South Carolina Law Review

Volume 27 | Issue 4 Article 8

2-1976

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TAX CONSEQUENCES OF SHORTAGES AND STOCK PURCHASES

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In the early months of 1974, many Americans began to feel the effects of the oil boycott imposed on certain Western nations and the resulting energy crisis. One conspicuous difficulty faced by many American businesses concerns shortages in the supplies of vital materials. In order to minimize supply problems during a period of shortage, companies have joined together in joint ventures[1] and have even resorted to bartering.[2] A widely used technique is the purchase of stock in a supplier company for the purpose of insuring a supply of that company's product to the purchasing company. In many instances, such a stock acquisition is the only practical means available to the taxpayer for maintaining a flow of necessary supplies. If business reasons dictate such an acquisition, the taxpayer should be familiar with the tax rules which have evolved in this area. The question discussed in this article is whether stock acquired in this fashion is to be treated as a capital asset or as an ordinary asset.

The law provides, with certain exceptions,[3] that the term

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1. Hill, *More Firms Entering Oil & Gas Business to Assure Own Supply*, The Wall Street Journal, July 15, 1974, at 1, col. 1.

2. Lublin, *Many Companies Turn to Bartering as Way to Get Vital Materials*, The Wall Street Journal, Feb. 13, 1974, at 1, col. 1.

3. INT. REV. CODE OF 1954, § 1221:

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> 1) stock in trade of the taxpayer or 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 trade or business;
>
> 2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
>
> 3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by —
>
> A) a taxpayer whose personal efforts created such property,
>
> B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
>
> C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

"capital asset" means property held by a taxpayer either in a business or personal context. The exceptions pertain to property of the taxpayer which constitutes the very items that he customarily buys and sells, such as inventory and property held primarily for sale to customers in the ordinary course of doing business.

Under the prima facie meaning of the statute, stock in a company purchased by another company would clearly appear to come within the definition of a capital asset. The statute does not make special provision for stock purchased for a noninvestment reason. In fact, the statute gives no consideration to underlying reasons for which stock may have been acquired. If a taxpayer company purchased stock in another company for the purpose of insuring a supply of the second company's product, and if the purchase of such a stock interest were held to be the purchase of a capital asset, when the stock was sold, a capital gain or capital loss would result.

Although the statute contains no exceptions to the definition of a capital asset which would cover the type of acquisition mentioned above, case law has created an exception for stock purchased as an integral part of the business operation of the purchasing company. One of the best known early cases on the subject, *Corn Products Co. v. Commissioner*,[4] involved a company which manufactured products from grain corn. When droughts caused a substantial increase in the price of spot corn, the company found itself in a bind because of its limited storage capacity. In order to insure itself an adequate supply of corn at an economical price it adopted a policy of buying corn futures at harvest time each year when the price seemed favorable. The company would take delivery of the corn that it needed in its manufacturing process. The balance of the futures contracts would be sold during early summer if it did not appear that a shortage would develop in the near future. The company argued that the futures contracts constituted "property" under § 1221 of the Internal Revenue Code and that the futures were unrelated to the company's manufacturing process. Accordingly, it argued that the large

4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

5) an obligation of the United States or any of its possessions, or of a state or territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

4. 350 U.S. 46 (1955).

gains and smaller losses which resulted from the sale of the futures should be treated as capital gains and losses.

Referring to § 1221 of the Code, the Supreme Court pointed out that an exception to the normal tax requirements of the Code is provided for and, therefore, "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."[5] The Court conceded that the corn futures did not come within the literal wording of § 1221 which defines the kind of property which is excluded from the definition of a capital asset. Even though the corn futures in *Corn Products* did not literally fall within one of the exceptions to the definition of a capital asset, the Supreme Court decided that capital gain and loss treatment under § 1221 was intended by Congress to apply only to transactions which are not the normal source of the taxpayer's business; it was not intended to apply to transactions resulting from the day-to-day operations of the business. Testimony of the company's officers before the Tax Court indicated that the corn futures were bought as a means of solving a supply and cost problem relating to an item necessary in the manufacture of its product.[6] As a factual matter, the Tax Court and the court of appeals had concluded that the purchases of corn futures constituted an "integral part of its manufacturing business."[7] Accordingly, capital gain and loss treatment was denied to the taxpayer, even though the corn futures did not specifically come within the definition of the exclusions listed in § 1221.

Incidental to and Proximately Related to Taxpayer's Business

If the purchase of the stock or security in question by the taxpayer is viewed as incidental and proximately related to the taxpayer's business, the cases hold that the stock or security is not a capital asset. In both *Western Wine & Liquor Co. v. Commissioner*[8] and *Clark v. Commissioner*[9] the taxpayer acquired stock in the American Distilling Company as a means of insuring itself a supply of liquor. In 1943, American Distilling passed a resolution permitting its stockholders to purchase pro rata amounts of whiskey at book value. A shortage of whiskey existed at that time and the taxpayers decided that buying stock

5. *Id.* at 52.
6. *Id.* at 51.
7. *Id.* at 50.
8. 18 T.C. 1090, *appeal dismissed*, 205 F.2d 420 (1952).
9. 19 T.C. 48 (1952).

in American Distilling was a satisfactory means of maintaining an adequate supply, thereby permitting the operation of their businesses in as near a normal manner as possible. After the purchase rights were exercised, the taxpayers in each case sold the stock at a loss.

