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Elements of Capital Gain--General (cont'd) What Is a Capital Asset

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ELEMENTS OF CAPITAL GAIN — GENERAL (cont'd)

WHAT IS A CAPITAL ASSET?

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The Statutory Definition

The definition of a capital asset contained in the Internal Revenue Code is disarming in its simplicity. Section 1221 states that the term "capital asset" means any "property" held by the taxpayer, whether or not connected with his trade or business. Obviously, such a broad definition standing alone would sweep the proceeds from almost every sale into the capital gain area. That result is prevented by the remaining provisions of section 1221, which set forth the types of property which are excepted from the broad general definition. This statutory pattern of a broad definition followed by definitive exclusions induces taxpayers to try to avoid falling within the exclusions. If the property is not within the exclusions, then the property is a capital asset, the gain on which is taxed as capital gain upon sale or exchange. Consequently, there is increasing pressure on the courts to interpret broadly the statutory exclusions and to restrict severely the meaning of "property," in the guise of effectuating basic congressional purposes with respect to the nature of the capital gain provisions. The courts have responded to this pressure by superimposing upon section 1221 a judicial concept of "property" that does, in effect, narrow its meaning.[1]

The purpose of this article is to discuss generally the statutory exclusions of section 1221 and the judicial concept of property; subsequent articles in this symposium analyze specific problems within these areas.

Statutory Exclusions as Affected by the Character of the Owner of the Property

Stock in Trade and Other Property of a Kind Includable in Inventory

To insure that the profits flowing from the day-to-day conduct of a business will be treated as ordinary income, the capital gain provisions exclude from their application property consisting of stock in trade or

1. See Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130 (1960); Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).

inventory of the taxpayer.[2] Hence, sales of such property are not sales of capital assets. This exclusion applies even to a bulk sale of inventory and stock in trade from which the taxpayer previously derived his income through sales to customers.[3]

Similarly, even if the property in question does not constitute stock in trade or inventory, if that property is held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business,"[4] it is not regarded as a capital asset. Accordingly, even though a taxpayer may not be classified as a "dealer" in the property involved, if he holds the property primarily for sale to customers in the ordinary course of business, its sale will result in ordinary income and not capital gain.[5]

This exclusion from the term "capital asset" is not difficult of application in so far as it relates to stock in trade and inventory, and its purpose is apparent. However, the exclusion of property held primarily for sale to customers in the ordinary course of business has been the subject of considerable litigation and will be discussed below.

Copyrights and Literary, Musical and Artistic Compositions

A second exclusion from the statutory definition of "capital asset" treats as ordinary income amounts paid to a taxpayer for his creative labor. It provides that a copyright, a literary, musical or artistic composition, and similar property are excluded from the term "capital asset" if (a) held by a taxpayer whose personal efforts created the property or (b) by a taxpayer whose basis for the property (for the purpose of determining gain) is determined, in whole or in part, by reference to the basis of the property in the creator's hands.[6] This exclusion is so broad in its application that it denies capital gain treatment to the amateur as well as the professional creator.[7]

If a number of individuals through their combined personal efforts as employees of a corporation create a copyright, that copyright may be classified as a capital asset in the corporate owner's hands if the corpora-

2. INT. REV. CODE OF 1954, § 1221(1). (Hereinafter cited as §).

3. Grace Bros., Inc. v. Commissioner, 173 F.2d 170 (9th Cir. 1949); compare § 337(b)(2), involving nonrecognition of gain on the bulk sale of inventory in connection with certain corporate liquidations.

4. § 1221(1).

5. See Girard Trust Corn Exch. Bank, 22 T.C. 1343 (1954). Real estate cannot be included in inventory. John S. Phipps, 19 B.T.A. 1293, 1297 (1930).

6. § 1221(3). The Regulations interpret "similar property" to cover theatrical productions, radio programs, newspaper cartoon strips, and other property eligible for copyright protection. Treas. Reg. § 1.1221-1(c). (Hereinafter cited as Reg.). A "character" in a book is within the scope of this exclusion. Stern v. United States, 164 F. Supp. 847 (D. La. 1958), *aff'd per curiam*, 262 F.2d 957 (5th Cir. 1959).

