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Capital Gains and Losses: A Primer (Part One)

Thomas J. Gallagher, Jr.

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CAPTIAL GAINS AND LOSSES: A PRIMER (Part One)

THOMAS J. GALLAGHER, JR.

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CAPITAL GAINS AND LOSSES: A PRIMER (Part One)*

THOMAS J. GALLAGHER, JR.**

I. OVERVIEW

A. Capital Gains and Losses

1. Introduction

Gain or loss from the sale or exchange of certain types of property held for more than one year is treated differently from income from services, sales of goods, and other routine activities. The type of property that may give rise to such gain or loss is referred to as a capital asset. The Internal Revenue Code (the Code) defines "capital assets" in section 1221 to include all classes of property (with certain exclusions),¹ regardless of the length of time that they are held.² The excluded classes of property generally are related to property used in trade or business. The design of section 1221 is to distinguish gain which arises over an extended period of time from that which arises from everyday occurrences.

In general, gain or loss from the sale or exchange of a capital asset is "capital gain" which may qualify for special tax treatment, or "capital loss" which may be subject to restrictions on deductibility. Whether gain or loss falls within the special rules covering capital assets ordinarily depends upon whether (1) it arises in a transaction involving a "sale or exchange," (2) of a "capital asset," (3) which has been "held by the taxpayer." However, there are special statutory provisions that artificially provide capital gain or loss treatment to some situations which actually do not involve the sale or exchange of a capital asset.³ Conversely, some transactions, which

* Part Two, consisting of sections III., IV., and V., will appear in the next issue of this Review.

The opinions, conclusions, and recommendations contained in this article are entirely those of the author and do not necessarily represent or reflect the opinions, conclusions, or recommendations of the Joint Committee on Taxation, United States Congress.

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1. See generally Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation* (pts. I, II), 59 YALE L.J. 837, 1057 (1950); Silverstein, *The Capital Asset Definition*, 1959 Tax Revision Compendium 1285; see also, E. COLSON, CAPITAL GAINS AND LOSSES (1975); Hjorth, *An Introduction to Capital Gains and Losses*, 41 WASH. L. REV. 764 (1966).

2. For a discussion of the holding period, see section IV., Gallagher, *Capital Gains and Losses: A Primer (Part Two)*, to be published in vol. 7:2 of FLA. ST. U.L. REV. [hereinafter cited as *Part Two*].

3. See Part Two, *supra* note 2, section III.H. regarding statutory sales or exchanges.

appear to involve the sale or exchange of a capital asset, are placed outside the boundaries of the capital gain and loss rules.⁴

The precise reasons for treating capital gain or loss differently from other gain, loss, or income are not crystal-clear. The traditional arguments in favor of a different treatment include the following: (1) the sale or exchange of a capital asset usually involves only a change in the form of the taxpayer's investment; (2) gain or loss essentially is a reflection of the price structure and therefore is illusory; and (3) generally gain which has accrued over a substantial time period should not be subjected to the progressive tax rates in the year in which it is realized because this will result both in a greater tax than that which would have been payable had the gain been realized annually, and it will force the taxpayer to keep his investment.⁵ But regardless of why Congress actually accorded capital gains and losses special treatment, the decision has been made and is manifested by the basic provisions contained in sections 1201-1255. Although the details of these provisions have changed since their predecessors were enacted in 1921,⁶ the special treatment underlying their existence has remained relatively constant.

The 1916 Revenue Act contained no provision which explicitly covered gains and losses from dealings in property.⁷ Taxpayers quickly contended, therefore, that gain realized on a sale of property was not "income" within the meaning of the sixteenth amendment. In 1921, the United States Supreme Court rejected this argument in *Merchants Loan & Trust Co. v. Smietanka*, and upheld the inclusion of capital gain in income.⁸

About the same time, Congress decided to tax capital gains at lower rates than those which were applicable to other income. In recommending the enactment of what was to become the Revenue

4. See section II.B. *infra*, for a discussion of the *Corn Products* doctrine; section II.J. *infra*, regarding the receipt or disposition of income-related items; Part Two, *supra* note 2, section III.B.-G. for a more complete discussion of different kinds of sales or exchanges.

5. See Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957); Folsom, *Capital Gains, Consumption, Capital Gains Taxes and the Supply of Savings*, 19 NAT'L TAX J. 434 (1966); Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy*, 12 B.C. INDUS. & COM. L. REV. 387 (1971); Katsoris, *In Defense of Capital Gains*, 42 FORDHAM L. REV. 1 (1973); Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Wallich, *Taxation of Capital Gains in the Light of Recent Economic Developments*, 18 NAT'L TAX J. 133 (1965). See also M. DAVID, *ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION* (1968).

6. Revenue Act of 1921, Pub. L. No. 98, § 106(a)(6), 42 Stat. 227; see H.R. REP. NO. 350, 67th Cong., 1st Sess. 10-11 (1921). For an excellent history of the capital gains provisions up to 1951, see TAX ADVISORY STAFF, U.S. DEP'T OF THE TREASURY, *FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES* (1951).

7. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 19 (1924), reprinted in 1939-1 (pt. II) C.B. 255.

8. 255 U.S. 509, 3 A.F.T.R. 3102 (1921).

Act of 1921,⁹ the House Ways and Means Committee reasoned that special tax rates were necessary to relieve reluctance to sell capital assets because of "fear of prohibitive tax."¹⁰ The more favorable tax rate adopted in 1921 was modified by the 1934 Revenue Act to require that less than the entire amount of capital gains be included in income.¹¹ The amount excludible depended on the length of time that the taxpayer owned the property. Both the preferential rate and inclusion provisions were changed substantially by the 1942 Revenue Act, which simply imposed a flat rate on part of the gain from the sale or exchange of a capital asset held for more than six months.¹² With the exception of the recent increase in the holding period necessary for longterm capital gain treatment, and some intervening definitional and rate changes, the congressional solicitude for capital gains has remained largely stable since the 1942 Act.¹³

The limited deductibility of capital losses from ordinary income, first enacted in 1924,¹⁴ is a corollary of the preferential treatment accorded capital gains. The Ways and Means Committee report noted that the full deductibility of capital losses from ordinary income was an "injustice to the Government" since it allowed taxpayers too much leeway to take advantage of losses while paying a lower tax on capital gains.¹⁵ All subsequent acts have retained some form of restriction on the deductibility of capital losses from ordinary income.¹⁶

2. In General

Gain or loss usually will not be characterized as "capital" unless it meets the express statutory requirements. Generally, whether a gain or loss is "capital" rather than "ordinary" depends upon: (1) its arising from a "sale or exchange,"¹⁷ (2) of property that is a

9. Revenue Act of 1921, Pub. L. No. 98, 42 Stat. 227 (1921) (current version at I.R.C. §§ 1202, 1211).

10. See H.R. REP. No. 350, *supra* note 6.

11. Revenue Act of 1934, Pub. L. No. 216, § 117(a), 48 Stat. 680 (1934) (current version at I.R.C. § 1202). The Revenue Act of 1978 repealed the noncorporate alternative tax (§ 1201(b), (c)). Pub. L. No. 95-600, § 401 (1978).

12. Revenue Act of 1942, Pub. L. No. 753, § 150(a), 56 Stat. 798 (1942) (current version at I.R.C. § 1223).

13. Pub. L. No. 95-600, § 402, 92 Stat. 2763 (1978) amended § 1202 by increasing the deduction from gross income from 50% to 60%. See generally sources cited at notes 1 & 5 *supra*; see also Blum, *The Decline and Fall of Capital Gains: 1921-1957*, 28 TAXES 838 (1950).

14. Revenue Act of 1924, Pub. L. No. 176, § 208(c), 43 Stat. 253 (1924) (current version at I.R.C. § 1211). See generally Warren, *The Deductibility by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. CHI. L. REV. 291 (1973).

15. H.R. REP. No. 67-1388, 67th Cong., 4th Sess. 2 (1923).

16. See generally Warren, *supra* note 14.

17. I.R.C. § 1222. For a discussion of the concept of "sale or exchange," see *Part Two, supra* note 2, section III.

“capital asset,” and that (3) is held by the taxpayer.¹⁸ However, some events which do not involve a sale or exchange, and some property which is not a capital asset, are characterized artificially as “capital” by the Code.¹⁹ Similarly, some events which appear to satisfy the general requirements are characterized otherwise.²⁰ Finally, there is a narrow, but uncertain, area in which both the property and the transaction involved seem to meet the statutory requirements, yet are characterized differently by a well established judicial gloss.²¹ As a result, whether a gain or loss is capital or ordinary depends not only upon satisfying the general statutory prerequisites, but also upon avoiding the broad exceptions carved out from those requirements.

3. *Definitional Problems*²²

Normally, taxpayers will have little problem in determining whether their property is a capital asset, which, when sold or exchanged, will result in a capital gain or loss. As long as the property and its disposition meet the statutory requirements, without falling into one of the exceptions, the gain or loss realized merely will be a question of amount and not of character. However, much litigation has taken place due to the special tax treatment accorded capital assets and to the lack of precise definitions in the Code as to what constitutes a capital asset. Section 1221 defines a capital asset simply as “property” held by the taxpayer, then lists several exceptions. Consequently, in many instances taxpayers have attempted, ingeniously, to structure their transactions to avoid the capital asset exceptions, and to bring them within the more favorable provisions. As a result, the Internal Revenue Service (the Service) and the courts are prone to interpret the exclusions broadly, except where the taxpayer seeks to obtain ordinary—rather than capital—loss treatment for transactions that fall within the statute.²³

18. I.R.C. § 1222. For a discussion of the holding period, see *Part Two, supra* note 2, section IV.

19. See, e.g., I.R.C. § 1231, regarding property used in a trade or business and involuntary conversions.

20. See, e.g., I.R.C. § 1236, denying capital gains treatment to dealers in securities.

21. See section II.B. *infra*, for a discussion of the *Corn Products* doctrine.

22. See generally *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 5 A.F.T.R.2d 1770 (1960); *Miller v. Commissioner*, 299 F.2d 706, 9 A.F.T.R.2d 628 (2d Cir. 1962); Del Cotto, “*Property*” in the *Capital Asset Definition: Influence of “Fruit and Tree,”* 15 BUFFALO L. REV. 1 (1965); Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956); Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964).

23. See, e.g., *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46, 47 A.F.T.R. 1789 (1955), discussed at section II.B. *infra*. See also Brown, *The Growing “Common Law” of*

The resulting tension inevitably leads to some inconsistent and irreconcilable decisions.²⁴ Nonetheless, as a general rule the taxpayer usually can determine in advance the proper classification of gain or loss arising from the sale or exchange of property.

B. *The Statutory Provisions*

1. *In General*

The general rules for determining whether property is a capital asset are contained in section 1221. It provides that the term "capital assets" includes all classes of property unless excluded specifically by that section. The exceptions include: (1) inventory, stock in trade, and property held primarily for sale to customers in the ordinary course of business; (2) depreciable property and real property used in a trade or business; (3) copyright, literary, or similar property held by a creator, or by certain transferees; (4) accounts or notes receivable acquired in a trade or business; (5) certain governmental obligations; and (6) federal publications received at less than fair market value. With this definition in mind, the task facing taxpayers and the courts is to give meaning to the statutory framework.

2. *Stock in Trade or Inventorial Property*

In part, section 1221(1) excludes from capital asset status "[s]tock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year"²⁵ The purpose of this exclusion is to distinguish between the routine receipts of a business and the gain or loss from investment.²⁶ Generally this is an easy task, and one which rarely leads to litigation.

Although the above-quoted part of section 1221(1) contains two categories of property, stock in trade and property includible in inventory, neither can exist realistically without being held by the

Taxation, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW THIRTEENTH TAX INSTITUTE 1 (J. Ervin ed. 1961).

24. See generally Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 MINN. L. REV. 1 (1964); Del Cotto, *supra* note 22; Eustice, *Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case*, 20 TAX. L. REV. 1 (1964); *The Troubled Distinction Between Capital Gain and Ordinary Income*, *supra* note 22.

25. Also, section 1231 excludes stock in trade from "quasi capital asset" status. See *Van Suetendael v. Commissioner*, 152 F.2d 654, 34 A.F.T.R. 638 (2d Cir. 1945) (taxpayer unsuccessful in claiming to be dealer in securities so as to qualify for ordinary loss treatment under I.R.C. § 1231).

26. *Malat v. Riddell*, 383 U.S. 569, 17 A.F.T.R.2d 604 (1966).

taxpayer primarily for sale to customers in the ordinary course of trade or business.²⁷ The principal question that will arise with regard to this part of section 1221(1), therefore, is whether the property is held for that purpose. With few exceptions, everyday merchandise, goods, products, and property includible in inventory will be easily identified.

Stock in trade and inventorial property does not lose its character when the taxpayer makes a bulk sale of that property. In *Drybrough v. Commissioner*, the taxpayer sold his collection agency business and was denied capital gain treatment on that portion of the sale allocable to the collection claims which were considered to be his stock in trade.²⁸ Other claims, not owned by the taxpayer, but collectible by his agency, were accorded capital asset treatment on the theory that they constituted a mass asset in the nature of goodwill.²⁹ Gain attributable to the sale of these files was capital gain.

Depending on the surrounding facts and circumstances, when a liquidating corporation distributes its inventory to its stockholders, who then sell the property, the sale may result in capital gain even though a sale by the corporation would have generated ordinary income.³⁰ But where there is a single shareholder who decides to liquidate the corporation, or where the shareholders sell the distributed property in a manner similar to that of the corporation's business, the gain will be ordinary income.³¹

Under section 1221(4), accounts receivable arising on the sale of inventory property are excluded from the category of capital assets.³²

3. Property Held for Sale to Customers

As noted previously, section 1221(1) excludes from the definition of capital asset stock in trade, property includible in inventory, and property held *primarily* for sale to customers in the ordinary course of the taxpayer's trade or business. The purpose of section 1221(1)'s exclusion is to distinguish profits and losses from daily business operations and gain or loss from an investment.³³

27. *Wood v. Commissioner*, 16 T.C. 213, 225-26 (1951).

28. 45 T.C. 424 (1966), *aff'd per curiam*, 384 F.2d 715, 20 A.F.T.R.2d 5678 (6th Cir. 1967).