Since the question of the relation between the stock acquisition and the taxpayer's business operation is one of fact, where a loss occurs when the stock is sold, the Government is more likely to view the stock as a capital asset which is unrelated to the taxpayer's business activities. Significantly, in *Western Wine & Liquor*, the court stated that the stock had been acquired "incident to the conduct of its business and not for investment."[10] The stock had been sold promptly after the purchase rights had been exercised. Since the stock had not been acquired as an investment, but only for the purpose of acquiring whiskey, it was treated as property primarily held for sale to customers in the ordinary course of business.[11]

In addition to acquiring stock for the purpose of securing a source of supply of a particular item, the taxpayer may buy the stock for the purpose of securing the services of personnel needed in its operation. If such a purpose for the stock acquisition is shown, it has been held to be a purpose which is directly related to the taxpayer's business and hence, the deduction, if there is a loss, is allowed in full when the stock is sold.[12]

Where an employment situation is involved, the problem might arise on the part of the individual seeking the job. In *Hirsch v. Commissioner*,[13] the plaintiff had spent much of his life in the home furnishing business. After undergoing surgery, the taxpayer was precluded from engaging in many activities. He was offered a position with a particular company; in order to secure the position, however, he was required to purchase stock in the company. When he sold the stock at a loss, the court allowed the loss in full. Referring to the question of proximate relationship, the court indicated that when comparing the taxpayer's business with the source of the loss, it is necessary to look at the primary motivation of the taxpayer. Giving consideration to the extensive

10. 18 T.C. at 1099.

11. *See* Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962). *But see* Exposition Souvenir Corp. v. Commissioner, 163 F.2d 283 (2d Cir. 1947) which was one of the cases relied on by the Government in *Western Wine & Liquor*.

12. Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971). Chemplast v. Commissioner, 60 T.C. 623 (1973).

13. 30 CCH Tax Ct. Mem. 1008 (1971).

experience of the taxpayer in the home furnishing field and the fact that the employment contract referred to the stock purchases, the court concluded that the taxpayer's primary motivation in buying the stock was merely to secure employment in his field.

The purchase of stock to protect a position that one already occupies may also constitute a purpose which is directly connected with a trade or business. In *Steadman v. Commissioner*,[14] the taxpayer was already a stockholder and general counsel of a company. He purchased additional stock on the premise that by doing so he would prevent a change in the management of the company and thereby protect his position as general counsel. The court, finding that the taxapyer had purchased the stock to protect his earnings flowing from his position with the company,[15] upheld the taxpayer's deduction.

Acquisition Unrelated to Taxpayer's Trade or Business

The *Corn Products* case held that corn futures contracts were not capital assets even though they did not specifically fit into a definition of one of the exceptions. The reason for the decision was that the purchase and sale of the futures contracts were integrally related to the taxpayer's trade or business. But *Corn Products* did not open the door to anyone conducting a farming operation to take business losses on commodity futures. In *Meade v. Commissioner*,[16] the taxpayer, a farmer, purchased and sold contracts for corn and cattle futures. He contended that losses resulting from the sale of the futures contracts were ordinary and did not result from the sale of capital assets. The taxpayer argued that the transactions were either true hedges which would effectively place the futures contracts outside the definition of a capital asset[17] or that the transactions were an integral part of the business operation of the taxpayer which would bring them within the *Corn Products* doctrine. The Tax Court concluded that

14. 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970).

15. *Compare* Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494 (9th Cir. 1970), (contracts relating to baseball players held to be an integral part of the taxpayer's business and, therefore, within the *Corn Products* doctrine), *and* Pressed Steel Car Co. v. Commissioner, 20 T.C. 198 (1953) (ordinary loss deduction allowed with respect to stock purchased to settle claims and relieve itself of a burdensome contract), *with* Southeastern Aviation Underwriter, Inc. v. Commissioner, 25 CCH Tax Ct. Mem. 412 (1966).

16. 32 CCH Tax Ct. Mem. 200 (1973).

17. *See* United States v. Rogers, 286 F.2d 277 (6th Cir. 1961).

there had been no true hedging arrangement. Instead, the court believed that the taxpayer had acted as a "legitimate capitalist,"[18] speculating in the futures market at the same time he bought cattle. The court, holding that *Corn Products* did not apply to such transactions, observed that the taxpayer's

> commodity transaction is not designed to secure a source of supply while he sells current inventory, for his concomitant action in the actual market was to purchase, not sell his stock in trade. In short, no protective business function whatsoever has been served.[19]

The *Meade* case demonstrates how close the relationship must be between the acquisition and the taxpayer's business. Although the taxpayer was a farmer and the commodity contracts related to corn and cattle futures, the taxpayer was unable to show a sufficiently direct connection between the futures transactions and his farming operation. To insure the success of his farming operation, it was not necessary to engage in futures transactions in the manner that he did in order to protect his business.

