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Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments

The various circuit courts presently have no uniform approach in determining the federal income tax treatment to be accorded the profits and losses arising from the premature termination and disposition of business contract arrangements. In an effort to find a consistent approach to the problem, Professor Chirelstein compares the old and new contract termination cases, reviews the important recent cases dealing with contract terminations and the various approaches and trends established therein, and analyzes the problem in light of the elements considered relevant in the resolution of particular cases. The author is critical of the Commissioner's efforts to reach an ordinary income result in these cases by manipulating the confusing concepts of "property" and "future income." He concludes that the real question is whether income from the sale of business property is to be treated as essentially different from other types of investment profits for the purpose of the capital gains tax, and suggests that a forthright answer to this question, rather than continued debate over the nature of qualifying property, is most likely to produce consistency as respects the tax treatment of contract termination transactions.

Marvin A. Chirelstein*

The federal courts of appeals have given considerable attention during the past few years to the question whether income arising from the termination or cancellation of a business contract qualifies as gain from the sale of a capital asset. The recent decisions — *United States v. Dresser Industries, Inc.*¹ in the Fifth Circuit,

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1. 324 F.2d 56 (5th Cir. 1963).

*Commissioner v. Ferrer*² in the Second, and *Wiseman v. Halliburton Oil Well Cementing Co.*³ in the Tenth, among others — are worth examining not only because they involve a recurring problem of capital asset classification on which the circuit courts themselves are now divided, but also because they seem to raise, uniquely, and within the framework of a single though highly variable fact situation, a number of major unresolved interpretative issues relating to the general application of capital gain. The courts appear to have experienced more than the usual difficulty in determining whether the elements of a “true” capital gain were present or lacking in these contract termination cases. Thus, Judge Friendly begins his opinion in *Ferrer* by remarking that “The difficulties Mr. Ferrer must have had in fitting himself into the shape of the artist [Toulouse-Lautrec in *Moulin Rouge*] can hardly have been greater than ours in determining whether the transaction here at issue fits the rubric ‘gain from the sale or exchange of a capital asset held for more than 6 months’ . . . or constitutes ordinary income, as the Commissioner contends.”⁴ Why such an awkward fit? The answer, if one can be found, may serve to illuminate or at any rate underscore some ambiguities of definition which at present complicate the administration of the capital gains tax.

The discussion that follows is divided into three parts: part I contains a brief description of applicable interpretative principles, contrasts the recent with the older contract termination cases, and summarizes what appears to be the Commissioner’s approach in this area; part II reviews some of the significant contract termination cases decided since 1960; and part III attempts an analysis of the contract termination problem in the light of the interpretative guides previously described.

I. THE VARIOUS APPROACHES TO CONTRACT TERMINATION CASES

It would seem reasonable to suppose, at this advanced point in our experience, that the principles of capital asset classification would be fairly well defined. In fact, as everyone knows, the elements of uncertainty surrounding the scope of the preference have shown a tendency to multiply rather than dwindle with the passage of time. The statute is immediately to blame: section 1221⁵ defines the term “capital asset” as “property,” not including property falling within five excepted categories, but it otherwise pro-

2. 304 F.2d 125 (2d Cir. 1962).

3. 301 F.2d 654 (10th Cir. 1962).

4. 304 F.2d at 126.

5. INT. REV. CODE OF 1954, § 1221. [All statutory references are to the Internal Revenue Code of 1954.]

vides no guidelines for determining whether an economic interest disposed of by a taxpayer qualifies for preference or not. The Supreme Court has continuously rejected the possibility of resolving interpretative problems under the statute by applying its definitional language in such a literal fashion as to render any economic interest a capital asset for tax purposes which rises to the dignity of "property" under local law rules and is not within one of the specific statutory exceptions.⁶ Instead, the Court has insisted that the capital asset definition "must be narrowly applied and its exclusions interpreted broadly" in order to serve the "basic congressional purpose."⁷ Although this approach sensibly reflects a desire to confine the scope of the capital gain preference in accordance with the presumption that Congress must have intended it to have limited effect, it creates a remarkable void as respects the content of the preference, since Congress has never adequately expressed its "basic . . . purpose" in establishing a system favorable to investment gain, but instead has largely left the matter to surmise.

The Court itself, however, besides rejecting a mechanistic interpretation of the statute and adopting the famous canon of construction quoted above, has made an effort over the years to fill the void by developing an affirmative "view" of the capital gains tax and by advancing certain criteria thought to be capable of application in resolving problems of capital asset classification. The Court's general view, which seems now to have acquired a settled form of expression,⁸ emerges from a handful of widely spaced capital gains opinions, beginning with *Burnet v. Harmel*⁹ and going on through *Hort v. Commissioner*,¹⁰ *Corn Products Ref. Co. v. Commissioner*,¹¹ *Commissioner v. P. G. Lake, Inc.*,¹² and most recently, *Commissioner v. Gillette Motor Transport, Inc.*¹³ These opinions embody (a) an assumption concerning the aim of

6. *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960).

7. *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955).

8. See *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960).

9. 287 U.S. 103 (1932) (bonus received on execution of an oil lease was ordinary income).

10. 313 U.S. 28 (1941) (payment to lessor for cancellation of unexpired portion of lease held ordinary).

11. 350 U.S. 46 (1955) (gains from sales of corn futures purchased by a corn processing company as insurance against price rises were ordinary income).

12. 356 U.S. 260 (1958) (amount received on sale of oil payment by owner of larger interest in the same property held ordinary).

13. 364 U.S. 130 (1960) (damages received for government's temporary seizure of taxpayer's transport facilities held ordinary).

Congress in enacting the capital gains tax, and (b) a two-fold limitation on the scope of the capital asset definition.

The assumption, which rests upon nothing more than a scrap or two of legislative history, is that Congress intended capital gain treatment as a means of relieving against the hardship of taxing previously accrued property appreciation all in one year.¹⁴ In *Burnet v. Harmel* the Court explained that prior to 1921

gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate . . . were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.¹⁵

The same thought was echoed much later in *Gillette Motor Transport*, the Court there stating that "the purpose of Congress [is] to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."¹⁶ *Burnet v. Harmel* was decided in 1932; *Gillette Motor Transport* in 1960. It is conceivable that by the later date Congress's objective in continuing the lower rate for capital gains had changed in favor of such considerations as the furnishing of investment incentives and the removal of impediments to capital mobility, and that the purpose of relieving against the hardship of income bunching had somewhat receded as a policy aim.¹⁷ At any rate, it is apparent that

14. H.R. REP. No. 350, 67th Cong., 1st Sess. 10-11 (1921); 1939-1 CONG. BULL. (pt. 2) 168, 176.

15. 287 U.S. at 106.

16. 364 U.S. at 134.

17. The Revenue Bill of 1963, as passed by the House, would have increased to 60% the deduction for gains from the sale of capital assets held for more than two years, and would have reduced the alternative tax on such gains to a maximum 21%. H.R. 8363, 88th Cong., 1st Sess. § 219(a) (1963). In explanation of this "reform" the committee report states:

Your committee has decreased the inclusion factor in the case of capital assets held over 2 years in part to correspond with the rate reduction provided for individuals generally. Probably more important, however, has been your committee's desire to "unlock" capital investments where the investor is willing to undertake new and riskier investments needed by the economy but finds it unprofitable because of the substantial tax liability he incurs at the time of the sale of his present holdings. It is estimated that this unlocking effect will stimulate the realization of capital gains to such an extent that in the first year revenues from this

the Court's assumption with respect to the congressional purpose has rarely if ever been used directly and by itself as a means of distinguishing capital gain from ordinary income. Thus, the courts have not extended this assumption to the point of denying capital gain where a taxpayer sells property under an arrangement calling for periodic annual purchase payments,¹⁸ nor has the Code, with a six-month holding period requirement and an installment sale election, been especially consistent with a bunched income rationale.

Taken in context, the Court's description of congressional purpose in *Burnet v. Harmel* and *Gillette Motor Transport* can probably best be understood as a means of providing a framework for the simple and fundamental conception that capital gain treatment is to be restricted to situations involving realized *value appreciation*. The point is perhaps too obvious to require explanation, but it nevertheless lies at the heart of the time-honored fruit-and-tree conundrum and is also a way of characterizing certain other common problems of classification, such as the problem of distinguishing between noncompete agreements and sales of good will.¹⁹ In any event, of the five major capital gain cases mentioned above, all but *Corn Products* were ultimately decided on the ground that the exchange in question did not involve a realization of gain traceable to an increment in the market value of the taxpayer's property. The Court's emphasis on property appreciation, therefore, seems to call for a determination in every case that what is paid for is value increment and not something else. In most cases the determination can be made quite casually; in a few, the matter is not so clear.

This stress on realized value appreciation as the only proper object of preferred treatment also relates in different ways to the two important rules of limitation developed by the Court in restricting the application of capital gain. The first such rule is derived from the assignment-of-income cases and expresses the

source will increase by \$450 million even though a smaller percentage of all capital gains is taken into account for tax purposes. This larger turnover of capital assets should result in increased investments and will be particularly helpful in tapping new sources of risk capital.

H.R. REP. NO. 749, 88th Cong., 1st Sess. 96 (1963). The provision, belatedly opposed by the Treasury, was rejected by the Senate.

18. See, e.g., *Commissioner v. Hopkinson*, 126 F.2d 406 (2d Cir. 1942); *Estate of Raymond T. Marshall*, 20 T.C. 979 (1953).

19. E.g., *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959); *Aaron Michaels*, 12 T.C. 17 (1949). In *Pines*, *Federal Income Taxation of Intangible Assets*, 8 TAX L. REV. 231, 237 (1953), the argument is made that the distinction between covenants not to compete and goodwill is illusory since the "net effect is a reallocation of future incomes between buyer and seller, whether there is a 'separable' covenant, an inseparable one, or no covenant at all."

familiar idea that capital gain treatment does not extend to amounts which merely represent a lump-sum "substitute" for future ordinary income.²⁰ The Ninth Circuit has recently stated the principle in standard terms as follows:

It is well settled that a right to receive future income which is commuted into a lump sum payment results in ordinary income just as the income if actually received in the future in several payments would be ordinary income. The nature of the right to receive future income as ordinary income does not change into capital gain by the mere receipt of a lump sum in lieu of such future payments.²¹

In effect, a prepayment of rent, interest, wages or the like, though it results in income bunching, is ineligible for preference.

But this future income limitation, however well settled, is subject to at least one major ambiguity: whether the denial of capital gain applies merely to prepaid income transactions, which may after all amount to little more than the financing or discounting of receivables; or whether, on the other hand, the rule also affects some situations in which the interest disposed of, although a right to future ordinary income, is also the taxpayer's entire interest in the property. In the latter situations, the property sold seems to reflect an admixture of fruit and tree, with the result that the factor of income prepayment is somewhat less apparent.²² The Court's decision in the *Hort* case and its broad language in *Lake*, as well as some lower court decisions, suggest that the future income rule extends to both types of situations, but as will be seen the matter is still very much in doubt.

The second of the Court's rules of limitation — now as familiar as the first — derives from the *Corn Products* decision. It is, briefly, that the capital gain preference does not apply to profits and losses "arising from the everyday operation of a business" even though these everyday dealings involve property which is not stock in trade in the usual sense and which, in addition, is of

20. Denying capital gain treatment to the sale of an oil payment the Court in the *Lake* case said: "The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property." 356 U.S. at 266.

21. *Holt v. Commissioner*, 303 F.2d 687, 690-91 (9th Cir. 1962).

22. ALI, DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 169-306 (Discussion Draft 1960). See generally Lyon and Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 295 (1962); Note, 49 IOWA L. REV. 89 (1963); Note, 69 YALE L.J. 693 (1964); Comment, *The P. G. Lake Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies*, 14 STAN. L. REV. 551 (1962).

a type that is usually identified with investment rather than business activity.²³ Thus, gain or loss on a sale of corporate securities may be ordinary if the securities have quasi-inventory status as in *Corn Products* or if they are acquired as part of a tie-in inventory purchase²⁴ or represent a current expense of carrying on the taxpayer's business.²⁵ The factor of value appreciation is here insufficient to produce capital gain in view of its everyday business source. *Corn Products* thus seeks to distinguish regular business income from investment gain by resorting to the context in which the income arises and by examining the function in that context of the property sold. A factual determination is then required as to what role the particular property plays in the taxpayer's business and perhaps as to the taxpayer's motive in acquiring the property.

