CAT 2005-08 - Commercial Activity Tax: I.R.C. Section 1221 and 1231 Assets Excluded from "Gross Receipts" -- Issued September, 2005; Revised February, 2006; Revised May, 2006; Revised August, 2008; Revised May, 2011

This is version 5 of this release. This release has been updated to incorporate a change in law enacted in Am. Sub. H.B. 1, 127th General Assembly (effective September 11, 2010), which establishes that deductions are now referred to as exclusions. The purpose of this information release is to clarify the assets referred to in Ohio Revised Code (R.C.) 5751.01(F)(2)(c) and described in IRC section 1221 or 1231. Receipts from the sale of these assets are excluded from the definition of "gross receipts," and therefore are not subject to the Commercial Activity Tax ("CAT").

R.C. 5751.01(F)(2)(c) states that receipts from the assets described in IRC section 1221 or 1231 are excluded from the definition of "gross receipts," and therefore are not subject to the CAT. IRC section 1221 primarily describes "capital assets" and provides in subsection (A)(2) that "capital assets" excludes assets used in the taxpayer's trade or business." IRC section 1231 covers assets used in the taxpayer's trade or business. Therefore, if the asset is a capital asset or an asset used in the taxpayer's trade or business, the *entire* gross receipt from the sale or other disposition of that asset is exempt from the CAT, regardless of whether the taxpayer recognizes a gain or loss from the sale, including IRC section 1245 or 1250 recapture income. If, however, the asset is not a capital asset or an asset used in the taxpayer's trade or business, all of the receipts from the sale or disposition of the asset are subject to the CAT.

26 U.S.C. 1221 – Capital Asset Defined

In general terms, "capital assets" include all property held by a taxpayer, regardless of duration, irrespective of whether the property is used in the taxpayer's trade or business. Because this definition is so broad, the IRC section excludes certain property from capital asset classification. The following property is not considered a "capital asset" under IRC section 1221. Therefore, receipts from the following assets are generally *included* in the definition of "gross receipts" under R.C. 5751.01(F)(2)(c), and are subject to the CAT:

- The taxpayer's stock in trade or other property included in inventory, and property held primarily for sale in the taxpayer's ordinary course of business;
- A copyright, composition (literary, musical, or artistic), letter, memo, or similar property held by the taxpayer or prepared for the taxpayer;
- Accounts or notes receivable acquired in the ordinary course of business either for services rendered, from property held for sale in the ordinary course of business, or from the sale of the taxpayer's stock in trade or other inventoriable assets;
- Certain U.S. Government publications obtained by the taxpayer below the normal public purchase price;
- Commodities derivative financial instruments held by commodities derivatives dealers; and
- Supplies generally consumed by the taxpayer in the ordinary course of business.

Capital assets (those assets described in I.R.C. 1221) generally include "nonbusiness" property — stocks, bonds, homes, cars, jewelry, and boats — owned and used *for personal or investment* purposes. A fishing pole, for example, held by a taxpayer for personal use and later sold at a yard sale is a capital asset and receipts from the sale of the fishing pole are not subject to the CAT. Receipts from the sale of a taxpayer's personal home (a capital asset) are exempt from the CAT. Inventoriable property is *never* treated as a capital asset, and receipts from the sale of inventory will always be subject to the CAT. Land and depreciable property used in business generally are *not* capital assets, although for the purpose of R.C. 5751.01(F)(2)(c), property "used in the trade or business" is excluded from the definition of "gross receipts," pursuant to IRC section 1231, and therefore receipts from the sale of property used in a taxpayer's trade or business are not subject to the CAT.

26 U.S.C. 1231 – Property Used in the Trade or Business and Involuntary Conversions

One of the specific exclusions enumerated in IRC section 1221 is for certain depreciable property used in the taxpayer's trade or business and real property used in the taxpayer's trade or business. For federal purposes, IRC section 1231 serves to clarify the definition of property "used in the trade or business," in order to treat certain types of this property as "capital assets." For CAT purposes, however, R.C. 5751.01(F)(2)(c) states that "receipts from the sale, exchange, or other disposition of *an asset described in sections 1221 or 1231* of the Internal Revenue Code" are excluded from the definition of "gross receipts," and are therefore not subject to the CAT. Since IRC section 1231 describes property "used in the trade or business," this property is also excluded from the definition of a "gross receipt," and therefore receipts from this property are exempt from the CAT.

IRC section 1231 defines "property used in the trade or business" as property that is "subject to the allowance for depreciation provided in [IRC section] 167" and certain types of real property not excluded under IRC section 1221. IRC section 1231 specifically states that timber, coal, and iron ore are considered property used in the trade or business, assuming they are contained in the ground. Once the mineral is removed from the ground, however, it is no longer an asset used in the trade or business, and therefore receipts from the sale of this mineral are subject to the CAT. Livestock (cows and horses) are used in the trade or business, but chickens are excluded from the definition of "livestock." Finally, unharvested crop on land, which is sold simultaneously to the same person is considered "property used in the trade or business."

