Brown v. Commissioner, T.C. Memo. 1962-66

A sale of stock to a tax-exempt organization, even when financed by future profits from the business and coupled with a leaseback arrangement, can be a bona fide sale qualifying for capital gains treatment if it is an arm's-length transaction with a real shift in economic benefits and risks.

Summary

Clay Brown and other petitioners sold their stock in Clay Brown & Company to a tax-exempt organization, the California Institute for Cancer Research. The purchase was financed through a non-interest-bearing note, payable from 90% of the rental income the Institute would receive from leasing the company assets back to a new operating company. The Tax Court held that this transaction constituted a bona fide sale, allowing the petitioners to treat the gains as long-term capital gains, rejecting the Commissioner's argument that it was a sham or a disguised distribution of profits.

Facts

Petitioners owned stock in Clay Brown & Company, a lumber business.
They sold all their stock to the California Institute for Cancer Research, a tax-exempt organization.
The agreed sale price was $1,300,000, paid with a non-negotiable, non-interest-bearing note.
The Institute liquidated Clay Brown & Company and leased the assets to Fortuna Sawmills, Inc., a newly formed operating company.
Fortuna agreed to pay 80% of its net profits as rent to the Institute.
The Institute agreed to pay 90% of the rent received from Fortuna to the petitioners until the purchase note was paid off.
The assets of Clay Brown & Company served as security for the note.
Petitioner Clay Brown became the general manager of Fortuna.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes, arguing the gain from the stock disposition was ordinary income, not capital gain.
The petitioners contested this determination in the Tax Court.

Issue(s)

1. Whether the disposition of stock in Clay Brown & Company constituted a bona fide sale for federal income tax purposes.
2. If the disposition is considered a sale, whether any portion of the payments received by petitioners should be treated as ordinary income in the form of interest.

Holding

1. Yes, the disposition of stock was a bona fide sale because it was an arm's-length transaction with a real change in economic ownership.
2. No, no portion of the payments should be treated as ordinary interest income because the agreed purchase price was explicitly without interest, and the negotiations did not contemplate an interest component.

Court's Reasoning

The court reasoned that the transaction was a bona fide sale because:

- **Arm's-Length Negotiation:** The sale price was the result of genuine negotiation and was within a reasonable range based on the company's earnings and asset value.
- **Change in Economic Ownership:** Petitioners relinquished equitable ownership of the assets when they transferred their stock, becoming creditors with a security interest, not owners. The court stated, "Petitioners by the transaction here involved parted with their equitable ownership of the assets when they transferred their stock to the institute and became the creditors of the institute with mortgages and a management contract as security for the payment of the purchase price of the stock. This change of interest constitutes a change of economic benefits…"
- **Business Purpose:** All parties had valid business purposes: petitioners wanted to sell, the Institute sought assets for cancer research funding, and Fortuna aimed to profit from operations.
- **No Tacit Agreement to Reacquire:** The court found no evidence of a prearranged plan for petitioners to reacquire the property or artificially trigger a default. The president of the Institute testified their goal was to fully own the assets for cancer research.
- **Distinguished from Sham Transactions:** Unlike cases where sellers retained control or the transaction lacked economic substance (citing *Gregory v. Helvering*, *Higgins v. Smith*, *Griffiths v. Helvering*, and *Burnet v. Harmel*), this case involved a real transfer to an independent entity. The court quoted *Union Bank v. United States*, stating, "We think it is logically and legally impossible for an owner to part with his property, for a consideration, without selling it."

Regarding the interest argument, the court found that the purchase agreement and note explicitly stated no interest was included. The price was negotiated based on the business's value as a going concern, not with an interest component in mind. The court cited precedent like *Elliott Paint & Varnish Co.*, stating that absent a clear agreement for interest, a portion of the purchase price will not be recharacterized as such.

Practical Implications

This case clarifies that sales to tax-exempt entities can qualify for capital gains treatment even with leaseback arrangements and financing tied to future profits. Key factors for determining bona fide sale status include:

- **Arm's-length negotiations** are crucial to establish a realistic sale price and terms.
- **Demonstrable shift in economic benefits and risks** from seller to buyer is necessary. The seller's interest should become that of a creditor, not an owner.
- **Absence of prearranged schemes** for the seller to regain control or artificially terminate the sale is important.
- **Explicit terms of the agreement** regarding interest (or lack thereof) will generally be respected by courts, absent evidence of sham transactions.

This case is significant for structuring sales of businesses to charities, allowing sellers to achieve capital gains treatment while charities can acquire businesses using future income streams. However, subsequent cases and legislative changes (like those addressed in the Supreme Court case *Commissioner v. Brown*, 380 U.S. 563 (1965), which affirmed this Tax Court decision but was later limited by tax law changes) have further refined the rules around these types of transactions, particularly concerning bootstrap acquisitions and related party leasebacks.