6 T.C. 757 (1946)

The character of gain from the settlement of a stock dispute is determined by the nature of the underlying transaction (investment vs. commission), and the loss attributable to a building converted to rental property is an ordinary loss, not a capital loss.

Summary

The taxpayer, McKean, received a settlement from a lawsuit regarding stock he was supposed to receive from a prior investment. The Tax Court addressed whether this gain was ordinary income or a long-term capital gain. The court also determined the nature of the loss from the sale of a residence converted to rental property. The court held that the settlement gain was a long-term capital gain because it stemmed from an investment, not a commission. Additionally, the loss on the building was deemed an ordinary loss, following the precedent set in *N. Stuart Campbell, 5 T.C. 272*.

Facts

McKean and Burnhome were business brokers who, through their corporation, Ridgeton, facilitated the sale of W.S. Quinby Co. stock. Burnhome agreed to invest a portion of his commission in Quinby Co. stock to be received by Bird, the purchaser. 45% of this investment was McKean's. Bird never delivered the stock. In 1939, McKean and Burnhome sued Bird for specific performance. In 1940, the suit was settled with Bird paying cash and notes. McKean also sold his residence in 1941, which had been converted to rental property in 1932.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in McKean's income tax for 1940 and 1941. The Commissioner argued that the gain from the Bird settlement was ordinary income, and the loss from the sale of the rental property was a long-term capital loss. McKean petitioned the Tax Court, arguing for long-term capital gain treatment on the settlement and ordinary loss treatment on the building sale.

Issue(s)

1. Whether the profit realized by McKean in 1940 from the settlement was taxable as ordinary income, short-term capital gain, or long-term capital gain.

2. What was the proper basis for depreciation of McKean's Commonwealth Avenue building in 1940?

3. What was McKean's basis in 1941 for determining gain or loss on the sale of the Commonwealth Avenue real estate?

4. Whether the loss attributable to the building was an ordinary loss or a long-term capital loss.

Holding

1. No, the profit was not ordinary income or short-term capital gain; Yes, it was a long-term capital gain because it derived from an investment in stock, not a commission for services.

2. The proper basis for depreciation was the fair market value of the building at the time of its conversion to rental property, as determined by the court.

3. McKean's basis was the fair market value at conversion, adjusted for depreciation and capital improvements.

4. Yes, the loss attributable to the building was an ordinary loss because it was property subject to depreciation but not used in a trade or business, following the precedent in *N. Stuart Campbell*.

Court's Reasoning

The court reasoned that the money received in the settlement was a capital gain because it originated from an investment in the Quinby Co. stock. The court emphasized that McKean and Burnhome were not employed by Bird nor did they receive a commission from him, thus the profit derived from the investment was capital gain. The court determined the brokers acquired "an economic ownership of one-half of the stock acquired by Bird." The court also found the brokers had been equitable owners of the stock for a period far in excess of the 18 months necessary to support a long term capital gain.

Regarding the Commonwealth Avenue property, the court determined the fair market value at the time of conversion. The court found that the loss on the building should be treated as an ordinary loss, relying on *N. Stuart Campbell, 5 T.C. 272*. The court stated it found "no reason for holding contrary to that decision, nor does there appear to be any material basis upon which this case might be distinguished from it."

Practical Implications

This case clarifies the distinction between ordinary income and capital gains in settlement scenarios, emphasizing that the origin of the claim dictates its tax treatment. It reaffirms that losses on depreciable property converted to rental use are ordinary losses, providing a tax benefit to property owners. Attorneys can use this case to advise clients on the tax implications of settlements involving investments and the characterization of losses on rental properties. This case remains relevant for understanding the tax treatment of gains and losses related to investment property and business assets.