29. 45 T.C. at 437; see section II.I.5. regarding allocation on the sale of a business.

30. *Greenspon v. Commissioner*, 229 F.2d 947, 48 A.F.T.R. 979 (8th Cir. 1956); *Grace Bros. v. Commissioner*, 173 F.2d 170, 37 A.F.T.R. 1006 (9th Cir. 1949). *But see Baker v. Commissioner*, 248 F.2d 893, 52 A.F.T.R. 707 (5th Cir. 1957).

31. *See id.*

32. See section I.E. *infra* for a discussion of accounts and notes receivable.

33. *Malat v. Riddell*, 383 U.S. 569, 17 A.F.T.R.2d 604 (1966); *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46, 47 A.F.T.R. 1789 (1955).

Section 1231(b)(1)(A), (B) includes a similar exclusion, but it provides more favorable tax treatment, in some instances, than the capital gain rules. Section 1231 allows capital gain, but ordinary loss, on the sale, exchange, and specified other dispositions of real property and depreciable property held for more than one year and used in a trade or business.³⁴

a. Primarily for Sale

In *Malat v. Riddell*, the Supreme Court was asked to interpret the word "primarily" in section 1221(1).³⁵ There, the taxpayer was a member of a partnership which developed and acquired rental realty. The partnership, in turn, was a participant in a joint venture which had acquired a parcel of land.³⁶ The joint venturers subdivided and sold part of the property after encountering financing problems, and reported the gain as ordinary income. When additional financing problems were aggravated by zoning restrictions, the taxpayer decided to sell his interest. He reported his gain as a capital gain. The Service challenged this characterization, asserting that the joint venture had the dual purpose of developing the parcel or holding it for resale. In either event, the government took the position that any gain was taxable as ordinary income because the tract was held primarily for sale to customers in the ordinary course of the taxpayer's business.³⁷ Conversely, the taxpayer claimed that the parcel was held for development, and that he was entitled to capital gains treatment because the property was not held primarily for sale in the ordinary course of his business. The Ninth Circuit Court of Appeals had affirmed the district court's finding for the Commissioner.³⁸

The Supreme Court rejected the Service's argument that the word "primarily" meant substantial and reversed the lower courts. The Court stated:

The purpose of the statutory provision with which we deal is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one hand (*Corn Products Co. v. Commissioner*, 350 U.S. 46, 52) and "the realization of appreciation in value over a substantial period of time" on the other (*Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134.). A literal

34. For a full discussion of section 1231, see section II.D. *infra*.

35. 383 U.S. 569 (1966). See generally, Bernstein, "Primarily for Sale": A Semantic Snare, 20 STAN. L. REV. 1093 (1968).

36. 383 U.S. at 569.

37. *Id.* at 570.

38. *Malat v. Riddell*, 347 F.2d 23, 15 A.F.T.R.2d 1121 (9th Cir. 1965).

reading of the statute is consistent with this legislative purpose. We hold that, as used in § 1221(1), "primarily" means "of first importance" or "principally."³⁹

On remand, the district court found that the realty was not held primarily for sale to customers.⁴⁰

In holding that the word "primarily," as used in section 1221(1), meant "of first importance" or "principally," the Supreme Court rejected the interpretation of the word as meaning a substantial purpose for holding the property. The latter construction had prevailed in the Tax Court⁴¹ and in the Second⁴² and Ninth Circuits,⁴³ while the one adopted by the Supreme Court had been the position of the Eighth Circuit.⁴⁴

Despite the interpretation of the word "primarily" in *Malat*, many questions and problems remain in attempting to classify a particular taxpayer's holding of specific property. When the property is similar to inventory or stock in trade, and when the taxpayer is in the trade or business of selling that property, few issues will arise—except where the taxpayer contends that some of the property is held for his own investment account. At one time this was a particularly acute problem where the taxpayer was a securities dealer who also invested in securities. However, since the enactment of section 1236, which requires such persons to identify investment property by following the prescribed guidelines,⁴⁵ the greatest amount of litigation has involved real estate⁴⁶ and the sale and rental of equipment.⁴⁷

Aside from these issues, *Malat* still requires a determination that the taxpayer is in a trade or business in the ordinary course of which

39. 383 U.S. at 572.

40. *Malat v. Riddell*, 275 F. Supp. 358, 18 A.F.T.R.2d 5015 (S.D. Cal. 1966).

41. See, e.g., *Municipal Bond Corp. v. Commissioner*, 41 T.C. 20 (1963), *rev'd in part*, 341 F.2d 683, 15 A.F.T.R.2d 408 (8th Cir. 1965); *Rollingwood Corp. v. Commissioner*, 15 T.C. 1010 (1950), *aff'd* 190 F.2d 263, 40 A.F.T.R. 1006 (9th Cir. 1951).

42. See, e.g., *S.E.C. Corp. v. United States*, 140 F. Supp. 717, 49 A.F.T.R. 1129 (S.D.N.Y. 1956), *aff'd per curiam*, 241 F.2d 416, 52 A.F.T.R. 356 (2d Cir.), *cert. denied*, 354 U.S. 909 (1957).

43. See, e.g., *Rollingwood Corp. v. Commissioner*, 190 F.2d 263, 40 A.F.T.R. 1006 (9th Cir. 1951), *aff'g* 15 T.C. 1010 (1950).

44. *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683, 15 A.F.T.R.2d 408 (8th Cir. 1965), *rev'g in part*, 41 T.C. 20 (1963).

45. See section II.B. *infra*.

46. See, e.g., *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 37 A.F.T.R.2d 76-679 (5th Cir. 1976), and cases cited therein.

47. See, e.g., *Continental Can Co. v. United States*, 422 F.2d 405, 25 A.F.T.R.2d 70-652 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970), discussed *infra* at notes 51-60 and accompanying text.

the property is primarily held for sale to customers.⁴⁸ This, in turn, necessitates the finding that the taxpayer has *customers* and that the property is, or would be, disposed of in the *ordinary* course of the taxpayer's business.

In addition, *Malat* did not address the interrelated questions of the point in time at which the purpose of the holding is crucial, or what actions are necessary to establish a definitive *change* of purpose in the holding. Naturally, all property offered for sale is held primarily for sale at the time of sale; therefore, some other more relevant time period must be selected on which to focus. Moreover, *Malat* offers no guidance in the situation where a taxpayer decides to terminate a business or to liquidate an investment which can be accomplished most profitably only by a period of recurrent sales or improvement activities. Here the question is hybrid: whether the sales occur in a trade or business and are inside or outside the ordinary course of any business, as well as being held primarily for sale to customers. A similar issue, and one on which *Malat* is equally silent, arises when the purpose for holding the property changes within the context of an ongoing business in which the property formerly was not held primarily for sale to customers.⁴⁹

Perhaps one of the most significant issues left untouched by the Court's decision in *Malat*, especially in view of its impact under both sections 1221(1) and 1231,⁵⁰ is whether a taxpayer may hold the same property in the business "primarily" for two different purposes. That is: Can an apparently single business actually be divided with regard to, and for the purpose of, characterizing the same type of property or its components? This question was presented to the court in *Continental Can Co. v. United States*.⁵¹ There the taxpayer manufactured and sold containers to customers in the ordinary course of its business. Prior to an adverse antitrust consent decree involving a tying arrangement, the company had leased can-closing machines to the purchasers of its containers. As a result of the antitrust action the company was required to grant to its closing equipment lessees the option to purchase the machines. In conjunction with the granting of these options, the company began a general sales program designed to sell the closing machines.⁵²

48. See *Juleo, Inc. v. Commissioner*, 483 F.2d 47, 32 A.F.T.R.2d 73-5275 (3d Cir.), *cert. denied*, 414 U.S. 1103 (1973).

49. See, e.g., *Continental Can Co. v. United States*, 422 F.2d 405, 25 A.F.T.R.2d 70-652 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970).

50. See *Juleo, Inc. v. Commissioner*, 483 F.2d 47, 32 A.F.T.R.2d 73-5275 (3d Cir.), *cert. denied*, 414 U.S. 1103 (1973).

51. 422 F.2d 405, 25 A.F.T.R.2d 70-652 (Ct. Cl.), *cert. denied*, 400 U.S. 819 (1970).

52. *Id.* at 407-08.

The average age of the machines sold was nearly seventeen years. In contrast, at the time the tax dispute arose the closing equipment had been offered for sale for less than a year. The company argued that these figures, when compared, established that the closing machines were capital assets, and that gain on their sale was capital gain resulting from the "realization of appreciation in value accrued over a substantial period of time."⁵³ The machines were held, it contended, primarily for rent, not for sale, since they were "separate from the main-stream of the enterprise."⁵⁴

The court rejected the company's arguments, reasoning that a change of purpose in holding the machines, prompted by the anti-trust action, occasioned the taxpayer's entry into the operation of a *dual* business, both of renting and selling the machines. Therefore, the reason for which the property was held prior to the change of purpose was unimportant: the time *was*. With regard to the primary purpose of the holding, it was held to be the date of the sale.⁵⁵ Here, the court found that the company was engaged in the regular sale of the machines, and thus in the dual business of selling (both the containers and the previously tied-in closing equipment) and renting.⁵⁶

In arriving at its decision, the *Continental Can Co.* court distinguished a series of decisions, relied upon by the company, referred to as the "liquidation" cases.⁵⁷ The court explained that the essence of the liquidation cases was the final and nonrecurring disposition of a holding or business, "such as small sales resulting from the inability to dispose of inherited or investment property en bloc, or the winding up (due to a reorganization, insolvency, etc.) of a business operation or a phase thereof."⁵⁸ Here, the sales were made as an incident of starting a new business—the antithesis of the liquidation cases.

The fact that the company's sales efforts were not too extensive did not convince the court that the machine sales were incidental to a rental business:

53. *Id.* at 409 (quoting *Malat v. Riddell*, 383 U.S. 569, 572, 17 A.F.T.R.2d 604 (1966)).

54. 422 F.2d at 409.

55. *Id.* at 410; see *Nadalin v. United States*, 364 F.2d 431, 18 A.F.T.R.2d 5158 (Ct. Cl. 1966); *Recordak Corp. v. United States*, 325 F.2d 460, 12 A.F.T.R.2d 6092 (Ct. Cl. 1964).

56. 422 F.2d at 410; see *Recordak Corp. v. United States*, 325 F.2d 460, 462, 12 A.F.T.R.2d 6092 (Ct. Cl. 1964).

57. 422 F.2d at 411; see, e.g., *Ackerman v. United States*, 335 F.2d 521, 14 A.F.T.R.2d 5307 (5th Cir. 1964); *Thompson v. Commissioner*, 322 F.2d 122, 12 A.F.T.R.2d 5451 (5th Cir. 1963); *Estate of Barrios v. Commissioner*, 265 F.2d 517, 3 A.F.T.R.2d 1126 (5th Cir. 1959); *Cebrian v. United States*, 181 F. Supp. 412, 5 A.F.T.R.2d 904 (Ct. Cl. 1960).

58. 422 F.2d at 411.

In [such a dual business setting, the word] “primarily” invokes a contrast, not between selling and renting, but between selling in the ordinary course of business and selling outside of that normal course. . . . [T]he goods are held “primarily for sale to customers in the ordinary course of . . . trade or business” because they are regularly offered for sale to customers as part of the normal operation of the enterprise. No case of this kind has allowed capital gains treatment.⁵⁹

In conclusion the court explained that the substantial appreciation of the property over a prolonged period of time did not alter the fact that it was held for, and sold to, customers in the ordinary course of the taxpayer’s business.⁶⁰

b. Factors Related to the Determination of the Existence of an Investment or Business

Because of the particularly factual nature of determining whether property is held as an investment or for sale to customers as an incident of the ordinary conduct of the taxpayer’s business, the courts have developed a number of factors which they generally use to make the distinction. Among those cited most frequently are:⁶¹

1. The income from the sales of the property in question, especially in relation to sales of other property, and the taxpayer’s other income;
2. The extent and intensity of sales and promotional activity;
3. The presence of an unrelated principal business;
4. The length of time that the property was held, together with any time necessary for development or management;
5. The method of, and the reason for, acquiring the property and disposing of it;
6. The value of retained property of a similar nature;
7. The use of the sales proceeds (*i.e.*, were the proceeds used to purchase additional property of the kind sold?);
8. The presence of substantial appreciation;
9. If the property is realty, whether it has been improved or subdivided;
10. Again, if the property is realty, whether it was sold by the taxpayer, if he was not a broker, or with the use of a broker;

59. *Id.* (quoting *Recordak Corp. v. United States*, 325 F.2d 460, 463, 12 A.F.T.R.2d 6092 (Ct. Cl. 1963)).

60. 422 F.2d at 411. *See also Biedenharn Realty Co. v. United States*, 526 F.2d 409, 37 A.F.T.R.2d 76-679 (5th Cir. 1976).

61. *See generally United States v. Winthrop*, 417 F.2d 905, 24 A.F.T.R.2d 69-5760 (5th Cir. 1969); *Gault v. Commissioner*, 332 F.2d 94, 13 A.F.T.R.2d 1571 (2d Cir. 1964); *Levin, Capital Gains or Income Tax on Real Estate Sales*, 37 B.U.L. REV. 165 (1957).

11. The taxpayer's other sources and amounts of income, including the history of income and losses.

Although no one of these factors is determinative, and no preestablished number of them inevitably leads to the conclusion that the property is held primarily for sale to customers in the ordinary course of business, there are certain patterns of facts which probably will lead to the conclusion that property is or is not held for sale to customers. For example, in *Goodman v. United States*, the taxpayer had a history of realizing greater amounts of income from participation in his clients' real estate endeavors than he did from the practice of law.⁶² When this fact was joined with the significant number of sales, the court of claims concluded that the taxpayer was holding the property for sale in the ordinary course of business even though the parcels were sold in an unimproved and undeveloped state.⁶³ The court simply explained that "there is no one formula for determining whether property is held for sale or investment. Each case presents its own unique set of facts, all of which must be considered"⁶⁴

Conversely, in *Mitchell v. Commissioner*⁶⁵ the Tax Court found the absence of improvements, subdivisions, and other activities to be persuasive as to the taxpayer's investment purposes. At the same time, it rejected the Service's argument that the real estate activities of the corporation in which Mitchell was an officer and shareholder should be attributed to him. The court found them to be "immaterial and irrelevant" because they were part of a separate enterprise.⁶⁶

When the taxpayer initially acquires the property intending to resell it, the courts have divided over whether it is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.⁶⁷ Those courts which have found such a holding probably are correct. But when the acquisition is an isolated event, it is more accurate to find that the taxpayer is an investor, and is not in the business of holding property primarily for sale to customers.⁶⁸ Of

62. 390 F.2d 915, 918, 21 A.F.T.R.2d 761 (Ct. Cl. 1968).