7. Compare § 1235, which provides capital gain treatment to patents regardless of the classification of the inventors as amateurs or professionals.

tion paid all expenses and costs and fairly compensated the individuals for their services.[8] However, if a copyright or similar property were transferred to a newly organized corporation in exchange for its stock and the stock were then sold, capital gain treatment would probably be precluded by the "collapsible corporation" provisions of the Code.[9]

The profit on the sale of a copyright by a person who received it as a gift from the creator will be treated as ordinary income. This result is dictated by the statutory exclusion from the definition of "capital asset" of property whose basis in the hands of the taxpayer is determined by reference to its basis in the hands of the creator. Since a donee takes his donor's basis for the property given,[10] the copyright in this case would not be a capital asset. This exclusion was deemed necessary to close a loophole for capital gain treatment previously available to a donee who did not hold the property primarily for sale to customers in the ordinary course of his business. Conversely, an heir of the creator or a purchaser from the creator may obtain capital gain treatment on the subsequent sale of the copyright since this property acquires a new basis in his hands when acquired from the creator.[11]

Accounts and Notes Receivable

The 1954 Code specifically excludes from the definition of a capital asset accounts and notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of business.[12] The 1939 Code did not exclude such accounts and notes receivable, and the courts generally held that such property, even though acquired in the course of the taxpayer's trade or business, was a capital asset.[13] This exclusion was added to the 1954 Code in order to accord ordinary, rather than capital, loss treatment to accounts and notes receivable previously included in income and subsequently sold at a loss. However, if such property is sold for an amount greater than the amount

8. Rev. Rul. 55-706, 1955-2 CUM. BULL. 300, 301.

9. § 341. See S. REP. NO. 2375, 81st Cong., 2d Sess. 84 (1950).

10. § 1015.

11. If the creator had sold his work prior to his death, amounts received thereafter are treated as income in respect of a decedent. Rev. Rul. 60-227, 1960 INT. REV. BULL. NO. 25, at 13; Rev. Rul. 57-544, 1957-2 CUM. BULL. 361. In view of the ordinary income treatment that attaches to the sale of property created by a taxpayer's personal efforts, the taxpayer should try to avoid the telescoping of that income into one taxable year. Two means of preventing that result are: qualifying the sale for installment method reporting or taking advantage of the "spreadback" provisions. §§ 453, 1302.

12. § 1221(4).

13. Graham Mill & Elevator Co. v. Thomas, 152 F.2d 564 (5th Cir. 1945); Max Torodor, 19 T.C. 530 (1952).

previously reported as income, the excess is treated as ordinary income because the property is not a capital asset.

The Code does not exclude all accounts and notes receivable from the definition of capital assets. For example, an otherwise non-capital receivable may be transformed into a capital asset by making it the subject of a gift.[14] Furthermore, accounts or notes receivable acquired for capital assets or "section 1231 assets" or acquired otherwise than in the ordinary course of business apparently fall outside the exclusion and therefore within the definition of a capital asset.

STATUTORY EXCLUSIONS AS AFFECTED BY THE INTRINSIC CHARACTER OF THE PROPERTY

Depreciable and Real Property Used in Trade or Business

Section 1221 excludes depreciable property and real property, if used in a trade or business, from the definition of a capital asset.[15]

In order for property to meet the latter exclusionary requirement of the statute — "use in the trade or business" — it is not necessary that at the time of its disposition it must be actively employed in the business; it is sufficient if it had previously been devoted to use in the business. Accordingly, the discontinuance of the active use of the property does not change its character previously established as business property.[16] However, if it can be established that the property had been abandoned by the taxpayer and had not been put to use in the business for many years, it will be regarded as a capital asset.[17]

One of the two types of business property which section 1221 excludes from the category of capital asset is that which is "depreciable." If the property sold is of this character, it is not a capital asset even though the taxpayer failed to take a depreciation deduction. In other words, the failure to take the deduction does not change the character of the property from depreciable to non-depreciable.[18] Similarly, the fact that the property has been fully depreciated at the time of sale is immaterial, since the property was of the character which is subject to the allowance for depreciation.[19]

Section 1221 also excludes real estate used in the taxpayer's trade or business. In this connection, considerable controversy has arisen with

14. Compare this treatment of receivables with the treatment accorded copyrights which are the subject of a gift; see discussion p. 258.

