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SOME LEGISLATIVE IMPLICATIONS OF THE HISTORY OF THE JUDICIAL INTERPRETATION OF SECTION 1221

by

HANS-DIETER SPROHGE*

INTRODUCTION

The history of judicial interpretation of the definition of a capital asset from the Supreme Court’s 1955 *Corn Products* decision to its 1988 *Arkansas Best* decision points out the need to link any reestablishment of a capital gains tax with a reformulation of the definitions of what is and what is not a capital asset. The history shows that without such a link congressional intent may be thwarted. Presumably, the objectives of any reestablishment of a preferential capital gains rate will include (1) removing the impediments to economic growth caused by taxing capital transactions at ordinary income rates and (2) increasing Government revenue. These objectives may be frustrated by using the rules applicable to ordinary income to tax capital transactions. The rules of ordinary income taxation may be misapplied if the list of properties specifically excluded from the definition of a capital asset is misinterpreted by the courts.¹

The history of judicial interpretation of the present formulation of the definition of an excluded asset shows that the definition can be given incompatible interpretations. As a result, the definition was applied to a variety of assets not specifically excluded from the definition of a capital asset. The *Corn Products* decision applied the definition to corn futures. At the time of the *Corn Products* decision and for most of the period following it, the conventional construction of the *Corn Products* decision was that the Supreme Court viewed the definition of an excluded asset to be any property essential to everyday operations. This view of the definition of an excluded asset served as precedent for expanding the list of excluded properties beyond those specifically excluded by the Internal Revenue Code (Code) from the definition of a capital asset. In the *Arkansas Best* decision, the Supreme Court attempts to limit the application of the definition of an excluded asset to those properties specifically excluded from the definition of a capital asset and to inventory related futures contracts.

As the Supreme Court itself points out which interpretations of the definition

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¹ Although the Code does not refer to them as such, for the sake of brevity the properties specifically excluded from the definition of a capital asset are herein referred to as excluded assets.
of an excluded asset would fulfill congressional policy objectives if a preferential capital gains rate is reestablished may not be settled by its Arkansas Best decision. Since futures contracts are not included in the definition of an excluded asset, the question arises whether the Arkansas Best decision would meet congressional policy objectives. Even if the decision would meet congressional policy objectives, lower courts may nevertheless interpret the decision in a manner not intended by the Supreme Court just as the Corn Products decision was interpreted by lower courts in a manner not intended by the Supreme Court.

This article consists of six sections. The first section briefly indicates the economic significance of the correct classification of property as either a capital or an excluded asset. In the second section, the definition of a capital asset and the list of properties specifically excluded from the definition are presented and analyzed. The analysis demonstrates how the present formulations of the definition of an excluded asset can be given a broad and a narrow interpretation. The third section discusses how the Corn Products decision was conventionally construed to be based on a broad interpretation of the definition of an excluded asset. The fourth section shows how post-Corn Products judicial developments relied on the conventional construction for expanding the list of excluded properties to properties not specifically excluded from the definition of a capital asset. Rather than going into detail about each type of property to which the definition of an excluded asset was applied, corporate securities are used as a surrogate for all of them. The fifth section presents the Supreme Court’s attempt to limit the application of the definition of an excluded asset to those properties specifically excluded from the definition of a capital asset and to inventory related futures contracts. Through an analysis of the Arkansas Best decision, this section also demonstrates that expansion of the list of excluded properties is not precluded by the Arkansas Best decision. The last section points out some policy issues Congress needs to consider if it reformulates the Code’s definition of a capital asset and the properties specifically excluded from the definition.

SOME ECONOMIC CONSEQUENCES OF A PREFERENTIAL CAPITAL GAIN RATE

Applying ordinary income rates to capital gains hobbles economic growth by (1) deterring the conversion of capital assets and (2) pushing up the rate of return required on the proceeds from the sale of a capital asset. If the appreciated value realized upon the sale of a capital asset is subject to ordinary income rates, it will be taxed more heavily at the time of sale than if the appreciation had been taxed on an annual basis. This higher tax liability deters the sale of a capital asset. For example, suppose the owner of a downtown parcel of unimproved land currently rents it out to an entrepreneur who uses it to operate a parking lot. Several years ago the

acquisition cost of the land was $10,000. Since then it has appreciated in value to $12,000. The landowner’s yield from rent is 5%. The landowner receives an offer for the market value of the land from a developer who wants to erect a hotel on the site. The developer’s plans include the creation of a parking lot in the basement of the hotel and a shopping mall on the first floor. Implementation of the developer's plans would benefit the local economy. Yet, the following deterrents to selling the parcel of land may deprive the local economy of the incremental growth that would result from the construction activity, hotel, and shopping mall: (1) If the sale is postponed, so is the tax. (2) If the land is never sold, the tax never has to be paid provided the owner holds the land until it is passed on by gift, charitable contribution, or death. (3) If the landowner is in a higher income bracket this year than he expects to be next year, he can reduce his tax liability by delaying the realization of gain. These impediments are all attributable to taxing capital gains at ordinary income rates. Taxing capital gains at preferential rates removes these obstacles to economic growth.