63. *Id.* at 921.

64. *Id.* at 919. *But see* *Lazarus v. United States*, 172 F. Supp. 421, 3 A.F.T.R.2d 1079 (Ct. Cl. 1959).

65. 47 T.C. 120 (1966).

66. *Id.* at 127. *See also* *Brown v. Commissioner*, 448 F.2d 514, 28 A.F.T.R.2d 71-5611 (10th Cir. 1971); *Tibbals v. United States*, 362 F.2d 266, 17 A.F.T.R.2d 1213 (Ct. Cl. 1966).

67. *See, e.g.*, *United States v. Burket*, 402 F.2d 426, 22 A.F.T.R.2d 5746 (5th Cir. 1968), and cases cited therein.

68. *See* *DeMars v. United States*, 27 A.F.T.R.2d 71-925 (S.D. Ind. 1968); *Hollis v. United States*, 121 F. Supp. 191, 46 A.F.T.R. 74 (N.D. Ohio 1954). *See also* *Bauschard v. Commissioner*, 279 F.2d 115, 5 A.F.T.R.2d 1725 (6th Cir. 1960).

course, the particular situation may indicate otherwise.

If the taxpayer is a partner, shareholder, or joint venturer in an enterprise which is in the business of selling property of a nature which the taxpayer, after holding for investment purposes, may sell on his own account, the courts should scrutinize the facts carefully before attributing the enterprise's activities to the taxpayer. Otherwise, the congressional purpose underlying the differentiation of capital assets may be frustrated.⁶⁹

c. Real Estate Dealers and Investors

Many of the factors enumerated above are used by the courts to separate the real estate dealer from the real estate investor. But because real property generally is thought of as the classic investment, the courts and the Service have experienced much difficulty in separating the two.⁷⁰

In classifying property under section 1221(1), the purpose for which the asset is acquired may or may not be an important consideration depending on other facts, such as whether a resale intent was effected, a development aborted, or an investment liquidated. More simply, the taxpayer's intention when the property is acquired is not necessarily relevant to a subsequent disposition. For instance, property that is inherited must await further action before it can be placed within section 1221(1). If the taxpayer proceeds to subdivide and improve it he may be found to be a dealer, and hence the realty will be covered by section 1221(1) unless section 1237 provides an exception.⁷¹ If the devisee is presently a dealer in the type of property inherited, he may find it difficult to establish that the property is not held for sale. Unless the devised property is treated differently than similar assets held for sale, the heir is sure to find it governed by section 1221(1).

The time expired between the property's acquisition and disposition will not necessarily favor the finding of an investment—the hallmark of a capital asset. In *Biedenharn Realty Co. v. United States*, the Fifth Circuit found that the taxpayer had acquired the land in question over an extended period of time with the dual intention of holding the property as an investment and of farming it until it had appreciated in value.⁷² The court found further that the investment aspects of the property gave way to the company's development and sale of over one thousand lots. The facts demon-

69. *See id.*

70. *See Gault v. Commissioner*, 332 F.2d 94, 13 A.F.T.R.2d 1571 (2d Cir. 1964).

71. *See notes 82-97 and accompanying text infra.*

72. 526 F.2d 409, 421, 37 A.F.T.R.2d 76-679 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976).

strated that the taxpayer had shed its investment frock, so that the gain was ordinary income.⁷³

However, even a dealer is entitled to capital gains on his investments. The crux of the problem is proving the existence of the investment when one is made in the same kind of property in which the taxpayer deals. *Scheuber v. Commissioner*⁷⁴ is an example of how a dealer established to the satisfaction of the court that a parcel of land was held for investment and not primarily for sale to customers in the ordinary course of his real estate business. Scheuber presented evidence that the land in question represented his retirement annuity, which was "cashed-in" when it became sufficiently valuable.⁷⁵

Although all the facts and circumstances are relevant to the classification of a dealer's property as an investment or as being held for resale, some activities that may appear neutral or irrelevant in fact may become pivotal in a subsequent litigation. Thus in *Biedenharn Realty Co. v. United States*, the district court held that the taxpayer was entitled to capital gains on its sale of numerous lots which had been held for a substantial period of time.⁷⁶ A panel of the Fifth Circuit affirmed this decision; however, in an en banc rehearing the full court reversed.⁷⁷ The court reasoned that the number of sales, together with a favorable economic market, indicated that the taxpayer was a dealer in the property. Moreover, it pointed out that *no* advertising or other explicit promotional activity was necessary because the combination of economic forces and available land resulted in the implicit advertising of the property: potential buyers received "inherent notice" that the land was for sale when they saw it gradually being improved.⁷⁸ From here it was an easy step to conclude that the land, acquired as an investment, was held primarily for sale in the ordinary course of business, even though no customers were solicited, and no for-sale signs were posted.

The "inherent notice" aspect of property development, subdivision, and sales not only indicates the nature of the taxpayer's activities, but also evinces the ordinariness with which the property is

73. *Id.*

74. 371 F.2d 996, 19 A.F.T.R.2d 639 (7th Cir. 1967).

75. *Id.* at 999. See also *Johnson v. United States*, 280 F. Supp. 412, 20 A.F.T.R.2d 5873 (N.D.N.Y. 1967), for a similar conclusion even though the property had been listed on the taxpayer's real estate inventory sheet.

76. 356 F. Supp. 1331, 31 A.F.T.R.2d 73-956 (W.D. La. 1973).

77. 509 F.2d 171, 35 A.F.T.R.2d 75-1019 (5th Cir. 1975), *rev'd*, 526 F.2d 409, 37 A.F.T.R.2d 76-679 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976). See generally Sills, *The "Dealer-Investor" Problem Revisited: Charting a Course to Avoid the Pitfalls*, 4 J. REAL EST. TAX. 24 (1976).

78. 526 F.2d at 418.

held and sold.⁷⁹ Conversely, intermittent sales of unimproved, un-subdivided, or large parcels of property may support a finding of an investment—even if the section 1237 safe-harbor rules are not met.⁸⁰ Similarly, physical problems, governmental restrictions, unfavorable economic conditions, or sales solicited from outsiders may bolster the taxpayer's arguments for capital gains.⁸¹

Congress enacted section 1237 in 1954 to ameliorate the situation of the investor-subdivider who holds real property as an investment.⁸² Often an investor is faced with the unpleasant alternative of being classified as a "dealer" if he does, and of foregoing a reasonable profit if he does not subdivide the realty. However, section 1237 is of limited applicability, and does not apply to corporate taxpayers.

Under section 1237 a subdivider will not be classified as a dealer, which would cause any gain to be ordinary income, merely because of the fact of the subdivision;⁸³ however, the taxpayer cannot otherwise be a dealer in real estate. To meet the statutory requirements of section 1237, the taxpayer must show that: (1) neither the tract nor any part of it has been held for sale to customers in the ordinary course of trade or business;⁸⁴ (2) during the year of the subdivision and sale of the tract, he held no other real property for sale to customers in the ordinary course of his trade or business;⁸⁵ (3) he has owned the property for five years, unless acquired by inheritance;⁸⁶ (4) he has made no substantial increase in the value of the parcel sold;⁸⁷ and (5) no such improvements are required to be made by the taxpayer under a contract of sale.⁸⁸

Whether an improvement is substantial, *and* substantially enhances the value of a lot, is a factual question. However, the regulations accord the taxpayer a safe harbor, stating that improvements

79. *Id.*; see *United States v. Winthrop*, 417 F.2d 905, 912, 24 A.F.T.R.2d 69-5760 (5th Cir. 1969) (the court in *Biedenharn Realty Corp.* stated that this was implied in *Winthrop*).

80. See notes 82-97 and accompanying text *infra*.

81. See Levin, *supra* note 61 for an extensive list of the cases and factors used by the courts.

82. S. REP. NO. 1622, 83d Cong., 2d Sess. 115 (1954). See generally Chandler, *The Failure of Section 1237 in Dealing with Sales of Subdivided Realty*, 60 MINN. L. REV. 275 (1976); Repetti, *What Constitutes a Dealer under Section 1237*, in NEW YORK UNIVERSITY SEVENTEENTH INSTITUTE ON FEDERAL TAXATION 651 (1959); Spandorf & Tonelson, *Capital Gains Provisions for Real Estate Investors in Sec. 1237 More Promise Than Fact*, 8 J. TAX. 201 (1958).

83. I.R.C. § 1237(a); Treas. Reg. § 1.1237-1(a)(1), (2) (1957).

84. I.R.C. § 1237(a)(1); Treas. Reg. § 1.1237-1(a)(2) (1957).

85. I.R.C. § 1237(a)(1); see *Hvidsten v. United States*, 185 F. Supp. 856, 6 A.F.T.R.2d 5414 (D.N.D. 1960).

86. I.R.C. § 1237(a)(3).

87. *Id.* § 1237(a)(2); Treas. Reg. § 1.1237-1(a)(2), (c) (1957).

88. I.R.C. § 1237(a)(2); Treas. Reg. § 1.1237-1(c) (1957).

which increase the value of a lot by ten percent or less shall not be considered substantial.⁸⁹ For example, clearing operations, minimum access roads, or a temporary field office are not considered to be substantial.⁹⁰ In addition, if the taxpayer has held the parcel or lot for ten years or more, certain other improvements which are necessary for marketability, such as the installation of drainage, sewage, or water facilities, will not be "substantial" under section 1237.⁹¹

For purposes of section 1237, a "tract of real property" is a single parcel, or two or more parcels which at any time were contiguous in the hands of the taxpayer.⁹²

If the taxpayer meets these requirements, gain realized on the sale of the first five lots during the taxable year is capital gain. Any sale made in or after the year in which the sixth lot is sold from a single tract is subject to a special five percent rule.⁹³ Gain on these sales is ordinary income in an amount up to, but not exceeding, five percent of the sales price. The remainder of any gain is capital gain.⁹⁴ Where two or more contiguous lots are sold to the same buyer in a single transaction, the taxpayer is considered to have sold one lot.⁹⁵

If the taxpayer sells more than five lots, the five percent rule applies to *all* lots sold. For example, if he sells six lots from the same tract in any year, five percent of the sale price of *each* lot is treated as ordinary income. Nevertheless, if the five percent rule applies, the taxpayer may offset selling expenses entirely against the ordinary income portion of the proceeds.⁹⁶ Consequently, the only ordinary income that is reportable is that portion of the five percent in excess of the selling expenses. If these expenses exceed the five percent, they reduce the taxpayer's capital gain.

Although section 1237 is of limited applicability, it can apply more than once to the same taxpayer.⁹⁷ For example, if the taxpayer sells no lots for five years after having sold a parcel, then that part of the tract remaining is considered to be a new tract under section 1237(c). Therefore, the taxpayer can sell five more lots prior to the

89. Treas. Reg. § 1.1237-1(c)(3)(ii) (1957).

90. *Id.* § 1.1237-1(c)(4); see *Revell v. United States*, 29 A.F.T.R.2d 72-877 (D.S.C. 1972) (roads substantially increased the value of the property); Rev. Rul. 59-31, 1959-1 C.B. 215.

91. Treas. Reg. § 1.1237-1(c)(5) (1957).

92. *Id.* § 1.1237-1(g)(1) (1957).

93. I.R.C. § 1237(b)(1); Treas. Reg. § 1.1237-1(a)(5), (e)(2)(ii) (1957).

94. I.R.C. § 1237(b)(1); for the relationship between sections 1237 and 1231, see Treas. Reg. § 1.1237-1(f) (1957).

95. Treas. Reg. § 1.1237-1(e)(2)(i).

96. *Id.* § 1.1237-1(e)(2)(ii).

97. *Id.* § 1.1237-1(g)(2).

applicability of the five percent rule.

Section 1237 is not applicable to losses, and it is not exclusive.⁹⁸ The investor-subdivider is free to establish his status as an investor under the section 1221(1) factors used by the courts to determine whether a taxpayer is a "dealer."⁹⁹ It would be to his advantage to do so, provided that he can show his status as an investor, where he has sold more than five lots from the same tract.

C. Property Used in Trade or Business

1. In General

Section 1221(2) excludes from the definition of a capital asset real property and depreciable personal property used in the taxpayer's trade or business.¹⁰⁰ Although section 1221(2) denies capital asset status to property of this type, section 1231 ordinarily will characterize gain or loss from its sale, exchange, or involuntary disposition.¹⁰¹ Under section 1231, qualified property—sometimes called "quasi-capital assets"—will generate capital gain if it is sold at a profit, but a deduction from ordinary income if it is disposed of at a loss. To come within section 1231 the taxpayer must be engaged in a trade or business and must establish that the property is used in that trade or business.¹⁰² It is insufficient that the taxpayer has acquired property which he expects to use in a trade or business that he plans to establish in the future.¹⁰³ This limitation is a corollary to the section 162 limitation which denies the deductibility of expenses as ordinary and necessary business expenses when they are incurred in seeking or preparing to enter a trade or business.¹⁰⁴

Prior to 1942, section 1221 excluded from capital asset status only depreciable property used in the trade or business. This resulted in strange decisions. For example, in the case of real estate, a building used in the taxpayer's trade or business was not, but the land on which it stood was, a capital asset. The statute was amended in 1942 to eliminate the difficult allocation problems which arose when a

98. *Id.* § 1.1237-1(a)(4).

99. *Id.*; see *Gordy v. Commissioner*, 36 T.C. 855 (1961) (taxpayer showed he was not in real estate business, and was accorded capital gains treatment).

100. I.R.C. § 1221(2).

101. *Id.* § 1231(b)(1); see section II.D. *infra*.

