Tully v. Commissioner, 13 T.C. 273 (1949)

An agreement where a party receives an interest in property in exchange for forbearing from selling stock and can realize capital gains upon the subsequent sale of the property, as the interest in property is considered a capital asset.

Summary

In *Tully v. Commissioner*, the U.S. Tax Court addressed whether a payment received by the taxpayer constituted ordinary income or a capital gain. The taxpayer, Henry J. Tully, agreed to refrain from selling his stock in Lincoln Underwear Mills, Inc., to Paul Polsky. In exchange, Carson and Ethel Potter assigned Tully a one-half interest in the building owned by them and leased to the corporation, subject to the Potters' prior interest. When the Potters subsequently sold the building to the corporation, Tully received a portion of the proceeds. The court held that Tully's interest in the building was a capital asset and that the payment he received was a long-term capital gain, not ordinary income.

Facts

Henry J. Tully and Carson Potter were shareholders and officers of Lincoln Underwear Mills, Inc. Friction arose between them and another shareholder, Paul Polsky. Polsky offered to sell his shares. To prevent Tully from selling to Polsky, Potter and his wife agreed that Tully would receive a one-half interest in a building they owned and leased to the company, subject to Potter's prior interest of $88,000. Tully agreed to not sell his stock to Polsky. Subsequently, the Potters sold the building to Lincoln Underwear Mills, Inc., for $150,000. Tully received $31,000, representing one-half of the sale proceeds above $88,000. Tully reported the $31,000 as a long-term capital gain.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency, asserting that the $31,000 was ordinary income. Tully challenged this determination in the U.S. Tax Court.

Issue(s)

Whether the $31,000 received by Henry J. Tully was ordinary income or a capital gain.

Holding

Yes, the $31,000 received by Tully was a long-term capital gain because Tully acquired an interest in the property that constituted a capital asset.

Court's Reasoning

The court found that the agreement between Tully and the Potters explicitly conveyed an interest in the building to Tully. The agreement stated that the Potters "do hereby assign, transfer and convey to… Tully, an undivided one-half (%) interest in the building and premises." The court found that the agreement transferred a definitive property interest to Tully. As a result, this property interest was held by Tully for more than six months before its sale. "We think the above assignment, transfer, and conveyance from the Potters to petitioner, as a matter of law, vested petitioner with a definitive interest in the building and premises concerned." The court rejected the Commissioner's argument that Tully's promise not to sell was a personal obligation and that he had no real interest in the property. The court further dismissed the alternative argument that the payment was a constructive dividend because the Commissioner had not properly raised it in the initial deficiency notice. The court determined that there was no evidence that the sale price was not the fair market value. The court referenced the 1939 Internal Revenue Code, which defined capital assets as property held by the taxpayer and stated that the gain was a capital gain because the interest was held for longer than six months.

Practical Implications

This case is significant because it establishes that receiving an interest in property as consideration for a promise (in this case, to refrain from selling stock) can be a capital asset. It informs the analysis of similar transactions, particularly those involving business arrangements or settlements where property interests are transferred. For tax attorneys, this case emphasizes the importance of carefully drafting agreements to clearly define the nature of the asset transferred and the consideration involved. If the asset qualifies as a capital asset and the holding period is met, then the payments or proceeds from its sale may be taxed at the lower capital gains rate rather than ordinary income rates. This case would also be cited in situations where a party receives consideration for restricting their business activities that could constitute a capital asset.