There is authority for the proposition that the acquisition of the stock of a new or existing company must be both an *integral and a necessary* act in the conduct of the taxpayer's business. In *McCurdy v. United States*,[20] the taxpayer was arguably in the business of renting land and equipment to a controlled corporation. He had spent many years in the Cincinnati area and had also done business in Indiana, Kentucky and Michigan. He had never done any business in Florida. The stock in question was purchased in a Florida corporation. The plan of the Florida corporation was to build a golf course and to develop a contiguous residential area. There was no evidence in the case to show a need which the individual business of the taxpayer had in the stock of the Florida corporation. Nor was there any apparent relationship between the stock purchased and a need of the individual business. A long-term capital loss was allowed instead of a deduction under § 162[21] of the Code. In the situation where a taxpayer purchases stock in connection with an expansion and there is no showing that the acquisition related to the perpetuation of an existing business, the purchase is treated as a capital investment rather than as a business expense.[22] Where the stock acquisition

18. Meade v. Commissioner, 32 CCH Tax Ct. Mem. 200, 210 (1973).
19. *Id.*
20. 328 F. Supp. 1068 (S.D. Ohio 1971).
21. INT. REV. CODE OF 1954, § 162.
22. Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969).

goes beyond alleviating a shortage and, in effect, opens up new and expanded business opportunites for the taxpayer, it should be expected that the Government will argue that the stock acquisition went far beyond an attempt to solve a shortage and, rather, constituted the entry into a new and expanded business. The investment funds, accordingly, will be categorized as a capital investment rather than as an expenditure directly related to furthering the taxpayer's original business.

This argument was made by the Government in *Grier v. United States*.[23] The plaintiff company had always been engaged in the operation of restaurant businesses and eating places. On learning that a particular roadside restaurant was for sale, it began negotiations for its purchase. When negotiations were nearly concluded, the plaintiff discovered that the restaurant was owned by a corporation rather than by the individual with whom negotiations had been conducted. That individual, however, was the sole stockholder. It was also revealed that the lessor of the premises was unwilling to agree to an assignment of the lease. Accordingly, the parties agreed that plaintiff company would purchase the stock of the restaurant corporation rather than purchase its assets. They believed that such a procedure would make acquiring the lessor's consent unnecessary. The stock was bought in 1956 and sold in 1959 at a loss.

The plaintiff company operated the restaurant business in the same manner it would have operated the business if it had not been a corporation. The court pointed out that although corporate stock is ordinarily treated as a capital asset, when it is acquired and retained as an incident to the operation of the taxpayer's business and not for investment purposes, its sale will result in ordinary gain or loss. It held that all of the facts indicated that the stock was acquired incident to the taxpayer's business and, hence, the loss was treated as an ordinary loss. It is significant to note, however, that in the *Grier* case the Government made the argument that the operations of the restaurant were not "closely geared" or "important" to the taxpayer's other activities. The court, however, indicated that it was not aware of any cases holding that where a corporation spends considerable time and effort in a particular activity which is similar although not exactly like its other activities, such activity will not constitute an "incident" of the corporation's business merely because

23. 216 F. Supp. 928 (M.D. Ill. 1963), *aff'd*, 328 F.2d 163 (7th Cir. 1964).

it is not "closely geared" or "important" to the other activities of the corporation.

A corporation acquiring stock in another business might have less of a problem than an individual would have in trying to show the required relationship between the stock acquisition and the business of the taxpayer. Because a corporation is purely a business creature, there is a tendency to believe that an interest by the corporation in different activities is designed to further the corporation's original business and purpose, unless it is clearly shown that an investment purpose was present. There may be a tendency to feel that the scope of a corporation's activities is broader than that of the average individual so that the individual may have a somewhat more difficult time in showing that the acquisition of a new activity was "incident" to his trade or business.[24]

Corporations often make investments in securities which are not directly connected with their business activities. Bonds, for example, might be purchased either as an investment or because of some business requirement. In *Bagley & Sewall Co. v. Commissioner*[25] the government of Finland required that the taxpayer deposit United States Government bonds as the security for the performance of a contract relating to the manufacture and delivery of two paper making machines. The Second Circuit held that the loss on the sale of the bonds was treated as a business expense rather than a capital loss because the purchase of the bonds was directly connected with the taxpayer's business and never would have taken place but for the requirement imposed on the taxpayer in connection with the contract. If, on the other hand, a taxpayer purchases bonds on a voluntary basis with primarily an investment motive, the fact that the bonds may be said to serve a business purpose will not defeat the investment character of the expenditure.[26]

24. M.F.A. Cent. Cooperative v. Brookwalter, 427 F.2d 1341 (8th Cir. 1970), *cert. denied*, 405 U.S. 1045 (1972), where a taxpayer was required to invest in stock of a bank as a prerequisite to borrowing from the bank and the stock could be disposed of only to another eligible co-op, and only with permission of the bank. The taxpayer was unable to show that the purchase of the stock was an ordinary and necessary expense related to its business; accordingly, it was held to be a capital asset.

25. 221 F.2d 944 (2d Cir. 1955).

26. Wilaka Builders, Inc. v. United States, 64-2 U.S. Tax Cas. 93,171 (S.D.N.Y. 1964).

Survival Test

As indicated above, in order for the taxpayer to treat the purchase of stock as a business expense, the expenditure must be proximately related to its business and necessary to its operation. How necessary does it have to be? If the taxpayer could have remained in business, but less successfully, without making the expenditure, will it still qualify, under *Corn Products*, as a non-capital asset? It might be more appropriate to say that the terminology of § 1221 will be strictly applied unless the taxpayer can show extremely unusual circumstances which require treating a purchase of stock, normally a capital asset, as an ordinary business item.