102. See I.R.C. § 1231(b)(1); Treas. Reg. § 1.1231-1.

103. See, e.g., *Nulex, Inc. v. Commissioner*, 30 T.C. 769 (1958).

104. See *Frank v. Commissioner*, 20 T.C. 511 (1953); Note, *Depreciation of Improved Real Property Held Solely for Later Sale*, 27 STAN. L. REV. 177 (1974). *But cf.* *Snow v. Commissioner*, 416 U.S. 500, 33 A.F.T.R.2d 74-1251 (1974) (taxpayer was allowed a loss deduction under § 174(a)(1) since the expenses incurred were "in connection with" his trade or business of developing a special-purpose incinerator; the Court noted that § 174 was enacted to expand the restrictive effects of § 162).

lump sum sales price was received for the land and building.¹⁰⁵ Since 1942, all business real estate has been removed from section 1221, regardless of whether it is depreciable. However, the allocation problem still exists when determining the purchaser's depreciation deductions, and when there is a sale of a business.¹⁰⁶

Unlike real property, personal property is treated as a capital asset under section 1221(2) and as a quasi-capital asset under section 1231 only if it is depreciable; nondepreciable personal property used in the trade or business, therefore, is a capital asset. Most tangible personal property used in a trade or business is depreciable, with the unusual exception of such items as antiques and art works which will not meet the requirements of section 167.¹⁰⁷ Intangible personalty, such as goodwill, trade names, trademarks, and secret processes, generally are nondepreciable.¹⁰⁸ Therefore, unless these assets are held for sale to customers in the ordinary course of business—an admitted rarity—they are capital assets.¹⁰⁹ Due to the amounts involved, the decisions finding or assuming that goodwill is a capital asset, because it is nondepreciable, are of particular importance, especially in the sale of a business.¹¹⁰

2. *The Use Requirement*

To be excluded from capital asset status by section 1221(2), the real and depreciable personal property must be *used* in the taxpayer's *trade or business*. Both facets of this requirement have generated a significant amount of litigation, especially where the property involved is idle at the time of its sale due to circumstances outside of the taxpayer's control,¹¹¹ and where there is a question of whether the taxpayer is engaged in a trade or business.¹¹² A similar problem arises in conjunction with section 1231 where property formerly used in the trade or business subsequently is held for sale.¹¹³

The leading case involving the question of whether property is

105. H.R. REP. NO. 2333, 77th Cong., 2d Sess. reprinted in 1942-2 C.B. 372, 414.

106. See section II.I. *infra*.

107. See Rev. Rul. 68-232, 1968-1 C.B. 79 (disallowing depreciation of works of art). *But see* Judge v. Commissioner, 45 T.C.M. (P-H) 1243 (1976) (court indicated that some "artwork" may be depreciable).

108. See section II.I. and section II.H. *infra* as to these items; Gregorcich, *Amortization of Intangible: A Reassessment of the Tax Treatment of Purchased Good Will*, 28 TAX LAW. 251 (1975); Comment, *Depreciability of Going Concern Value*, 122 U. PA. L. REV. 484 (1973).

109. See, e.g., *United States v. Jones*, 194 F.2d 783, 41 A.F.T.R. 861 (10th Cir. 1952) (bus franchise); *Huckins v. United States*, 5 A.F.T.R.2d 1222 (S.D. Fla. 1960) (secret process).

110. See section II.I. *infra*.

111. See sources cited at note 121 *infra*.

112. See section I.C.3. *infra*.

113. *Id.*

used in the taxpayer's trade or business is *Carter-Colton Cigar Co. v. Commissioner*.¹¹⁴ There, the company conducted its wholesale tobacco products distribution business from a leased store and warehouse in Charlotte, North Carolina. In 1926 it purchased an unimproved lot on which it planned to build a store and warehouse to be used for its principal place of business. After having plans and specifications prepared for the building, the company was unable to proceed with the construction due to the depression. In 1934 one of the two major stockholders died, and thereafter the other abandoned the idea of building the new store.

From 1935 to 1943 the lot was unsuccessfully offered for sale, but in the interim a small amount of revenue was derived from its rental for billboard advertising space. When in 1943 the company received its first and only offer, the property sold for \$4,000. The company took an ordinary loss deduction of approximately \$3,000, the amount it lost on the sale, on the basis that the lot was property used in its business. The government disallowed the loss on the ground that the property was a capital asset, since it never was actually used in the taxpayer's trade or business.¹¹⁵

The Tax Court allowed the ordinary loss deduction. It reasoned that the property was used in the taxpayer's business within the meaning of the statute because the evidence established that it was purchased for business reasons, toward which significant steps were taken. That the lot was not used to the full extent of the taxpayer's initial expectations was excused by the "later developing circumstances over which [it] had no control" and which prevented the construction.¹¹⁶ The slight income that the company received from the advertising lease was irrelevant to the court's decision.¹¹⁷

In *Carter-Colton Cigar Co.*, the court cited *Wright v. Commissioner*¹¹⁸ for support. Wright had owned two summer cottages that he held out for rent. Several months after one of the cottages was destroyed by a hurricane, he listed the land for sale. When he sold the land five years later, he deducted the damage from the hurricane as an ordinary loss. The Commissioner contended that the loss was capital. The court allowed the ordinary loss, explaining that even though the real estate had ceased to be used actively in the taxpayer's business, it had not lost its character as "real property used in his trade or business," and thus it was not a

114. 9 T.C. 219 (1947).

115. *Id.* at 220.

116. *Id.* at 221.

117. *See id.*

118. 9 T.C. 173 (1947).

capital asset.¹¹⁹ Relying on section 167(a)(1) precedent, the court read the term "used in the trade or business" synonymously with "devoted to the trade or business."¹²⁰ This construction was broad enough to encompass all such property, whether actually in use or not, even after the actual business had become impossible.¹²¹

Despite the broad interpretation given to the word "used" in section 1221(2) by the Tax Court in *Wright and Carter-Colton Cigar Co.*, not all property acquired by the taxpayer for use in its trade or business will be excluded from capital asset status if it is never used in that trade or business. For instance, in *Davis v. Commissioner* the taxpayer purchased a lot on which he intended to build a paint shop.¹²² However, at the time of purchase, he was unaware that the property was zoned exclusively for residential use. Twenty years after discovering the zoning restrictions, he sold the lot at a loss. The court held that the lot was a capital asset because it was not and never could have been used in the taxpayer's trade or business. Therefore, the loss was a capital loss.¹²³

Unlike the situation in *Wright*, where the real estate had been used for business purposes, and that in *Carter-Colton Cigar Co.*, where all preparations had been completed to use the lot for the wholesale business, the taxpayer in *Davis* was not thwarted by external circumstances over which he had no control or of which he could have had no knowledge. Moreover, in the absence of a variance, the property purchased for the paint shop simply could not have been used for that purpose. Therefore, because the proximate relationship between the property and the business, evident in *Wright and Carter-Colton Cigar Co.*, was missing in *Davis*, the property could not come within the reasoning of the *Wright* decision as being "devoted" to use in the taxpayer's trade or business.

Admittedly the line drawn between these situations is a fine one, but in *Davis* there simply was no way of telling whether the property

119. *Id.* at 174.

120. The word "devote" appears to come from *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941), *aff'd*, 133 F.2d 509, 30 A.F.T.R. 932 (6th Cir. 1943).

121. 9 T.C. at 174. *See also* *Wofac Corp. v. United States*, 269 F. Supp. 654, 19 A.F.T.R.2d 1601 (D.N.J. 1967) (land, building, and equipment idle for five years); *Kruse v. Commissioner*, 29 T.C. 463 (1957) (ordinary loss allowed for theater closed for more than six months prior to foreclosure sale); *Alamo Broadcasting Co. v. Commissioner*, 15 T.C. 534 (1950) (ordinary loss allowed when diesel unit bought in Mexico had to be sold there on failure to obtain permission of Mexican government to export unit to United States); *Wilson Line, Inc. v. Commissioner*, 8 T.C. 394 (1947) (dismantled parts of marine railway were used in trade or business five years after dismantling); Rev. Rul. 58-133, 1958-1 C.B. 277 (ordinary loss allowed when land purchased for business use was sold at a loss after engineering study showed it was unsuitable for taxpayer's needs).

122. 11 T.C. 538 (1948).

123. *Id.* at 541.

was purchased for business use, or because of its residential zoning: that is, for investment or personal reasons. Without some unequivocal indication of the business character of the property, it met the definition of a capital asset under section 1221. To hold otherwise would allow business taxpayers to avoid downside investment risks by the availability of an ordinary, rather than a capital, loss.¹²⁴

3. Rental Activity

Section 1221(2) excludes only real property and depreciable personal property used in the trade or business. Since corporations are presumed to be in business, the only real question as to corporate property generally is whether the asset is used in that business.¹²⁵ However, individually owned property often raises many questions concerning the existence of a trade or business. And if there is a trade or business, the question then becomes whether the property involved is used in that business so as to preclude it from capital asset characterization by section 1221(2). Most frequently these issues arise in regard to individually owned rental real estate.¹²⁶ If an individual owns rented real estate which subsequently is sold at a loss, he may be facing not only the prospect of a capital loss, but also the very real possibility that no loss deduction will be allowed because the court found that he did not *enter* the rental activity for profit.¹²⁷ Consequently, the stakes are likely to be higher when an individual, as opposed to a corporation, attempts to establish that rental realty is used in his trade or business.

When an individual taxpayer owns a multi-occupant building, the responsibilities of renting and maintaining the structure will put him in the rental business, regardless of whether the taxpayer or an agent carries out those duties.¹²⁸ For example, in *Fackler v. Commissioner* the court found that the rental activities constituted a trade or business notwithstanding that the taxpayer, "a busy and

124. Cf. *Corn Products Ref. Co. v. Commissioner*, 350 U.S. 46, 47 A.F.T.R. 1789 (1955) (taxpayer was allowed ordinary loss).

125. See *International Shoe Machine Corp. v. United States*, 491 F.2d 157, 33 A.F.T.R. 2d 74-619 (1st Cir.), cert. denied, 419 U.S. 384 (1974); *International Trading Co. v. Commissioner*, 275 F.2d 578, 5 A.F.T.R.2d 970 (7th Cir. 1960).

126. See generally Brown, *Individual Investment in Real Estate: Capital Gains vs Ordinary Income; Attaining Nondealer Status; Structuring Disposition of Investment; Dealer as Investor; Implications of Investor-Dealer Partnership*, in *NEW YORK UNIVERSITY SCHOOL OF LAW THIRTY-FOURTH TAX INSTITUTE* 189 (S. Reiner ed. 1976).

127. I.R.C. § 165(c)(3); Treas. Reg. § 1.165-9(a), (b); see, e.g., Warren, *supra* note 14. But see *International Trading Co. v. Commissioner*, 275 F.2d 578, 5 A.F.T.R.2d 970 (7th Cir. 1960). See also *International Trading Co. v. Commissioner* 484 F.2d 707, 32 A.F.T.R.2d 73-5500 (7th Cir. 1973).

128. See, e.g., *Fackler v. Commissioner*, 133 F.2d 509, 30 A.F.T.R. 932 (6th Cir. 1943); *Union Nat'l Bank v. United States*, 195 F. Supp. 382, 8 A.F.T.R.2d 5133 (N.D.N.Y. 1961).

successful lawyer," merely visited the property once or twice weekly.¹²⁹ The evidence showed that the taxpayer acquired the property for the purpose of operating it for a profit commensurate with the number of tenants and the amount of services required to be rendered.¹³⁰ It was irrelevant that the taxpayer supplied the services through agents and employees because "carrying on a business through agents . . . is in fact a common practice."¹³¹

If the property is unimproved land, or a single-family dwelling, the classification of the taxpayer's holding is a much closer question. Whether the rental activity will be treated as a business depends upon many factors, no one of which is always decisive.¹³² Some of the factors considered by the courts include:¹³³

1. The nature of the taxpayer's principal business, *i.e.*, whether it is related to rental real estate;
2. The amount of income generated by the rentals as compared to the amount and sources of the taxpayer's other income, if any;
3. The time spent by the taxpayer and/or his employees in managing the property and providing services;
4. Whether the property is, or has been, used for personal or recreational purposes by the taxpayer;¹³⁴
5. The manner in which the taxpayer acquired the property, especially if it is one of several which he has owned;¹³⁵ and,
6. The manner in which the activity was carried on, including the history of income or losses.¹³⁶

The weight given to any one of these considerations depends on the particular facts under consideration.

Many of the older cases appear to be quite liberal in classifying a single rental property as a trade or business. This tendency is ex-

129. 133 F.2d 509, 510, 30 A.F.T.R. 932 (6th Cir. 1943).

130. *Id.* at 511.

131. *Id.*

132. See Comment, *The Single Rental as a "Trade or Business" under the Internal Revenue Code*, 23 U. CHI. L. REV. 111 (1955).

133. See, *e.g.*, *Lowry v. United States*, 384 F. Supp. 257, 37 A.F.T.R.2d 74-6206 (D.N.H. 1974); *Roehner & Roehner, Loss Deduction on the Sale of an Abandoned Residence: Case-Law Thinking in Statutory Interpretation*, 23 FORDHAM L. REV. 196 (1954); *Swanson, Loss on the Sale of Residential Property*, 33 TAXES 589 (1955).

134. See, *e.g.*, *Lowry v. United States*, 384 F. Supp. 257, 34 A.F.T.R.2d 74-6206 (D.N.H. 1974) and the cases cited therein. See also I.R.C. § 183; *Carey & Gallagher, Requisite Greed: The Section 183 Regulations*, 17 TAX COUNSELOR'S Q. 375 (1973).

135. Compare *Grier v. United States*, 120 F. Supp. 395, 45 A.F.T.R. 1975 (D. Conn 1954), *aff'd per curiam*, 218 F.2d 603, 46 A.F.T.R. 1536 (2d Cir. 1955), with *Hazard v. Commissioner*, 7 T.C. 372 (1946).

