6 T.C. 1225 (1946)

A taxpayer's profit from relinquishing rights to stock acquired through an investment is considered a capital gain, not ordinary income, if the taxpayer held equitable ownership of the stock for the required period.

Summary

Burnhome involved a dispute over whether proceeds from a settlement agreement regarding stock ownership should be taxed as a long-term capital gain or as ordinary income. The petitioner, part of a brokerage group, had an agreement to receive stock in exchange for financing a stock purchase. The court determined that the brokers had an equitable ownership interest in the stock and that the proceeds from relinquishing their rights constituted a capital gain because they had held the stock for longer than the holding period. The court also addressed the basis for depreciation on a rental property.

Facts

A group of brokers, including the petitioner, entered into an agreement with Bird to finance the purchase of Quimby Co. stock. In exchange for their financial backing, the brokers were to receive one-half of the Quimby stock Bird acquired, after covering Bird's financing costs and taxes. A memorandum agreement stipulated that if the brokers became dissatisfied before the stock division, Bird would repay their investment. Prior to stock division, a dispute arose, leading to litigation that was settled in 1940. The brokers relinquished their rights to the Quinby stock for approximately $125,000, resulting in a net gain of $20,324.97 for the petitioner.

Procedural History

The Commissioner of Internal Revenue determined that the sum received by the petitioner was ordinary income, not a long-term capital gain. The Tax Court was petitioned to review this determination.

Issue(s)

1. Whether the sum received by petitioner in settlement of his claim to certain stock constitutes a long-term capital gain or ordinary income for tax purposes.

2. What was the fair market value of a building when it was converted to rental property for depreciation purposes?

3. Is the loss sustained on the sale of the building an ordinary loss or a capital loss?

Holding

1. Yes, because the brokers acquired an economic ownership of one-half of the stock

and held it for longer than the period necessary to support a long-term capital gain.

2. The fair market value of the property was $45,000, with $25,000 attributable to the building.

3. The loss was an ordinary loss because it was not used in a trade or business.

Court's Reasoning

The court reasoned that the agreement between the brokers and Bird created an equitable ownership interest in the stock for the brokers, not merely an option. The court emphasized that the brokers made an investment in the stock and were entitled to dividends, thus demonstrating beneficial ownership. The court stated, "Under the contract the broker made an investment in the stock, they acquired a present beneficial ownership therein, and, pending the clearing up of Bird's financing obligations and the taxes in connection therewith, the brokers were entitled to the dividends on their shares." The court also noted that the right to compel Bird to repurchase the stock did not negate the sale, characterizing it as a sale on condition subsequent. Since the brokers held this interest for more than 18 months, the proceeds from relinquishing their rights qualified as a long-term capital gain. On the depreciation issue, the court weighed expert testimony and other factors to determine the fair market value of the property when converted to rental use. Citing *Heiner v. Tindle*, 276 U.S. 582, the court affirmed the fair market value at the time of its conversion is the proper measure. The court also followed its prior holding in *N. Stuart Campbell, 5 T.C. 272*, regarding the treatment of losses on the sale.

Practical Implications

Burnhome clarifies how agreements to receive stock in exchange for financing can create equitable ownership interests, impacting the tax treatment of subsequent transactions. This case demonstrates that such arrangements are not merely options but can convey actual ownership rights. This case highlights the importance of documenting the intent of parties and the specific terms of financing agreements when determining whether proceeds should be treated as capital gains or ordinary income. The case also reinforces the principle that depreciation is based on the fair market value of the property at the time of conversion to rental use. It demonstrates that losses on the sale of rental buildings are treated as ordinary losses not capital losses.