In *Waterman, Largen & Co. v. United States*,[27] the taxpayer was in the business of selling, on a commission basis, yarn made by various mills. It lost one of its major accounts, became insolvent and threatened with the loss of its corporate existence. A mill located in South Carolina was for sale and the individuals behind the major account which had been lost agreed to take over the South Carolina mill. The parties agreed that the taxpayer could become the exclusive sales agent of the new corporation running the South Carolina operation if the taxpayer agreed to purchase $100,000 of the new corporation's stock. Eventually, the taxpayer sold the stock at a $75,000 loss. Even though the taxpayer was faced with avoiding liquidation or the dissolution of its worsted division at the time the stock was purchased, the Government argued that the stock had been purchased for the purpose of expansion of taxpayer's business on a permanent basis. The court held that the loss should be deducted either under § 162(a)[28] or § 165(a)[29] of the Code. It termed the expenditure "basically designed to insure continued life"[30] and stated that the ordinary and necessary business expense deduction under § 162 should not be denied merely because there was also the possibility that business expansion might result. The *Waterman* case reaches a sound result because it seems clear that the taxpayer was in no position to be investing. It had no excess funds for that purpose and was struggling to survive.

27. 419 F.2d 845 (Ct. Cl. 1969).
28. *See* note 21 *supra*.
29. INT. REV. CODE OF 1954, § 165:
(a) GENERAL RULE — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
30. 419 F.2d at 853.

A purchase of stock in another company which assists the taxpayer in the operation of its business and is a necessary expenditure should be sufficient to keep the stock from being a capital asset. In *Livesley v. Commissioner*,[31] the taxpayer and her husband were food brokers, distributors and wholesale dealers primarily in potatoes and onions. Between 1951 and 1952, demand for potatoes exceeded the supply and, on various occasions, the taxpayers could not purchase potatoes. In order to protect themselves against a shortage and also with the possibility of expansion in mind, the taxpayers bought the stock of a company which had been a country shipper (bought from farmers and sold to wholesalers) of potatoes. The Government contended that purchase of the stock was not really required to obtain potatoes. The facts indicated, however, that the taxpayers had been able to buy only small amounts of potatoes before they purchased the stock. After the stock purchase, the taxpayer's purchases from the company increased substantially.

The court indicated that it was not necessary for the taxpayers to prove that if they had not made the expenditures for the stock, their partnership would have been ". . . cripplied or would have failed. Responsible businessmen make legitimate expenditures every day which would not measure up to such a 'survival' test."[32]

The decided cases show that taxpayers should expect to be successful in arguing the stock is not a capital asset if they can show that the stock acquisition was an ordinary and necessary expense which was directly related to their trade or business. It will not be required of them to establish that unless the stock was purchased they would not have survived as a business. The ap-

31. 19 CCH Tax. Ct. Mem. 133 (1960).

32. *Id.* at 140. Along lines that the stock acquisition must be a last desperate attempt by the taxpayer to keep its head above water, before it will be considered a noncapital asset, the Government argued in *Southeastern Aviation Underwriters, Inc. v. Commissioner*, 25 CCH Tax Ct. Rep. 412 (1966), that the taxpayer had not exhausted all possibilities of obtaining an aviation management contract before it purchased stock in the company in question which enabled it to obtain a satisfactory aviation insurance management contract. Prior to the purchase of the stock in question, the taxpayer had rejected a contract offered by Lloyd's of London which would have greatly changed the nature of the taxpayer's operations, in the opinion of the court. To have accepted that contract, in the judgment of the taxpayer, would have been detrimental to the interests of the taxpayer. According to the court, the evidence also showed that prior to the stock purchase the taxpayer had made reasonable efforts, though unsuccessful, to secure an aviation management contract. The court held that the loss resulted from the sale of the stock in question and was properly deductible as a business expense or an ordinary loss.

proach taken by the courts seems proper; otherwise many expenditures for stock which insured a source of supply of inventory to a taxpayer or otherwise materially benefitted its day-to-day operations would be treated as capital in nature, unless some emergency aspect of the purchase could be shown. Such a result would unnecessarily hamper the freedom of companies (or other taxpayers) to make their own business decisions and receive a full business expense or business loss deduction for an expenditure which was made without any typical investment motives in mind.

Length of Time Stock Held

Although it is possible for a taxpayer to make an acquisition of stock and feel confident that because of the business nature of the purchase an ordinary gain or loss will result when the stock is sold, it is not only the events surrounding the purchase which are significant. The purpose for which the stock is actually held, particularly at the time of its disposition, will also have to satisfy the business orientation test if the taxpayer is to succeed in classifying the transaction as one involving a noncapital asset. In one of the early cases[33] in which a ruling in favor of the taxpayer on this issue was made, the court indicated that the taxpayer had sold the stock as promptly as possible after its purpose had been accomplished. The taxpayer's purpose was to insure itself a supply of whiskey; when the whiskey shortage ended, the taxpayer sold the stock in question.[34]

If the taxpayer retains the stock too long after it is no longer needed to accomplish the business purpose for which it was acquired, the stock will become a capital asset. Perhaps the two leading cases on this point are *Gulftex Drug Co. v. Commissioner*[35] and *Missisquoi Corp. v. Commissioner*.[36] These cases are helpful in at least setting limits on the time the stock may be safely held after the purpose of its acquisition has been accomplished. The *Gulftex* case was one of the "whiskey cases" where the taxpayer had acquired stock in American Distilling because of the purchase rights associated with the stock. The

33. Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1090 (1952).

34. *See also* Enoch v. Commissioner, 57 T.C. 781 (1972), where the bonds in question were purchased only to meet FHA requirements. The bonds were held not to come within the definition of a capital asset under § 1221 of the Code, and the court stated: "The bonds were sold as soon as the FHA loan was repaid and the restrictions were lifted." *Id.* at 798.