Over and above the difficulties that this determination may present in a given case, there is a serious uncertainty as to how far the "everyday business" rule extends. Thus, what kinds of profits and losses are to be regarded as arising from the "normal" operation of a business or profession? Does *Corn Products* apply only to property having quasi-inventory or quasi-business expense status, or does it broadly extend to the income of a business enterprise from whatever business source derived?²⁶ This issue partly concerns the relationship of the *Corn Products* doctrine to section 1231 of the Code, which specifically affords capital gain treatment to sales of real or depreciable property used in the trade or business.²⁷ It also partly concerns the peculiar status of business intangibles, which, if nondepreciable, do not qualify for capital gain treatment under section 1231, but on the other hand generally lack the character of stock in trade.

These interpretative issues — those relating to the scope of the Supreme Court's future income limitation, as well as those arising under the *Corn Products* decision — all seem in a measure to be present in the contract termination cases mentioned at the outset. Thus, typically in this situation, the contract disposed of is one which the taxpayer has entered into in the regular course of his

23. 350 U.S. at 52; see Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956).

24. *Western Wine & Liquor Co.*, 18 T.C. 1090 (1952); Rev. Rul. 40, 1958-1 CUM. BULL. 275.

25. *Commissioner v. Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir. 1955).

26. See Freeman, *Is There a New Concept of a Business Asset?* 36 TAXES 110 (1958).

27. Rev. Rul. 77, 1958-1 CUM. BULL. 118. Compare *E. I. du Pont de Nemours & Co. v. United States*, 288 F.2d 904 (Ct. Cl. 1961); *Ralph H. Peters*, 37 T.C. 799 (1962).

business or professional activities and represents a claim to future income based upon a commitment to buy or sell goods or services over a period of years. The length of term of the commitment necessarily varies. In some instances, the agreement is simply one and perhaps only a minor feature of the taxpayer's commercial life, and the commitment is limited to a stated number of years or is measured by the expected useful life of a specific asset such as a patent. In others, the agreement is the foundation upon which the taxpayer's business or profession is built so that the term of the commitment is indefinite or spans the anticipated life of the entire enterprise. At some point during the course of the agreement, the taxpayer is invited, either by the other contracting party or by a third person, to surrender or convey his contract rights, and is offered a cash consideration for his claim to the future contract benefits. This consideration is usually a lump sum, but it sometimes takes the form of a percentage or royalty payment arrangement. The question, when he accepts, is whether the amount received by the taxpayer for surrendering his contract rights shall be treated as ordinary income or as payment in exchange for a capital asset. There is present here the commutation of future income factor; present also, though usually given less attention by the opinion writers, is the factor of business dealings, whether or not of an "everyday" variety.

With respect to the question of capital gain or ordinary income, the older contract disposition cases could fairly readily be grouped on the basis of the type of contract claim at issue. Leasehold interests and "encumbrances,"²⁸ like life estates,²⁹ were regarded as capital assets when disposed of by the lessee. Employment contracts,³⁰ as well as management, franchise, exclusive agency and exclusive output agreements³¹ — indeed, virtually any

28. See *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954); *Commissioner v. Ray*, 210 F.2d 390 (5th Cir.), *cert. denied*, 348 U.S. 829 (1954); *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir.), *cert. denied*, 345 U.S. 939 (1952); Rev. Rul. 531, 1956-2 CUM. BULL. 983.

29. See *Allen v. First Nat'l Bank & Trust Co.*, 157 F.2d 592 (5th Cir. 1946); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946); *Bell's Estate v. Commissioner*, 137 F.2d 454 (8th Cir. 1943).

30. See *Gordon v. Commissioner*, 262 F.2d 413 (5th Cir. 1958); *George K. Gann*, 41 B.T.A. 388 (1940); *Thurlow E. McFall*, 34 B.T.A. 108 (1936); Rev. Rul. 301, 1958-1 CUM. BULL. 23.

31. See *Commissioner v. Pittston Co.*, 252 F.2d 344 (2d Cir. 1958) (right to purchase entire output of coal mine for ten years); *Leh v. Commissioner*, 260 F.2d 489 (9th Cir. 1958) (supply contract to purchase specified quantity of gasoline); *Roscoe v. Commissioner*, 215 F.2d 478 (5th Cir. 1954) (exclusive management agreement); *Commissioner v. Starr Bros.*, 204 F.2d 673 (2d Cir. 1953) (release from exclusive sales agency); *General Artists Corp. v. Commis-*

agreement that could be characterized, simply, as "an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another . . . or by rendering services"³² — were usually regarded as noncapital. There were exceptions,³³ but in the aggregate it appeared that a consensus had developed among the courts of appeals. Thus, the Tenth Circuit, having held in *Jones v. Corbyn*³⁴ that the surrender of an exclusive life insurance agency to the insurance company for a lump-sum payment produced capital gain, later substantially repudiated that decision and indicated its accord with other circuits finding ordinary income on similar transactions.³⁵ And the Second Circuit, following a period of hesitation, agreed that payments made to a lessee for the cancellation of his lease result in capital gain.³⁶ As a consequence, the location of the dividing line between dispositions of contract rights which qualify as capital assets and those that do not seemed reasonably clear prior to the unsettlement in this area occasioned by the new wave of appellate court decisions.

These newer cases appear to be shifting the dividing line in the direction of a broader capital gain classification for contract rights, although the trend is by no means uniform among the circuits. The shift, if there is one, is on two fronts. First, some courts, notably the Second and Fifth Circuits, seem more willing than in the past to grant capital gain treatment in cases where the contract right surrendered, although not a lease in the usual understanding, can be assimilated to a lease in the sense that by it the taxpayer has acquired a right to make periodic use of property belonging

sioner, 205 F.2d 360 (2d Cir. 1953) (exclusive right to serve as booking agency for popular singer); *Appalachian Elec. Power Co. v. United States*, 158 F. Supp. 138 (Ct. Cl. 1958) (agreement between two utilities to interchange surplus power). The cases are reviewed in Bechly, *Sale of a Contract — Capital Gain or Ordinary Income*, 35 TAXES 759 (1957).

32. *Commissioner v. Ferrer*, 304 F.2d 125, 130-31 (2d Cir. 1962).

33. Principal examples are *Commissioner v. Goff*, 212 F.2d 875 (3d Cir.), *cert. denied*, 348 U.S. 829 (1954), finding capital gain on termination of an exclusive output agreement; and *Jones v. Corbyn*, 186 F.2d 450 (10th Cir. 1950), holding that payment for the surrender of an exclusive life insurance agency produced capital gain. See also *Elliot B. Smoak*, 43 B.T.A. 907 (1941). In *Rev. Rul. 374, 1955-1 CUM. BULL. 370*, the Service without discussion held that the sale of an exclusive agency contract by one distributor to another qualified for capital gain treatment.

34. *Supra* note 33.

35. *Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654 (10th Cir. 1962).

36. *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954).

to another.³⁷ Among the older cases, only *Commissioner v. Goff*,³⁸ decided by the Third Circuit, appears to have alluded to the "lease" characterization in a context other than that of the conventional relationship between landlord and tenant with respect to real property. Second, there may be a tendency, again by the Fifth Circuit, to find a capital gain element in the sale or termination of a personal service agreement such as a management contract.³⁹ Indeed, the Fifth Circuit has recently cited *Jones v. Corbyn*, thought to have been interred by its creator, with approval.⁴⁰ This is not to suggest that there has been a direct reconsideration of the rule that amounts received upon the cancellation of an employment contract are ordinary income, but only that it may be less difficult now than formerly to establish that the termination of the taxpayer's employment was accompanied by the transfer of a property interest having capital asset characteristics and usually designated as good will. In both types of cases, the courts, or some of them, are exhibiting an increased readiness to perceive some sort of present right to an asset-in-being which is larger than, or is in addition to, a mere claim to future ordinary business or employment income.

As noted, these recent cases are not unanimous in moving toward a broader capital gain classification for contract dispositions. Rather, they appear to divide on the issue, with the division being not only between the circuits themselves, but in one and possibly two instances between different panels of the same court

37. See, e.g., *United States v. Dresser Indus., Inc.*, 324 F.2d 56 (5th Cir. 1963); *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).

38. 212 F.2d 875 (3d Cir.), *cert. denied*, 348 U.S. 829 (1954).

39. See *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962). See also *George J. Aitken*, 35 T.C. 227 (1960), in which the taxpayer, employed as a solicitor by a fire and casualty insurance agency, on his retirement sold the agency certain file data, called "expirations," relating to the terms and expiration dates of insurance policies he had sold. The Tax Court, finding that the taxpayer possessed a property right in the accumulated file data, held that the receipt was capital gain as against the Commissioner's contention that the payment represented an accrued right to future renewal commissions. *Accord*, *Commissioner v. Killian*, 314 F.2d 852 (5th Cir. 1963). The *Aitken* decision, *supra*, is thus to the effect that an employee may develop attributes of goodwill in the performance of his job, provided that the goodwill element is reflected in a document or other separable property having independent economic value and is not part of the consideration rendered the employer in return for the payment of regular compensation, the latter apparently being an issue for determination under local law. See also *Merle P. Brooks*, 36 T.C. 1128 (1961).

40. *Nelson Weaver Realty Co. v. Commissioner*, *supra* note 39, at 900, n.3.

as well.⁴¹ Furthermore, this disagreement is squarely over the scope of the capital asset definition in section 1221. Thus, since almost all of these cases involved a mutual cancellation of rights and obligations between the original contracting parties, those courts which ultimately arrived at an ordinary income result might well have done so with a minimum of effort and analysis by emphasizing the absence of a sale or exchange in the transaction. The fact that none of the courts felt satisfied to rest its decision on that ground, though each was urged to do so by the Commissioner, indicates that the courts do not regard the purely technical requirements of sale or exchange, *i.e.*, that a separately disposable property interest survive the transaction, as an acceptable means of resolving the capital gain issue in this class of case.⁴² Instead, the courts all appear to be committed to the harder task of deciding whether the interest disposed of constitutes a capital asset.

Once the sale or exchange requirement is passed, however, the courts are hard put to isolate the appropriate principles of classification. The Commissioner apparently regards the Supreme Court's future income limitation as his strongest weapon in these cases, and the courts in general seem ready to agree that the issue is at least properly considered in those terms. Taking this approach, the Commissioner usually asserts two grounds for treating contract termination payments as ordinary income. They are, first, that a contract which involves nothing more than a contingent right to make money is not a capital asset, and second, that an amount paid for the termination of a contract under which the taxpayer would otherwise have derived future ordinary income is a mere substitute for that future income and retains the same

41. In addition to the admitted conflict in the Fifth Circuit—*compare* *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962), with the Fifth Circuit cases cited in notes 48 & 50 *infra*—there is difficulty in reconciling the ordinary income feature of the Second Circuit's decision in *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962), with the capital gain result reached in *Ayrton Metal Co. v. Commissioner*, 299 F.2d 741 (2d Cir. 1962), both cases involving the termination of a right to cash payments. As respects inter-circuit conflicts, see discussion in Part II hereof.

42. See, *e.g.*, *Bisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (5th Cir. 1963); *Ferrer*, *supra* note 41. Section 1241, added to the Code in 1954, provides that payments received by a lessee for the cancellation of a lease or by a distributor for cancellation of a distributorship agreement shall be treated as received upon a sale or exchange of the lease or agreement, but in the latter case only if the distributor has made a substantial capital investment in the distributorship. The effect of this section is unclear, see *Commissioner v. Pittston Co.*, 252 F.2d 344, 348 (2d Cir. 1958), but in any event it deals only with the sale or exchange requirement and has no application in determining whether the lease or distributorship is a capital asset. S. REP. NO. 1622, 83rd Cong., 2d Sess. 444 (1954).

character as the original.⁴³ It is not clear whether these two grounds differ in some important way, or whether the first ground is simply a broader version of the second. A contract claim is certainly "property" in the constitutional sense. This fact may not be enough by itself to assure capital gain treatment, but, if not, the failure of what is admittedly property to qualify as a capital asset would generally have to be due to some circumstance relating to its acquisition, use, disposition, etc. Presumably the fatal circumstance, in the Commissioner's view, is to be found in the substitution factor. Thus, payment for performance of the contract and payment for relinquishment differ only as to time of receipt, and this difference, whatever consequence it may have in precipitating the taxpayer's liability for tax, is not one which the Commissioner regards as capable of changing future ordinary income into present capital gain.

In the broader alternative, it may be the Commissioner's position that a simple contract relationship representing nothing more than an expectancy or set of expectancies is inherently lacking in the property characteristics of a capital asset, so that amounts derived from the disposition of such a contract necessarily become ordinary income. Here the emphasis would be upon the term "property" as a minimum requirement of capital asset status, though the term would then be intended not in any universal sense but as if subject to an intrinsic limitation which effectively excludes some kinds of contract rights.