Taxing capital gains at ordinary rates pushes up the rate of return required for the reinvestment of the proceeds from the sale of a capital asset to a level higher than would be the case if the gains were taxed at lower capital gains rates. For example, suppose the landowner is contemplating reinvesting the proceeds from the sale of the land in common stock of a new venture. The landowner must weigh the 5% rate of return he currently receives in the form of rental revenue against the rate of return of an investment in the new venture of an amount equal to the proceeds from the sale of the land reduced by the tax payable on its appreciation. As the tax rate increases and threatens to absorb a larger proportion of the accrued gain on an investment, the investor becomes less willing to cash in his appreciated investment property in order to take advantage of the new investment opportunities. The rate of return required in order for the new investment of the reduced amount to merely equal the yield of the old investment increases and the investment opportunities offering such a return decreases. For example, if the landowner is subject to a 90% tax rate, his proceeds will be $12,000. Assuming no transaction costs, the rate of return the new venture will have to yield the landowner in order for him to break even is 5.8% of 16% more than his old investment. The consequences of taxing capital gains at ordinary income rates are considerable for the economy and Government tax revenues.

Economic growth is slowed by taxing the appreciation in value of capital assets at ordinary income rates. Economic growth is maximized if each individual allocates his investment resources to maximize his yield. Obviously different individuals view the same investment opportunity differently. As long as each individual invests in those opportunities he thinks have the greatest relative value, society’s resources are allocated with maximum market efficiency. To the degree

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to which the amount of taxes payable upon the sale of a capital asset deters its sale and the reinvestment of the proceeds, maximum efficiency will not be obtained. Deterring the sale of capital assets limits the pool of available capital for reinvestment. Raising the rate or return required on the reinvestment of the proceeds from the sale of a capital asset discourages risk taking. Generally, investments yielding a high rate of return are riskier than those yielding a low rate of return. High rates of return are usually associated with new growing ventures. Hence, by pushing up the rate of return required on the reinvestment of the proceeds of the sale of capital assets, economic growth is stultified.

It is perhaps too obvious to require explanation, but tax revenues from capital gains can not be collected unless they are realized. The Government’s tax revenues on capital gains are limited to the degree to which taxing them at ordinary income rates deters their realization. Furthermore, to the degrees to which taxing capital gains at ordinary income rates stunt economic growth, they limit the creation of new jobs and the taxes on the income of those jobs. By limiting the maximum tax rates on capital gains, Congress may remove the deterrent effects that ordinary income rates have on economic growth and Government tax revenues.

THE DEFINITION OF A CAPITAL ASSET

The Internal Revenue Code (Code) defines “capital gain” and “capital loss” in terms of “the sale or exchange of a capital asset.” Section 1221 defines a capital asset as follows:

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 of 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 in part by reference to the basis of such property in the hands if a taxpayer described in subparagraph (A) or (B);
(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);
(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by--
(A) a taxpayer who so received such publication, or
(B) a taxpayer in whose hands the basis of such publication is determined for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A). 6

The problem with this definition is that the list of properties excluded from the class of capital assets is subject to alternative constructions. The list may be construed to be a definition by genus and difference or as an enumerative definition.

Every definition has two parts, a definiendum and a definiens. 7 The definiendum (literally, "thing to be defined") is the word or expression the meaning of which the definition attempts to explain. 8 The definiens (literally, "thing that does the defining") is the explanation of the word or expression to be defined. 9 Usually, the definiens explains the essential attributes of the definiendum. For example, one of the essential attributes of the definiendum "mammal" is "possesses a spine." The proof that an attribute is essential is that a contradiction results if the definiendum is affirmed while one or more of its essential attributes is negated. For example, a "spineless mammal" is a contradiction. Something can not be both "spineless" and a "mammal."

6 Id.
7 N. RESCHER, INTRODUCTION TO LOGIC 30 (1964).
8 Id.
9 Id.
Definition by genus and difference consists of the following two-step procedure:

1. The definiendum is located within some broad class (the genus).
2. Some essential attribute (the difference or specific difference) that distinguishes the definiendum from the other members of the genus is indicated.¹⁰

One logical construction of the Section 1221 definition of an excluded asset is that it is a definition by genus and difference. On this construction of the Section 1221 definition of an excluded asset, the definiendum is property and the specific difference is not specified. The specific difference must be inferred from what is common to each excluded asset. The significance of this view of the nature of the definition of an excluded asset is that the list of excluded assets may be expanded beyond that provided in Section 1221.¹¹