35. 29 T.C. 118 (1957).

36. 37 T.C. 791 (1962).

taxpayer retained the stock for a period of 9 years; it did not dispose of the stock after benefitting from the whiskey purchasing rights granted by the stock. For the years 1946 through 1952, the year of sale, dividends were paid with respect to the stock. It is significant to note that the stock was listed on the New York Stock Exchange and, therefore, it could have been easily liquidated.

The court pointed out that the purpose of the stock holding can change in a case of this kind and it is the purpose at the time of the sale which determines how the transaction will be taxed.[37] The taxpayer was held to have retained the stock as an investment after receiving the benefits from the whiskey purchasing rights. The court stated that ". . . when it held the stock beyond a reasonable time, after exercising the whiskey-purchasing privileges, it deprived itself of the benefit of the type of deduction allowed in the cases cited and relied upon by it."[38]

The *Missisquoi* case involved a taxpayer who purchased debentures in 1950 for the purpose of insuring itself a supply of unbleached sulphite pulp which it used in the manufacture of its product. The business necessity for holding the debentures ended no later than 1951, but the debentures were not sold until 1955. The interest paid on the debentures was 3% and during the years 1951-1955 the taxpayer received substantial amounts of interest. The court conceded that a noninvestment motive had caused the taxpayer to acquire the debentures in the first instance, even though the securities had the characteristics of a reasonable investment. It, nevertheless, pointed out that the taxpayer held the securities for at least 3 years after the need for unbleached sulphite pulp disappeared. Under these circumstances, there was no longer any reason for treating the debentures as anything other than capital assets. According to the court, capital gain or loss treatment will apply unless the securities are disposed of within "a reasonable time" after the business reason for their acquisition has ceased to exist. The president of the taxpayer had testified that beginning in 1952 he had made efforts to sell the debentures, but the court believed that there had not been "very exhaustive efforts" made to sell the securities. Retaining the debentures as an investment, moreover, was consistent with the taxpayer's history of investing in Government bonds and other securities. It was also noted that the debentures were carried on the company's

37. 29 T.C. at 121.
38. *Id.*

books as an investment and the gain realized on the redemption of some of the debentures in 1954 was reported by the taxpayer as a long-term capital gain. Although none of these factors, if taken alone, would prove that the taxpayer was holding the securities for investment purposes, taken together the court treated them as evidence of an investment purpose which tended to defeat the taxpayer's contention that the securities were being held only until such time as a buyer could be found.[39]

How long may the taxpayer wait after he no longer has a business need for keeping the stock or security in question before he sells it? Both the *Missisquoi* and *Gulftex* cases express the view that he must dispose of the stock within "a reasonable time" after the business need ceases. How long is a "reasonable time" when someone is attempting to sell a security? In *Booth Newspapers, Inc., v. United States*,[40] it took the taxpayer seven months to find a buyer for the stock and negotiate a sale. That period of time was not sufficient to convert the stock into a capital asset held for investment purposes. In *Booth Newspapers*, the stock owned in Michigan Paper Co. was not a listed stock, and the taxpayer relied on a firm of consulting engineers to find a purchaser. The decision to sell the stock in that case was made in July, 1953; negotiations for the sale began in the fall of 1953; the stock was actually sold in February, 1954. Had the stock in question been listed on the New York Stock Exchange, however, the court might have regarded its retention for seven months after the need for it had ended as effectively converting it into a capital asset. In that situation, because the stock could be readily sold, it would appear that the only logical explanation for retaining it was that the taxpayer wanted to hold it as an investment.[41]

The facts and circumstances of each case will no doubt control in reaching a determination of whether or not a taxpayer waited too long to effect the sale of securities. If there are no impediments to a sale, it would seem that a taxpayer would be

39. It has been held that the manner in which an asset is carried on the taxpayer's books is not conclusive. Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958); Tulane Hardwood Lumber Co. v. Commissioner, 24 T.C. 1146 (1955).

40. 303 F.2d 916 (Ct. Cl. 1962).

41. In Missisquoi Corp. v. Commissioner, 37 T.C. 791 (1962), the Tax Court expressed its opinion with respect to the dangers inherent in holding readily salable stock or securities until a better price can be obtained: "While it may have been a sounder business tactic to hold these debentures until a better price could be obtained for them rather than to dump them at a loss within a reasonable time after the necessity for holding them ceased, we do not think this is the kind of business activity which permits ignoring the capital gains and loss provisions." *Id.* at 798.

running a substantial risk in holding the stock longer than even several months, unless unusual facts would justify such a holding. Such unusual facts were present in *FS Services, Inc. v. United States*.[42] There, the taxpayer was a wholesaler of petroleum products and, because of supply problems, it became necessary for the taxpayer to acquire an interest in five refineries. The interest was acquired by a newly formed company, Premier Petroleum, the stock of which was purchased by the taxpayer and two other cooperatives in 1948. When the shortage ended the stock in Premier Petroleum was sold; the sale, however, took place seven years after the need for the stock ended. The court held that the acquisition had been based on valid business considerations and that there was no intent to make a capital investment. The Government relied on *Gulftex* and *Missisquoi* in arguing that at some time before the sale of the stock the original business purpose of the taxpayers changed to an investment purpose.

Despite the lapse of seven years after the shortage ended and before the stock was sold, the court held that the taxpayer could take an ordinary loss deduction. It pointed out that in *Gulftex* the stock was listed on the New York Stock Exchange and was readily salable. In the instant case, the stock was unlisted and had little marketability. The taxpayer had always shown a willingness and a desire to sell the stock and it made every reasonable effort to dispose of it. Under these circumstances, there was no conversion of the stock into a capital asset.