II. A DISCUSSION OF THE SIGNIFICANT RECENT CASES

The recent cases involve various types of contracts, some previously considered by the courts, others novel. There continues to be fairly general agreement that payments made to an employee for the cancellation of a bare employment contract are ordinary income⁴⁴ and that the cancellation of a lease results in capital gain;⁴⁵ but outside of these familiar situations the decisions present

43. *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962); Rev. Rul. 18, 1961-1 CUM. BULL. 5, 8; Rev. Rul. 301, 1958-1 CUM. BULL. 23; Bechly, *supra* note 31.

44. See *Holt v. Commissioner*, 303 F.2d 687 (9th Cir. 1962); *Roscoe v. Commissioner*, 215 F.2d 478 (5th Cir. 1954). Compare *Nelson Weaver Realty Co. v. Commissioner*, *supra* note 43.

45. See *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960). See also *Fairmont Park Raceway v. Commissioner*, 327 F.2d 780 (7th Cir. 1964). Compare *Voloudakis v. Commissioner*, 274 F.2d 209 (9th Cir. 1960) (ordinary income, where lease "assigned" for periodic payments, assignor retaining right of re-entry on default).

a somewhat confused picture and no longer lend themselves to a classification scheme based wholly upon the subject matter of the contract released. Instead, since the opinions in this area are invariably concerned in one way or another with the presence or absence of qualifying "property," it may be more useful, or at any rate more interesting, to group the cases in terms of the approach taken by the courts to what is apparently regarded by all as the basic and decisive issue. Conceding that the same decision may reflect more than a single reason for the result reached, the cases can nevertheless be divided into three categories: first, those decisions in which the disposition of a contract right is treated simply as an anticipation of future income, under a standard *Hort-Lake* analysis;⁴⁶ second, at the opposite pole, those which openly or impliedly reject the *Hort-Lake* approach and instead regard the termination of a contract right as a sale of property qualifying for capital gain; and third, those, largely in the Second Circuit, which are decided under a rule of "substantiality" based upon an assumed distinction between simple contract claims and possessory interests in the nature of a lease. The cases in each category, to repeat, uniformly apply a concept of qualifying property, but with differing results.

1. *Standard Approach*

Cases using the standard *Hort-Lake* analysis continue to emphasize the idea of equivalence, or substitution, as between present and future contract receipts. In *Holt v. Commissioner*,⁴⁷ for example, the taxpayer, a motion picture producer, received a lump-sum payment from Paramount Pictures for the release of a contract calling for the taxpayer to produce a stated number of films over a period of years for a fee plus a percentage of the gross receipts from each picture. Public interest in the type of film produced by the taxpayer had suddenly declined. The Ninth Circuit, predictably, found the receipt to be ordinary income on the ground that the sum paid represented a substitute for amounts which would have been compensation for personal services had the parties simply carried out their original contract obligations. The Supreme Court's decision in *Hort* was especially relied upon for the proposition that a transaction which involves no more than the receipt of the "present discounted value" of future earnings does not produce capital gain, even though the right to obtain those earnings may constitute "property" in an abstract sense.

46. *Hort v. Commissioner*, 313 U.S. 28 (1941); *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958).

47. 303 F.2d 687 (9th Cir. 1962).

As in *Hort*, the court thus viewed performance of the contract and nonperformance as equivalent for tax purposes and had little difficulty in concluding that the termination payment was personal service income.

The Fifth Circuit, in two cases involving management and agency contracts, has also reached an ordinary income result by application of the *Hort-Lake* future income limitation, though another panel of the same court has taken an opposite view. In *United States v. Eidson*,⁴⁸ the taxpayers, individuals, had entered into a 10-year contract to manage a mutual assessment insurance company and to act as the company's exclusive agent. Their compensation was 40% of gross annual premiums less the expense of operating the insurance company. The taxpayers subsequently assigned the management and agency contract to another insurance company for a cash payment, the contract then having seven years to run but subject to renewal. The court held the receipt to be ordinary income as reflecting the cash value of what would otherwise have been earned during the remaining term of the contract, although the district court had found that the renewable agreement in effect represented the taxpayer's equity in the non-stock insurance company.⁴⁹ *Bisbee-Baldwin Corp. v. Tomlinson*⁵⁰ also involved the termination of an agency relationship, in this instance the sale of a group of mortgage service contracts under which the taxpayer, as agent for certain mortgage buyers, undertook to service the mortgage accounts for a fee based upon a percentage of the outstanding balance of each loan. Despite a recent decision to the contrary in the same circuit, the court sustained the Commissioner in treating the amounts received on assignment of the service contracts as a substitute for future service fees taxable as ordinary income. The court conceded, however, that the taxpayer's files and records possessed independent value as customers lists, and accordingly it remanded the case for an allocation of the total purchase price between the right to fees and the value of the taxpayer's good will.

Cases involving exclusive licenses for the use of patents and copyrights are represented in each of the three categories designated above, with the Tenth Circuit's decision in *Wiseman v. Halliburton Oil Well Cementing Co.*⁵¹ being the most traditional

48. 310 F.2d 111 (5th Cir. 1962).

49. *Accord* *United States v. Woolsey*, 326 F.2d 287 (5th Cir. 1963); *Hyatt v. Commissioner*, 325 F.2d 715 (5th Cir. 1963), *affirming* 20 CCH Tax Ct. Mem. 1635 (1961); *Joseph W. Brown*, 40 T.C. 861 (1963). See also *Paul Small Artists, Ltd.*, 37 T.C. 223 (1961).

50. 320 F.2d 929 (5th Cir. 1963).

51. 301 F.2d 654 (10th Cir. 1962).

in approach. The contract ultimately relinquished in *Halliburton Oil* related to a patented process for the creation and stimulation of oil and gas production. In 1949, Halliburton, the taxpayer, obtained from the owner of the patent, Stanolind Oil and Gas Company, an exclusive license to use and grant sublicenses for use of the process. Four years later, partly as a result of Halliburton's research and development work, there was an unprecedented demand for the process which the taxpayer could not fill, and after considering various alternatives, Halliburton agreed to release to Stanolind its exclusive license and right to grant sublicenses in exchange for a nonexclusive license to use the process without payment of royalties, plus an annual payment from Stanolind equal to one-third of the royalties which the latter should receive from any new licensees. In 1953, the taxpayer received more than \$400,000 as its share of annual royalties and sought to treat the amount as long-term capital gain.

Placing primary reliance on *Hort* and *Lake*, the Tenth Circuit found ordinary income in this situation and held that "the royalty received by Halliburton under the 1953 agreement was no more than a substitute for future income which Halliburton would have received from granting third party licenses, had it chosen to exercise that right . . ."⁵² The court dismissed the taxpayer's argument that the exclusive license constituted a substantial property right by stating that since the basic patent remained the property of the patent owner, the taxpayer's "rights were dependent entirely upon the contract."⁵³ It also stressed that as the taxpayer had previously deducted its development costs as a current expense, its basis for the contract right was zero, and hence, apparently, the payments received by it could not be treated as a return of capital.

The cases in this standard *Hort-Lake* category, of which the foregoing are merely representative, range fairly widely in subject matter but have no noticeable unifying elements other than the basic conception that a right to future income from a contract relationship is not a capital asset. The opinions sometimes emphasize the factor of individual or corporate personal services when it is present; in other instances the absence of a capital outlay is stressed; and in still others, consistent with the theory that payment for the termination of a contract constitutes a "discounting" of future receipts, importance has been given to the certainty or probability that the income will materialize and to the predictability of the amounts anticipated. But these factors are not

52. *Id.* at 658.

53. *Ibid.*

always present in the cases that are decided for the Commissioner, and if present are not always stressed, so that by and large they do not serve as "tests" or criteria and at all events cannot convincingly be used to distinguish the cases in this category from those in the next.

2. *The New Wave*

Judge Cameron's opinions in *Nelson Weaver Realty Co. v. Commissioner*⁵⁴ and *United States v. Dresser Industries, Inc.*,⁵⁵ particularly the latter, contain a forceful exposition of the view that the *Hort* and *Lake* decisions, to the extent deemed applicable to contract termination payments, have been misapplied. These cases obviously stand in sharp contrast to the same circuit's decisions in the *Eidson* and *Bisbee-Baldwin* cases and to the Tenth Circuit's decision in *Halliburton Oil*.

Nelson Weaver Realty, like *Bisbee-Baldwin*, involved the termination or assignment of a mortgage service contract. The taxpayer had previously entered into a contract with New York Life Insurance Company whereby the realty company became the exclusive mortgage sales and service agency for New York Life within a specified territory. Having operated under the contract for eight years and having accumulated some 1800 mortgage accounts, the taxpayer, with New York Life's consent, sold its right to service these accounts, together with all related files and records, to another service agency for a cash sum. The court held that the payment produced capital gain and rested its decision, in part at least, on the ground that the service agreement represented a major item in the taxpayer's capital structure to which was attributable "more than half of its business operations over a period of years." Although the gross service fees anticipated by the purchaser under the contract were presumably ascertainable, the court found that the amount paid for the service contract bore no inevitable discount relationship to the net income to be earned by the purchaser, since the latter would be obliged to sustain the uncertain cost of performing the services called for by the contract. On this ground it distinguished the *Lake* case, in which the right to income being sold was certain in net amount. In addition, or perhaps in the alternative, the court stressed that the transaction involved not only the mortgage service contract, but also files and records having independent value as customers lists. A dissent argued,

54. 307 F.2d 897 (5th Cir. 1962).

55. 324 F.2d 56 (5th Cir. 1963).

on the basis of *Williams v. McGowan*,⁵⁶ that the total purchase price should have been "comminuted into its fragments" and allocated between the value of the right to receive service fees and the value of the remaining property transferred, presumably the files and records, with the amount allocated to the service contract to be treated as ordinary income on the ground that the taxpayer to that extent "was simply converting future income into present income." The dissenting view was in effect adopted by a majority of the judges sitting in *Bisbee-Baldwin*.

The *Dresser Industries* case presented the same court with a second opportunity to focus upon the scope and applicability of the *Hort-Lake* future income limitation. As in *Halliburton Oil*, the taxpayer in *Dresser Industries* had previously acquired an exclusive license to practice a patented process belonging to another firm (though not a right to grant sublicenses) in exchange for a percentage of the fees earned thereby. After a period of some fifteen years, the taxpayer and the patentee entered into a new arrangement under which the taxpayer agreed to release the exclusive feature of the original grant (retaining, however, a non-exclusive right to practice the patent) and accepted as consideration for such release the sum of \$500,000 to be paid by the patentee out of royalties earned from licensing third parties.

The court, again speaking through Judge Cameron, sustained the taxpayer's treatment of amounts received under the later agreement as capital gain, the Commissioner having argued for ordinary treatment on the ground that these amounts represented the anticipation of future ordinary income. *Hort-Lake* limitations, insofar as they might be thought to apply to the sale of a contract right as distinguished from other property such as land or securities, were frankly rejected, the court stating that the *Lake* case should not be interpreted

to mean that any money paid which represents the present value of future income to be earned is always taxed as ordinary gains. As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income We conclude therefore, that the sale was not merely the present sale of the right to earned income, to be paid in the future. Taxpayer had an asset, a right, a property which would produce income. The fact that the income which *could* be earned would be ordinary income is immaterial; such would be true of the sale of all income-producing property.⁵⁷

56. 152 F.2d 570 (2d Cir. 1945) (on sale of going business each asset treated separately so losses on stock in trade were ordinary).

57. 324 F.2d at 59.

Moreover, conceding that the purpose of the capital gain tax might be to ameliorate tax burdens on gains accruing over a substantial period of time and realized in one particular year, the court found that precisely that had occurred in the case at hand: "What increased in this case, over those years, was the value of the right 'exclusively' to practice the patent. When that right was sold back to . . . [the patentee], a capital gain occurred."⁵⁸ The court also stated that it considered the release of the exclusivity feature of the license as the cutting off of a "vertical slice" of the taxpayer's rights, rather than, as in *Lake*, the carving out of a short-term income interest from a larger estate: "The tree was sold, along with the fruit, at least insofar as that branch was concerned."⁵⁹

For good measure, a concurring opinion characterized the Commissioner's position as "bad economics" and "bad law."⁶⁰

The *Nelson Weaver Realty* and *Dresser Industries* decisions are uniquely forthright in their rejection of the Commissioner's future income analysis, but there are other decisions which may reflect a similar point of view. Among the older cases, as indicated above, the Third Circuit's *Goff* decision⁶¹ may be said to have taken the same approach. More recently, the Second Circuit, in *Ayrton Metals Co. v. Commissioner*,⁶² found capital gain in connection with the relinquishment by the taxpayer, an ore broker, of its right to participate in profits derived by another brokerage firm from an exclusive dealing arrangement with the owner of a Bolivian antimony mine. The taxpayer had initially exchanged its participation right for a "commission" based on future profits on purchases of the ore, and then subsequently gave up its claim to the commissions in exchange for a lump-sum payment. The court characterized the initial exchange as a sale of a partnership interest.⁶³ By way of dictum, however, it stated that it would generally regard a right to future income, taken by itself, as a capital asset, provided that the amount of the future income was uncertain and had not been earned or accrued at the time the taxpayer's interest was disposed of. This view, which may not be entirely consistent with some portions of the same court's later

58. *Id.* at 61.