An enumerative definition provides a complete list of the items to which the definiendum applies.¹² For example, an enumerative definition of "U.S. Coin" is "penny, nickel, dime, quarter, half-dollar, dollar." The set of items that constitute the definiendum in an enumerative definition may or may not have an essential, or set of essential, attributes that is common to each member of the set and that differentiates it from items not belonging to the set. If the essential attributes are not known, they are difficult to infer from the members of the set. For example, no one particular metal is an essential attribute of "U.S. Coins" because they are variously composed of copper, nickel, or silver. Since the list of excluded assets is short, another logical construction of the Section 1221 definition of an excluded asset is that it is an enumerative definition. The significance of this view of the nature of the definition of an excluded asset is that the list of excluded assets may not be expanded beyond that provided in Section 1221.¹³

THE CORN PRODUCTS CASE

*Corn Products Refining Co. v. Commissioner* concerned, in part, the tax treatment to be accorded profits and losses from transactions in corn futures.¹⁴ More specifically, do such gains and losses result in capital gains and losses or do they give rise to ordinary income and deductions? The Corn Products Refining Company (CPRC) was a manufacturer of products made from grain corn, including starch syrup, sugar, and their by-products feed and oil. CPRC's principal product was

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¹⁰ *Id.*

¹¹ The view that the Section 1221 definition of an excluded asset is a definition by genus and difference is here referred to as the broad construction.

¹² RESCHER, *supra* note 7, at 36.

¹³ The view that the Section 1221 definition of an excluded asset is an enumerative definition is here referred to as the narrow construction.

starch from which cerelose was derived. Cerelose is a refined sugar that competes with cane and beet sugar, but at a lower price. The price competitiveness of cerelose with substitutable cane and beet sugars is a function of the cost of the most important direct material input used in the manufacturing process, grain corn. If the price of spot corn is sufficiently high, price competition will be difficult if not impossible. CPRC experienced uncompetitively high price levels for spot corn during the 1934 and 1936 droughts in the corn belt. To avoid a recurrence of the inability to engage in price competition because of high spot prices for corn, the CPRC considered two strategies.

The two strategies were based on the seasonal pattern of spot corn prices. All else being equal, spot corn prices are generally lower at harvest and rise over time as supplies dwindle until the next harvest. One strategy that takes this seasonal pattern into account is to buy spot corn at harvest and store it until needed. This strategy meant building additional storage capacity. Another strategy is to buy future corn and take delivery as needed to satisfy manufacturing operations and sell the remainder in early summer if no shortage is imminent. If shortages develop, futures can be sold as spot corn is bought for grinding. In this manner, a balanced position can be reached with respect to any increase in spot corn prices. In 1937, CPRC adopted the futures strategy "as a part of its corn buying program" and "as the most economical method of obtaining an adequate supply of corn" without incurring the expenditure of large sums for additional storage facilities. To build additional storage capacity in order to maintain a large supply over a long time would require incurring burdensome financing costs both on the facilities and the large inventory. As a result of implementing the futures strategy, CPRC had net annual gains from transactions in corn futures in some years and net annual losses in others. The tax treatment to be accorded these gains and losses turned on the Supreme Court’s interpretation of Section 1221.

The Corn Products Decision

The Supreme Court decided the issue of whether the results of CPRC’s transactions in corn futures should be accorded capital or ordinary tax treatment in favor of the Commissioner. That is, the Court held that CPRC’s profits and losses from corn futures should be accorded ordinary loss tax treatment. The Court’s reasoning was, in part, as follows:

Nor can we find support for petitioner’s contention that hedging is not within the exclusions of § 117(a) [now § 1221]. Admittedly, peti-

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15 Id. at 48.
16 At the time of the Corn Products decision, the definition of a capital asset was promulgated in Section 117 of the 1934 Code. Section 117 is the forerunner of Section 1221 of the present Code. The statutory schema remains the same. All subsequent references to the definition of a capital asset or excluded asset are to Section 1221 of the current Code.
tioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of §117 [now 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. *Burnet v. Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday operations of a business be considered as ordinary income or loss. The preferential treatment provided by §117 applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments and to remove the deterrent effect of those burdens on such conversions." *Burnet v. Harmel*, 287 U.S. at 100. Since this section is an exception to the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term "capital assets" in §117. See *Hort v. Commissioner*, 313 U.S. 28, 31; *Kieselbach v. Commissioner*, 317 U.S. 399, 403.17

The conventional construction of these words was that the Court interpreted the definition of an excluded asset as a definition by genus and difference. On this construction of the *Corn Products* decision, the Supreme Court was viewed as accepting "property" as the genus and finding the difference by examining congressional intent. According to the Court, Congress intended property used in everyday operations to be accorded ordinary tax treatment. Thus, the Court's implicit definition of an "excluded asset" was "property used in everyday operations." The Court examined CPRC's futures contract transactions to determine whether they were essential to "everyday operations." By concluding that the futures contracts were essential to "everyday operations," the Court held that the results of those transactions should be accorded ordinary tax treatment, even though futures contracts are not excluded assets. Some commentator's who share this construction of the Corn Products decision are Chirelstein,18 Gustafsson,19 Javaras,20 LeMaster,21 Surrey,22 Troxell & Noall,23 and Tucker.24 Additionally, a number of

17 *Corn Products*, 350 U.S. at 52.