15. § 1221(2).

16. Alfred Kruse, 29 T.C. 463 (1957); Graves Bros. Co., 17 T.C. 1499 (1952).

17. Stewart Title Guar. Co., 20 T.C. 630 (1953); *cf.* Alamo Broadcasting Co., 15 T.C. 534 (1950).

18. Claire A. Pekras, 12 P-H Tax Ct. Mem. 827, *aff'd per curiam*, 139 F.2d 699 (6th Cir. 1943), *cert. denied*, 322 U.S. 739 (1944).

19. Rev. Rul. 55-706, 1955-2 CUM. BULL. 300.

respect to whether the rental of a single piece of real estate, such as a home, is a "business" of a taxpayer who devotes all his working hours to the operation of another vocation. The determination of whether such rental constitutes a trade or business of the taxpayer is to be made in the light of all the facts in the particular case. If the taxpayer's activities with respect to the property are no more extensive than leasing the property or collecting rent, it is difficult to conclude that the taxpayer is thereby conducting a business. However, if the property requires active management by the taxpayer or his agents, if frequent repairs must be made, or if there are numerous tenants or employees, the rental of the property would appear to be a trade or business of the taxpayer and, hence, the property would not be a capital asset.[20]

It should be noted that, notwithstanding the "business property" exclusion, section 1231 allows the net *gain* on the sales of such property held for more than six months, if the total gains exceed the total losses, to be treated as capital gain unless the property is stock in trade, inventory, or held primarily for sale to customers. If the total losses exceed the total gains, the net loss is treated as an ordinary loss. Therefore, if both losses and gains are involved, it is advantageous for the taxpayer to try to establish that the property sold at a loss was stock in trade, inventory, or held primarily for sale to customers; such losses would then be treated as ordinary losses and would not be offset against the section 1231 capital gains. Losses which are subject to section 1231 reduce the only-partially-taxable capital gain. Eliminating the necessity of this offset thus gives a double benefit to the taxpayer.

STATUTORY EXCLUSIONS AS AFFECTED BY THE PURPOSE FOR WHICH THE PROPERTY IS ACQUIRED OR HELD BY THE TAXPAYER

Property Held Primarily for Sale to Customers

The last statutory exclusion from the definition of capital asset to be considered[21] is "property held by the taxpayer primarily for sale to cus-

20. The cases in this area in many respects appear inconsistent. Sometimes it is the taxpayer who argues that he has been conducting a business, and sometimes it is the Commissioner of Internal Revenue who so argues, depending upon whether an ordinary or capital loss is desired. Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958); *cf.* Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam,* 218 F.2d 603 (2d Cir. 1955), holding that the rental of a single piece of real estate does not cause the taxpayer to be engaged in business. The contrary result is reached in Reiner v. United States, 222 F.2d 770 (7th Cir. 1955); Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943); Leland Hazard, 7 T.C. 372 (1946); Daniel O'Madigan, P-H TAX CT. REP. & MEM. DEC. (29 P-H Tax Ct. Mem.) ¶ 60,212 (Oct. 7, 1960). See also Susan P. Emery, 17 T.C. 308 (1950), wherein the Tax Court held that unimproved rental property was not property used in business. *Cf.* John E. Good, 16 T.C. 906 (1951).

21. § 1221(5), not considered here, excludes, in general, from the definition of a capital asset any governmental obligation issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

tomers in the ordinary course of his trade or business."[22] The purpose of this exclusion obviously is to treat the "normal source of business income"[23] as ordinary income. The problem in this area is to determine whether, in a particular case, the property sold had been so held for sale to customers or whether it had been an investment. For years the courts have struggled unsuccessfully for a formula that would provide a ready answer. Failing in that, they have looked for assistance to various criteria, such as the purpose of acquisition (sale or investment), the number of sales, advertising and selling efforts, the "busyness" test,[24] the taxpayer's other activities, and the purpose for which the proceeds were reinvested. Since each case is to be determined on its own facts, it is not surprising that there is little consistency among the cases.