136. See generally *Carey & Gallagher, supra* note 134.

plained in part by the fact that prior to 1942, when section 167(a)(2) was enacted, depreciation deductions were allowed on property only if it was "used in the trade or business." Similarly, an individual could deduct the expenses of managing property only if they qualified as section 162 business expenses. Apparently the deductions were allowed on the rationale that rental property constituted a trade or business. Since the enactment of sections 167(a)(2) and 212, however, there has been less reason to use this theory, and therefore more consistency in finding the rental property to be a capital asset.¹³⁷

D. Copyrights, Literary, Artistic and Similar Interests and Patents

1. Copyrights, Literary, Artistic and Similar Interests

Section 1221(3) excludes copyrights, literary, musical, or artistic compositions, letters and memoranda, in the hands of the person for whom they were prepared, and similar property from classification as a capital asset if it is held by a taxpayer whose "personal efforts" created the property.¹³⁸ In addition, they are denied capital asset characterization if held by a taxpayer in whose hands the basis of the property is determined, for purposes of determining the gain from a sale or exchange, in whole or part with reference to the basis of the property in the hands of the person whose efforts created the property.¹³⁹ In excluding "similar property" from the special treatment accorded to capital assets, the proscription is expansive enough to include such interests as theatrical productions, radio programs, newspaper cartoon strips, and any other property which qualifies for either statutory or common law copyright protection.¹⁴⁰ But it does not cover designs, inventions, or patents, which are

137. See I.R.C. § 183. The Tax Reform Act of 1976 added § 280A to the Code to deal specifically with vacation homes and the expenses incurred in relation to them. See also *Giordan v. Commissioner*, 45 T.C.M. (P-H) 497 (1976) (disallowing, in part, maintenance deductions for Florida real estate even where rentals exceeded expenses, since taxpayer had received the property from deceased spouse). The *Giordan* court cited H.R. REP. NO. 658, 94th Cong., 1st Sess. 162-65 (1975). 45 T.C.M. (P-H) at 499 n.3.

138. See generally F. FELDMAN & S. WEIL, *ARTWORKS: LAW, POLICY, PRACTICE* (1974); Beghe, *The Artist, the Art Market and the Income Tax*, 29 TAX L. REV. 491 (1974); Duke, *Foreign Authors, Inventors, and the Income Tax*, 72 YALE L.J. 1093 (1963); Gorewitz, *Artists/IRS: A Modest Proposal*, 119 CONG. REC. 39090 (1973); Rosenbaum, *Entertainer's Corporations and Capital Gains*, 12 TAX L. REV. 33 (1956); Shine, *Some Tax Problems of Authors and Artists*, 13 TAX L. REV., 439 (1958).

139. Treas. Reg. § 1.1221-1(c)(1); see Beghe, *supra* note 138, at 493-94.

140. Treas. Reg. § 1.1221-1(c)(1); see *Stern v. United States*, 164 F. Supp. 847, 2 A.F.T.R.2d 5741 (E.D. La. 1958), *aff'd per curiam*, 262 F.2d 957, 3 A.F.T.R.2d 717 (5th Cir. 1959). See also *Cranford v. United States*, 338 F.2d 379, 14 A.F.T.R.2d 5904 (Ct. Cl. 1964).

protected exclusively under sections of the patent, and not copyright, law.¹⁴¹ Finally, section 1221(3) assets do not qualify as "quasi-capital assets" under section 1231(b)(1)(C).¹⁴²

The statutory terms "property" and "personal effort" are among the problem areas of section 1221(3), as can be seen by the decision in *Stern v. United States*.¹⁴³ In that case, which involved both pre- and post- section 1221(3) years, the taxpayer created "Francis," a talking army mule, which was the subject of several short stories written by the taxpayer while he was in the army.¹⁴⁴ After his discharge the plaintiff published two novels dealing with Francis' exploits. These efforts culminated in the sale to Universal Studios of the motion picture rights and all of the taxpayer's "right, title and interest" in Francis. In return for the transfer the taxpayer was to receive \$50,000, five percent of the net proceeds from the movies, and seventy-five percent of any incidental licensing fees.¹⁴⁵

Because the transaction covered both pre- and post- section 1221(3) years, the court found that the taxpayer had realized capital gains as to the pre-statutory period since Francis was "property" created by the taxpayer outside the realm of his usual business activities as a newspaper publisher: creating Francis was a hobby, not a business.¹⁴⁶ However, as to the years in which section 1221(3) applied, the proceeds were found to be ordinary income generated by "similar property" within the purview of section 1221(3). The court rejected the taxpayer's contentions that, because Francis was not subject to copyright, the income generated by the sale was capital in nature being derived from the disposition of an "intellectual conception."¹⁴⁷ Instead, the court adopted the view that the character Francis was inseparable from the literary description given it in

141. Treas. Reg. § 1.1221-1(c)(1).

142. *Id.* § 1.1231-1(c)(1)(ii); see section II.D. *infra* for a discussion of section 1231. *But see* Desilu Prod., Inc. v. Commissioner, 34 T.C.M. (P-H) 1856 (1965); Griffin v. Commissioner, 33 T.C. 616 (1959) for exceptions where the owner is a purchaser or legatee.

143. 164 F. Supp. 847, 2 A.F.T.R.2d 5741 (E.D. La. 1958), *aff'd per curiam*, 262 F.2d 957, 3 A.F.T.R.2d 717 (5th Cir. 1959). See generally Linton, *Tax Problems with Television Properties: Films, Copyrights and Property Rights*, 26 J. TAX. 240 (1967).

144. 164 F. Supp. at 848.

145. *Id.* at 848-49.

146. *Id.* at 851-52. Prior to the enactment of § 1221(3), copyrights, literary compositions, and other property created by the personal efforts of the taxpayer were treated as capital assets only when the "creator" was an amateur. Otherwise, the property was said to be primarily for the purpose of sale to customers in the ordinary course of business, thus excluded from the definition of capital asset by § 117(a)(1)(A), now § 1221(1). *Cranford v. United States*, 338 F.2d 379, 14 A.F.T.R.2d 5904 (2d Cir. 1944). *Compare* Herwig v. *United States*, 105 F. Supp. 384, 42 A.F.T.R. 147 (Ct. Cl. 1952) and *TeLinde v. Commissioner*, 18 T.C. 91 (1952) with *Rider v. Commissioner*, 200 F.2d 524, 42 A.F.T.R. 993 (8th Cir. 1952) and *Goldsmith v. Commissioner*, 143 F.2d 466, 32 A.F.T.R. 1005 (2d Cir. 1944).

147. 164 F. Supp. at 851.

the novels, so that regardless of its susceptibility to copyright, it was a "literary composition" or "similar property"; therefore, it came within the congressional intent to deny capital gains treatment to income derived by the taxpayer whose personal efforts created the property upon its disposition.¹⁴⁸

The *Stern* discussion of "similar property," particularly that not susceptible to copyright, was amplified in *Cranford v. United States*.¹⁴⁹ There the court of claims was presented with the issue of whether section 1221(3) applied to a plan that was to be developed into a television or radio program. The taxpayer's "intellectual conception" involved a mathematical formula allowing a quiz program sponsor to give away money to contestants on a progressive basis. No aspect of the scheme was subject to copyright.¹⁵⁰ After being submitted to an agency in return for a seventy-five dollar assignment and a moral obligation for additional amounts if successful, the plan was implemented in a program format.¹⁵¹ The taxpayer received weekly payments from the agency pursuant to the "moral obligation clause" and subsequently received an additional payment representing a one-third interest in the licensing of a television show.¹⁵² Like the *Stern* taxpayer, Cranford contended that section 1221(3) was inapplicable because his idea was not subject to copyright and therefore could not fall within the definition of "similar property."¹⁵³

The court of claims rejected this argument. It construed the "similar property" clause as an expansion of the "copyright, literary, musical or artistic" clause of section 1221(3), and found that Congress intended that section to encompass products of personal efforts. Copyright protection was irrelevant. "[A]ll types of artistic works which are products of personal effort and skill are excluded from the definition of a capital asset, by virtue of the term 'similar property,' unless specifically excepted."¹⁵⁴

By definition, section 1221(3) applies only to one whose *personal*

148. *Id.* at 852; *cf.* *Miller v. Commissioner*, 299 F.2d 706, 9 A.F.T.R.2d 628 (2d Cir. 1962) (the proceeds of a contract selling the right to make the film "The Glenn Miller Story" were ordinary income: the "right" was not "property"); *Regenstein v. Commissioner*, 35 T.C. 183 (1960) (the court suggested that an employee group insurance plan created by a specialist was "similar property" and that it was not "property": decided on other grounds). *See also* *Del Cotto*, *supra* note 22; *Eustice*, *supra* note 24.

149. 338 F.2d 379, 14 A.F.T.R.2d 5904 (Ct. Cl. 1964).

150. *Id.* at 380.

151. *Id.* at 380-81.

152. *Id.* at 381.

153. *Id.*

154. *Id.* at 384. *See also* *Desilu Prod., Inc. v. Commissioner*, 34 T.C.M. (P-H) 1856 (1965); *Regenstein v. Commissioner*, 35 T.C. 183, 190 n.2 (1960).

efforts created such property, or whose basis for purposes of determining gain or loss on sale or exchange is determined in whole or part with reference to the basis of the property in the creator's hands.¹⁵⁵ Consequently, incident to the disposition of such property by a taxpayer not covered by section 1221(3), questions of characterization may arise as to whether the property was held in the "ordinary course" of the taxpayer's business or as an investment.¹⁵⁶

In contrast to the tax treatment of the individual creator is that accorded to a corporate producer of literary property, shown by Revenue Ruling 55-706.¹⁵⁷ The principal corporation was engaged in the production and distribution of motion pictures. It sold two hundred fully depreciated films to another corporation to convert idle resources into working capital. The Service explained that although many corporations produce section 1221(3) property, such property is excluded therefrom because it is not produced by the personal efforts of any one individual.¹⁵⁸ In addition, the Service noted that because the sale was an isolated transaction, and the property was not held primarily for sale, the taxpayer realized capital gain.¹⁵⁹

A theory similar to that posited in Revenue Ruling 55-706 was advanced in *Commissioner v. Ferrer*,¹⁶⁰ where the court stated that section 1221(3) did not apply to the sale of production rights in a play. The actor-taxpayer, a newly turned producer, entered into a contract with the author of *Monsieur Toulouse* under which the actor acquired a multitude of rights and a power of approval, or a prohibitory power, as to some transactions. In return for a royalty advance, Ferrer received a "lease" of the exclusive rights to the United States production of the play, a right to forty percent of the proceeds of a film, together with other rights if he produced the play,

155. Treas. Reg. § 1.1221-1(c)(1).

156. See *Fidler v. Commissioner*, 231 F.2d 138, 49 A.F.T.R. 400 (9th Cir. 1956); *Griffin v. Commissioner*, 33 T.C. 616 (1959).

157. 1955-2 C.B. 300, *modified*, Rev. Rul. 62-141, 1962-2 C.B. 182.

158. 1955-2 C.B. at 301.

159. *Id.* at 302. The latter part of the Ruling, concerning capital gains, was modified in Revenue Ruling 62-141 to guarantee that motion pictures would be considered to be held primarily for sale to customers when the possibility of sale to television exists. 1962-2 C.B. 182. Moreover, where any film is produced for television rental and subsequently sold, § 1221(1) applies to both the rental and sale. *Id.* While the rationale of Revenue Ruling 62-141 appears sound, it still must square with the Supreme Court's decision in *Malat v. Riddell*, 383 U.S. 569, 17 A.F.T.R.2d 604 (1966). In *Desilu Prod., Inc. v. Commissioner*, 34 T.C.M. (P-H) 1856 (1965), the Tax Court refused to adopt the Service's position in Revenue Ruling 62-141, on the ground that it both attempted to create an all-inclusive category and an irrebuttable presumption of the taxpayer's dual purpose.

160. 304 F.2d 125, 9 A.F.T.R.2d 1651 (2d Cir. 1962). See also *Eustice*, *supra* note 24, and section II.J.5. *infra* for the tax consequences of the sale of contract rights.

and a power of prohibition on the disposition of the film rights.¹⁶¹ After executing the agreement, it was abandoned in favor of a film contract with a third party. That agreement paid Ferrer a salary for acting in the film and a percentage for releasing his interest in the initial contract.¹⁶²

Although the Commissioner never asserted that any of the interests involved fell within section 1221(3), the court took it upon itself to explain why the lease of the play was not covered by that section. Emphasizing the intended narrow scope of "created by the personal efforts of the taxpayer," the court found that production of the play involved many persons other than the taxpayer, as well as a significant amount of risked capital invested by him. For these reasons, the court concluded that the taxpayer was not the "creator" of the production.¹⁶³

The support for this conclusion is tenuous. The Senate Report states that "[t]he amendment [section 1221(3)] will also exclude from the capital asset category any property *similar* to that specifically named; for example, a radio program which has been created by the personal efforts of the taxpayer."¹⁶⁴ This statement is supplemented by Treasury Regulation section 1.1221-1(c) which provides: "the phrase 'similar property' includes for example, such property as a theatrical production" In referring to a *production* rather than to a play, it could be argued persuasively that the regulations are intended to distinguish between the playwright and the play producer, and to include both within the purview of section 1221(3). A successful theatrical production requires both literary and artistic factors which may be, but are not always, found in the play itself. Moreover, the fact that both the Congressional Reports and the Treasury Regulations refer to at least one other instance of separation of the composing from the presentation, that is, in radio programs, lends some support to this distinction between the activities.

The fact that the *Ferrer* court found the taxpayer to be a novice producer gives no credibility to the court's dicta as to section 1221(3). It would, however, bolster the section 1221(1) finding that the taxpayer did not release his rights under the initial contract "in the ordinary course of his trade or business."¹⁶⁵ Section 1221(3) is not addressed to the professional, as opposed to the occasional, copy-

161. 304 F.2d at 127-28.

162. *Id.* at 128.