Factors Showing Investment Purpose

The purpose of the taxpayer is to acquire the inventory within a particular period of time. The purpose for which the stock was acquired was one which could be accomplished within a relatively short period of time.

It seems logical that the more stock a taxpayer acquires in another company, the greater an investment purpose he has. The Internal Revenue Service would be expected to argue that a taxpayer should acquire only enough stock to insure itself a source of inventory or to otherwise accomplish his business purpose.[43] The percentage of stock ownership acquired is probably still a factor to consider in deciding whether or not an investment purpose is present but, since the ruling was issued, case law has not

42. 413 F.2d 548 (Ct. Cl. 1969).
43. Rev. Rul. 58-40, 1958 CUM. BULL. 275.

found that factor to be controlling.[44] In *Booth Newspapers*, the two taxpayers involved purchased *all* of the stock of Michigan Paper Co., but they, nevertheless, were successful in showing that the stock was not a capital asset.

A case which was distinguished from *Booth Newspapers* and which clearly shows one situation where an investment purpose would result is *Duffey v. Lethert*.[45] The taxpayer company in that case was a jobber in the paper business but did not manufacture any of its own paper. In 1957, the taxpayer paid $10,000 to Educational Institute of Industry, Inc., for 500 shares of common stock and 50 shares of preferred stock in the Institute. The Institute had been formed to conduct research and studies in industry and for the purpose of developing and publishing surveys. In buying the stock, the taxpayer was not motivated by the thought of receiving dividend income. It was motivated by the thought of receiving profit on additional sales of paper to Harrison and Smith Company, one of the organizers of the Institute. The taxpayer, however, made practically no sales as a result of its stock acquisition. In 1959, the taxpayer sold its stock back to the Institute for only a fraction of what it had paid. Later, the Institute discontinued its operation.

The Court in *Duffey* referred to *Booth Newspapers* as being a very different kind of a case, since, in *Booth*, there was a shortage of newsprint which was essential to the taxpayer's operation. The stock in the paper company was acquired to secure a source of supply of newsprint, a purpose directly related to the business of the taxpayers. In *Duffey*, the taxpayer was not a struggling taxpayer which needed the business benefit it thought might result from the acquisition of stock in the Institute. In fact, the Institute, through Harrison and Smith, purchased only a small amount of paper, but the taxpayer still had a taxable income of $190,000 for the year 1958. The court stated that "[i]t is conceded that the stock purchase may have been a desirable one or even a reasonable one (if expansion of sales was desired) but it does not follow that the purchase was ordinary and necessary."[46] The court then went on to state the key difference between the two cases:

> There is a lot of difference in buying a source of supply of paper to keep from going out of business and buying stock in a new

44. Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).
45. 63-1 U.S. Tax Cas. 88,182 (D.C. Minn. 1963).
46. *Id.* at 88,191.

> and totally unproved company in an effort to increase sales. The former case is one of a necessary expenditure; the latter a speculative one. It does not matter that the gain to be derived took the form of profit on Duffey Company sales rather than dividend income from the Institute.[47]

The investment purpose in *Duffey* is found in the taxpayer's absence of need to acquire the stock and also in the nature of the company in which the ownership interest was acquired. The Institute was a new organization which was formed as a new venture; its stock was acquired primarily with a view toward future gain rather than to solve any immediate business problem of the taxpayer.

The way in which a transaction is treated on the books of the taxpayer may have some bearing on how the transaction will be treated. In one case,[48] the taxpayer was required to purchase stock in another company in order to secure springs at O.P.A. ceiling prices which it needed in the manufacture of furniture. The springs were treated on the taxpayer's books as part of the inventory for cost purposes. The stock was entered on the taxpayer's books in an account titled "securities." The stock was sold back to the company from which it was purchased in the year after purchase. The court refused to treat the stock as part of the cost of goods sold. It indicated that the record failed to show that the purchase and sale of the stock were anything other than what they appeared to be.[49] The decision was not based on the way the stock had been classified by the taxpayer, but it appears that the classification was one factor which influenced the decision.

In *Tulane Hardwood Lumber Co. v. Commissioner*,[50] the fact that the taxpayer had entered the debentures in question on its books as an investment and had received interest on the debentures was a consideration referred to by the court on the question of investment versus business expense. In that case, however, those factors were not sufficient to overcome other facts in the case indicating the business nature of the debenture acquisition.

In *Journal Co. v. United States*,[51] the taxpayer was successful on this issue even though it had almost $20,000 in dividends over four years from its stock acquisition and the transac-

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47. *Id.*
48. McGhee Upholstery Co. v. Commissioner, 12 CCH Tax Ct. Mem. 1455 (1953).
49. *Id.* at 1456.
50. 24 T.C. 1146 (1955).
51. 195 F. Supp. 434 (E.D. Wis. 1961).

tion had been shown in the taxpayer's records under an account labelled "Investments Special." The court in that case commented in detail on the effect of an entry in the taxpayer's books. It treated the entry as being competent evidence on the question of intent behind the stock transaction. It went on to state, however, that the entry had not properly reflected the nature of the transaction and the taxpayer could be permitted to show by other evidence the true intent of the transaction. Referring to the terminology used by the taxpayer in its own records, the court noted that "[t]his choice is not conclusive on the question of intent where the record clearly indicates that the Journal bought, retained, and sold the stock in order to secure a source of newsprint."[52]

Viewing the cases which have commented on the effect of the terminology used by the taxpayer in its books and on other factors such as the receipt of dividend or interest income with respect to the security, one is drawn to the conclusion that these facts come into prominence only if the taxpayer is unable to show by other evidence the business nature of the acquisition. If the facts will not justify a conclusion that the transaction was business oriented, then the court will more than likely refer to the taxpayer's own classification[53] (where the taxpayer termed it an investment) and the receipt of income with respect to the securities to support a decision against the taxpayer.