59. *Id.* at 58.

60. *Id.* at 61, 62.

61. 212 F.2d 875 (3d Cir.), *cert. denied*, 348 U.S. 829 (1954.)

62. 299 F.2d 741 (2d Cir. 1962).

63. On the other hand, in *United States v. Woolsey*, 326 F.2d 287 (5th Cir. 1963), involving the sale of an insurance agency partnership, the court declined to view the sale of the several partners' interests as a circumstance apart from the termination of the partnership's agency under section 741 of the

decision in *Commissioner v. Ferrer*,⁶⁴ is essentially in accord with that expressed in *Dresser Industries*. In substance it is, simply, that the sale of a right to future income, not yet earned or accrued, reflects the very image of a capital gain.

3. *Equitable Interest Standard*

The Second Circuit's decision in *Commissioner v. Ferrer* seems in a sense to lie midway between *Halliburton Oil* and *Dresser Industries*; at any rate, it has been cited as a source of interpretative inspiration both by those courts that do, and by that court which does not, consider the substituted income rule to be applicable to contract termination payments.

As a matter of incidental history, the Second Circuit prior to *Ferrer* appeared to follow the pattern generally prevailing among the courts, having found capital gain upon a lessee's surrender of its lease to the lessor,⁶⁵ but also having found ordinary income upon the cancellation of an exclusive distributorship,⁶⁶ the sale of exclusive agency rights,⁶⁷ and the termination of an exclusive right to buy the output of a coal mine. In the last of these decisions, *Commissioner v. Pittston Co.*,⁶⁸ the court held that the taxpayer's contract right to acquire the mine output lacked the quality of a "substantial" property interest for the reason, in part, that the taxpayer's sole remedy would have been in damages had the other contracting party elected to breach its contract obligation by selling coal to third parties. In this respect, the court stated, the taxpayer's status was different from that of a lessee whose rights in the leased premises are enforceable in equity. No citation to local law rules was offered in support of this conclusion; indeed, a dissenting opinion, while disputing the basic relevance of the substantiality test, expressed doubt as to whether the taxpayer's relief actually would have been restricted to money damages under the particular circumstances of the case. On the other hand, this

Code. Therefore, the termination payment was held to be ordinary income under a standard *Hort-Lake* analysis. The same result was reached in *Holt v. Commissioner*, 303 F.2d 687 (9th Cir. 1962), under the Int. Rev. Code of 1939, ch. 1, § 117, 53 Stat. 50 (pt. 1). Compare *Hatch v. Commissioner*, 198 F.2d 26 (9th Cir. 1952). In addition, or in the alternative, the court in *Woolsey, supra*, held that the term "unrealized receivables" in section 751(a) & (c) of the Code was broad enough to cover contract rights involving future income not yet earned.

64. 304 F.2d 125 (2d Cir. 1962).

65. *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954).

66. *Commissioner v. Starr Bros., Inc.*, 204 F.2d 673 (2d Cir. 1953).

67. *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953).

68. 252 F.2d 344 (2d Cir. 1958).

question of the remedy available seems to have been merely one of several criteria applied by the majority in determining whether the taxpayer's rights had substance, and it is not at all clear that the court would have decided the case differently had the taxpayer shown that it would have been entitled to equitable relief under local law in the event of a breach by its promisor. The analogy to lessee status, turning in the end upon the availability of equitable relief, nevertheless becomes the principal point at issue in *Ferrer*. As a consequence, the outcome of the *Ferrer* case has a somewhat fortuitous quality, with the taxpayer apparently failing to achieve full capital gain treatment solely by reason of an accident of legal draftsmanship which might well have been averted by the parties had anyone foreseen the court's position.

A rather detailed account of the background of *Ferrer* will be helpful. In November, 1951, the actor Jose Ferrer entered into a standard Dramatic Production Contract with Pierre LaMure for the production of a play based upon LaMure's novel "Moulin Rouge," a biography of Henri de Toulouse-Lautrec. By the contract, LaMure granted to Ferrer, in return for a percentage of the weekly box-office receipts, the exclusive right to produce and present the play in the United States and Canada. In addition, Ferrer acquired a 40% share in the motion picture, television and radio rights, provided that the play was produced and presented within a specified time limit. A week or two after signature of the contract, director-producer John Huston called Ferrer to inquire whether he would be interested in playing the lead role in a motion picture to be based on "Moulin Rouge." Ferrer replied affirmatively, but then advised Huston that he, Ferrer, was the owner, or part-owner, of the motion picture rights and that if Huston desired to acquire those rights he would have to negotiate with Ferrer. In the negotiations that followed, Huston's attorney insisted on "either an annulment or a conveyance" of the Dramatic Production Contract between Ferrer and LaMure. Ferrer tentatively agreed and signed a letter prepared by LaMure's attorney under which the contract between Ferrer and LaMure was "cancelled and terminated in all respects." Ferrer withheld delivery of the letter, however, pending completion of arrangements between himself and Huston.

Ultimately, in May, 1952, Ferrer entered into a contract with Huston's independent production company by which the latter engaged Ferrer's services to play the Toulouse-Lautrec role. Ferrer was to receive a stated salary, which worked out in the year in question, 1953, to be about \$110,000 and which Ferrer reported as ordinary income. In addition, he was to receive "percentage

compensation," a stated percentage of the net motion picture distribution profits. Following signature of this agreement, Ferrer delivered to LaMure the letter terminating their prior agreement; LaMure then transferred the motion picture rights to Huston.

The motion picture, "Moulin Rouge," was successfully produced, and in 1953, in addition to his salary, Ferrer received nearly \$180,000 as percentage compensation. The issue in the case, simply, was whether this latter amount should be taxed to Ferrer as ordinary income or as capital gain.

The Commissioner argued in the Tax Court, and later on appeal, that Ferrer's percentage compensation should be regarded as nothing more than additional payment for personal services as a motion picture actor. In reply, Ferrer was permitted to introduce a letter from Huston's attorney, written almost a year after the May contract signing, and likewise oral testimony by the same person, to the effect that the percentage money had been paid for the release of the Dramatic Production Contract and not as additional salary. The Tax Court fully credited this evidence and, finding the contract to be a capital asset and its release to be a sale or exchange, held that the entire amount of the percentage compensation was long-term capital gain.⁶⁹

On appeal by the Commissioner, the circuit court declined to reverse the Tax Court's findings on the personal service issue. It did, however, reassess the character of the contract rights which Ferrer had acquired and then released, by treating each as a separate economic interest in the basic copyright. It determined, following a laborious dissection of the contract, that these rights were essentially threefold: (1) the right to produce and present the play, (2) the right to consent or refuse consent to any disposition of the motion picture rights prior to the time that the play had run for a specified period, and (3) the right to receive 40% of any motion picture proceeds if the play was in fact produced. The court then proceeded to examine the New York cases with a view to determining whether, under state law, the taxpayer had obtained an interest in the copyright which could be said to resemble that of a lessee in the sense that equitable relief would have been available had his rights been the subject of interference. On this basis it decided that right (1) was analogous to a lease and vested in the taxpayer an equitable interest in the play; that right (2) resembled an "encumbrance" and created an equitable interest in the motion picture rights; but that right (3), despite some case authority suggesting the contrary, produced no "affirmative equitable interest" whatever, being merely a right to receive "a

69. *Jose V. Ferrer*, 35 T.C. 617 (1961).

percentage of certain avails . . . as further income from the lease of the play."⁷⁰ Accordingly, rights (1) and (2) were given capital asset status and right (3) ordinary status, and the case was remanded to the Tax Court for an allocation of the percentage money among the several interests.

As respects rights (1) and (2), the court rejected the view that these interests should be excluded from capital gain treatment because receipts from the play, had it been produced, would have been ordinary income. "The latter," said the court, "is equally true if a lessee of real property sells or surrenders a lease from which he is receiving business income or subrentals,"⁷¹ yet the courts are together in regarding a lease as a capital asset in the hands of a lessee. As respects right (3), on the other hand, the court likewise refused in effect to take the position that this interest qualified as a capital asset merely because it represented a right to income not yet earned and uncertain in amount. The latter right was compared to that of a lessee entitled to receive from his lessor "a percentage of what the lessor obtained from other tenants attracted to the building by the lessee's operations."⁷² Since such percentage payments would result in ordinary income, a sale of the lessee's right thereto for a lump sum payment produced ordinary income as well. The court cited the *Holt* and *Hort* decisions for this conclusion, though both apparently involved the problem from a lessor's standpoint.

In brief, the "equitable interest" rule — of which the Second Circuit seems so far to be the chief proponent⁷³ — is thus apparently intended to distinguish between situations in which a contract confers upon the taxpayer a right to derive income by making or preventing the disposition of specific property, and situations in which the contract merely creates a right to share in the proceeds of the disposition of property belonging to another. Carried out in terms of a "remedy" concept, it seems to follow that if the taxpayer's interest is enforceable only by dam-

70. 304 F.2d at 133.

71. *Id.* at 132.

72. *Id.* at 134.

73. In *Maryland Coal & Coke Co. v. McGinnes*, 225 F. Supp. 854 (E.D. Pa. 1964), the court found ordinary income on the termination of an exclusive agency agreement entitling the taxpayer to sell all the coal from a mine for the entire life of the mine at a stated commission. Citing *Ferrer*, the court stated that the agency contract was not a capital asset for the reason that it failed to confer upon the taxpayer "an enforceable estate, encumbrance or interest in an object or thing. . . . But the right created here was simply one to perform a service, that of an agent to sell his principal's interest in personal property, *i.e.*, the coal which . . . [the mine owner] produced, which carries with it no interest in either the coal or the mine." *Id.* at 857-58; *cf.* *Weyerhaeuser S.S. Co. v. United States*, 192 F. Supp. 615 (W.D. Wash. 1961).

ages and not by injunction or specific performance, that interest then ultimately consists of a right to share proceeds and not to dispose of property.

The technique of fragmentation utilized in *Ferrer* is itself noteworthy and is rather original for cases of this sort, though as with everything in this skillfully devised opinion it has an air of likelihood and plausibility. But was it truly appropriate to consider and analyze each of the taxpayer's contract rights as a separate unit, instead of treating the contract, as the Tax Court had, as one single economic interest? Suppose, to use the court's leasehold analogy, that a lessee is entitled to occupy certain premises for a term of years. The lease provides for a stated annual rental, but provides also that this stated rental is to be reduced by payment to the lessee of a percentage of the rents received by the lessor from other tenants in the same building. In exchange for a lump sum, the lessee now surrenders his *entire* leasehold interest, including his right to rent reduction payments. It seems quite clear that such a transaction would produce capital gain. There might be doubt about the result if the lessee sold off the right to percentage payments by itself and retained the lease, but where the leasehold is disposed of as well there seems to be no reason to deny capital gain treatment once it is conceded that a lease is a capital asset. In *Ferrer* the "lessee" retained nothing, and certainly the right to share in the motion picture proceeds was a part of the overall lease arrangement, not an independently acquired interest. It is difficult to see, therefore, why right (3) should have been carved out of the basic contract and treated as if disposed of for a separate consideration when that was simply not the case, except as this procedure may have been necessary to reach the desired result.