In this connection, an interesting problem has arisen, particularly where real estate is involved. The courts are seemingly in conflict as to whether property acquired originally for investment is converted into a non-capital asset on the "liquidation" of that property where considerable activities are required in order to dispose of the property, or whether the investment character remains despite such activities.[25] For example, a taxpayer who has held a large tract of unimproved land as an investment for many years and who now wishes to dispose of it may find it necessary and more profitable to subdivide the land and install sewers and other improvements.

Other cases have wrestled with the treatment of the gain on the sale of houses which, when constructed, were required by law to be rented and which were subsequently sold when the "no sales" restrictions were lifted.[26] The question here was whether the property was held primarily[27] for rental or primarily for sale to customers.

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22. § 1221(1).

23. Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).

24. See Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938); William E. Starke, 35 T.C. No. 4 (Oct. 7, 1960).

25. For capital gain treatment, see Estate of Barrios v. Commissioner, 265 F.2d 517 (5th Cir. 1959); Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957); Consol. Naval Stores Co. v. Fahs, 227 F.2d 923 (5th Cir. 1955); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955). For ordinary income treatment, see Pennroad Corp. v. Commissioner, 261 F.2d 325 (3d Cir. 1958); Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1952).

26. For capital gain treatment, see Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956); Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955); Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1954); Victory Housing No. 2, Inc. v. Commissioner, 205 F.2d 371 (10th Cir. 1953); Delsing v. United States, 186 F.2d 59 (5th Cir. 1951). For ordinary income treatment, see Pool v. Commissioner, 251 F.2d 233 (9th Cir. 1957); Pacific Homes, Inc. v. United States, 230 F.2d 755 (9th Cir. 1956); Home Co. v. Commissioner, 212 F.2d 637 (10th Cir. 1954); Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951). *Cf.* Winnick v. Commissioner, 199 F.2d 374 (6th Cir. 1952). It has been held that a builder realizes ordinary income rather than capital gain upon the sale of a building which he constructed as part of a package deal involving his selection of the site, assistance in design and lease negotiation, making financial arrangements, and construction of the building. Heebner v. Commissioner,

This problem is, of course, not confined to real estate. Where personal property has been leased, its subsequent sale may result in ordinary income on the theory that the purpose of holding the property was both for rental and sale.[28] However, if the sales are regarded as a necessary incident of the rental business but not the business itself of the taxpayer, the property may retain its character as a capital asset.[29]

With respect to the tax treatment accorded a person who engages in a substantial number of purchases and sales of stock, it has been determined that trading in securities for a person's own account, regardless of how extensive the trading may be, is not "selling to customers."[30] Accordingly, such securities are capital assets.[31] While normally securities in a securities dealer's hands are not considered to be capital assets because they are held for sale to customers, they may be, if within thirty days after their acquisition they are properly identified as an investment, and if, thereafter, the securities are not held for sale to customers.[32]

The courts have encountered difficulty in applying the "primarily held for sale to customers" concept in cases in which the taxpayer claims the character of the property was changed from an ordinary asset to a capital asset by virtue of the liquidation or termination of the business through the sale of the property. Generally speaking, such efforts on the part of the taxpayer have failed.[33] However, where a liquidating corporation distributes its inventory to its shareholders, who then sell it, it has been held that the inventory comes into their hands as a capital

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CCH 1961 STAND. FED. TAX REP. (60-2 U.S. Tax Cas.) ¶ 9548 (3d Cir. June 23, 1960). See also James E. Kesicki, 34 T.C. No. 70 (June 30, 1960); Rev. Rul. 59-345, 1959-2 CUM. BULL. 136.

27. "Primarily" as used in § 1221(1) has been interpreted to mean "essential" or "substantial," not "principal" or "chief." Rollingwood Corp v. Commissioner, 190 F.2d 263 (9th Cir. 1951).