Treatment by Taxpayer

The cases involving the tax treatment available to the taxpayer who acquires stock for a business purpose have been neither precise nor consistent in describing the manner in which the taxpayer should report the transaction for this reason. It may be useful to refer to the various possibilities and some of the cases which are authority for each.

We might first consider the case where a taxpayer acquires stock in a company to insure himself a supply of inventory. When the inventory is sold, the taxpayer will realize ordinary income.

52. *Id.* at 438.

53. Listing securities as an investment by a taxpayer on its books, income produced by the securities while they are held, the fact that the purchaser had other investments, and whether or not there was a ready market for the securities have been referred to as "other indicators of intent." Troxell & Noall, *Judicial Erosion of the Concept of Securities as Capital Assets*, 19 TAX L. REV. 185, 203-4. The authors of that article take the position that of the four "other" indicators stated, only the indicator of a ready market for the security is significant.

Assume that he paid $10,000 for the stock in question and he retains it for two years, or just long enough to accomplish his purpose. He then sells the stock for $5,000. Where the stock is sold for less than its basis, it has been held that the difference between the sales price and the basis may be deducted as an ordinary and necessary business expense.[54]

Where the stock becomes worthless, it has been held that an ordinary *loss* results in the amount of the purchase price of the stock. In *Steadman v. Commissioner*,[55] the taxpayer purchased the stock to protect his position as general counsel with a company and, accordingly, the stock was not treated as a capital asset. If it has been treated as a capital asset as is the usual situation in the case of stock, then the loss would have been limited to capital loss treatment.[56] Since the stock was not treated as a capital asset, the loss was simply deductible as a business loss.[57]

In the whiskey supply cases,[58] the courts added the loss resulting from the sale of the stock to the cost of goods sold. This means that the loss would be added to the cost basis of the liquor which was acquired and would have the effect of reducing the profit on the liquor when it is sold. Since the liquor results in ordinary income when sold, this type of adjustment would reduce the amount of income subject to ordinary income tax rates and have the same effect as the allowance of a business expense or a business loss. The Government viewed the entire transaction as being made up of two parts—one, an acquisition of liquor and two, an acquisition of stock. The Government then argued that the separate stock purchase and sale gave rise to a short term capital loss. Viewing the transaction in this manner, the Govern-

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54. Hogg v. Allen, 105 F. Supp. 12 (D.C. Ga. 1952); Bagley & Sewall Co. v. Commissioner, 20 T.C. 983 (1953). The *Bagley & Sewall* case is somewhat different from the usual inventory case because the taxpayer was required to purchase United States Government bonds to secure the performance of a contract. The factual difference from the inventory cases is not significant, however, in deciding how to treat the disposition of the bonds. When the bonds were disposed of at a loss, the loss was treated as an ordinary and necessary business expense.

55. 424 F.2d 1 (6th Cir. 1970).

56. INT. REV. CODE OF 1954, § 165(g):

> (1) GENERAL RULE — If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

57. *Id.* § 165(a).

58. Clark v. Commissioner, 19 T.C. 48 (1952); Western Wine & Liquor Co. v. Commissioner, 18 T.C. 1090 (1952).

ment then contended that the cost basis of the liquor was only the amount actually paid for the liquor. Accordingly, when the liquor was sold, a larger gain would result than would be the case if the cost basis of the liquor were increased by the amount of the loss on the sale of the stock.

This cost of goods sold theory may be troublesome where the stock is sold in a year after the inventory or other property is sold.[59] Let us assume that the stock is acquired in the first year for the purpose of securing certain needed inventory. After the inventory is acquired, it does not sell, and eventually, in the second year, the taxpayer sells the stock at a price lower than was paid for it. If the cost of goods sold theory is used, would the loss on the stock be added to the cost of goods acquired in the second year (it may be that no goods were even acquired in that year) or must the loss be added to the cost of goods sold in the first year? If that is the case, it would be necessary for the taxpayer to file an amended return or claim for refund for the first year.

The Government's position prevailed in *McGhee Upholstery Co. v. Commissioner*.[60] There, the taxpayer purchased the stock of another company in 1946 in order to secure springs which were needed to manufacture furniture. A loss resulted from the sale of the stock in the year following the acquisition of the stock and springs. The court upheld the Government's position and held that the stock was simply a capital asset which gave rise to a capital loss when it was sold. It went on to state, however, that "[e]ven if it had been concluded that the purchase of the shares was to be treated as a part of the cost of goods, it was a purchase in 1946 and not in 1947, and any attempt to treat the loss either as cost of goods purchased in 1947 or an operating loss in that year would be clearly wrong."[61] It is difficult to follow the court's reasoning that an operating loss would be improper in 1947. Since the sale of stock actually occurred in 1947, that would appear to be the proper year for the operating loss, if one were to use the "loss theory" rather than the cost of goods sold theory. In any event, it seems clear that the cost of goods sold theory can cause problems with respect to the proper year to report the transaction. Because the amount of the loss cannot be determined until the stock is disposed of, it is strained to term the amount of the loss as a part of the cost of goods sold. Ordinarily, cost of goods

59. *See* Holzman, *Tie-in Purchases—Buyer's Loss on Resale*, 34 TAXES 411 (1956).
60. 12 CCH Tax Ct. Mem. 1455 (1953).
61. *Id.* at 1456.

sold items will represent expenditures made at or close to the time when the goods are actually acquired or in a transaction directly connected with their acquisition. Where the taxpayer must wait a substantial period of time (perhaps years) before he can ascertain the amount of his loss, it is difficult to think of the loss as a cost of goods sold item, particularly with reference to goods purchased years before.

