January 4, 1922.

OPINION NO. 996.

TAXATION: INCOME TAX.

The owner of property who transfers it to a new corporation organized by him in exchange for stock in such new corporation is not liable to the payment of an income tax on such transfer even though the transaction should show a book profit to such owner.

Hon. A. Lewis, Jr.,
Treasurer, Territory of Hawaii,
Honolulu, T.H.

Dear Sir: I received yesterday from Deputy Tax Assessor Palmer a letter addressed to you by Tax Assessor Wilder, requesting the opinion of this department upon a question of law relating to the assessment of an income tax in a certain case. Attached to Mr. Wilder's letter is a letter from Mr. Carlsmith of Hilo relative to the same letter. While this last letter is perhaps not as specific as it should be the following facts can reasonably be gathered therefrom:

A merchant who has been doing business as such for more than twenty-five years desires to incorporate his business and proposes to convey to the proposed corporation (1) his stock in trade, (2) certain leasehold interests, and (3) the good-will of the business. It is stated in Mr. Carlsmith's letter that "No profit will accrue to the present owner." I assume by this that it is meant that the stock in trade will be transferred to the corporation at cost or less. It would be somewhat difficult to determine whether, under these circumstances and without further details, the leaseholds and goodwill

are to be transferred without profit to the present owner.

The present owner proposes to take stock in the new corporation in payment for the said stock in trade, leasehold interest and good will and will continue as the active manager and controller of the new corporation. The inquiry is now made as to whether or not under the circumstances above indicated the present owner would be liable to the payment of an income tax on this transfer.

Of course if we accept as true the general statement that "No profit will accrue to the present owner" there would seem to be no reason for the inquiry, as the income tax is imposed only on "gains, profits and income." For the purposes of this opinion I will therefore assume that the stock in trade was sold at cost or less and that the leasehold and good-will were sold at a profit. As above indicated it is plain that under this assumption no income tax can be assessed upon the transfer of the said stock in trade. Can such a tax be imposed because of the transfer of leasehold and good-will for profit? I am inclined to think not.

The leaseholds have been held by the owner for a number of years and the assumed increased value of the same cannot be referred to any particular taxation period nor to the taxation period during which the transfer took place. The same situation exists with regard to the transfer or sale of the good-will. This species of property, if it can be called property, increases or decreases with the life of the business according as the business is prosperous or otherwise. It starts at zero and either remains there or increases in value with the passage of time and the prosperity of the business. The

assumed increase of the value of the good-will must therefore be referred to a long period of time (25 years in this case) and cannot be referred to any particular taxation period.

It would seem therefore that both the sales of these leaseholds and of the good-will would come within the rule laid down in the Castle case, 18 Haw. 129. In that case it was held that one who bought stock in 1898 and sold at a profit in 1905 was not liable to pay an income tax for the taxation period running from July 1st to December 31st in 1905.

So far as the sale of the leasehold interests is concerned the profits derived therefrom, under Section 1307, R.L.H. 1915, would not in any event be taxable unless these leaseholds were purchased within two years prior to the date of the sale.

It is extremely doubtful whether a transaction of this kind can be regarded as a sale within the meaning of the income tax statute.

"The word 'sale' usually imports a money consideration." *Alcorn vs. Gieseke,* 158 Calif. 390, 111 Pac. at 101.

"A sale is generally understood to mean the transfer of property for money." Colgan vs. Farmers and Mechanics Bank, 69 Ore. 469, 114 Pac. 460 at 464.

Section 1307, R.L.H. 1915, refers to sales of certain kinds of property including the amount of sales of movable property. The transaction involved in the case now under consideration is not technically a sale but is more in the nature of an exchange or barter. The present owner proposes to exchange the property above referred to for a certain number of shares of stock which would have at the outset at lease an uncertain value.

"Under the Federal income tax laws of 1861 and 1870 it was held that a bona fide exchange of stocks for other property, however much to the apparent advantage of the owner of the stocks, was not a sale thereof from which a profit was derived liable to taxation as income." Black on Income Taxes, page 326.

It seems to me to be very plain that the converse of this proposition is equally true, namely, that a bona fide exchange of property for stocks would not be taxable even though the transaction showed a book profit in favor of the owner of the property.

I am of the opinion, therefore, and so advise you, that under the circumstances above indicated no income tax can be assessed against the present owner of this property by reason of such proposed transfer to the corporation.

I return herewith the communications left with me by Mr. Palmer. I am,

Yours very truly,

HARRY IRWIN,

Attorney General.