Tully v. Commissioner, 28 T.C. 265 (1957)

Income derived from the sale of a property interest, even if that interest was acquired in consideration for a contractual obligation (not to sell stock), is treated as capital gain if the property interest qualifies as a capital asset and is held for more than six months.

Summary

In *Tully v. Commissioner*, the Tax Court addressed whether income received by Henry Tully from the sale of a building interest was taxable as ordinary income or capital gain. Tully received a one-half interest in a building from the Potters in exchange for his promise not to sell his stock in Lincoln Underwear Mills to a rival stockholder. When the building was later sold, Tully received $31,000, which he reported as long-term capital gain. The Commissioner argued it was ordinary income. The Tax Court held that Tully acquired a capital asset in the building interest, and the income from its sale was properly characterized as long-term capital gain, not ordinary income.

Facts

Henry Tully owned 100 shares of Lincoln Underwear Mills stock. Another stockholder, Polsky, offered to sell his shares or buy Tully's or Potter's shares due to management disagreements. Potter, another major shareholder, wanted to prevent Polsky from gaining control and wanted to ensure Tully would not sell his shares to Polsky. To prevent Tully from selling to Polsky, the Potters (Carson and Ethel), who owned the building occupied by Lincoln, agreed to give Tully a one-half interest in the building. The agreement, dated September 20, 1947, stated that in consideration for Tully's promise not to sell his stock to Polsky, the Potters conveyed to Tully a one-half interest in the building, subject to the Potters' prior interest of $88,000. In September 1948, the building was sold to Lincoln for $150,000. Tully received $31,000, representing half the excess of the sale price over $88,000.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Tully's income tax for 1948, arguing that the $31,000 was ordinary income, not capital gain as reported by Tully. Tully petitioned the Tax Court to contest this determination.

Issue(s)

1. Whether the one-half interest in the building received by Tully constituted a capital asset.
2. Whether the $31,000 received by Tully from the sale of the building interest should be taxed as ordinary income or long-term capital gain.
3. Whether the $31,000 constituted a constructive dividend from Lincoln Underwear Mills.

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Holding

1. Yes, the Tax Court held that Tully did acquire an undivided interest in the Potter property, and this interest constituted a capital asset because the agreement explicitly assigned, transferred, and conveyed the interest.
2. The Tax Court held that the $31,000 was taxable as long-term capital gain because it resulted from the sale of a capital asset held for more than six months.
3. No, the Tax Court rejected the Commissioner's argument that the $31,000 was a constructive dividend, finding no evidence to support this claim and noting it was a new issue not properly raised.

Court's Reasoning

The Tax Court reasoned that the 1947 agreement clearly and unambiguously conveyed a property interest to Tully. The court emphasized the language of the agreement: "do hereby assign, transfer and convey to the said HENRY J. TULLY, an undivided one-half (1/2) interest in the building and premises." The court dismissed the Commissioner's argument that Tully's promise not to sell stock created a mere personal obligation, stating that the agreement vested a definitive property interest in Tully, irrespective of his future stock ownership. The court stated, "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." Because this property interest was held for more than six months and then sold, the gain qualified as long-term capital gain under Section 117 of the Internal Revenue Code of 1939. The court distinguished *Merton E. Farr*, a case relied upon by the Commissioner, noting that in *Farr*, no actual property interest was conveyed. Finally, the court rejected the constructive dividend argument, deeming it a new issue improperly raised and unsupported by evidence of unfair market value in the building's sale.

Practical Implications

Tully v. Commissioner clarifies that the substance of a transaction, specifically the actual transfer of a property interest, will govern its tax treatment, even if that interest arises from an unusual arrangement like a non-compete agreement related to stock ownership. For legal professionals, this case underscores the importance of clearly documenting the transfer of property rights in agreements to ensure intended tax consequences. It highlights that receiving property in exchange for contractual obligations can lead to capital gain treatment upon disposition of that property, provided the asset qualifies as a capital asset and the holding period requirements are met. This case is relevant in structuring business transactions where non-traditional forms of consideration, such as property interests, are exchanged for contractual promises, particularly in closely held corporations and shareholder agreements. Later cases distinguish *Tully* based on the specific language of agreements and whether a genuine property interest was actually

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conveyed versus a mere promise of future payment contingent on certain events.

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