It is possible that the expenditure for stock can be deducted as interest under § 163. In *Penn Yan Agway Cooperative, Inc. v. United States*,[62] the taxpayer was a farmers' purchasing cooperative and, as a condition to borrowing money from a bank, it was required to purchase certain stock from the lender bank on a quarterly basis. Taxpayer sought to deduct, either as interest under § 163 of the Internal Revenue Code or as an ordinary and necessary business expense under § 162 of the Code, the amount by which its payment for the stock exceeded its fair market value. The Government argued that the stock represented a capital investment and that there had been no disposition of the asset which would give rise to a capital loss.[63]

The court held that the amount in controversy represented interest which could be deducted as such under § 163. It reached that result ". . . particularly because the amount of such stock required to be purchased by law and by the loan agreements involved was measured by a percentage of the interest payable on plaintiff's outstanding loan obligations to the bank issuing the stock."[64]

A final possibility is for the sum paid for the stock in question to be treated as an investment and for future additional amounts paid to the supplier company, for example, to be treated as additional contributions to the capital of the company, rather than part of the cost of goods sold. There is authority in cases involving payments made over and above O.P.A. ceiling prices[65] that the

62. 417 F.2d 1372 (Ct. Cl. 1969).

63. *Id.* at 1373.

64. *Id.* at 1382. In M.F.A. Cent. Cooperative v. Bookwalter, 427 F.2d 1341 (8th Cir. 1970), where it was found that the taxpayer received stock for the "additional money" paid, the purchase price of the stock was held not to be interest and was not treated as a deductible ordinary and necessary business expense. The interest concept did not appeal to the court because the stock was not considered by the parties to be payments for the use of money. The stock, which had not been sold or exchanged, was treated as a capital asset under § 1221. In addition, the court indicated that the stock had not become worthless and therefore § 165 did not apply.

65. Sullenger v. Commissioner, 11 T.C. 1076 (1948); Young v. Commissioner, 11 CCH Tax Ct. Mem. 863 (1952).

excess amount paid should be treated as part of the cost of goods sold. But additional contributions were held to be contributions of capital[66] where a taxpayer was required to purchase stock of a meat supplier and then make additional payments to insure a supply of meat. Had all of the additional payments been treated as part of the cost of goods sold, the cost of such goods would have risen above the price permitted by law and the taxpayer would have been in the position of having made illegal payments. The court was reluctant to attribute such conduct to the taxpayer.

Conclusion

Although the statute defining a "capital asset"[67] seems to provide a clear definition and even specifies exceptions which fall outside of the general definition, courts have added their own exception in the case of a purchase of securities (normally a capital asset) which is directly related to the operation of the business. Many uncertainties exist in this area: Will the initial stock purchase be treated as made for investment or business purposes? What type of "business purpose" will satisfy the court-made exception to the definition of a capital asset? How quickly must the stock be sold after the business purpose of its acquisition ceases to exist? One writer has suggested that many of the problems in this area could be solved by establishing objective guides for applying the *Corn Products* doctrine, by requiring a taxpayer to make an irrevocable election to treat the stock as non-capital at the time he acquires it (an election which would not, however, be binding on the Commissioner) and by setting a time limit on how long an asset may be held in order to qualify under the non-capital asset category.[68] It would appear impractical and undesirable for Congress to attempt to legislate an answer to these problems. The key question involved is essentially factual in nature, and it is no more difficult to resolve than other factual problems presented by the Internal Revenue Code. For example, the question of whether or not a particular asset is held "primarily for sale to customers in the ordinary course of his trade or business"[69] is a factual question which courts constantly contend with in determining the capital gain or loss versus ordinary income question. Resolving the instant problem involves the same kind of consider-

66. Sackstein v. Commissioner, 14 T.C. 566 (1950).
67. INT. REV. CODE OF 1954, § 1221.
68. Kauffman, *A Second Look at the Corn Products Doctrine*, 41 TAXES 605 (1963).
69. INT. REV. CODE OF 1954, § 1221(1).

ations and is no more difficult. The establishment of rigid rules in this area could have the effect of restricting the activities of companies and other taxpayers particularly in times of shortages, when the ability to choose any logical means of satisfying a supply problem should be available. In cases where non-capital asset status is permitted, the tendency of recent cases seems to be to treat the loss as a business expense or business loss, rather than as part of the cost of goods sold. Business loss treatment seems most appropriate because an asset has been disposed of. That treatment also clearly fixes the year of loss. Although the area presents difficulties, the courts have taken a fair approach to the issue and, if taxpayers understand the many cases which have been decided in taxpayers' favor, they should have a reasonably clear picture of what might be expected when they acquire a security to alleviate a shortage in order to give that security a non-capital asset status.