163. See Del Cotto, *supra* note 22.

164. S. REP. No. 2375, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 C.B. 483, 543 (emphasis added).

165. I.R.C. § 1221(1); see, e.g., *Desilu Prod., Inc. v. Commissioner*, 34 T.C.M. (P-H) 1856 (1965); *Griffin v. Commissioner*, 33 T.C. 616 (1959).

right holder. Rather it is designed to reach the creator of the property and anyone who holds such property with reference to the creator's basis. With these considerations in mind, *Ferrer* should not be relied upon as authority for the proper construction of section 1221(3).¹⁶⁶

Additional problems encountered by a holder of an interest in a copyright or artistic composition arise in determining whether payments received from the sale or exchange of the interest are actually payments for a capital asset or for "collapsed anticipation of future income."¹⁶⁷ The final holding in *Ferrer* illustrates the complexities of this argument. The court held that both the "lease" of the play and the power to prevent distribution of the motion picture rights were capital assets. This conclusion was premised, in part, on the finding that both rights constituted an "equitable interest" in the copyrights: a "cloud" on the author's title.¹⁶⁸

The court took a different approach in analyzing the remaining interest—the right to receive a percentage of proceeds from sale of the film rights. Because the right was contingent upon actual production of the play, the court could have viewed Ferrer's right either as an option to acquire an interest in the movie rights or as income to be received for Ferrer's services in producing the play. Since the contract was void of any language granting Ferrer an option, the court chose to characterize the interest as a contingent right to receive ordinary income in the future.¹⁶⁹ Hence, Ferrer's release of the right was only a "collapsed anticipation of future income."

In addition to generating many variations on this sort of problem in classifying the asset, dispositions of creative property have caused similar difficulties in determining whether a sale or exchange has occurred, or whether a license has been issued.¹⁷⁰ The conceptual problems involved here are analogous to those in the assignment of income cases, especially since a license looks very much like the fruit and not the tree.¹⁷¹ But due to the many divisions to which a copyright may be subjected, with each division retaining its larger identity, most have been found to be sales even where the

166. See, *Martin v. Commissioner*, 50 T.C. 347 (1968). See also *Bellamy v. Commissioner*, 43 T.C. 487 (1965) (taxpayer's release of rerun rights distinguishable from Ferrer's sale of the lease; ordinary income rather than capital gain); Rev. Rul. 55-706, 1955-2 C.B. 300, *modified*, Rev. Rul. 62-141, 1962-2 C.B. 182 (isolated sale gets capital gain treatment).

167. See generally *Del Cotto*, *supra* note 22; *Eustice*, *supra* note 24; see also section II.J.5. *infra* as to the sale of contract rights.

168. 304 F.2d at 133.

169. *Id.* at 133-36.

170. See, e.g., Rev. Rul. 60-226, 1960-1 C.B. 26.

171. For a discussion of the "Fruit and Tree" and the assignment of income doctrines, see *Del Cotto*, *supra* note 22.

creator retains some rights under the copyright, or where payments are made on an extended or contingent basis.¹⁷² As a result, the retention of royalties under an exclusive licensing agreement generally will be considered to be installment payments on the sale price.¹⁷³

Finally, it should be noted that although the primary operational device in the television and film industries, especially with production, is the percentage participation "lease," or license, congressional action has been taken toward eliminating the conversion of personal income into capital gains vis-a-vis the sale of participation shares and/or corporate liquidations.¹⁷⁴ The two principal checks have been the section 1221(3) noncapital asset characterization upon transfer to a controlled corporation under section 351, and section 341's collapsible corporation provisions which will cause ordinary income treatment of the gain realized on redemption.¹⁷⁵

2. Patents

In contrast to section 1221(3)'s treatment of copyrights and similar property, section 1235 provides that royalties and other income paid to inventors, and certain other persons, in return for the transfer of "all substantial rights" to a patent or to an interest therein, qualify for long term capital gains.¹⁷⁶ Congress carved out this distinction to assure that income from the transfer of certain patents would be taxed as long term capital gain, and thereby "provide an incentive to inventors to contribute to the welfare of the Nation."¹⁷⁷ The professional inventor can report his normal income as long term capital gain.¹⁷⁸

Provided that a holder of a patent, or of an undivided interest in

172. See generally *Ferrer*, 304 F.2d 125; *Stern v. United States*, 164 F. Supp. 847; *Herwig v. United States*, 105 F. Supp. 384, 42 A.F.T.R. 147 (Ct. Cl. 1952); Rev. Rul. 60-226, 1960-1 C.B. 26; *Del Cotto*, *supra* note 22.

173. *Ferrer*, 304 F.2d 125; *Eustice*, *supra* note 24; see Note, *A Comparison of the Tax Treatment of Authors and Inventors*, 70 HARV. L. REV. 1419 (1957); Comment, *Taxation of Literary Property Income*, 12 MERCER L. REV. 370 (1961). But see *Cory v. Commissioner*, 230 F.2d 941, 49 A.F.T.R. 379 (2d Cir. 1956).

174. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶¶ 12.01-.09 (1971).

175. *Id.*

176. I.R.C. § 1235. See generally *Morreale, Patents, Know-How and Trademarks: A Tax Overview*, 29 TAX LAW. 553 (1976). Expenditures for the self-development of patents are deductible as business expenses under § 174(b), but only until a patent is issued. Treas. Reg. § 1.174-2(a)(1), 4(a)(2), (4). See also *Snow v. Commissioner*, 416 U.S. 500, 33 A.F.T.R.2d 74-1251 (1974).

177. S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).

178. *United States v. Zacks*, 375 U.S. 59, 12 A.F.T.R.2d 5902 (1963); Treas. Reg. § 1.1235-2(d)(3).

one, transfers property consisting of "all substantial rights to [it], or of an undivided interest in all such rights to a patent," the transfer is considered to be a sale or exchange of a capital asset held for more than six months.¹⁷⁹ This characterization applies whether or not the payments, in exchange for which "all substantial rights" are transferred, are dependent upon the transferee's use of the patent and are payable over the time that it is used.¹⁸⁰ Moreover, Treasury Regulation section 1.1235-1(c)(1) specifies that amounts received in connection with, or as compensatory damages awarded for, patent infringement are to be considered payments attributable to a section 1235 transfer, to the extent that they are related to a transfer which initially qualified under section 1235.¹⁸¹

This preferential treatment is, however, restricted to those persons "whose efforts created [the] property," or who acquired their

179. Treas. Reg. § 1.1235-1(a); see, e.g., *Busse v. Commissioner*, 479 F.2d 1147, 32 A.F.T.R.2d 73-5068 (7th Cir. 1973); *Burde v. Commissioner*, 352 F.2d 995, 16 A.F.T.R.2d 5885 (2d Cir. 1965), cert. denied, 383 U.S. 966 (1966); *C.A. Norgren Co. v. United States*, 268 F. Supp. 816, 20 A.F.T.R.2d 5183 (D. Colo. 1967); *Armco Steel Corp. v. United States*, 263 F. Supp. 749, 19 A.F.T.R.2d 461 (S.D. Ohio 1966).

Patent amortization comes under § 167, and may be subject to § 1245 recapture. See *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974).

"All substantial rights" are not conveyed where the patent holder retains rights "which are of value at the time the rights to the patent . . . are transferred." Treas. Reg. § 1.1235-2(b)(1) (emphasis added). See also *Estate of Klein v. Commissioner*, 507 F.2d 617, 35 A.F.T.R.2d 75-457 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975); *Mros v. Commissioner*, 493 F.2d 813, 33 A.F.T.R.2d 74-996 (9th Cir. 1974); *Fawick v. Commissioner*, 436 F.2d 655, 27 A.F.T.R.2d 71-381 (6th Cir. 1971); *Blake v. Commissioner*, 67 T.C. 7 (1976).

Under the regulations it does not matter whether such rights are retained by the grantor or by another. Treas. Reg. § 1.1235-2(b)(1); see *Fawick v. Commissioner*, 436 F.2d 655, 27 A.F.T.R.2d 71-381 (6th Cir. 1971); *Blake v. Commissioner*, 67 T.C. 7 (1976) (Wilbur, J., concurring).

A field-of-use license will not be a qualifying transfer if other rights of value are not transferred to that transferee. The license must be to all practical fields. *Estate of Klein v. Commissioner*, 507 F.2d 617, 35 A.F.T.R.2d 75-457 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975); *Mros v. Commissioner*, 493 F.2d 813, 33 A.F.T.R.2d 74-996 (9th Cir. 1974); *Fawick v. Commissioner*, 436 F.2d 655, 27 A.F.T.R. 2d 71-381 (6th Cir. 1971); *Blake v. Commissioner*, 67 T.C. 7 (1976). The 1954 Senate Report explained:

By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent).

S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954) (emphasis added).

Geographically-restricted licenses probably are subject to similar treatment, see *Morreale, supra* note 176, at 559-60, as are successive licenses. Treas. Reg. § 1.1235-1(c)(3). But see *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004, 1015 n.5, 20 A.F.T.R.2d 5153 (Ct. Cl. 1967). The result is questionable when the patent is part of a larger patented invention. Compare *Merck & Co. v. Smith*, 261 F.2d 162, 2 A.F.T.R.2d 6161 (3d Cir. 1958) with Treas. Reg. § 1.1235-2(b)(1)(iv).

180. See, e.g., *Poole v. Commissioner*, 46 T.C. 392 (1966).

181. See, e.g., *Blake v. Commissioner*, 67 T.C. 7 (1976).

interest from the creator for consideration in money or money's worth *prior* to the time the patent was put into use.¹⁸²

A "holder" of a patent is an individual whose efforts created the patent property, and who would qualify as the "original and first" inventor under the patent law.¹⁸³ Alternatively, the holder may be an individual who acquired his interest in the patent property, prior to its actual reduction to practice, in exchange for consideration paid to the inventor in money or money's worth, and so long as he is related neither to the inventor nor the inventor's employer.¹⁸⁴ This requires that the interest be acquired prior to the successful testing and operation of the invention under operating conditions, and in no event will a transaction qualify subsequent to the invention's earliest commercial exploitation.¹⁸⁵

The qualification on a holder's status prohibiting an employment relationship is a flexible one, but it must be established contemporaneously with the acquisition of the substantive interest and when the compensatory obligation is fixed definitely.¹⁸⁶ Once the holder status is established, however, the consideration may be paid during a subsequent employment relationship. But section 1235 is inapplicable if the payments are received as compensation for services rendered by an employee under an employment contract which obligates the inventor to transfer his rights to the employer.¹⁸⁷ Whether the payments are for services or for a transfer of all substantial rights, or of an undivided interest, in the patent property is a factual question. Thus, depending upon the circumstances, holder status may be attained despite the existence of an employment setting, and especially if the payments are contingent upon the production,

182. See *Busse v. United States*, 543 F.2d 1321, 38 A.F.T.R.2d 76-5984 (Ct. Cl. 1976); *Burde v. Commissioner*, 352 F.2d 995, 16 A.F.T.R.2d 5885 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966). See generally *Morreale*, *supra* note 176; Comment, *Capital Gains Treatment on Proceeds from Patent Transfers*, 34 Mo. L. Rev. 98 (1969).

183. I.R.C. § 1235; Treas. Reg. § 1.1235-2(d)(1). See generally *Busse v. United States*, 543 F.2d 1321, 38 A.F.T.R.2d 76-5984 (Ct. Cl. 1976) (taxpayer must be a patent holder within meaning of section 1235(a) or (b) to qualify for the section 483(f)(4) exception to the imputed interest rule).

184. *Busse v. United States*, 543 F.2d 1321, 38 A.F.T.R.2d 76-5984 (Ct. Cl. 1976); *Burde v. Commissioner*, 352 F.2d 995, 16 A.F.T.R.2d 5885 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966).

The owner of a patent, however, may be able to obtain capital gain treatment outside of § 1235. Treas. Reg. § 1.1235-1(b); Rev. Rul. 69-482, 1969-2 C.B. 164; see *Thomson v. United States*, 25 A.F.T.R.2d 70-697 (E.D.N.Y. 1969); *Coplan v. Commissioner*, 28 T.C. 1189 (1957). But see *Taylor v. Commissioner*, 39 T.C.M. (P-H) 1626 (1970); *Poole v. Commissioner*, 46 T.C. 392 (1966).

185. Treas. Reg. § 1.1235-2(d)(i), 2(e).

186. See *Chilton v. Commissioner*, 40 T.C. 552 (1963), *acq.*, 1964-1 C.B. 4.

187. See, e.g., *Downs v. Commissioner*, 49 T.C. 533 (1968); *Blum v. Commissioner*, 11 T.C. 101 (1948), *aff'd*, 183 F.2d 281, 39 A.F.T.R. 665 (3d Cir. 1950).

use, or sale of the transferred rights, or their value to the employer. That is, the payments must be attributable to the transfer of the patent rights and not to the fact of employment alone.¹⁸⁸

While the section 1235 holder of a patent must be an individual, regardless of whether he is in the business of making inventions or buying and selling patents, each member of a partnership may qualify individually for a share of the partnership's patent proceeds. Moreover, each of the individual partner's distributive shares will qualify even if the partnership is not comprised exclusively of such persons.¹⁸⁹

Another restriction on the application of section 1235 is the exclusion of certain related persons, corporations, and trusts from status as a holder. Although the related persons rule of section 267(b) is applicable in this regard, brothers and sisters may claim holder status.¹⁹⁰

E. Accounts and Notes Receivable

Accounts and notes receivable acquired by the taxpayer for services rendered in the ordinary course of his business or pursuant to the sale of inventory, stock in trade, or property held for sale in the ordinary course of that trade or business are excluded from the definition of "capital assets" by section 1221(4).¹⁹¹ Therefore, if the taxpayer accepts notes receivable in exchange for services, he must report the fair market value of the obligation as income.¹⁹² If the note is disposed of later for less than the previously reported amount, the difference between the two figures represents an ordinary loss.¹⁹³ Conversely, a disposition in an amount in excess of that reported initially is ordinary income.¹⁹⁴

F. Disguised Interest Income

Section 1221(5) excludes from the term "capital asset" certain short term government obligations issued at a discount and without

188. Treas. Reg. § 1.1235-1(c)(2).

189. *Id.* § 1.1235-2(d)(2); Dunn, *Tax Considerations in Patent Assignments and Licenses between Related Corporations*, 16 TAX L. REV. 315 (1961).

190. See also Rev. Rul. 69-482, 1969-2 C.B. 164; Treas. Reg. § 1.1235-1(b).

191. Treas. Reg. § 1.1221-1(d).

192. See, e.g., *Pounds v. United States*, 372 F.2d 342, 19 A.F.T.R.2d 514 (5th Cir. 1967); *McFall v. Commissioner*, 34 B.T.A. 108 (1936). See also sections II.J.1., 4., 5. *infra*.

193. See *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *aff'd in part and rev'd in part without discussion of this point*, 335 F.2d 125, 14 A.F.T.R.2d 5349 (9th Cir. 1964); Rev. Rul. 73-558, 1973-2 C.B. 298.