**POST-CORN PRODUCTS DEVELOPMENTS**

An ordinary loss may be netted against both ordinary income and a capital gain.30 A capital loss may be netted only against a capital gain.31 An unused capital loss may be carried back three years or forward five years to offset a capital gain in those years.32 Any losses remaining after the three year carryback and five year carryforward period expire."33 Therefore, a taxpayer with a loss from a capital asset would prefer to have the loss classified as ordinary.

Under the conventional construction of the *Corn Products* decision, a loss from a capital asset may be accorded ordinary tax treatment if the loss can be shown to result from an asset that is essential to everyday operations. Since on the conventional construction, no test is provided by the Court for determining whether an asset is essential to everyday operations, such a test had to be developed. The first test to develop for determining the circumstances under which property would be considered essential to everyday operations was the business motivation test. That motivation should be determinative for the classification of an asset as business or investment is not immediately evident. For example, no significant objective difference exists among various shares of the same class of stock in the same corporation. Except for insignificant differences attributable to stock certificates, one common share of General Motors is virtually indistinguishable from any other outstanding share with respect to the risks and rewards of ownership. Nevertheless, the profits and losses resulting from ownership of common shares are given different tax treatment for different holders of the same type of security. The tax treatment of an investor in corporate securities is different from a dealer in the same type of securities. Since no objective attributes differentiate capital assets that are from those that are not essential to everyday operations, the courts in post-*Corn Products* cases looked to subjective factors.

They found them in taxpayer motivation. For a taxpayer with a loss in an asset only two motivations are relevant on the conventional construction of the *Corn

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30 I.R.C. § 165(a) (1986).
31 I.R.C. § 1211(a) (1986).
32 I.R.C. § 1212(a) (1986).
Products decision, investment and business motivation. The acquisition and holding of an asset may be motivated solely by investment purposes, solely by business purposes, or by a combination of business and investment purposes. Initially the courts applied the predominant motivation test. In the predominant motivation test, all factors indicating either investment or business motivation were weighed to ascertain whether the acquisition and holding of the asset was motivated primarily by a business purpose. Under the predominant motivation test, if the taxpayer was motivated primarily by investment purposes in acquiring and holding an asset, the asset was classified as investment property. If the taxpayer was motivated primarily by business purposes in acquiring and holding an asset, the asset was classified as business property. The predominant motivation test was used by the courts from the date of the Corn Products decision until 1971. Many early court decisions citing Corn Products deal with a single pattern of facts: the purchase of securities in order to secure a source of raw materials or inventory. Such acquisitions are known as tie-in purchases. Eventually the predominant motivation test was expanded to accord ordinary income tax treatment to corporate securities acquired for a variety of business reasons.

THE PREDOMINANT MOTIVATION TEST

Typical of the tie-in purchases cases is Booth Newspapers, Inc. v. United States in which the taxpayer, a newspaper publisher, purchased shares of a paper mill to assure a steady supply of newsprint during a shortage. Subsequently, when the shortage eased and newsprint became available from regular sources of supply, the publisher sold the shares. The taxpayer treated the loss as an ordinary loss. The Commissioner contended Booth had acquired a manufacturing subsidiary that it held for some years. As such, Booth’s loss was a capital loss. The Court citing Corn Products, among other precedential cases, formulated the predominant motivation test as follows:

[i]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be [sic] found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

By applying the primary motivation test to Booth’s acquisition of the paper mill stock, the Court found that Booth’s primary motivation was to acquire a source of

34 Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962).
35 Id. at 921.
newsprint even if the subsidiary continued to manufacture and sell an unrelated line of products as well. In the hands of Booth, the paper mill stock was not a capital asset. Hence, Booth's losses on the paper mill stock were ordinary losses. Raw material and inventory are not the only assets used in a business in everyday operations.

Losses on securities purchased for other than tie-in considerations qualified for ordinary income tax treatment if the acquisition could be shown to be primarily motivated by the needs of everyday operations. For example, in Schlumberger Technology Corp. v. United States, the taxpayer's primary business was measuring physical phenomena in the earth for aid in the detection of oil, gas, and other minerals, as well as for scientific space exploration and other purposes. Electromechanical Research Incorporated (EMR), a wholly owned subsidiary of Schlumberger, "was also engaged in the measurement business, using taxpayer's and its own expertise and research to develop telemetry devices and related measurement components for use by military and space agencies in above ground measurement problems." EMR purchased the stock of American Systems Incorporated (ASI). ASI was organized for the purpose of designing, developing, manufacturing, and programming electronic systems, equipment and components for military use. Schlumberger believed that ASI's personnel could help it, through personal contacts, in obtaining government contracts for the electronic businesses in which it and EMR were engaged. Because of unexpected adverse business conditions and ASI's failure to obtain governmental systems contracts, Schlumberger sold the stock in its subsidiary at a loss.