IRC section 1231 looks to how long a taxpayer holds a particular business asset in order to determine whether an otherwise ordinary asset should be considered a capital asset under the IRC. However, R.C. 5751.01(F)(2)(c) specifically states that receipts from the disposition of an asset described in either of these two sections is exempt from the CAT "without regard to the length of time the person held the asset." Therefore, receipts from the assets described in IRC section 1231 are exempt from the CAT regardless of how long they are held, and irrespective of whether they are treated as ordinary or capital assets.

Again, receipts from assets used in the taxpayer's trade or business are excluded from the definition of "gross receipts," and are therefore not subject to the CAT. These assets generally include property devoted to the taxpayer's trade or business — office buildings, machinery, automobiles and trucks, computers, and office furniture — property owned and used for a business purpose. A farmer selling land, including crops growing on the land, *can* exclude receipts from the sale if both the crops and the land are simultaneously sold to the same person. A farmer who harvests corn for sale *cannot* exclude receipts from this transaction from the CAT. Receipts from the sale of livestock, regardless of age, that are used for draft, breeding, dairy, or sporting purposes (including horses and cows, but not chickens) are exempt from the CAT as the sale of property used in the trade or business, regardless of the length of time the livestock is held. However, receipts by a farmer or other taxpayer who finishes steers in a feed lot for slaughtering are *not* considered IRC section 1231 property and are therefore subject to the CAT as inventory of the taxpayer. For example, a farmer who receives gross receipts stemming from the sale of a dairy cow used on his farm may exclude these receipts from her CAT liability calculations. However, a farmer who raises cattle for slaughter may not exclude the receipts he receives from the sale of the cattle, because the beef cattle are considered part of his inventory.

A taxpayer who sells acreage including standing timber can exclude receipts from this sale from the CAT. However, a taxpayer who cuts the timber for the purpose of selling it in the trade or business *cannot* exclude receipts from this transaction from the CAT. The sale of a business receives special treatment. Receipts from the sale of the stock and assets of the business are excluded from the CAT as IRC section 1221 property. Receipts from any outstanding accounts receivable or inventory held by the business at the time of the sale, however, are subject to the CAT. With regard to the sale of accounts receivable, however, it is important for the taxpayer to note that R.C. 5751.01(F)(2)(ee) provides an exclusion for amounts realized from the sale of an account receivable to the extent the receivable was reported in the taxpayer's taxable gross receipts.

Goodwill

For illustration purposes, assume a business is sold for $500,000, including $100,000 for goodwill. A common question is whether this $100,000 of goodwill is subject to the CAT. R.C. 5751.01(F)(2)(c) identifies IRC section 1221 and 1231 assets as being excluded from the definition of a "gross receipt," and therefore receipts from the sale of these assets are exempt from the CAT. Neither IRC section 1221 nor 1231 exclude goodwill from the definition of a capital asset. **Therefore, goodwill is a capital asset and thus a receipt relating to goodwill is excluded from the definition of a "gross receipt," and is not subject to the CAT under R.C. 5751.01(F)(2)(c).***(1)* In the above example, the entire gross receipt of $500,000 is exempt from the CAT as a gross receipt from the sale of a capital asset.

IRC section 338(h)(10) Election

For federal income tax purposes, taxpayer may elect to treat certain stock sales as asset sales. When the taxpayer makes this election pursuant to IRC section 338(h)(10), the sale of the stock of a business is treated as the sale of the business' assets. R.C. 5751.01(F)(2)(c) provides for the exclusion of receipts from the sale of stock as an asset described in IRC section 1221. For CAT purposes the transfer will still be treated as the sale of stock, rather than a transfer of assets. As such, no CAT is due with respect to the amounts realized upon the disposition of the stock.

Examples

Following is a sample list of different types of assets and whether the receipts from these assets are subject to the CAT:

Property	Subject to the CAT?
Personal residence	NO
Office building sold by investor	NO
Personal car (used for pleasure)	NO
Delivery truck not part of inventory	NO
Stocks and bonds (personal investment)	NO
Accounts receivable	YES
Supplies used in the taxpayer's business	YES
Fishing pole sold at yard sale	NO
Fishing pole sold by a retailer	YES
Jewelry not sold by retailer/wholesaler	NO
Hedging transactions	NO*(2)*
Personal sailboat (used for pleasure)	NO

Copy machine used for business purposes	NO
Inventory	YES
Golf clubs sold at a yard sale	NO
Golf clubs sold by a professional player	NO
Unextracted oil sold with land	NO
Extracted mineral	YES
Sale of a cow (livestock) – non-inventorial	NO
Sale of poultry (livestock)	YES
Sale of farmland with growing crops	NO
Sale of harvested crops	YES
Copyright	YES
Sale of a business – stock certificates	NO
Sale of a business – accounts receivable	YES
Sale of a business – inventory	YES
Sale of a business – business equipment	NO

ENDNOTES:

(1) See *Messer v. Commissioner* (1971), 438 F.2d 774; *Terminal Co., Inc. v. US* (1969), 296 F. Supp. 1084; *Commissioner v. Killian* (1963), 314 F.2d 852.

(2) Hedging transactions are also excluded from gross receipts to the extent the transactions are entered into primarily to protect a financial position. R.C. 5751.01(F)(2)(c).