28. Greene-Haldeman v. Commissioner, 6 Am. Fed. Tax. R.2d 5565 (9th Cir. 1960); S.E.C. Corp. v. United States, 140 F. Supp. 717 (D.C.N.Y. 1956), *aff'd per curiam*, 241 F.2d 416 (2d Cir. 1957).

29. Hillard v. Commissioner, 6 Am. Fed. Tax R.2d 5284 (6th Cir. 1960); Philber Equip. Corp. v. Commissioner, 237 F.2d 129 (3d Cir. 1956).

30. Commissioner v. Burnett, 118 F.2d 659 (5th Cir. 1941); George R. Kemon, 16 T.C. 1026 (1951). *But see* Herman Katz, P-H TAX CT. REP. & MEM. DEC. (29 P-H Tax Ct. Mem.) ¶ 60,200 (Sept. 28, 1960) (gain from the sale of stock in eight corporations held ordinary income even though the taxpayer was not a dealer, because the taxpayer organized the corporations for the purpose of selling the stock).

31. This result obtains whether the person is regarded as an investor or trader engaged in business. However, it is to be noted that in the real estate area there is no distinction taxwise between a "trader" and "dealer." Charles H. Black, Sr., 45 B.T.A. 204 (1941), *acq.*, 1941-2 CUM. BULL. 2.

32. § 1236. Such investment cannot give rise to ordinary loss treatment on its subsequent disposition even though at the time of disposition it is held for sale to customers in the ordinary course of business. § 1236(b); Reg. § 1.1236-1(b).

33. See Baker v. Commissioner, 248 F.2d 893 (5th Cir. 1957); Simonsen Indus. v. Commissioner, 243 F.2d 407 (7th Cir. 1957); Grace Bros., Inc. v. Commissioner, 173 F.2d 170 (9th Cir. 1949).

asset.[34] Furthermore, property which in the hands of a decedent was held primarily for sale to customers may be a capital asset in the hands of his estate.[35]

The fact that the property which is purchased and sold is not of a type with which the taxpayer usually deals in his business does not necessarily mean that such property was a capital asset; if the property was purchased for purposes of resale, it will generally be regarded as an ordinary asset.[36]

The "Property" Concept

It has been noted above that section 1221 approaches the problem of defining a capital asset negatively by stating specifically what is not a capital asset; anything not so excepted is a capital asset. In view of the favorable tax treatment accorded capital gains, it would seem more reasonable instead to set forth affirmatively a specific, limited definition of a capital asset. The latter approach is, in effect, being recognized by the courts, since in recent years there has been a significant trend in the judicial interpretation of the term "capital asset" — a trend which limits sharply the meaning of "property" by excluding from it all property held in a taxpayer's business other than as an *investment.*

This trend was spearheaded by the decision of the Supreme Court in *Corn Products Refining Company v. Commissioner,*[37] wherein it was held that a manufacturer of corn products which bought and sold corn futures as an integral part of its manufacturing business was not entitled to treat such futures as a capital asset. The Supreme Court admitted that the corn futures could not be placed into any of the statutory exclusions to the definition of a capital asset. However, it approached the problem not from the statutory definition of a capital asset, but from what it regarded as a corollary purpose of the capital gain statutes: to tax as ordinary income the income from the day-to-day operation of a business regardless of the nature of the asset from which the income was derived. The Court held that the gains of the Corn Products Refining Company from the corn futures were "closely geared to a company's manufacturing enterprise . . . [and] important to its successful operation,"[38] and, therefore,

34. Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956). See Commissioner v. Williams, 256 F.2d 152 (5th Cir. 1958); Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958).

35. Estate of Jacques Ferber, 22 T.C. 261 (1954), *acq.,* 1954-2 CUM. BULL. 4.

36. Hollis v. United States, 121 F. Supp. 191 (N.D. Ohio 1954); Morris W. Zack, 25 T.C. 676 (1955), *aff'd per curiam,* 245 F.2d 235 (6th Cir. 1957). *Contra,* Commissioner v. Williams, 256 F.2d 152 (5th Cir. 1958); Fidler v. Commissioner, 231 F.2d 138 (9th Cir. 1956); Reynolds v. Commissioner, 155 F.2d 620 (1st Cir. 1946); Anatole Litvak, 23 T.C. 441 (1954), *nonacq.,* 1958-2 CUM. BULL. 9.