One suspects in the end that this complex decision reflects an unstated compromise which traces back in some manner to the issue of personal services. The court in discussing right (3) cited the Tax Court's earlier decision in *Herman Shumlin*,⁷⁴ in which the producer of a play, entitled under a standard Dramatic Production Contract to share in the proceeds from the sale of motion picture rights by the playwright, was held to have received ordinary income when, subsequent to a sale of the motion picture, he agreed to release his right to percentage payments for a fixed sum. The Tax Court evidently viewed the later transaction as a sale of accrued personal service income, equivalent to the discounting of a note received as compensation for services. Presumably the same view might have been taken of this aspect of the *Ferrer*

74. 16 T.C. 407 (1951).

case, except that the transaction in *Ferrer* preceded rather than followed the rendering of substantial services by the taxpayer. But the fact that the cancellation of Ferrer's contract preceded the production of the play seems unimportant to the tax result; in effect, the reward for services materialized at a very early point in the history of Ferrer's "career" as a producer, rather than, as the parties had expected, at a substantially later date. The situation then somewhat resembles the cancellation of an employment or service arrangement as in *Holt*. This characterization of the transaction, under which Ferrer's right to share in the motion picture proceeds would be viewed simply as an apportionment of the enhancement in value of LaMure's property resulting from Ferrer's efforts as a producer (rather than as a feature of the "lease"), tends to make the court's procedure in requiring an allocation of the receipt somewhat more intelligible. It is as if (taking a leaf from *Williams v. McGowan*⁷⁵) a part of the receipt, presumably the lesser part, were allocable to Ferrer's entrepreneurial interest in the play production, the realization of which would have required some capital outlay, and the balance attributable to a personal service factor requiring no outlay whatever. Be that as it may, the court itself said nothing about personal services in this context, but chose instead to express the result reached in terms of a distinction based on qualifying property.

To summarize, the status of contract termination payments under the recent decisions is largely bound up with the conflict over the meaning of "property" under the Supreme Court's future income limitation. *Halliburton Oil* and *Dresser Industries* conveniently represent opposite points of view. It is just possible to distinguish these two cases on the ground that the consideration for the release of the taxpayer's rights in *Halliburton Oil* was a share of future royalties payable over the life of the patent and without limit as to amount, while in *Dresser Industries* the consideration, though payable out of earnings, was limited to a maximum figure. The disposition in the former case might therefore be considered as lacking in finality, particularly when viewed in combination with Halliburton's retained right to use the patent on a royalty-free basis.⁷⁶ Nevertheless, the disagreement between the decisions seems basic. Absent the element of carved-out interest as respects the particular property disposed of, the Fifth Circuit (or, at any rate, one panel thereof) perceives no sound reason for distinguishing between contract rights to earn future income and other property interests of a concededly capital na-

75. 152 F.2d 570 (2d Cir. 1945).

76. See *Cory v. Commissioner*, 230 F.2d 941 (2d Cir. 1956).

ture, such as land or securities.⁷⁷ The Tenth Circuit, on the other hand, still representing a majority view in this respect, perceives no sound reason for distinguishing between present receipt and future receipt of amounts derived from a single contractual commitment when the character of the income anticipated is, admittedly and without question, ordinary.

Deadlocked over the scope of the future income limitation, *Halliburton Oil* and *Dresser Industries* are in a sense balanced by the *Ferrer* decision — or both are accepted, or both are rejected, it is hard to say which. Read together, the Tenth and Fifth Circuit opinions tend to respond to one another in that peculiarly circular manner which perhaps inevitably characterizes an analysis that is based upon assumed distinctions between income and capital, fruit and tree. *Ferrer* then purports to dissipate the paradox by treating the issue as if it were actually capable of being solved in terms of a rule of substantial property, of which the principal ingredient, surprisingly, is derived from local law remedy concepts.

III. AN EVALUATION OF RELEVANT FACTORS

How shall the relevant authorities be applied by the courts in deciding whether the termination of a contract right produces capital gain or ordinary income? As indicated earlier, the sources of law in this sparsely settled area are, chiefly, a vague statute containing a somewhat discredited property requirement, a conception (possibly outmoded) of Congress' purpose in establishing the preference for capital gains, and a twofold limitation on the scope of the capital asset definition under which substitutes for future income as well as so-called everyday business profits are excluded from preferential treatment.

⁷⁷ One wonders how far the *Dresser Industries* court is now prepared to go in treating future income rights as qualifying property. What, for example, would have been its decision in the *Holt* case — the termination payment there resulting from a decline in the market value of the taxpayer's services and not from any factor of external property appreciation? The Court in *Dresser Industries* indicated that the appropriate discrimination is between a right to earn income in the future, a capital asset, and a right to collect income already earned, a non-capital asset until taxed. There is at least an inference, supported by the same court's decision in *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962), and by its disapproval of *United States v. Eidson*, 310 F.2d 111 (5th Cir. 1962), that a like distinction would be maintained although the right relinquished by the taxpayer should involve the performance of individual personal services as an employee for a fixed wage. It may be noted that the court did not find necessary to its decision the same aspect of business liquidation which appeared to influence the outcome in *Nelson Weaver Realty*, *supra*. The absence of capital outlay, stressed in *Halliburton Oil*, also was ignored.

1. *Value Appreciation*

At the outset one may put aside those cases in which a taxpayer disposes of a right to receive deferred payment for a service already performed. The status of an earned income claim simply depends upon its source. If receipt of the claim would have been ordinary income had the claim been valued and taxed when the service was completed, a sale of the claim in advance of collection yields the same tax result; and this is true whether the claim was fixed in amount or contingent.⁷⁸ The cases that have given difficulty, on the other hand, are those in which the right to future income is disposed of in advance of performance and yet is found to have a liquidating value to the payee.

Simply described, the latter situation is one in which *A* obligates himself to furnish a continuous service (skills, land, patent rights, etc.) to *B* for a term of limited duration, while *B* agrees to compensate *A*'s service at a fixed dollar rate or at a rate calculated as a percentage of receipts. The parties thus exchange guarantees of cost and return based upon supply-demand conditions governing the value of *A*'s service at the time the contract is entered into. If the market for *A*'s service stays at or near the contract price throughout the term of the contract, neither party profits solely by reason of the commitment since each could have obtained an equivalent result by resorting to the market on a day-to-day basis had this been practical. If the market for *A*'s service changes, on the other hand, and if the change is not later washed out by a swing in the opposite direction, the commitment brings a profit or windfall return to the party in whose favor the spread between market and contract price develops. Thus, if the market for *A*'s service goes down, *A* will derive profit by selling the service to *B* at a price which exceeds the cost of acquiring it from others; if the market for *A*'s service improves, *B* profits by acquiring the service at a cost below the price at which it may be furnished to others.

As long as the contract is performed in accordance with its terms, neither the Commissioner nor the parties themselves will be concerned to distinguish between the element of profit (or loss) resulting from changed market conditions and the element of wages, interest, or rent returned to the productive factors that make up the subject matter of the contract. Both elements may be present in the income realized by the parties, but there is no

78. See *Rosen v. United States*, 288 F.2d 658 (3d Cir. 1961); *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958); *Floyd L. Turner*, 38 T.C. 304 (1962); *Bessie Lasky*, 22 T.C. 13 (1954), *petition for review dismissed*, 235 F.2d 97 (9th Cir. 1956), *aff'd*, 352 U.S. 1027 (1957); *Herman Shumlin*, 16 T.C. 407 (1951).

reason and probably no way to separate one from the other while the parties continue to meet their contract obligations. However, if the contract is terminated prior to completion, whether by voluntary action or by breach, *A* and *B* will then be obliged to take account of the profit or windfall factor in their relationship by capitalizing the value of the commitment for purposes of liquidation. One would therefore expect the amount of the liquidation payment to differ substantially from the amount that the payee would have earned by fully performing the contract. Discounted for anticipation, this figure would tend to reflect the amount of positive or negative profit which each party would expect to realize by completing the contract, over and above the return available on like commitments in the current market.

Contract termination thus presents an essentially familiar picture: one in which the parties to an existing commitment experience a change in the rate of return to be expected from it, and elect, for reasons satisfactory to each but doubtless involving a judgment of the future, to liquidate their bargain. It is difficult to imagine what else the Supreme Court could have had in mind in speaking of "situations . . . involving the realization of appreciation in value."⁷⁹

The distinction between "lessor" and "lessee" is sometimes said to be an important one in this area,⁸⁰ presumably by reason of the taxpayer's lessor status in the *Hort* case, but on analysis it appears to have no special bearing on the issue of capital gain or ordinary income. The lessor derives income from the lease itself, while the lessee derives income from subleasing the property or utilizing it in connection with the production of goods or services for sale to others. But since both parties bind themselves to exchange a designated commodity at a stated price for a period stretching out into the future, each assumes the same type of market risk and each will sustain a profit or loss in the event of a change in the value of the leased premises. The arrangement becomes advantageous to the lessor (employee, lender) when the cost of furnishing the land (labor, capital) declines; it becomes advantageous to the lessee (employer, borrower) when the value of the same commodity goes up. There is no apparent reason why the surrender of that advantage should not have the same tax consequence to either party. Abstractly stated, the lessor's status resembles that of a bondholder entitled to fixed annual interest payments, whose bond appreciates in dollar value because of a general decline in the market rate of interest. The bondholder can

79. *Commissioner v. Gillette Motor Transp. Inc.*, 364 U.S. 130, 134 (1960).

80. See Rev. Rul. 129, 1953-2 CUM. BULL. 97.

now, if he desires to replace his original capital, go to the market for a capital sum equivalent to his bond investment and obtain the same sum at a lower cost than that at which he has agreed to furnish it to the bond issuer. If, instead, he elects to dispose of the bond, whether to a third party or to the issuer, he receives back his original investment plus an additional amount sufficient to restore a portion of the loss in earning power occasioned by the drop in interest rates. The disposition is regarded as gain-producing, and the gain is regarded as capital. A lessor also supplies capital under an arrangement calling for fixed payments on the lessee's part. If rentals decline in the market, the lessor's interest appreciates correspondingly. When the lessee buys in the lease, the lessor recovers his original capital (the leased premises) and receives cash in addition. Again, the transaction produces taxable gain which is attributable to a decline in the lessor's cost of furnishing his capital to the lessee. If this gain qualifies as "value appreciation" in the bondholder case, it ought to do so for the lessor as well.

The above description by and large fits the cases reviewed in the preceding section, though without reflecting all of their complexity. The *Holt*, *Eidson*, *Bisbee-Baldwin*, and *Nelson Weaver Realty* cases seem to involve a taxpayer whose status resembles that of a lessor (*A* in the example above), the cost of whose service has declined since the original contract date. Without requiring further performance, the taxpayer's lessee or employer (Paramount Pictures in the *Holt* case) now pays over to the taxpayer, in liquidation of its commitment, an amount reflecting the difference between the contract price for the taxpayer's service and the price which the same service commands in the current market; or in the alternative, a third party, willing to furnish the same service at a smaller net return, acquires the right to substitute his performance for that of the taxpayer by payment of a cash consideration. *Halliburton Oil*, *Dresser Industries*, *Ferrer*, and perhaps *Ayrton Metals* appear to raise the question from the lessee's standpoint, the value of the leased premises (patent, copyright, etc.) having substantially increased in value over the contract term. Here it is the lessor, or as in *Ferrer*, a third party, who desires to acquire the taxpayer's profitable opportunity by making payment of the commuted value of the taxpayer's right to future income less the current cost of performance. In all instances, viewed from the payor's side, the payment is obviously made not for performance on the part of the payee, but for a right to substitute the payor's own performance or participation at a lesser net return than that available to the payee by reason of the contract.

Viewed from the payee's side, the receipt compensates not for the performance of a service, but for the relinquishment of an opportunity to earn profits by furnishing that service to the payor at a cost below the contract price or by acquiring that service from the payor at a cost below the market.

Considered as involving the sale of an opportunity to profit rather than a compensated service, the contract termination cases — even those arising on the “lessor's” side — generally do seem to present an instance of accrued value appreciation within the meaning of *Burnet v. Harmel* and *Gillette Motor Transport*. A broad test of this would be whether the taxpayer possesses an interest which can be disposed of for a consideration without the further commitment of his own resources, that is, without obligation on the taxpayer's part to perform a further service or to furnish anything additional in the way of labor or capital. This, of course, is an outstanding circumstance in all of the cases reviewed, so that as respects the presence of value appreciation, the *Dresser Industries* decision is no less than accurate. By the same token, to the extent that such decisions as *Holt*, *Eidson*, and *Bisbee-Baldwin* may seem to equate contract liquidation payments with an advance upon future services, they are literally in error. The source of value in these cases is in the contract commitment itself and in the willingness of the parties to take the risks of the market for the period agreed upon. In most instances there is no significant capital investment in the contract and hence the contract right is usually without a basis; but while this fact may, as the *Halliburton Oil* case suggests, have some bearing on the Code requirement of “property,” it has no apparent consequence for “value.” The contract cases thus appear to conform with the Supreme Court's assumption as to congressional purpose.

