25 T.C. 676 (1955)

Income from the sale of property is classified as ordinary income if the property was held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, not as a capital asset.

Summary

The U.S. Tax Court considered whether income derived from the sale of bomb hoists should be taxed as ordinary income from a trade or business or as capital gain. The court determined that the income was ordinary income because the hoists were held primarily for sale to customers in the ordinary course of business. The court also addressed whether the taxpayers' sons and son-in-law were part of a joint venture. The court held they were not, and therefore the sons' and son-in-law's shares of the profit from the sales of the bomb hoists were not included in the income of the petitioners.

Facts

In 1948, Sam Breakstone contracted to purchase 1,565 electric bomb hoists, surplus from World War II, from H.J. Johnson Company. Breakstone experienced financial difficulties, and could not complete the payments. He offered to sell an interest in the hoists to J.H. Tyroler. Tyroler contacted Morris W. Zack, the president of M.W. Zack Metal Company, about investing in the hoists. Zack, his two sons, and his son-in-law agreed to take a one-third interest in the hoists with Zack taking 40% of the one-third interest and each of the others taking 20% of the one-third interest. They signed an agreement with Breakstone and Tyroler. Zack provided a check for $15,000 towards the purchase. Breakstone continued to try to sell the hoists, using brochures and contacting potential customers. Several sales of hoists were made to various entities. The remaining hoists were eventually abandoned. Zack and his associates reported long-term capital gains on the sale of the hoists, while the Commissioner contended that the income was taxable as ordinary income.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency against Morris and Sarah Zack, arguing that income from the sale of bomb hoists should be taxed as ordinary income from a trade or business, and that the sons and son-in-law were not members of the joint venture. The Zacks appealed this determination to the U.S. Tax Court.

Issue(s)

1. Whether the petitioners were taxable on one-third or only two-fifteenths of the income realized from the sale of the bomb hoists.

2. Whether the income from the sale of the hoists was taxable as ordinary income

from a trade or business or as capital gain.

Holding

1. No, because Zack’s sons and son-in-law each owned a bona fide 20 per cent interest in an undivided one-third interest in the hoists, Zack was properly taxed on 40% of the gross receipts.

2. Yes, because the sales of the hoists were sales to customers in the ordinary course of Zack’s trade or business.

Court’s Reasoning

The court determined that the agreement between Zack, his sons, and his son-in-law to share in the interest in the bomb hoists on a percentage basis was valid, and therefore the Commissioner erred by including the sons’ and son-in-law’s shares of the profit from the sales of the hoists in the income of the petitioners. The court also held that the income from the hoist sales was ordinary income, not capital gains, because the hoists were held primarily for sale to customers in the ordinary course of business. The court emphasized that the only purpose in buying the hoists was to resell them. The court noted the active efforts of Breakstone, Tyroler, and Zack’s salesmen to market the hoists. The court cited the Internal Revenue Code of 1939 section 117 (a)(1), which addresses the taxation of capital assets.

The court stated, “The only purpose in buying the bomb hoists was to resell them at a higher price. There was no “investment” such as might be made in other types of property, but on the contrary there was a general public offering and sales in such a manner that the exclusion of the statute cannot be denied.”

A dissenting opinion argued that there was not the continuity of sales necessary for the conduct of a business, highlighting the small number of sales transactions over an extended period and a lack of a ready market for the specialized hoists.

Practical Implications

This case highlights the importance of characterizing sales of goods. Businesses and individuals must carefully analyze whether property is held for investment or for sale in the ordinary course of business, as this affects tax liability. The frequency of sales, marketing efforts, and the nature of the asset are key factors. The case indicates that even a single transaction with a primary purpose of resale may be considered a business transaction depending on the circumstances. Subsequent cases would likely consider the character of the sales and the intent of the seller. Attorneys should advise their clients on the importance of the frequency and nature of their sales activities.