The issue before the Fifth Circuit was whether Schlumberger's loss was to be treated as an ordinary loss or as a loss from the sale of a capital asset. The Government rejected the predominant motivation test as the correct basis for deciding the issue. It argued that the loss was a capital loss for two reasons: The securities were neither acquired as (1) a "temporary business expedient" as in the tie-in purchase cases nor (2) to protect an existing business. The Fifth Circuit rejected both arguments adhering instead to the primary motivation test. It held that although the ASI acquisition was not essential to Schlumberger's primary business of measuring physical phenomena in the earth for aid in detecting minerals, the acquisition was essential to Schlumberger's secondary line of business of developing telemetry devices and related measurements for use by military and space agencies. Hence, Schlumberger's loss on ASI stock qualified for ordinary loss tax treatment. Had Schlumberger realized a gain on the sale of ASI stock, it could have claimed a capital gain on its tax return--in all probability without question from the Internal Revenue Service (Service). Under the predominant motivation test any taxpayer could claim ordinary tax treatment on losses from securities by demonstrating a business reason for acquiring them or capital tax treatment on gains by simply

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36 Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971).
37 Id. at 1116.
38 Id. at 1120.
claiming them as such on the return. This possibility led to the next stage in the development of the everyday operations test, namely, the substantial investment motivation test and the exclusive investment test.

**The Substantial Investment Motivation Test**

The conventional construction of the *Corn Products* decision in conjunction with the predominant motivation test increased the potential for taxpayer whipsaw. On the one hand, if a taxpayer realized a loss from the sale of securities acquired with part-business and part-investment motivations the taxpayer could obtain ordinary loss tax treatment by arguing that the securities were bought primarily for business purposes. On the other hand, if a taxpayer realized a gain from the sale of securities acquired with part-business and part-investment motivations the taxpayer could obtain capital gains tax treatment simply by claiming them as such on his return or, if questioned by the Service, by arguing that the securities were bought primarily for investment purposes. This whipsaw potential has its origins in the conventional construction of the *Corn Products* decision.

On the conventional construction, capital assets are distinguished from excluded assets on the basis of the everyday operations test. If the everyday operations test bifurcated property into two mutually exclusive and exhaustive classes this whipsawing would not be possible. Recall that because “business investment” is not a contradiction proves that “business purpose” and “investment purpose” are not mutually exclusive and exhaustive classes of property. Thus, on the conventional construction, property may be classified as both business property and investment property. The primary motivation test, by giving equal weight to business and investment motives and by characterizing the acquisition of securities in accordance with the dominant motivation, makes it no more difficult to argue that the securities are capital assets than it is to claim that they are not. The substantial investment motivation test evolved to close this loophole.

Unlike the predominant motivation test, the substantial investment motivation test does not require the weighing of investment motives against business motives in the acquisition of securities to determine which predominates and, therefore, the tax treatment of any losses upon their subsequent disposition. The substantial investment motivation test focuses solely on investment motives. Under the substantial investment motivation test, if substantial investment considerations motivated the acquisition of securities, then any loss realized upon their subsequent disposition would be denied ordinary loss tax treatment even if business motives predominate. In other words, whether or not the acquisition of the securities is essential to everyday operations is simply irrelevant. The securities may be necessary to assure a source of raw materials or inventory but would still be capital assets if their acquisition was at least partially motivated by investment considerations. Initially what constitutes a “substantial” investment motive was not clarified.
Eventually, any investment motivation was considered a substantial investment motive.

In 1971, the substantial investment motivation test was first applied in *Dearborn Co. v. United States*. In *Dearborn*, the taxpayer, a furniture manufacturer, purchased stock of Munising Delaware (MD), a producer of kiln dried lumber and furniture dimension parts, as well as a seller of a wide variety of finished wood products. At the time of acquisition, raw materials were difficult to obtain. It later sold the stock at a loss. The issue before the Court of Claims was whether, the loss should be accorded ordinary or capital tax treatment. Dearborn contended that it acquired the stock to fulfill one of its major business needs, wood supplies. The Government argued that Dearborn had acquired the stock as a permanent investment with a view to increasing its own business, managing MD’s business for fee income, receiving dividends from MD stock, and sharing in potential capital growth of MD’s business of selling a wide variety of wood products. The Court found that the predominant motivation for Dearborn’s acquisition of MD stock were based on business considerations. Nevertheless, the Court held that the shares of MD in the hands of Dearborn were capital assets because their acquisition was also motivated by investment considerations. The Court found the following to be indicative of investment motivation: (1) The stocks were acquired without a premium over market value. (2) The investment was permanent rather than temporary. (3) An investment profit was anticipated. Since shares of MD were capital assets in the hands of Dearborn, they were to be accorded capital loss tax treatment. In its decision the Court of Claims did not quantify the term “substantial.”

