.¹⁰ Section 1239 defines a controlled corporation as one which has more than eighty per cent in value of its outstanding stock owned by the taxpayer, his spouse, and his minor children and minor grandchildren, but it does not define the word "owned."¹¹ In many instances the Commissioner can avoid this definitional problem¹² inherent in section 1239 by utilizing section 1245 or section 1250 instead of section 1239.¹³ Subject to certain limitations, sections 1245 and 1250, like section 1239, tax the gain realized upon the sale of a depreciable asset as ordinary income. This is accomplished by recapturing certain depreciation deductions and taxing an equivalent part of the realized gain at ordinary income rates, thereby reducing, and in many cases eliminating, the recognition of gain at capital gains rates.¹⁴ However, under sections 1245 and 1250, complete recovery of the realized

10. INT. REV. CODE OF 1954, § 1239:

"(a) TREATMENT OF GAIN AS ORDINARY INCOME—In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

(1) between a husband and wife; or

(2) between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren; any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

"(b) SECTION APPLICABLE ONLY TO SALES OR EXCHANGES OF DEPRECIABLE PROPERTY.—This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167."

11. *Ibid.*

12. For a discussion of this and related definitional problems, see generally Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 TAX L. REV. 253 (1960).

13. See generally Lasseigne, *The Revenue Act of 1964: Depreciation of Real Property, Controlled Corporations and Personal Holding Companies*, 39 TUL. L. REV. 41 (1964); Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 YALE L.J. 1483 (1963).

14. If § 1245 property is disposed of, the amount by which the lower of the amount realized or the recomputed basis of the property exceeds the property's adjusted basis is taxed at ordinary income rates. INT. REV. CODE OF 1954, § 1245(a)(1). An asset's recomputed basis is determined by adding to its adjusted basis all adjustments attributable to periods after December 31, 1961. INT. REV. CODE OF 1954, § 1245(a)(2). Generally, all depreciable assets other than buildings and their structural components are § 1245 property. INT. REV. CODE OF 1954, § 1245(a)(3).

If § 1250 property is disposed of, the applicable percentage of the lower of (1) the additional depreciation or (2) the excess of the amount realized over the adjusted basis of the property is taxed at ordinary income rates. INT. REV. CODE OF 1954, § 1250(a)(1). The applicable percentage is 100% minus one percentage point for each full month the property was held over twenty full months. INT. REV. CODE OF 1954, § 1250(a)(2). Additional depreciation includes adjustments attributable to periods after December 31, 1963, except that in the case of property held for more than one year, it means such adjustments only to the extent that they exceed adjustments that would have been taken under the straight line method of depreciation. INT. REV. CODE OF 1954, § 1250(b). Generally, § 1250 property consists of depreciable real property which is not section 1245 property. INT. REV. CODE OF 1954, § 1250(c).

gain as ordinary income cannot be accomplished if the sale price of the asset exceeds its original cost, if the asset is a building which has been held for more than one year, or if the asset was acquired prior to 1962 in the case of "section 1245 property" or prior to 1964 in the case of "section 1250 property."

In those instances in which capital gains treatment is not adequately prevented by the application of either section 1245 or section 1250, the definition of ownership as that term is used in section 1239 becomes critical. The regulations indicate that not only stock owned outright, but also stock owned beneficially by the taxpayer, his spouse, and his minor children and minor grandchildren is included within the eighty per cent ownership requirement.¹⁵ However, in *Mitchell v. Commissioner*,¹⁶ the first case to consider the section 1239 definition of ownership, this Regulation was expressly rejected as applied to the trust situation.¹⁷ In *Mitchell* the taxpayer and his wife held 79.54 per cent of the stock in a corporation, most of the remaining stock having been placed in irrevocable trusts in favor of the taxpayer's minor children. The Court of Appeals for the Fourth Circuit reversed the Tax Court¹⁸ and held that the stock which was beneficially owned by the taxpayer's minor children could not be added to the taxpayer's 79.54 per cent ownership interest to bring him within the eighty per cent requirement. In support of its position the *Mitchell* court pointed out that in other sections of the Code when Congress intended to include beneficial ownership within the statutory language it referred not merely to "stock owned" but to "stock owned, directly or indirectly, by or for" the taxpayer.¹⁹ Moreover, when section 1239 was first introduced in Congress the term "owned" was so modified.²⁰ Since the modifying phrase was not included in the final bill the court argued that Congress did not intend to include beneficial interests within the eighty per cent ownership requirement. In addition, the court reasoned that since the taxpayer's control over the trustee was based only upon a spirit

15. Treas. Reg. § 1.1239-1 (1957). "For the purpose of section 1239, a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren."