2. *Future Income*

Once the contract cases are seen to contain the requisite element of realized value appreciation, the propriety of applying the income anticipation doctrine of *Hort* and *Lake* becomes very doubtful unless some long-standing assumptions about these decisions are now to be discarded. It is usually said that the present value of an asset reflects the discounted sum of the future income payments expected to be derived from it. Nevertheless, the tax law “prefers” gains realized upon the occasion of a change in rate of capitalization over gains realized in the form of periodic income distributions. This preference can be carried out only if enhancement of property value is sharply distinguished from periodic income. In general, the distinction is administered by means of a termination

of interest requirement under which the taxpayer is afforded capital gain only if he acts so as to create a definitive change in the form of his holdings. Apart from their disputed application to the contract termination cases, the *Hort* and *Lake* decisions have long been regarded by the tax bar as concerned solely with the need to apply this latter requirement in the rather unusual case in which a right to receive income for a limited period is separately disposed of by the owner of a larger interest in the same property.

In this situation the Supreme Court has held in effect that the sale of a short-term income interest by the owner of the underlying corpus is to be considered as equivalent to the receipt of periodic income payments and not as the realization of any change in property value. The rule, which has an obvious function in preventing the conversion of ordinary investment income into capital gain by periodic anticipation, is usually explained by comparing the status of two shareholders owning the same appreciated security, one of whom sells his dividend rights for an advance period, say five years, while the other retains and exercises his rights in the normal fashion.⁸¹ Assuming no change in the value of the security, at the end of five years each shareholder will still be the owner of the same appreciated property, and each will have received five years worth of dividends, though over a different time-period. Since both will thus have retained the unrealized gains inherent in their investments, the amount received by each is deemed to be income rather than property appreciation. For the same reason, if the purchaser of the short-term dividend right should subsequently resell his acquired interest for an amount in excess of his unamortized cost, the gain would presumably be considered as attributable to property appreciation and not to periodic income.⁸²

The facts in the *Hort* case actually differ somewhat from the illustration just given, but the Court's reasoning, particularly its view of the basis issue, seems consistent with the theory of the illustration. In *Hort* the taxpayer had inherited certain real estate subject to 15-year lease. Subsequently, when the lease still had some nine years to run, the taxpayer and his lessee agreed to a cancellation of the lease in consideration for a cash payment by the lessee, the leased premises having substantially declined in value. The taxpayer argued for the recognition of a loss on the ground that his inherited basis for the lease (the commuted value of the unma-

81. See ALI, DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 273-74 (1960).

82. See *Blair v. Commissioner*, 300 U.S. 5 (1937); Rev. Rul. 251, 1954-2 CUM. BULL. 172.

tered rental payments) exceeded the cash received plus the fair market value of the leased premises for the remaining nine-year term. The Court held, however, that the cash payment represented ordinary gain. The decision contains the observation that "basically the payment was merely a substitute for the rent reserved in the lease,"⁸³ and this statement, taken by itself, may be said to indicate that the Court regarded the taxpayer's right to income payments as lacking in the essential characteristics of a capital asset. But the result can also be attributed to the taxpayer's ownership of the underlying fee and to the Court's unwillingness to consider the taxpayer's inheritance as consisting of two independently valuable properties. Thus, in addition to finding that the cash payment was ordinary income under the circumstances, the Court denied the taxpayer a separate basis for the leasehold and in effect, as in the illustration, reserved the entire change in capital value to the fee interest.

That the intention in *Hort* and *Lake* was merely to affirm that a sale of income rights unaccompanied by a disposition of the underlying property is to be treated as a prepayment of rents, dividends, etc., and not as the realization of capital appreciation, is indicated by the Court's practice of relying on assignment-of-income decisions to support an ordinary income result in the former cases. Thus, *Helvering v. Clifford*,⁸⁴ *Helvering v. Horst*,⁸⁵ and *Harrison v. Schaffner*⁸⁶ are cited in *Lake*, and *Horst* in *Hort*. Since they do not otherwise bear upon the definition of capital asset, the relevance of these assignment-of-income decisions to the issue of capital gain must derive from the presence of a termination of interest requirement in both areas. The Court evidently considers the requirement as having equivalent effect whether the litigated issue relates to choice of taxable person or to a choice between capital gain and ordinary income, and the same parallel application has been stressed by the Commissioner.⁸⁷

It seems unlikely, therefore, that *Hort* and *Lake*, despite broad language in both, can reasonably be interpreted as holding that a right to create future income simply fails, by reason of an inherent defect in the property itself, to meet the definitional requirements of section 1221. The customary carved-out interest reading is far more tenable, particularly as the broader view is highly susceptible to attack by extension, as in the *Dresser*

83. 313 U.S. at 31.

84. 309 U.S. 331 (1940).

85. 311 U.S. 112 (1940).

86. 312 U.S. 579 (1941).

87. See Rev. Rul. 275, 1958-1 CUM. BULL. 22; Rev. Rul. 251, 1954-2 CUM. BULL. 172.

Industries opinion. One would have to place a limit on such a broad view in order to avoid the conclusion that a sale of land or securities also involves a sale of future income rights,⁸⁸ and then limit it still further to prevent its application to a sale of goodwill. In effect, such an exclusionary principle would have to be confined to intangible interests involving little or no capital outlay and interests having a limited and predictable useful life. But the statute contains no such distinctions, and the courts are not likely to feel authorized to create a detailed set of criteria involving these elements on a case-by-case basis.

In the end, it seems most satisfactory to read the *Hort* and *Lake* decisions in the usual way and to restrict their application to situations involving a sale of detached income rights by one retaining a residual interest in the same property. But since this element of carved-out interest is generally lacking in the contract termination cases, this line of authority seems rather vulnerable from the Commissioner's standpoint and may ultimately lead away from a finding of ordinary income.

3. *Substantial Property*

As an alternative to the future income theory, the Commissioner has also sought to limit capital gain by application of a property requirement. The courts, too, have sometimes found ordinary income on the ground that the taxpayer's contract rights lacked the status of property, particularly in cases involving the cancellation of an agency or employment agreement.⁸⁹ The Second Circuit, moreover, has given special emphasis to the distinction between substantial and insubstantial property rights in this context, and traces of the same approach can be found in *Halliburton Oil*.

The Commissioner, although conceding that payment to a lessee for cancellation of a lease results in capital gain, has stated that he "will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset . . . and will treat amounts received in consideration of such relinquishment as constituting ordinary income . . ." ⁹⁰ Despite the focus on "relinquishment," it is apparent that the Commissioner now frequently finds ordinary income whether the contract is released to the other contracting party or is assigned to a third

88. Compare *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960), in which the court found capital gain on the sale of a lease having slightly more than two years to run.

89. See *Thurlow E. McFall*, 34 B.T.A. 108 (1936).

90. Rev. Rul. 531, 1956-2 CUM. BULL. 983-84.

party.⁹¹ He has never stated precisely why he considers simple contract rights as lacking in the characteristics of a capital asset, but the explanation may lie in the view either that a contract right is not a capital asset because it calls for a continuing performance on the taxpayer's part, or that a contract "is not the sort of property which is susceptible of ownership for a length of time as is a share of stock, a bond, or a thing."⁹²

To the extent that this reasoning seems to equate contract termination payments with amounts paid as compensation for a service rendered or to be rendered, it tends to resemble the *Hort-Lake* future income analysis and is subject to the same objections, which relate both to the impropriety of extending *Hort* and *Lake* beyond the carved-out interest situation with which those decisions were intended to deal, and to the error made in regarding contract termination payments as an advance for service rather than as an instance of realized value appreciation. To the extent that the Commissioner's approach involves an "ownership" concept, it is simply puzzling. What aspect of ownership is at issue? Literally, the contract belongs to the taxpayer in the sense that his rights thereunder cannot legally be terminated. Moreover, these rights necessarily date from the time that the contract is entered into; from that point on there is a possibility of gain over and above the cost of furnishing or acquiring the particular service and likewise an exposure to loss if the commitment turns out to have been ill-judged, so that the taxpayer is "at risk" from the outset. The contract is salable in the broad sense; hence it is "held," and the choice to sell or retain depends upon the same general and individual considerations that would be expected to influence the possessor of any income-producing asset. In these respects the situation sufficiently resembles other kinds of economic venturing, including the possession of "a share of stock, a bond, or a thing," so that talk of "ownership," without additional explanation, seems fairly artificial.

The *Ferrer* decision also applies principles of property and ownership, but with a specific refinement. Thus, the Second Circuit distinguishes between substantial and insubstantial property rights on the basis of an equitable remedy standard. A mere claim to damages in the event of breach fails to convey an appropriate sense of possession, it appears, while a right to injunctive relief imports an interest which resembles direct ownership of the property constituting the subject matter of the contract. But

91. See *Paul Small Artists, Ltd.*, 37 T.C. 223 (1961).

92. *Thurlow E. McFall*, 34 B.T.A. 108, 110; see Rev. Rul. 301, 1958-1 CUM. BULL. 23, 24.

while the particular outcome in *Ferrer* has an attractive quality of compromise, as a test of general application the availability of injunctive relief seems unlikely to produce defensible results. The taxpayer in *Pittston*, for example, seems no less entitled to capital gain treatment than the taxpayer in *Ferrer*, and in some respects the claims of the former are more appealing. As in *Ferrer*, the remedy standard also means that state law is to play an important and perhaps determinative role in defining "property" in these cases, although the Supreme Court in the *Lake* case, confronted with the fact that an oil payment constitutes an "interest in land" under Texas law, expressly rejected the use of state property concepts for the purpose of capital asset classification.

On analysis, it appears that insofar as a distinction based upon the availability of an equitable remedy has the effect of creating a category of non-capital contract rights, it again involves the assumption that payment for the termination of a contract calling for continued performance on the payee's part is essentially an advance upon services. Thus, suppose that *A* desires the cancellation of his contract with *B*, not because the value of *B*'s service to *A* has changed in the market, but because *A* now intends to devote his own income-producing resource to a wholly different use or to withdraw those resources and dispose of them for cash. If *B* is limited to damages in enforcing his contract rights, *A* need offer no more for the cancellation of those rights than an amount reflecting the assumed value of *B*'s damage claim, taking into account *B*'s duty to mitigate. Where the market value of *B*'s service remains unchanged, therefore, *A* would theoretically offer little or nothing for *B*'s consent to cancellation. On the other hand, if *B* is entitled to injunctive relief, he thereby possesses a charge or restraint upon *A*'s property which he need not release except for a consideration. *A* would then be obliged to pay a premium for his freedom from the contract, just as the issuer of a bond might be obliged to pay a premium for the right to call the bond prior to maturity.

It is possible, by manipulation of a property test, to distinguish between a payment to *B* for the release of *B*'s restraint upon *A*'s freedom to dispose of his property, and a payment to *B* which reflects the present value of *B*'s performance rights. Thus, the former can be realized only by disposing of the contract and not through continued performance; the latter can be realized as well by performing the contract to completion. The Second Circuit's stress on injunctive relief may be rationalized as a willingness to identify the premium or penalty feature with capital gain; when equitable restraints are lacking, on the other hand, the court re-

gards the amount received as attributable solely to performance rights (non-substantial property) and agrees with the Commissioner in finding ordinary income.⁹³

But whatever substance can be found in an equitable interest standard, there is again the broader question of why a contract right, having acquired a liquidating value, should not be regarded in the same light as a share of stock, a bond, or a thing, whether or not it qualifies as an equitable interest in property. Thus, if capital gain extends to the premium received by a bondholder on the bond's being called prior to maturity, it also extends to the realization prior to maturity of an increase in the value of the bond resulting from a decline in interest rates. As noted previously, the status of a bondholder following a drop in interest rates, and the status of one committed to a performance obligation following a drop in the cost of his performance, are generally similar in the sense that each now owns a thing which can be sold at a gain to someone willing in effect to substitute his own capital or performance for that of the seller. If the performance obligor is given ordinary income treatment, the bondholder should be treated in the same fashion; yet all are aware that the bond is a capital asset. The same is true, as the court apologetically points out in *Ferrer*, of a debenture, than which "it would be hard to think of a contract more 'naked' . . . yet no one doubts that it is a 'capital asset' if held by an investor."⁹⁴

What has been said in connection with the future income limitation applies equally to an analysis based upon substantial and insubstantial property rights. Unless the courts are prepared to undertake the development of an elaborate set of criteria involving such elements as capital outlay and length of pay-out period, it is difficult to see how distinctions based on property and ownership can be maintained with any appearance of logic. The Supreme Court has stated that the proper object of capital gain treatment is value appreciation. If that element is lacking, the presence of property in an abstract sense will not save matters from the taxpayer's standpoint. It seems as well to apply the same maxim in reverse and to say that if the element of value appreciation is present, the concept of property ought not to be available to the Commissioner as an exclusionary device. The Court's value premise is, in a sense, a simple and reliable one, and

93. The fragmentation procedure in *Ferrer* may be stretched to fit this distinction. The court there required an allocation of the percentage money between anticipated performance income and the premium (so to speak) paid for release of the taxpayer's equitable restraints, with the former apparently expected to absorb the major share of the total.