In *W.W. Windle Co. v. Commissioner*, the term “substantial” was used to mean “any.” Since 1912 Windle was in the business of processing and selling raw woolen stock and other woolen materials used by manufacturer’s of woolen cloth. During the 1950s, many of Windle’s customers went out of business because of increased foreign competition. As a result, Windle’s sales declined from approximately $9,500,000 in 1956 to $3,000,000 in 1961. To assure itself of a source of demand, Windle created a captive customer by organizing and purchasing a controlling interest in Nor-West Fabrics, Inc. (NWFI), a company that was to manufacture woolen products and, hence, buy wool products from Windle. Prior to establishing NWFI studies predicted that NWFI would be profitable and that Windle would profit from sales to it i.e., the value of Windle’s share in NWFI was expected to appreciate in value over time. NWFI’s actual performance did not meet expectations. It was profitable in only two out of its approximately nine years of operations. Eventually, NWFI’s assets were insufficient to meet the demands of its creditors and the corporation was liquidated at a loss to Windle.

The issue before the Tax Court was whether Windle’s loss on NWFI stock

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39 *Dearborn Co. v. United States*, 444 F.2d 1145 (Ct. Cl. 1971).
40 *Id.* at 1148.
should be accorded ordinary or capital tax treatment. Windle’s contended that its acquisition and holding of NWFI stock was motivated by business considerations and that therefore the stocks were excluded assets. The Government argued that Windle’s acquisition was partially motivated by investment considerations and that any investment motivation required capital tax treatment. The Court found evidence both of investment motivation and business motivation and that the latter predominated. Nevertheless, the Court held that stock purchased with any investment motive is a capital asset even if there is a predominant business motive for the purchase. The Court provided two reasons for its ruling. One reason is that the predominant motivation test enables the taxpayer to expand the list of excluded assets in Section 1221 to property unrelated to that list. Another reason for the ruling is that in the absence of a substantial investment motivation test, taxpayers would be presented with greater opportunities to whipsaw by claiming an “ordinary loss on unsuccess- ful investments and capital gains on successful one.”\footnote{Id. at 713.} Windle is the last development in motivation tests based on the conventional construction of the Corn Products decision prior to the Supreme Court’s Arkansas Best decision.

**The Arkansas Best Case**

Arkansas Best Corporation (ABC) is a holding company with subsidiaries engaged in the businesses of interstate trucking, new tire sales, used tire retreading, and data processing. In 1968 as part of a growth through acquisition strategy, ABC acquire 65% of the outstanding common stock of the National Bank of Commerce (NBC), located in Dallas. During ABC’s holding period, NBC went through a growth phase (from 1969 to 1972) and a problem phase (from 1973 and 1976). During both phases, ABC acquired additional shares of NBC stock by purchase, capital calls, stock dividends, and conversion of debentures. During the growth phase, the capital calls were made to accommodate the growth; during the problem phase, the capital calls were made in response to loan portfolio problems. Near the end of NBC’s growth phase, a 1970 amendment to the Bank Holding Company Act required ABC to divest itself of NBC or to cease acquisitions of either new, or going-concern, lines of nonbanking businesses. In 1971, ABC filed an irrevocable declaration of divestiture with the Federal Reserve Bank of Dallas that committed ABC to divest itself of control of NBC by 1981. In 1975, ABC sold 51% of the outstanding shares of NBC in one block and the balance of its holdings in installments from 1976 to 1980 pursuant to an option granted in 1975. The sales were made at a loss to ABC.

**The Supreme Court’s Arkansas Best Decision**

The issue before the Supreme Court was whether the losses ABC realized from the disposition of its holdings of NBC stock were to be accorded ordinary or capital
loss tax treatment. ABC's case before the Court relied upon three arguments each of which the Court refuted: First, ABC argued that the Section 1221 definition of the term "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)" turns on the motivation behind the acquisition of the property. The Court rejected this argument because (a) the Section 1221 definition of a capital asset does not mention a motivation test and (b) such a test is in direct conflict with the definition's parenthetical phrase "whether or not connected with his trade or business."

ABC also contended that the five exceptions to the definition of a capital asset listed in Section 1221 are illustrative rather than exhaustive 'and that courts are therefore free to fashion additional exceptions in order to further the general purposes of the capital asset provisions.' The Court rejected this argument for three reasons. (a) The locution "but does not include" in the Section 1221 definition of the term "capital asset" as "property held by the taxpayer[,] . . . but does not include" signifies that the five classes of property listed as exceptions are exclusive. Without calling it such, the Court viewed the exceptions to the definition of a capital asset as an enumerative definition of an excluded asset. (b) The legislative history supports the view that the five classes of property listed as exceptions to the definition of a capital asset are mutually exclusive. (c) The five exclusions would be "superfluous if assets acquired primarily or exclusively for business purposes were not capital assets." For example, inventory, depreciable property used in a taxpayer's trade or business, and accounts receivable acquired in the ordinary course of business would satisfy such a business motive test.