16. 300 F.2d 533 (4th Cir. 1962).

17. For a discussion of the rejection of the regulation in the *Mitchell* case, see 47 MINN. L. REV. 493 (1963).

18. 35 T.C. 550 (1960).

19. See INT. REV. CODE OF 1954, §§ 267(c), 707(b).

20. H.R. REP. No. 586, 82d Cong., 1st Sess. 120 (1951).

"[S]tock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its stockholders, partners, or beneficiaries. . . .

"[I]f an individual owns more than 10 percent in value of the outstanding stock of a corporation, . . . that individual shall likewise be considered as owning the stock of the corporation owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or the half blood), ancestors, and lineal descendants."

of confidence and cooperation, stock held by the trustee could not be included within the eighty per cent requirement because it was not within the control of the taxpayer or his minor children.

The petitioner in *Trotz* relied upon *Mitchell* as support for the proposition that beneficial interests are not included within the eighty per cent ownership requirement and argued that he had, at most, a beneficial interest in the stock issued to the third party. In rejecting the petitioner's argument, the *Trotz* court emphasized that the petitioner had failed to appreciate the significance in *Mitchell* of the lack of control by either the taxpayer or his minor children over the stock beneficially owned by the children. Thus, the *Trotz* court expressly adopted the control test implicit in the reasoning of the *Mitchell* opinion and made it abundantly clear that ownership under section 1239 does not turn on the distinction between legal and beneficial ownership.²¹

As discussed previously, the basic policy reason for the adoption of section 1239 was to prevent the favorable tax treatment made possible by sales of depreciable assets between a taxpayer and a corporation which he in fact controlled. Congressional intent that section 1239 be applicable only in cases in which the taxpayer actually controlled the corporation is made evident by two modifications incorporated into the final bill in response to Senate objections to the original House proposal.²² The stock ownership requirement was raised from fifty to eighty per cent, and the broad categories of relationships covered in the original constructive ownership provision²³ were narrowed so as to include only the taxpayer's spouse, minor children and minor grandchildren, parties over whom the taxpayer is likely to exercise a large measure of control. Thus, by adopting a control test as the basis for determining stock ownership, the *Trotz* court has complemented the legislative policy behind section 1239. It is interesting to speculate to what extent the Internal Revenue Service will attempt to apply the control test. In analogous gift situations, where it would seem that completion of a gift would turn upon relinquishment of control by the donor, the Internal Revenue Service has accepted the arbitrary rule that a gift is complete when the donor, retaining no legal or equitable powers in himself, conveys to an independent trustee, regardless of the degree of actual influ-

21. Harry Trotz, 43 T.C. 127, 132-33 (1964).

22. S. REP. No. 781, 82d Cong., 1st Sess., pt. 1, at 69-70 (1951). "It appears that the House provision would deny capital gains treatment to some bona fide transactions while failing to deny such treatment in cases of clear avoidance."

23. In the original bill the taxpayer was deemed to own stock owned directly or indirectly by or for his spouse, and if he and his spouse owned more than ten per cent of the outstanding stock of the company, he would also be considered as owning stock held directly or indirectly by or for his brothers, sisters, ancestors and lineal descendants. H.R. REP. No. 586, 82d Cong., 1st Sess. 120 (1951).

ence that the donor may have over the trustee.²⁴ Adherence to this rule in section 1239 cases, while offering the same administrative convenience that it provides in the gift cases, would open a loophole allowing some control situations to escape section 1239 treatment. For example, section 1239 would not apply to a taxpayer who appoints as trustee an adult son or another person over whom he might exercise strong influence, provided the other is not his spouse, minor children or minor grandchildren. However, this loophole was presumably created deliberately when Congress itself limited the imputation of stock ownership in section 1239 to spouses, minor children and minor grandchildren.

24. Treas. Reg. § 25.2511-2(g) (1954), formerly Treas. Reg. 108, § 86.3 (1943), as amended, T.D. 5366, 1944 CUM. BULL. 583; T.D. 5606, 1948-1 CUM. BULL. 129, and T.D. 5833, 1951-1 CUM. BULL. 83.