94. 304 F.2d at 129-30.

as the cases show by their confusion, there is a good deal to be said for taking it at face value instead of seeking limitations in an undefined property requirement.

4. *Everyday Business*

Once the presence of realized value appreciation is admitted, as perhaps it ought to be in these cases, the only real question left for consideration is whether the result for tax purposes is affected by the business context factor. A notable thing about the Commissioner's expressed position in this area is that it seems to derive so little from the obvious fact that each of the cases discussed above involved business property and business income. Yet it would appear to be precisely this circumstance that brings on the Commissioner's deficiency action in the first place. If any of the foregoing cases had arisen outside the taxpayer's business or profession — if, for example, an investor had purchased Ferrer's right to share in the motion picture proceeds and had then resold that right at a profit — the result would quite clearly have been capital gain⁹⁵ and there is little likelihood that the Commissioner would contend otherwise at the present time. Thus, the Commissioner has held that the sale of bond coupons acquired separately from the bond produces capital gain;⁹⁶ likewise he shows no inclination to relitigate the treatment of life estates. In effect, he now contests the status of income rights only when the issue comes up in a business setting. The difficulty is that he does so in terms broad enough to apply to investment property as well, a point which the courts in *Dresser Industries* and *Ferrer* emphasized to his disadvantage.

Finding ordinary income on a sale of corn futures acquired by a processing company as insurance against an increase in the price of its basic raw material, the Supreme Court in *Corn Products*⁹⁷ explained its holding with another reference to congressional intent:

Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income.⁹⁸

95. See *Pat O'Brien*, 25 T.C. 376 (1955); *Pacific Finance Corp.*, 12 CCH Tax Ct. Mem. 419 (1953).

96. Rev. Rul. 251, 1954-2 CUM. BULL. 172.

97. 350 U.S. 46 (1955).

98. *Id.* at 52.

The Court has not found an opportunity in the ten years since *Corn Products* was decided to expand upon the meaning of this language. While the general rule of construction for which the decision is best known has become axiomatic in capital gain law, there is uncertainty as to how the *Corn Products* doctrine works in the area to which it specifically applies, that is, the treatment of business property which is not real or depreciable within section 1231. In addition to business contracts, this miscellaneous or residual category may include securities, commodities futures, goodwill, and presumably other business interests not presently identifiable. The classification of business contracts can thus be generalized as a problem of how to treat any business property not squarely within the stock-in-trade exception and not a section 1231 asset.

The interpretative possibilities arising out of the *Corn Products* decision are usually said to be twofold: first, a restrictive interpretation under which the *Corn Products* doctrine would apply only to business property which can reasonably be assimilated to stock in trade; and second, a broader view under which the doctrine would be extended to cover most or all business property which is not real or depreciable.⁹⁹ So stated, the issue in effect is whether the quoted language was merely in aid of an expanded construction of the stock-in-trade exclusion, or whether something more was intended.

The Commissioner's approach to *Corn Products* has been rather circumspect, but on the whole he seems to adopt the narrower stock-in-trade interpretation.¹⁰⁰ Published rulings dealing with the specific application of the *Corn Products* doctrine have mostly been concerned with the treatment of gain or loss on the sale of stock, bonds, or other securities purchased as a means of obtaining

99. See ALI, *op. cit. supra* note 81, at 354; Freeman, *Is There a New Concept of a Business Asset?*, 36 TAXES 110 (1958).

100. Thus, Treas. Reg. § 1.1221-1(a) (1957) states simply: "The term 'capital assets' includes all classes of property not specifically excluded by section 1221." The Commissioner has utilized *Corn Products* in resolving doubts about the scope of the stock in trade exclusion. See Rev. Rul. 141, 1962-2 CUM. BULL. 182 (motion picture and television films produced with a view to outright sale following an initial period of leasing held within the class of stock in trade). He has also attempted to apply *Corn Products* in cases involving property sold along with business inventory or acquired as a by-product of ordinary business activity. See Rev. Rul. 77, 1958-1 CUM. BULL. 118 (deposits on depreciable containers used by taxpayer in shipping its products and forfeited by customers on failure to return them). But the courts have not been especially receptive to the creation of a category of ordinary by-products income. See *E. I. du Pont de Nemours v. United States*, 288 F.2d 904 (Ct. Cl. 1961) (rejecting Rev. Rul. 77, *supra*); *Ralph H. Peters*, 37 T.C. 799 (1962); *McCullough Transfer Co.*, 27 T.C. 822 (1957).

needed business property such as inventory.¹⁰¹ It is reasonably plain in these cases that the securities are regarded by the taxpayer not as an investment in the usual sense but as a necessary business expenditure. Ultimately, the taxpayer's business needs having been met (or thwarted), the securities are disposed of or become worthless. In this situation the Service has ruled that ordinary gain or loss results if "the objectives for which the stock or securities are purchased are such as may be accomplished and the stock or securities disposed of within a relatively short time after their acquisition."¹⁰² Securities entitling the taxpayer to obtain "a specific amount of . . . inventory within a specified time,"¹⁰³ or enabling the taxpayer to overcome a "temporary" inventory shortage by acquiring a specific proportion of a supplier's output, are thus viewed as ordinary. On the other hand, securities purchased in order to meet a long-term business need — one that is not associated with a particular transaction or with a temporary condition — are evidently regarded as capital assets despite the absence of a non-business "investment" motive. The dividing line, of course, is not known. Clearly enough, however, the Service will resist ordinary loss treatment where the underlying business arrangement is subject to no fixed termination date,¹⁰⁴ or where the securities represent control of the issuer.¹⁰⁵ Presumably, ordinary treatment is permitted only if, at the time the securities are purchased, the end of their usefulness in the taxpayer's business is well in view. Although these rulings are expressed in terms of gains as well as losses, it seems apparent that the Service is principally concerned with the loss side of the situation, and indeed almost all of the business-related securities cases decided by the courts to date have involved claims of ordinary loss.¹⁰⁶

101. See Rev. Rul. 41, 1958-1 CUM. BULL. 86; Rev. Rul. 40, 1958-1 CUM. BULL. 275; cf. Rev. Rul. 18, 1961-1 CUM. BULL. 5.

102. Rev. Rul. 40, 1958-1 CUM. BULL. 276.

103. Rev. Rul. 40, 1958-1 CUM. BULL. 275.

104. See Rev. Rul. 44, 1963-1 CUM. BULL. 11, *acquiescing in* Ancel Greene & Co., 38 T.C. 125 (1962). A previous ruling, Rev. Rul. 41, 1958-1 CUM. BULL. 86, finding capital loss in the sale by the taxpayer, a mortgage company, of stock in the Federal National Mortgage Association (FNMA), acquired as a condition of selling mortgages to the Association, was rejected in *McMillan Mortgage Co.*, 36 T.C. 924 (1961), *acquiesced in result*, 1963-1 CUM. BULL. 4. Section 162 of the Code now permits the cost of FNMA stock in excess of its value at the issue date to be deducted as an ordinary and necessary business expense.

105. See *Electrical Fittings Corp.*, 33 T.C. 1026, 1031 (1960).

106. The *issuer* of securities under a tie-in purchase arrangement has ordinary income to the extent of the difference between the issue price and the investment value of the securities. Rev. Rul. 18, 1961-1 CUM. BULL. 5. See also *Aircraft Mechanics, Inc.*, 30 T.C. 1227 (1958).

Despite the Commissioner's position, taxpayers have enjoyed remarkable success in persuading the courts to permit these securities losses to be deducted in full, even when the tied-in business arrangement was of a long-term variety. In *Booth Newspapers, Inc. v. United States*,¹⁰⁷ for example, the taxpayers, newspaper publishers, acquired all the stock of a paper mill company in order to assure themselves an adequate supply of newsprint during a period of shortage. Subsequently, when the shortage eased and newsprint became available from regular sources of supply, the taxpayers disposed of their paper mill stock at a substantial loss. The Commissioner contended that the taxpayers, having acquired a manufacturing subsidiary and having held the same for almost seven years, should be limited to a capital loss deduction on selling it. But the Court of Claims, stressing the taxpayer's urgent need for newsprint, found the loss to be part of the cost of obtaining vital inventory and permitted a full ordinary deduction. The court reasoned that the paper mill stock had been purchased not as an investment but "as an integral and necessary act" in the conduct of the taxpayers' business and concluded that the loss was within the scope of the *Corn Products* doctrine.¹⁰⁸ The Tax Court has reached a similar result in a number of decisions, notably *Tulane Hardwood Lumber Co.*¹⁰⁹ in which full deduction was allowed for a loss on the sale of debentures of a supplier corporation acquired by the taxpayer as a means of obtaining a dependable source of supply. The Commissioner has indicated his disagreement with the reasoning in *Tulane Hardwood*,¹¹⁰ though it appears at present that as respects inventory supply situations his litigating efforts may be confined to cases involving the securi-

107. 303 F.2d 916 (Ct. Cl. 1962).

108. To the same effect see *Journal Co. v. United States*, 195 F. Supp. 434 (E.D. Wisc. 1961); *Smith & Welton v. United States*, 164 F. Supp. 605 (E.D. Va. 1958). See also *Byerlite Corp. v. Williams*, 286 F.2d 285 (6th Cir. 1960). Loss on securities purchased to obtain a sales outlet or to retain the good will of an important customer has also been held ordinary. *John J. Grier Co. v. United States*, 328 F.2d 163 (7th Cir. 1964); *Hagan v. United States*, 221 F. Supp. 248 (W.D. Ark. 1963).

109. 24 T.C. 1146 (1955). See also *Weather-Seal, Inc.*, 22 CCH Tax Ct. Mem. 471 (1963); *Electrical Fittings Corp.*, 33 T.C. 1026 (1960); *Helen M. Livesley*, 19 CCH Tax Ct. Mem. 133 (1960); *Arlington Bowling Corp.*, 18 CCH Tax Ct. Mem. 896 (1959).

110. 1958-1 CUM. BULL. 6 n.11. The Commissioner apparently still places reliance on *Exposition Souvenir Corp. v. Commissioner*, 163 F.2d 283 (2d Cir. 1947), and *Logan & Kanawha Coal Co.*, 5 T.C. 1298 (1945). See Rev. Rul. 41, 1958-1 CUM. BULL. 86; Rev. Rul. 40, 1958-1 CUM. BULL. 275. Both decisions would appear to be in doubtful status at present, however. See *Commissioner v. Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir. 1955); *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955).

ties of a subsidiary and to cases involving securities held "too long," *i.e.*, beyond the point at which the tie-in purchase function continues to have importance.¹¹¹

The implications of decisions like *Booth Newspapers* and *Tulane Hardwood* for the classification problem presented by section 1221 are not entirely clear. The stock-in-trade exclusion can hardly be extended to apply to a long-term supply arrangement, and the courts generally make no effort to treat the securities themselves as an inventory substitute. On the other hand, some of the decisions do indicate that the courts considered the securities as non-capital assets by reason of the taxpayer's business purpose in acquiring them, and that ordinary loss treatment is actually the result of a classification of the property under section 1221. Thus, the Tax Court, in a situation resembling that in *Booth Newspapers*, has stated that "stock purchased in the ordinary course of business . . . is not a capital asset, and the loss upon its sale is deductible from ordinary income."¹¹² Elsewhere, however, the court has noted that the problem of business-related securities may be resolved in favor of ordinary loss "without specific consideration of the capital gains and loss provisions,"¹¹³ that is, presumably, by regarding the loss as allocable to the unrecovered cost of acquiring a valuable business relationship and permitting it to be deducted as an ordinary business expense or as an ordinary loss when that relationship is terminated. The matter of precise characterization is not especially important where a loss is present, since the end result is not greatly affected by whether the loss is reflected as cost of goods sold, as a business expense under section 162, or as an ordinary loss under section 165.¹¹⁴

Although the two are not usually considered together, the contract termination and the business-related securities cases quite obviously have elements in common; indeed, the one would seem to be the obverse of the other.¹¹⁵ Thus, both involve the termination of a previously acquired business opportunity, frequently a contract right. In *Tulane Hardwood*, the debenture purchase was tied in with a five-year supply contract. To the extent that

111. *Missisquoi Corp.*, 37 T.C. 791 (1962); *Gulftex Drug Co.*, 29 T.C. 118 (1957), *aff'd per curiam*, 261 F.2d 238 (5th Cir. 1958).

112. *Electrical Fittings Corp.*, 33 T.C. 1026, 1031 (1960).

113. *Missisquoi Corp.*, 37 T.C. 791, 796 (1962).