37. 350 U.S. 46 (1955).

38. *Id.* at 50.

were not capital gains. Accordingly, it now appears that transactions involving assets which are an essential aspect of a taxpayer's business will bear ordinary income consequences even though those assets do not fall within the section 1221 exclusions.[39]

To escape the thrust of the *Corn Products* case, it is necessary that the particular property be classified as an investment. Clearly, shares of stock purchased as an investment are capital assets. However, where a taxpayer is required by a seller to purchase the seller's stock in order to be allowed to purchase the seller's product as inventory for his business, the courts have allowed the taxpayer to deduct as an ordinary loss his loss on his subsequent sale of the stock. This result is reached, even though the stock does not fit into any of the statutory exclusions, on the theory that the stock was not purchased for investment purposes but as a part of the operation of the taxpayer's business. In reaching the result that the loss on the sale is deductible as an ordinary loss, the courts depart from a strict interpretation of the statutory language that stock is "property." They conclude that the purchase and sale of the stock is merely an incident in the conduct of the taxpayer's business. In some instances the loss is allowed as an ordinary and necessary business expense, which obviates the necessity of determining whether the stock is "property."[40] Some decisions have met the problem directly and have concluded that the loss is attributable to a sale of an ordinary asset;[41] others do not clearly state the basis of their reasoning.[42]

These decisions show that the courts will not regard separately these tie-in purchases, with the result that an asset which, standing alone, would be property falling outside the statutory exclusions is nevertheless regarded as a non-capital asset because it was purchased in conjunction with other property held primarily for sale to customers.[43] As an initial proposition, it is difficult to conclude that the stock in these tie-in purchases was property held primarily for sale to customers. However, the *Corn Prod-*

39. See Mansfield Journal Co. v. Commissioner, 274 F.2d 284 (6th Cir. 1960); Weiler v. United States, CCH 1960 STAND. FED. TAX REP. (60-2 U.S. Tax Cas.) ¶ 9725 (M.D. Pa. 1960).

40. Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955); Edwards v. Hogg, 214 F.2d 640 (5th Cir. 1954); Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955); Rev. Rul. 58-40, 1958-1 CUM. BULL. 275. *Cf.* Gulftex Drug Co., 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958) (wherein the stock was regarded as an "investment" because of the length of time it was held prior to its sale); Exposition Souvenir Corp. v. Commissioner, 163 F.2d 283 (2d Cir. 1947). See § 1054, added to the Internal Revenue Code in 1960, with regard to FNMA stock.

41. See Western Wine & Liquor Co., 18 T.C. 1090 (1952), *acq.*, 1958-2 CUM. BULL. 8.

42. See Electrical Fittings Co., 33 T.C. No. 115 (March 18, 1960), wherein the court said it is not necessary to state the particular section under which the loss is allowable although the particular circumstances indicated that "it should be allowed" under § 165.

43. *Quaere:* Would the courts have reached the same result if the stock had been sold at a profit rather than at a loss?

ucts decision renders academic the question of the proper basis upon which these tie-in cases will be decided. If the facts indicate that the stock was not acquired as an investment, but rather as an "integral part of the taxpayer's business," the stock will be an ordinary asset, not a capital asset.