Finally, ABC maintained that the ultimate support for its position that motivation determines the character of an asset is the *Corn Products* decision. The Court rejected ABC's reliance on the *Corn Products* decision on the grounds that such reliance is based on a misinterpretation of the decision. The Court provided explicit interpretation of various parts of the *Corn Products* decision. When the Court stated in *Corn Products* that "the definition of a capital asset must be narrowly applied and its exclusions interpreted conventionally," what the Court meant was that the inventory exclusion of Section 1221, not that the phrase "property held by the taxpayer," was to be interpreted conventionally:

[although the corn futures were not "actual inventory," their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of "property of a kind which would properly be included in the inventory of the taxpayer" in § 1221.]

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44 Id.
45 Id. at 975.
46 Id.
When the Court stated in *Corn Products* that the reason CPRC’s futures contracts were not treated as capital assets was that the futures were “an integral part of its business,” what the Court meant was that the futures could not be considered substitutes for stored grain corn unless this close connection existed between the stored grain corn and the future contracts. If this connection did not exist, then CPRC’s futures dealings would amount to speculation in corn futures.

The Court added that another reason for not permitting securities to be treated as capital assets, without referring to it as such, is to prevent taxpayer whipsawing. The Court stated that one reason behind the *Corn Products* decision was to prevent CPRC from whipsawing the Government.

In the *Arkansas Best* decision, the Supreme Court stated that the correct interpretation of the *Corn Products* decision is as follows: “*Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business’ inventory-purchase system fall within the inventory exclusion of § 1221.”

In a footnote to this sentence, the Court notes that 25 years have elapsed since the *Corn Products* decision has been used by various courts to treat as ordinary assets property that is not specifically excluded from the class of capital assets in Section 1221. However, the Court felt bound by the language of the Code regardless of Congress’ reticence. The footnote adds that the creation of any exclusions from the class of capital assets as provided for in Section 1221 based on business motives, “must come from congressional action, not silence.”

**HOW THE LIST OF EXCLUDED PROPERTIES MAY BE EXPANDED IN LIGHT OF ARKANSAS BEST**

The *Arkansas Best* decision did not reverse the *Corn Products* decision. Rather, in *Arkansas Best*, the Court interpreted its earlier *Corn Products* decision. That interpretation reads, in part, as follows:

The Court stated in *Corn Products* that the company’s futures transactions were “an integral part of its business designed to protect its manufacturing operations against price increases in its principal raw material and to assure a ready supply for future manufacturing requirements.” 350 U.S., at 50. The company bought, sold, and took delivery under the futures contracts as required by the company’s manufacturing needs. As Professor Bittker notes, under these circumstances, the futures can “easily be viewed as surrogates for the raw material

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*Id.* at 977.

*Id.*
These words imply that the Court views surrogates for the inventory exclusion of Section 1221 to be subject to the same tax treatment as inventory itself. Hence, the list of excluded properties may be expanded beyond those specifically excluded by the Code from the definition of a capital asset if such properties can be shown to be surrogates for inventory. For example, in order for losses in corporate securities to be accorded ordinary tax treatment, the losses must be incurred because the securities were surrogates for inventory. An indication of how property may be regarded as a surrogate for inventory by the Court is provided by what it accepted as surrogate for grain corn in *Corn Products*:

...although the corn futures were not actual inventory, their use as an integral part of the taxpayers inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they were within a broad reading of "property of a kind which would properly be included in the inventory of the taxpayer in Section 1221."

By analogy, if corn futures are a substitute for grain corn because they are an integral part of an inventory-purchase system, then any property that is an integral part of an inventory-purchase system also should be substitutes for the inventory itself. For example, corporate securities that are an integral part of an inventory-purchase system also should be substitutes for the inventory itself.

How securities may constitute an integral part of an inventory purchase system can be inferred by analogy from these words:

A business connection although irrelevant to the initial determination of whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer’s business in *Corn Products* was crucial in whether the corn futures could be considered surrogates for the stored inventory of the raw corn. For if the futures dealings were not part of the company’s inventory-purchase system, and instead amounted simply to speculations in corn futures, they could not be considered substitutes for the company’s corn inventory, and would fall outside even a broad reading of the inventory exclusion.

These words show that the Court distinguished between speculation in futures and the use of futures as an integral part of an inventory-purchase system on the basis of

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49 Id. at 976.
50 Id.
51 Id.
a business connection. In *Corn Products*, inventory is the business connection. Hence, the purchase and sale of futures contracts constitutes speculation if inventory is unaffected and is an integral part of an inventory-purchase system if inventory is affected. In order for property to be an integral part of an inventory-purchase system, inventory must be affected by the purchase and sale of the property. For example, in order for corporate securities to be an integral part of an inventory-purchase system, inventory must be affected by the purchase and sale of the securities.