194. *Merchants Acceptance Co. v. Commissioner*, 33 T.C.M. (P-H) 988 (1964); see *Merchants Nat'l Bank v. Commissioner*, 199 F.2d 657, 42 A.F.T.R. 749 (5th Cir. 1952) (amounts received on previously charged off notes were ordinary income).

stated interest. Section 1221(5) excludes only obligations which have a fixed maturity date no later than one year from the date of issue. This exclusion was enacted in 1941, and was intended to bar capital gain treatment for any amount of the discount because the discount is the same as stated interest on an obligation issued at face value. Because of their short term, section 1221(5) obligations are unlikely to appreciate or decline in value. This, together with the absence of stated interest, supports the legislative determination that the discount is equivalent to interest and should be taxed as ordinary income.¹⁹⁵

G. Government Publications Received Without Charge or at a Reduced Price

Section 1221(6), enacted by section 2132 of the Tax Reform Act of 1976, removes from the definition of a capital asset any United States governmental publication that a taxpayer receives from the government, or from any governmental agency, at other than the price for which it is offered for sale to the public. The exclusion applies to the taxpayer who received the publication from the government and to any taxpayer in whose hands the publication's basis is determined in whole or in part by reference to the basis of the taxpayer who received the publication from the government.¹⁹⁶ The provision applies to sales, exchanges, and contributions made after the effective date of the Act.

Section 1221(6) originated in the Senate's version of H.R. 10612; there was no comparable provision in the House bill.¹⁹⁷ The Conference Report states that the amendment to section 1221 was intended to prevent taxpayers who received government publications either without charge, "e.g., copies of the Congressional Record received by Members of Congress," or at a reduced price, from claiming a charitable contributions deduction for the full fair market value of any governmental publications donated to a charity for a use related to its exempt purpose.¹⁹⁸ However, section 1221(6) is phrased broadly enough to encompass much more than charitable contributions. Indeed, it removes from section 1221 any governmental publication received free or at a reduced charge by the taxpayer from the government or from any United States agency. It does not appear to include literature or other publications that might be

195. Treas. Reg. § 1.1221-1(e).

196. I.R.C. § 1221(6)(B).

197. See H.R. REP. NO. 1515, 94th Cong., 2d Sess., 399, 532, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4118, 4229.

198. *Id.*

received free of charge from a United States office, but which are not "publication[s] of the United States Government."

That both section 1221(6) and the underlying report refer to publications received without charge (or at a price other than that at which the publication is offered for sale to the public) indicates that no part of the publication is to be considered a capital asset and that no part of the taxpayer's gain is to be treated as capital gain.¹⁹⁹

Although it is not clear from the Senate's comments, section 1221(6) appears to be based on the reasoning that a taxpayer who receives an item at the government's expense should not be permitted to parlay that largesse into a double benefit.

II. STATUTORY AND JUDICIAL EXCEPTIONS

A. *In General*

Section 1221 broadly defines "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business) . . .," and then lists six exceptions.²⁰⁰ This broad definition grants taxpayers great leeway in structuring transactions so as to receive either capital gain or ordinary loss treatment. In response to these attempts to tamper with the basic capital asset definitional provisions, the Congress and judiciary have created certain statutory and judicial exceptions to section 1221. Congress has enacted Code sections to cover many common transactions that it determines should or should not be eligible to receive the special tax treatment; the courts have construed the relevant Code sections and provided judicial glosses to establish a consistent treatment for those transactions that do not specifically fall within the definitional provisions. This section of the article deals with those exceptions.

B. *The Corn Products Doctrine*

One of the most well known judicial glosses on the definition of a capital asset is the *Corn Products* doctrine.²⁰¹ Essentially, the doc-

199. See *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 37 A.F.T.R.2d 76-679 (5th Cir. 1976) (court rejected alternative of allocating gain between capital gain and ordinary income).

200. I.R.C. § 1221(1)-(6).

201. See *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 47 A.F.T.R. 1789 (1955). See generally Brown, *The Growing "Common Law" of Taxation*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW THIRTEENTH TAX INSTITUTE 1 (J. Ervin ed. 1961); Freeman, *Is There a New Concept of a Business Asset?*, 36 TAXES 110 (1958); Javaras, *Corporate Capital Gains and Losses—The Corn Products Doctrine*, 52 TAXES 770 (1974); Kauffman, *A Second Look at the Corn Products Doctrine*, 41 TAXES 605 (1963); Note, *Judicial Treatment of "Capital" Assets Acquired For Business: The New Criterion*, 65 YALE L.J. 401 (1956); 23 U. FLA. L. REV. 609 (1971).

trine holds that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset and falls within one of the section 1221 exceptions. Thus, depending on the relationship of the property to the business, the asset may be found to be a part of that business, inventory, or stock in trade, or held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

The *Corn Products* doctrine is most frequently applied to the purchase of securities, whose tax treatment depends on the purpose for which they were acquired. Securities bought in the ordinary course of business are non-capital assets, and any subsequent gain or loss is ordinary. On the other hand, securities purchased as an investment are capital assets, and their sale generates only capital gain or loss. When a taxpayer buys property to assure a source of supply or a source of income for its business, the property acquired begins to appear less like an investment and more like an ordinary business precaution even though it may not be used directly in the taxpayer's operations. Consequently, it becomes important to determine the reason for the purchase, and thereby to characterize any resulting gain or loss. *Corn Products* is the starting point for such a determination.

In *Corn Products Refining Co. v. Commissioner*,²⁰² the taxpayer had bought corn futures to protect its business from losses which would arise when it had to fill contract demands at a price lower than the cost of corn on a rising market.²⁰³ The taxpayer established that occasionally it made a profit on the sale of the futures when it did not require delivery on those contracts and sold them instead. However, the evidence showed that in buying the futures the taxpayer was interested primarily in protecting its business operations from an upside risk. By purchasing the futures and taking delivery on them "as it found necessary to its manufacturing operations"²⁰⁴ and selling when no shortage appeared imminent, the company effectively protected itself against substantial price increases. But in 1942 *Corn Products* incurred a \$110,000 loss, which it attempted to treat as a capital loss after reporting it as an ordinary loss.

The Supreme Court recognized that the futures met the liberal definition of a capital asset, and did not fall within any statutory

202. 350 U.S. 46, 47 A.F.T.R. 1789 (1955).

203. See, e.g., Cunnane, *Acquiring Capital Items for Non-Capital Purposes, or When Is a Capital Asset Not a Capital Asset?* in *NEW YORK UNIVERSITY TWENTY-NINTH ANNUAL INSTITUTE ON FEDERAL TAXATION* 705 (H. Sellin ed. 1971); Note, *Taxpayer Motivation And The Corn Products Doctrine*, 29 *TAX LAW*. 660 (1976) [hereinafter cited as *Taxpayer Motivation*].

204. 350 U.S. at 48.

exception.²⁰⁵ Nevertheless, the Court held that they were ordinary assets because they were an integral part of the taxpayer's business. It noted that the capital asset provisions were exceptions to the normal income tax rules, and as such must be strictly construed. To hold otherwise, the Court said, would denigrate the congressional intention of limiting the special tax treatment accorded to capital assets only to gains and losses which arise from the sale or exchange of property outside the stream of daily occurrences.

When the *Corn Products* doctrine is invoked, the courts must ask if the taxpayer purchased and held the property with a predominant business, as opposed to investment, purpose.²⁰⁶ Where a predominant business purpose is found the taxpayer must recognize a gain or loss as ordinary.²⁰⁷ Conversely, a predominant investment motive will cause gain or loss to be capital.

It would, of course, be to the taxpayer's advantage to have gains characterized as capital and losses as ordinary. The lack of standardized guidelines by which the taxpayer's predominant intent can

205. *Id.* at 51-52.

206. *Union Pac. R.R. v. United States*, 524 F.2d 1343, 36 A.F.T.R.2d 75-6251 (Ct. Cl. 1975); *Agway, Inc. v. United States*, 524 F.2d 1194, 36 A.F.T.R.2d 75-6157 (Ct. Cl. 1975); *Dearborn Co. v. United States*, 444 F.2d 1145, 27 A.F.T.R.2d 71-1520 (Ct. Cl. 1971); *Steadman v. Commissioner*, 424 F.2d 1, 25 A.F.T.R.2d 70-926 (6th Cir. 1970); *W.W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *appeal dismissed*, 550 F.2d 43, 39 A.F.T.R.2d 77-783 (1st Cir.), *cert. denied*, 431 U.S. 966 (1977); *International Flavors & Fragrances, Inc. v. Commissioner*, 62 T.C. 232 (1974), *rev'd & remanded*, 524 F.2d 357, 36 A.F.T.R.2d 75-6054 (2d Cir. 1975).

In *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494, 25 A.F.T.R.2d 70-788 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970), the court applied *Corn Products* to § 1231. *Cf.* *United States v. Hess*, 341 F.2d 444, 15 A.F.T.R.2d 404 (10th Cir. 1965) (dictum to the same effect). *See also* *Commissioner v. Bagley & Sewall Co.*, 221 F.2d 944, 47 A.F.T.R. 790 (2d Cir. 1955), where the court found that a loss on governmental obligations required to be posted by the taxpayer as security for the performance of a contract was an ordinary loss. Although the Service contended that the loss should have been treated as a capital loss because the bonds were capital assets, the court reasoned that the bonds would not have been acquired by the taxpayer in the absence of the security requirement in the contract. Therefore, the acquisition and holding of the bonds was integrally related to the taxpayer's business. Hence, the loss was ordinary. *See Schlumberger Technology Corp. v. United States*, 443 F.2d 1115, 28 A.F.T.R.2d 71-5019 (5th Cir. 1971); *Waterman, Largen & Co. v. United States*, 419 F.2d 845, 24 A.F.T.R.2d 69-5841 (Ct. Cl. 1969); *FS Services, Inc. v. United States*, 413 F.2d 548, 24 A.F.T.R.2d 69-5180 (Ct. Cl. 1969); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916, 9 A.F.T.R.2d 1693 (Ct. Cl. 1962); *International Flavors & Fragrances, Inc. v. Commissioner*, 62 T.C. 232 (1974) *rev'd & remanded*, 524 F.2d 357, 36 A.F.T.R.2d 75-6054 (2d Cir. 1975); *Tulane Hardwood Lumber Co. v. Commissioner*, 24 T.C. 1146 (1955); *Western Wine and Liquor Co. v. Commissioner*, 18 T.C. 1090 (1952). In *Estate of Laughlin v. Commissioner*, 30 T.C.M. (CCH) 227 (1971), the taxpayer sought to assert *Corn Products* to obtain ordinary loss treatment on soybean futures, but the court found that the futures were purchased for speculation and not as an integral part of the taxpayer's business.

In determining the taxpayer's intent the Court's decision in *Malat*, section I.B.3.a., *supra*, might be useful.

207. *See* 350 U.S. at 50-51.

be determined has led to apparently inconsistent results in apparently consistent settings. To eliminate the ability to contend that property was a capital asset if gain is realized, but a non-capital asset if loss is incurred, Congress has considered many proposals. For example, H.R. 10902, passed by the House of Representatives on August 25, 1976, would have enacted new section 1254.²⁰⁸ This provision would have required most taxpayers to notify the Service that they were holding securities for business reasons within thirty days after acquiring the securities. Once the taxpayer notified the Service that the securities were being held for business purposes they were to be characterized as non-capital assets. If the taxpayer did not notify the government, then any gain or loss realized thereafter would be capital gain or loss. The House Ways and Means Committee Report stated that the new section was intended to preclude the taxpayer from contending that gain was capital and that loss was ordinary depending on whether the market was up or down. In addition, the new section was designed to clarify an area in which each case previously had been categorized by its own facts. The report specifically cited *Union Pacific R.R. v. United States*,²⁰⁹ *W. W. Windle Co. v. Commissioner*,²¹⁰ and *Carsello v. Commissioner*,²¹¹ as examples of this inconsistency.

One of the primary reasons given by the Ways and Means Committee supporting H.R. 10902 was the lack of standards with which courts can administer the *Corn Products* doctrine. In part it is this absence of guidelines that accounts for the remarkable ability of taxpayers to argue that losses are ordinary, and that gains are capital, depending upon the results of a sale. Rarely will a taxpayer acquire property exclusively for business purposes. Instead, each business purchase is probably accompanied by a substantial investment motive.²¹² A typical *Corn Products* hedge against upside risks will be joined by an anticipation of making a profit in the business as well as on the disposition of the hedge itself. Thus, the courts are faced with the task of determining which purpose is predominant where the transaction is imbued with both business and investment purposes.²¹³

208. 94th Cong., 2d Sess. (1976). Cf. I.R.C. § 1236 (which requires security dealers to label their acquisitions as held for investment purposes in order to have gain from the sale or exchange thereof considered capital gain).

209. 524 F.2d 1343, 36 A.F.T.R.2d 75-6251 (Ct. Cl. 1975).

210. 65 T.C. 694 (1976), *appeal dismissed*, 550 F.2d 43, 39 A.F.T.R.2d 77-783 (1st Cir.), *cert. denied*, 431 U.S. 966 (1977).

211. 35 T.C.M. (CCH) 832 (1976).

212. See Rev. Rul. 75-13, 1975-1 C.B. 67.

213. *Id.*

Balancing motivations is a difficult task, especially in tax cases.²¹⁴ The decisions of the few courts which have been requested to do so in *Corn Products* settings are not in agreement.²¹⁵ While most courts confronting the problem have not adopted the alternative of allocating the results between capital and ordinary treatment according to a rough approximation of business and investment purposes,²¹⁶ they also have not agreed on the point at which one purpose clearly leads to the total characterization of the transaction despite the presence of a significant, but secondary, contrary motivation.²¹⁷ Moreover, no uniformity has emerged as to the effect of a subsequent change of purpose in holding the asset, regardless of whether that purpose was predominant at the time of sale, when the property was acquired primarily for another reason. For example, property purchased for business reasons, but subsequently held to the time of sale for investment purposes, may or may not be treated as a capital asset.²¹⁸

C. *Disguised Interest Income*

1. *Original Issue Discount*

Section 1232 was enacted to prevent the transformation of interest income into capital gain through the issuance of corporate or government bonds and obligations at a price below their stated redemption price at maturity.²¹⁹ Original issue discount is defined

214. See generally, Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967); *Taxpayer Motivation*, *supra* note 203.

215. Compare *Union Pac. R.R. v. United States*, 524 F.2d 1343, 36 A.F.T.R.2d 75-6251 (Ct. Cl. 1975) with *Agway, Inc. v. United States*, 524 F.2d 1194, 36 A.F.T.R.2d 75-6157 (Ct. Cl. 1975) and *Dearborn Co. v. United States*, 444 F.2d 1145, 27 A.F.T.R.2d 71-1520 (Ct. Cl. 1971).