114. See *Huston, Tie-In Sales: Treatment of Loss on Resale of Property Purchased for the Purpose of Obtaining Other Property*, 10 TAX L. REV. 145 (1954).

115. *But see Mansfield Journal Co. v. Commissioner*, 274 F.2d 284 (6th Cir. 1960), finding ordinary income on the sale of rights under a newsprint supply contract, the court placing principal reliance on the "everyday business" language of *Corn Products*.

the cost of the debentures exceeded their true investment value, the taxpayer was simply prepaying a portion of the cost of the merchandise to which it was entitled from the issuer. The *Pittston* case, which also involved an integrated loan-supply contract arrangement, would appear to differ from *Tulane Hardwood* chiefly in the respect that the contract turned out to be valuable instead of worthless. The Commissioner, nevertheless, has argued the two situations in different terms. In the contract cases he has opposed capital gain treatment by contending for a broad construction of the *Hort* and *Lake* decisions; in the securities cases he has opposed ordinary loss treatment by pressing for a narrow application of the *Corn Products* doctrine. In effect, the Commissioner has sought an ordinary gain-capital loss rule for cases involving the disposition of a business relationship, while taxpayers, with rather more success on the whole, have sought the opposite pattern.

A capital gain-ordinary loss pattern (that is, a combination of *Dresser Industries* and *Booth Newspapers*), if one should emerge, would suggest that business contracts and arrangements, and perhaps other non-depreciable business personalty such as stock exchange seats,¹¹⁶ had come to achieve a status resembling that of section 1231 property. Such a development would be wholly accidental, however; there is no indication that Congress intended a section 1231 pattern to apply more generally than it does. On the other hand, the business related securities cases provide some evidence that nondepreciable personal property which plays a role in the everyday operation of a business enterprise may be regarded as ordinary despite the structure of the capital asset definition. In addition, there is the point that although the property at issue in *Corn Products* could readily have been assimilated to inventory, the Supreme Court chose to decide the case in a manner that suggests it was responding to a problem of broader dimension than the limited question of whether securities or commodities futures can be brought within the stock-in-trade exclusion.

If nothing else, posing the contract termination problem as one relating to the classification of business income takes the issue out of the *Hort-Lake* framework and focuses attention on the one

116. Compare *Samuel Cummins*, 19 T.C. 246 (1952). The taxpayer, engaged in the business of buying and selling commodities, sustained a loss on the sale of a seat on the New York Produce Exchange. The Tax Court found a capital loss on the ground that the seat, though admittedly business property, was neither stock in trade, nor real property, nor (since not definitely limited in duration) depreciable property. The court's subsequent decisions in the cases cited in note 109 *supra*, suggest that the *Cummins* situation might now result in ordinary loss.

element which differentiates these business contract cases from those involving investment property such as life estates. The conflict among the cases can better and more simply be understood in business asset classification terms than in terms of the customary fruit-and-tree analysis. Thus, *Dresser Industries* may be explained as an attempt to assimilate the termination of a business contract to a sale of goodwill, the capital asset status of which is presumably beyond question.¹¹⁷ *Halliburton Oil*, on the other hand, would appear to treat termination payments as if attributable to the sale of stock in trade or services. *Ferrer*, again occupying the middle ground, reflects an effort to formulate a distinction between a sale of underlying productive facilities and a sale of end products or services on the basis of a concept of substantial property, thus in effect assimilating some kinds of nondepreciable business interests to section 1231 property. Again, this latter effort possesses an attractive quality of compromise, though one may question the relevance of an injunctive relief standard which is nowhere found or implied in the statute.

In singling out certain productive facilities for capital gain treatment under section 1231, Congress has adopted a standard of depreciability as respects the status of personal property used in business. Presumably, property is depreciable if its acquisition

117. Normally, however, a sale of goodwill requires a sale of the taxpayer's entire business, so that a transaction involving less than a disposition of the total enterprise would not appear to qualify as such. See *Dodge Bros. v. United States*, 118 F.2d 95 (4th Cir. 1941); cf. *Henry Maddock*, 16 T.C. 324 (1951). *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962), indicates that the court may have been influenced in finding capital gain by the fact that the contract termination was equivalent to a termination of a major feature of the taxpayer's business—a partial liquidation, so to speak. The same consideration was not present in *Dresser Industries*, however, and, though present, was not deemed significant in cases like *United States v. Eidson*, 310 F.2d 111 (5th Cir. 1962) and *United States v. Woolsey*, 326 F.2d 287 (5th Cir. 1962).

The sale of a contract incident to a sale of the business as a whole would seem to sufficiently resemble a transfer of goodwill to justify capital gain treatment, provided that the business involved a significant element of public patronage and was not merely an employment activity. *Masquelette's Estate v. Commissioner*, 239 F.2d 322 (5th Cir. 1956). On the other hand, the sale of a right to profit, particularly a right of limited duration, by an ongoing business enterprise involves no goodwill transfer and presents instead the question whether the contract right itself is a capital asset. A distinction based on business liquidation would appear to be a defensible one and it is not inconceivable that such a distinction might derive from the Supreme Court's "everyday business" language in *Corn Products*. So viewed, the *Corn Products* decision would be of a piece with *Hort* and *Lake* in the sense that it, too, would involve an application of the termination of interest requirement found in the latter cases.

involves some capital outlay on the taxpayer's part and if the property is of limited duration in the taxpayer's business. Business contracts involving no initial acquisition cost to the taxpayer would therefore generally seem to lack the quality of depreciability for purposes of section 1231.¹¹⁸ The implication may be that such property, being nondepreciable, also lacks an essential characteristic of a business capital asset. Admittedly, a contrary implication is also available, though largely by reason of the failure of the Code to create a completed classification system for business property. The choice, at all events, is reasonably straightforward and lies between a narrower and a broader conception of the application of the capital gains tax in a business setting.

CONCLUSION

The outlook for uniform tax treatment of contract cancellation payments seems dim at present. While the older cases, like the

118. The courts, busy with questions of property and income anticipation, have given little consideration to whether business contracts belong in the category of depreciable property used in the trade or business, although taxpayers have sometimes contended for section 1231 treatment in the alternative. *United States v. Dresser Industries*, 324 F.2d 56 (5th Cir. 1963). In Rev. Rul. 4, 1960-1 CUM. BULL. 303, the Commissioner held that a leasehold which, at the time of its sale, had more than 30 years to run constituted real property, and if used in the seller's business, constituted a section 1231 asset. Presumably a lease for less than 30 years is regarded by the Commissioner as a capital asset under section 1221 and not as section 1231 property. See Rev. Rul. 531, 1956-2 CUM. BULL. 983. *But see Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960) (treating leasehold having 10 months to run as section 1231 property); *Marc D. Leh*, 27 T.C. 892 (1957), *aff'd*, 260 F.2d 489 (9th Cir. 1958) (short-term supply contract might be section 1231 property, but finding no sale or exchange). See also Rev. Rul. 374, 1955-1 CUM. BULL. 370, finding in the circumstances that a distributorship was a capital asset under section 1221.

While an intangible, such as a leasehold, may presumably qualify as "depreciable" property if its acquisition involves some cost to the taxpayer, *Tom S. Baker III*, 38 T.C. 9, 14 (1962), the application of section 1231 to the contract termination cases reviewed above seems unlikely. Generally, these contract arrangements require no capital outlay, prepayment of rents or fees or other initial acquisition costs, but instead involve a continuing forward exchange between the parties. The costs of performance on each side are incurred periodically and are deductible when incurred. The taxpayer almost invariably has a zero basis for his contract rights. *Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654 (10th Cir. 1962). Contract rights acquired at no cost would not properly appear on the taxpayer's books as an asset. FINNEY & MILLER, *PRINCIPLES OF ACCOUNTING: INTRODUCTORY* 201, 215 (6th ed. 1963). See *Aircraft Mechanics, Inc.*, 30 T.C. 1227 (1958). Depreciability for purposes of sections 167 and 1231 would seem at least to require that there have been an initial investment in the contract and hence something to exhaust. *Great Western Fuel Co.*, 8 B.T.A. 9, 12 (1927).

more recent ones, were essentially inconsistent, they did at least largely confine capital gain to real estate lease cancellations, so that the decisions were superficially reconcilable by reference to the subject matter of the contract terminated. The *Ferrer* and *Dresser Industries* decisions have altered this by extending capital gain treatment to non-real estate transactions; likewise, the *Nelson Weaver Realty* and *Dresser Industries* decisions are bluntly in conflict with other recent decisions within and without the Fifth Circuit. The Supreme Court, nevertheless, is pretty clearly not of a mind to grant review in these cases,¹¹⁹ although the general issue seems not unimportant from the standpoint of the need for consistent administration of the capital gains tax. As respects legislative action, Congress in 1954 took a tentative step in this area by "supplying" the requirement of sale or exchange for certain leasehold and distributorship transactions, but it obviously did not intend thereby to provide any overall solutions, and there is even doubt whether it intended to suggest a direction or trend in attitude. The prospect for further legislation of a character sufficiently refined to deal with the status of contract termination payments is exceedingly remote. Yet the cases have begun to multiply.

As suggested, the decisions of the circuit courts of appeals, with the exceptions of *Dresser Industries*, *Jones v. Corbyn*,¹²⁰ and perhaps *Commissioner v. Goff*,¹²¹ are generally based upon considerations of a highly artificial character, though in this respect they merely reflect the position taken by the Commissioner himself. On analysis, it appears that the termination of a contract interest does involve the realization of an increment in property value, and in this respect the situation matches up with the Supreme Court's reiterated assumption concerning the congressional purpose in establishing a preference for capital gain. This is true, moreover, without regard to the specific subject matter of the contract, and likewise, without regard to whether the taxpayer happens to occupy the status of "lessor" or "lessee" in the particular case at issue. Restrictions based on a conception of anticipated future income or on a requirement of property ownership are subject to

119. For example, the following cases would appear to have offered a promising opportunity for review: *Pittston Co. v. Commissioner*, 252 F.2d 344 (2d Cir.), *cert. denied*, 357 U.S. 919 (1958); *Commissioner v. Goff*, 210 F.2d 390 (5th Cir.), *cert. denied*, 348 U.S. 829 (1954); *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953). Consider Judge Raum's remarks in *Marc D. Leh*, *supra* note 118, at 898.

120. 186 F.2d 450 (10th Cir. 1950).

121. 212 F.2d 875 (3d Cir.), *cert. denied*, 348 U.S. 829 (1954).

criticism on two counts: first, they are unsupported by the Court's landmark capital gain decisions, and in the case of the property restriction they may even be in conflict with the Court's general approach in construing section 1221; second, taken literally, both restrictions go too far in limiting the definition of capital asset, or to put the matter otherwise, neither can logically be confined to contract termination transactions without a detailed legislative effort aimed at furnishing the requisite criteria. Viewed solely in terms of its economic structure and apart from the business context in which the situation often arises, the prototypical contract termination case exhibits the essential characteristics of a capital gain — realization and value increment — and hence the position expressed in *Dresser Industries* seems quite correct in abstract.

On the other hand, the propriety of a broad capital gain rule for all business contract terminations seems doubtful. What is involved, after all, is business profits, that is, profits attributable to a systematic activity normally conceived of as the prime generating source of income taxable at ordinary rates. The difficulty is that the capital gains tax does not in terms distinguish between business and non-business activities. Instead, the statute in effect divides business property into three categories: (1) stock in trade and property closely related thereto, (2) section 1231 assets, and (3) other property, including goodwill and other intangible interests such as contract arrangements. Property in the first two categories is dealt with by specific statutory designation: it is ordinary or capital, as the case may be, whether disposed of separately or as part of an overall liquidation of the taxpayer's business. Property in the third category is in a doubtful status, although the structure of the statute seems to point towards capital asset treatment. On the other hand, the Supreme Court's decision in *Corn Products* may be taken as authority to treat some if not all of the property interests in this residual category as ordinary. Moreover, the business-related securities cases suggest that some courts, in some circumstances, are willing to assume that this was precisely the Court's intention.

In the end, the contract termination cases present the question of how business assets should be classified in the absence of an express designation by the statute. Neither the courts nor the Commissioner have yet considered the matter in this way, having devoted themselves for the most part to a manipulation of the "property" requirement. It seems clear that the latter procedure is responsible for the present state of judicial conflict in this area; it may also be that conflict would appear whatever the prevailing

analysis. What is fundamentally at issue, however, is the role of capital gain in business. Putting aside tactical considerations, therefore, the development of meaningful legal argument seems to require that the issue be considered in terms of the reach of the *Corn Products* decision and its impact upon enterprise profits in general.