**POLICY ISSUES RAISED BY JUDICIAL INTERPRETATIONS OF SECTION 1221**

The history of judicial interpretation of the definition of a capital asset points out the need to link any reestablishment of a capital gains tax with a reformulation of the Section 1221. Presumably, Congress’ objectives in any reestablishment of a preferential capital gains rate include stimulating economic growth and increasing Government revenue. The achievement of these objectives may be undermined if ordinary tax treatment is accorded gains and losses resulting from transactions in capital assets. The history of judicial interpretation of Section 1221 suggest that congressional economic policy objectives may be undermined for two reasons: (1) In the *Arkansas Best* decision, the Section 1221 definition of an excluded asset may be interpreted incorrectly. (2) In the *Arkansas Best* decision, the Section 1221 definition of an excluded asset is interpreted correctly but the Supreme Court’s interpretation may be interpreted incorrectly by lower courts.

In the *Arkansas Best* decision, the Supreme Court itself points out the possibility that its interpretation may not serve congressional economic policy:

> Although congressional inaction is generally a poor measure of congressional intent, we are given some pause by the fact that over 25 years have passed since *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), was initially interpreted as excluding assets acquired for business purposes from the definition of a capital asset. See *Booth Newspapers, Inc. v. United States*, 157 Ct. Cl. 886, 303 F.2d 916 (1962). Without any sign of disfavor from Congress. We cannot ignore the unambiguous language of § 1221, however, no matter how reticent Congress has been. If a broad exclusion from capital-asset status is to be created for assets acquired for business purposes, it must come from congressional action, not silence.\(^{52}\)

As these words show, the Supreme Court does not find fault with the notion that according ordinary tax treatment to business property would further congressional economic policy. However, the formulation of the definition of an excluded asset in Section 1221 does not allow the ordinary tax treatment of business property. Thus,

\(^{52}\) Id at 977 n. 7.
an issue raised by the Supreme Court that needs to be addressed if preferential capital gains rates are reestablished by Congress is whether the Section 1221 definition of an excluded asset should be reformulated to include business property.

Even if the Supreme Court’s interpretation of Section 1221 is correct, the history of post-Corn Products developments suggests that the lower courts may incorrectly interpret the Arkansas Best decision. On the Supreme Court’s interpretation of Section 1221, ordinary tax treatment is limited to those properties specifically excluded from the definition of a capital asset or to properties that are substitutable for one of the excluded properties, e.g., corn futures. In the Arkansas Best decision, the Supreme Court used a substitution test to justify the ordinary tax treatment of losses in Corn Products’ grain futures. This substitution test may evolve in the lower courts in a manner unforeseen and unintended by the Supreme Court just as the everyday operations test in its Corn Products decision evolved in a manner unforeseen and unintended by the Supreme Court. To wit, the substitution test may evolve so as to allow the ordinary tax treatment of losses resulting from transactions in property that is neither an inventory-related futures contract nor specifically excluded from the definition of a capital asset. Such an evolution would undermine congressional economic policy just as the courts undermined congressional economic policy for approximately thirty years (if the Arkansas Best decision is correct) by allowing ordinary tax treatment of losses resulting from transactions in property that is neither an inventory-related futures contract nor specifically excluded from the definition of a capital asset. Thus, an issue raised by post-Corn Products developments prior to the Arkansas Best decision that needs to be addressed if preferential capital gains rates are reestablished by Congress is how to reformulate the Section 1221 definitions so that they are less likely to be misinterpreted.

The judicial history reveals that the present formulation of Section 1221 is subject to incompatible interpretations partially because the list of properties specifically excluded from the definition of a capital asset may be interpreted as either a definition by genus and difference or as an enumerative definition. Post-Corn Products developments prior to the Arkansas Best decision equated capital assets with investment property and non-capital assets with business property. On the one hand, if Congress intends to tax transactions in investment property at preferential capital gains rates and transactions in business property at ordinary income rates, it should reformulate Section 1221 accordingly. Since listing all investment and business properties separately is impracticable, an enumerative definition is impracticable. Defining a capital asset as investment property and an excluded asset as business property may lead to misapplication of tax rates if what constitutes an investment or a business property is not clear. Thus, any definition of investment property and business property by genus and difference must be accompanied by criteria in accordance with which investment property or business property can be identified as such. On the other hand, Congress may intend to tax either (1) only those properties currently specifically excluded from the Section
1221 definition of a capital asset or (2) those properties currently specifically excluded from the Section 1221 definition of a capital asset and substitutes for those properties. In either case, appropriate qualifiers need to be added to the current formulation of the list of excluded assets.

CONCLUSION

The history of the judicial interpretation of Section 1221 is characterized by inconsistency. In the past, congressional policy objectives for granting preferential rates for capital gains included stimulating economic growth and raising Government revenue. The inconsistent interpretations of Section 1221 may have undermined congressional economic policy. These inconsistent interpretations are directly attributable to imprecise definitions of what is and what is not a capital asset. If Congress reestablishes a preferential capital gains rate, it needs to reformulate Section 1221 in order to forestall undermining of its economic policy and to prevent unnecessary litigation.