Furthermore, the word "property" in section 1221 is broad enough to encompass intangible items, such as compensation, rent, dividends and interest. While recognizing that in the abstract such claims might be property, the courts have failed to accord them that status for capital gain purposes. Consistent with the "investment" purpose of the capital gain provisions, the courts refuse to treat as capital assets items that basically represent income rather than an increase in the value of income-producing property.[44] Accordingly, the rule has evolved that the amount received for an assignment, sale or other disposition of a right to ordinary income will be regarded as an anticipatory receipt of ordinary income rather than as proceeds from the sale of a capital asset. Nowhere has this principle been more evident than in the area of compensation for personal services. The sale of rights to compensation, even if such rights have been converted into "property" such as a note or a contract, gives rise to ordinary income.[45] This concept has been extended to payments received for covenants not to compete,[46] but not to payments for goodwill, which is consistently regarded as a capital asset.[47]

The transfer of an entire interest in property which contains an element of accrued but unpaid ordinary income will not clothe the built-in income with capital asset protection. In such a situation, the proceeds from the property sold will be separated, and that portion which represents ordinary income will be taxed as such. For example, the consideration received for the sale of a note on which payments of principal and interest are in default is taxable as ordinary income to the extent the consideration received exceeds the face value of the note.[48] Furthermore,

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44. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958).

45. Glenn E. Alexander, 34 T.C. No. 78 (July 29, 1960); David L. Gordon, 29 T.C. 510 (1957); Samuel Towers, 24 T.C. 199 (1955), *aff'd on other issues,* 247 F.2d 233 (2d Cir. 1957); W. F. Jessop, 16 T.C. 491 (1951); Herman Shumlin, 16 T.C. 407 (1951); Charles J. Williams, 5 T.C. 639 (1945). See § 1221(4).

46. Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Beals' Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936).

47. Rev. Rul. 55-79, 1955-1 CUM. BULL. 370. See Rev. Rul. 60-301, 1960 INT. REV. BULL. NO. 38, at 7.

48. Fisher v. Commissioner, 209 F.2d 513 (6th Cir.), *cert. denied,* 347 U.S. 1014 (1954). See also Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942), wherein a declared dividend on stock was sold shortly before it became payable; F. Rodney Paine, 23 T.C. 391 (1954), *rev'd on other grounds,* 236 F.2d 398 (8th Cir. 1956).

the courts have recently determined that gains from the sales of annuity and endowment policies were not gains from the sales of capital assets.[49]

A present realization of future income, even though accomplished by the sale of property, will not be regarded as arising from the sale of a capital asset.[50] The theory, as recently expressed by the Supreme Court in *Commissioner v. P. G. Lake, Incorporated*,[51] wherein carved-out oil payment rights were sold, is that since the consideration is paid for the right to receive future income, it is taxable as ordinary income and is outside the capital gain protection afforded to "property." In reaching this conclusion, the Supreme Court brushed aside the question of whether the oil payment rights were interests in land and whether they were "property" within the scope of section 1221. The proceeds from the sale of a right to future *ordinary income* retain an ordinary income status.

CONCLUSION

A capital asset is defined in section 1221 as "property held by the taxpayer," to which broad definition there are specific statutory exclusions. These exclusions do not generally give rise to substantial legal questions of interpretation. However, since every item which falls outside these exclusions, and which might, in the normal sense, be regarded as "property," will be classified as a capital asset, the courts have taken upon themselves the task of determining whether under a particular set of facts the asset sold is "property" within the congressional purpose in enacting the capital gain provisions. Accordingly, it is to be expected that the "property" concept will be flexible rather than rigid. The Supreme Court has stated the principle that the term "capital asset" is to be construed narrowly in order to conform to the congressional purpose of granting capital gain treatment only in situations involving the realization of appreciation in the value of property. Therefore, payments received from the normal operation of a business and payments which flow from income or in substitution of income will not be from property qualifying as a capital asset.[52]

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49. Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960); Arnfeld v. United States, 163 F. Supp. 865 (Ct. Cl. 1958).

50. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958). See Commissioner v. Gillette Motor Transp., 364 U.S. 130 (1960).

51. 356 U.S. 260 (1958).

52. For further discussion of the subjects discussed herein, see Freeman, *Is There a New Concept of Business Asset?* 36 TAXES 110 (1958); Huston, *Tie-In Sales*, 10 TAX L. REV. 145 (1954); Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956); Zarky, *Capital Gain Concepts: What Is a Capital Asset? When Is There a "Sale or Exchange?"* U. SO. CAL. 1959 TAX INST. 357; Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion*, 65 YALE L.J. 401 (1956).