***5 T.C. 296 (1945)***

When property is received in a tax-free exchange, the holding period of the property given up in the exchange is included in the holding period of the property received, even if the property given up was not a capital asset.

**Summary**

Euleon Jock Gracey exchanged a drilling rig used in his business (not a capital asset) for stock in a corporation in a tax-free exchange. He then sold the stock within a month. The IRS argued that the stock was held for less than 18 months, making the gain fully taxable. The Tax Court held that because the stock was received in a tax-free exchange, the holding period included the time Gracey held the drilling rig, regardless of the rig's status as a non-capital asset. This significantly impacted the tax treatment of the gain, allowing it to be treated as a long-term capital gain.

**Facts**

- Gracey was a partner in Cron and Gracey, an oil well drilling business.
- The partnership dissolved, distributing assets including a drilling rig acquired in 1935.
- In February 1940, Gracey and DeArmand formed C.I. Drilling Co., exchanging their drilling rigs for stock (Gracey received 500 shares).
- The exchange was a tax-free exchange under Section 112(b)(3) of the Internal Revenue Code.
- Gracey's drilling rig had an undepreciated cost basis of $29,658.18. This became the basis for his stock.
- On March 6, 1940, Gracey sold 250 shares for $25,000, realizing a gain of $10,170.91.

**Procedural History**

- Gracey and his wife filed a joint return treating the gain as a long-term capital gain (asset held > 24 months).
- The Commissioner of Internal Revenue determined the stock was held less than 18 months, making the entire profit taxable.
- Gracey petitioned the Tax Court, challenging the Commissioner's determination.

**Issue(s)**

Whether the holding period of stock received in a tax-free exchange includes the holding period of the property exchanged, even if the property exchanged was not a capital asset.

**Holding**

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Yes, because Section 117(h)(1) of the Internal Revenue Code mandates that the holding period of property received in a tax-free exchange includes the holding period of the property exchanged, regardless of whether the exchanged property was a capital asset.

**Court's Reasoning**

- The court acknowledged the Commissioner's argument that the drilling rig was not a capital asset and, therefore, its holding period should not be included.
- However, the court emphasized the clear language of Section 117(h)(1), which states that in determining the holding period of property received in a tax-free exchange, "there shall be included the period for which he held the property exchanged."
- The court noted that the statute does not limit its application to situations where the property given in the exchange is a capital asset.
- The court stated, "It is not stated in that provision that its application is limited to instances where the property *given* in an exchange is a capital asset. The provision applies where the property *received* in an exchange is a capital asset. The terms of subsection (h) (1) are clear."
- The court found the statutory provision controlling, despite the Commissioner's contrary interpretation and prior rulings.

**Practical Implications**

- This case clarifies the application of Section 117(h)(1) concerning the holding period of assets received in tax-free exchanges.
- It establishes that the holding period of the transferred property tacks on to the holding period of the received property even if the transferred property is not a capital asset.
- Attorneys should advise clients that tax-free exchanges can be a valuable tool for accelerating the holding period of capital assets, potentially leading to more favorable capital gains treatment upon disposition.
- Later cases and IRS guidance must be reviewed to ensure the continued validity of this interpretation, as tax laws and regulations are subject to change.
- The ruling affects tax planning strategies involving the exchange of business assets for investment assets, where the timing of a subsequent sale is crucial.

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