216. Allocations are used in a number of instances in the Code. See I.R.C. §§ 162, 167, 183, 274, 482, 631(a), 1237; *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 37 A.F.T.R.2d 76-679 (5th Cir. 1976), *cert. denied*, 429 U.S. 819 (1977) (rejecting such allocations under § 1221(1)); *cf. Galena Oaks Corp. v. Scofield*, 218 F.2d 217, 220, 46 A.F.T.R. 1444 (5th Cir. 1954) (gain from sale of 102 houses over a fourteen month period held to be ordinary gain as the property was held primarily for sale in the ordinary course of business). See generally ALI, *Draft of a Study of Definitional Problems in Capital Gains Taxation* § X1237, at 32-34, 81-84 (Apr. 22, 1960).

217. See generally *Missisquoi Corp. v. Commissioner*, 37 T.C. 791, 797-98 (1962); *Cunhane*, *supra* note 203; *Taxpayer Motivation*, *supra* note 203.

218. See sources cited *id.* See also *W.W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976); *International Flavors & Fragrances, Inc. v. Commissioner*, 62 T.C. 232 (1974), *rev'd & remanded*, 524 F.2d 357, 36 A.F.T.R.2d 75-6054 (2d Cir. 1975); *Rev. Rul. 75-13*, 1975-1 C.B. 67.

219. See *United States v. Midland-Ross Corp.* 381 U.S. 54, 57, 15 A.F.T.R.2d 836 (1965); *Helvering v. Union Pac. R.R.*, 293 U.S. 282, 14 A.F.T.R. 705 (1934); *General Foods Corp. v. United States*, 530 F.2d 923, 37 A.F.T.R.2d 76-706 (Ct. Cl. 1976), *cert. denied*, 429 U.S. 867 (1977); *Boise Cascade Corp. v. United States*, 36 A.F.T.R.2d 75-5847 (Ct. Cl. 1974), *rev'd in part*, 530 F.2d 1367, 37 A.F.T.R.2d 76-696 (Ct. Cl. 1976), *cert. denied*, 429 U.S. 867 (1977);

by section 1232(b)(1) as the difference between the issue price and the face value, or "stated redemption price," of the bond or obligation at maturity. Gain attributable to the discount is characterized as ordinary income because it "is a form of interest income [which] in fact is deductible as an interest payment by the issu[er]" ²²⁰ Sales or exchanges of evidences of indebtedness are capital transactions, provided that the obligation is a capital asset in the hands of the taxpayer. ²²¹ From this treatment Congress carved out certain exceptions, including gain attributable to original issue discount. Subject to a de minimis principle, such gain is taxed as gain from the sale of a non-capital asset, regardless of whether the obligation is sold or redeemed. ²²² If the original purchaser holds the obligation to maturity, the entire amount of the discount is ordinary income. But if the obligation is sold or redeemed prior to maturity, only that portion of the discount accrued up to the date of the sale or redemption is taxed as ordinary income. ²²³

In *United States v. Midland-Ross Corp.*, ²²⁴ the Supreme Court considered what characterization should be accorded to non-interest bearing promissory notes originally issued at a discount. Although the taxpayer had reported the gain as capital gain under section 117 of the 1939 Code, he conceded that any gain attributable to the discount was not caused by market fluctuations, but by the economic equivalent of interest: the simple passage of time. ²²⁵ The Court ruled in favor of the government, premising its decision on the traditionally narrow construction given the term "capital asset." It explained that:

Although original issue discount becomes property when the obligation falls due or is liquidated prior to maturity and [§ 1221] define[s] a capital asset as "property held by the taxpayer," we have held that

"not everything which can be called property in the ordinary sense . . . qualifies as a capital asset. . . ."

H.R. REP. No. 1337, 83d Cong., 2d Sess. A275, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4110; S. REP. No. 1622, 83d Cong., 2d Sess. 433 reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4745. See generally, Landis, *Original Issue Discount After the Tax Reform Act of 1969*, 24 TAX LAW. 435 (1971); N.Y. State Bar Ass'n, Tax Section, Comm. on Corporate Taxation, *Comments on Proposed and Final Regulations on Income Tax Treatment of Corporate Debt Issued at Discount*, 50 TAXES 274 (1972).

220. H.R. REP. No. 1337, 83d Cong. 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4110.

221. Treas. Reg. § 1.1232-1(a) (1978).

222. *Id.*; I.R.C. § 1232(b)(1).

223. See I.R.C. § 1232(a)(2).

224. 381 U.S. 54, 15 A.F.T.R.2d 836 (1965).

225. *Id.* at 55-56, 55 n.1.

[T]his court has consistently construed "capital asset" to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income. . . . Similarly, earned original issue discount cannot be regarded as "typically involving the realization of appreciation in value accrued over a substantial period of time . . . [given capital gains treatment] to ameliorate the hardship of taxation of the entire gain in one year."

Earned original issue discount serves the same function as stated interest, concededly ordinary income and not a capital asset; it is simply "compensation for the use or forbearance of money."²²⁶

In *Commissioner v. National Alfalfa Dehydrating & Milling Co.*,²²⁷ the Court focused on the narrow question of whether a discount may result when debt obligations are issued in exchange for property other than cash. The corporation had issued fifty dollar (face value), five percent bonds for its equally-valued outstanding preferred stock. At the time of the exchange, however, the stock had a market value one-third less than its face value. The corporation therefore claimed that since the stockholders in effect had been issued bonds at a discount, it was entitled to an interest deduction. The Court held that no discount resulted where the corporation issued its obligations (debenture bonds) in exchange for its own outstanding preferred shares.²²⁸

The original issue discount element of section 1232 obligations must be taken into income ratably over the holding period of the indebtedness.²²⁹ As the discount element is included in income, there is a corresponding basis increase.²³⁰ These rules thus attempt to create parallel tax treatment for the holder of the obligation and the issuer, for the issuer may deduct the amount of the discount ratably over the life of the obligation.²³¹

If the obligation was intended to be called prior to maturity, the gain is ordinary income less any previously recognized part of the

226. *Id.* at 56-57 (quoting *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134, 5 A.F.T.R.2d 1770 (1960), and *Deputy v. DuPont*, 308 U.S. 488, 498, 23 A.F.T.R. 808 (1940)). See also *Pattiz v. United States*, 311 F.2d 947, 11 A.F.T.R.2d 478 (Ct. Cl. 1963).

227. 417 U.S. 134, 33 A.F.T.R.2d 74-1347 (1974).

228. *Id.* at 155. The Court reasoned that although the form of retained capital had been changed, the corporation had not incurred any additional costs for borrowing money, and hence an interest deduction would be improper. *Id.* at 154. See Wolf, *Original Issue Discount: Before and After National Alfalfa*, 28 TAX LAW. 325 (1975).

229. I.R.C. § 1232(a)(3)(A).

230. *Id.* § 1232 (a)(3)(E).

231. Section 1232 pre-emptes § 483 in this regard. See Treas. Reg. § 1.483-1(b)(3) (1978). In applying § 453, original issue discount is excluded from both the selling and the contract prices. Treas. Reg. §§ 1.453-1(b)(3); 1.1232-3(b)(2)(iii) (1978).

discount.²³² Where the discounted instrument is purchased from the initial holder, the purchaser is treated the same as the seller unless the obligation is purchased at a premium. However, the purchaser may deduct any cost in excess of the prior owner's adjusted basis ratably over the obligation's remaining life.²³³

Original issue discount generally will not arise where the obligation is issued for property other than cash,²³⁴ in a reorganization,²³⁵ or as a result of a basis reduction due to Subchapter S losses.²³⁶ In addition, section 1232 does not apply to savings accounts,²³⁷ or to tax exempt obligations under section 103.²³⁸ The Regulations, however, have applied section 1232 to certificates of deposit, time deposits, and various other deposit plans offered by financial institutions.²³⁹ Special rules apply to determining the discount factor where bonds and warrants are issued together.²⁴⁰

2. Imputed Interest

Congress enacted section 483 in 1964²⁴¹ "to prohibit a seller from avoiding ordinary income liability by merely labeling receipts as selling price rather than interest . . ." ²⁴² Under section 483 a portion of each payment under a deferred payment sales contract may

232. I.R.C. § 1232(a)(2)(A).

233. See I.R.C. § 1232(a)(3).

234. Treas. Reg. § 1.1232-3(b)(2)(iii) (1978). See also *National Alfalfa Dehydrating & Milling Co. v. United States*, 417 U.S. 134.

235. Treas. Reg. § 1.1232-3(b)(2)(iii) (1978) (applying the general rule to I.R.C. §§ 361, 371, 373, and 374, but not to § 351); cf. Treas. Reg. § 1.1232-3(b)(1)(iv) (1978) (original issue discount "taint" is retained in a reorganization).

236. Compare Rev. Rul. 64-162, 1964-1 C.B. 304 with Rev. Rul. 68-537, 1968-2 C.B. 372.

237. See *Dwyer v. United States*, 27 A.F.T.R.2d 71-924 (N.D. Ala. 1970), *aff'd sub nom. Cato v. United States*, 442 F.2d 927, 27 A.F.T.R.2d 71-1236 (5th Cir. 1971).

238. I.R.C. § 1232(a)(2)(C)(i).

239. Treas. Reg. § 1.1232-3A(e) (1978).

240. I.R.C. § 1232(b)(2).

241. See *Shanahan v. United States*, 315 F. Supp. 3, 26 A.F.T.R.2d 70-5785 (D. Colo. 1970), *aff'd*, 447 F.2d 1082, 28 A.F.T.R.2d 71-5544 (10th Cir. 1971), regarding the retroactive application of § 483.

242. *Robinson v. Commissioner*, 439 F.2d 767, 768, 27 A.F.T.R.2d 71-970 (8th Cir. 1971); see H.R. REP. No. 749, 88th Cong., 1st Sess. 196-98 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 605-08 (1964). Prior to the enactment of § 483, the entire amount was treated as the purchase price. See *Paine v. Commissioner*, 236 F.2d 398, 50 A.F.T.R. 10 (8th Cir. 1956); *Kingsford Co. v. Commissioner*, 41 T.C. 646 (1964).

Under § 483(f)(4), the general rule of § 483(a) may not be applicable in the case of a transfer of a patent. See *Busse v. United States*, 543 F.2d 1321, 38 A.F.T.R.2d 76-5984 (Ct. Cl. 1976); cf. I.R.C. § 163(b) (which allows an interest deduction for unstated interest on personal property bought on the installment plan). See generally Bonovitz, *Problems of Imputed Interest in Installment Sales of a Corporate Business*, in NEW YORK UNIVERSITY TWENTY-SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 821 (H. Sellin ed. 1969); Murdoch, *Imputed Interest and Section 483*, 44 TAXES 866 (1966); Thorington & Hardegree, *Imputed Interest—A Potential Tax Trap*, 54 A.B.A.J. 808 (1968).

be treated as interest, rather than as part of the sales price, if the contract does not provide for interest, or provides for interest below the rate prescribed by the Treasury. Section 483 applies to any payment on account of the sale or exchange of property, provided that (1) the selling price is more than \$3,000,²⁴³ (2) the payment is part or all of the sales price, (3) the payment is due, under the contract, more than six months after the date of the sale or exchange, (4) one or more payments are due more than one year after the date of the sale or exchange, and (5) under the terms of the contract, there is "total unstated interest" as defined in section 483(b).²⁴⁴ Section 483(d) contains a separate rule for imputing interest where the payments are indefinite as to time, liability, or amount.²⁴⁵

Section 483 is explicitly designed to prevent a seller from receiving interest income taxed at capital gains rates by increasing the total deferred amount of the sales price to reflect the unstated interest. Where a portion of each payment represents ordinary interest income, section 483 operates to preclude the seller from converting the interest into capital gains by not specifying interest in the obligation.²⁴⁶

The imputation of interest under section 483 may disqualify an installment sale from the favorable treatment accorded by section 453.²⁴⁷ This would occur if, pursuant to section 483, the selling price is reduced to reflect the unstated interest to the point that the down payment exceeds thirty percent of the adjusted selling price in the year of the sale.²⁴⁸

D. Section 1231

Section 1221(2) excludes from the definition of a capital asset "property, used in [the taxpayer's] trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business"²⁴⁹ Nevertheless, while section 1221(2) removes these noninventory

243. I.R.C. § 483(f)(1).

244. I.R.C. § 483(c). "Total unstated interest" means "an amount equal to the excess of (1) the sum of the payments to which [§ 483] applies which are due under the contract, over (2) the sum of the present values of such payments and the present values of any interest payments due under the contract." I.R.C. § 483(b).

245. I.R.C. § 483(d); see *Commissioner v. Brown*, 380 U.S. 563, 578 n.9, 15 A.F.T.R.2d 790 (1965); S. REP. No. 830, 88th Cong., 2d Sess. 103 reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1673, 1776.

246. I.R.C. § 483.

247. *Robinson v. Commissioner*, 439 F.2d 767, 27 A.F.T.R.2d 71-970 (8th Cir. 1971).

248. *Id.* See I.R.C. § 453(b)(2)(B).

249. I.R.C. § 1221(2); see section I.C. *supra*.

business assets from the category of capital assets, section 1231 may treat gain on their disposition as gain from the sale or exchange of a capital asset.²⁵⁰ Because of this intimate relationship between sections 1221(2) and 1231, neither provision can be fully understood without reference to the other. Hence, the section 1221(2) exclusion must be considered with regard to section 1231, which, again, may characterize gain from the sale, exchange, or involuntary conversion of these non-capital assets as capital gain.

Properties covered by section 1231, which must have been held for more than one year,²⁵¹ are often referred to as "quasi capital assets" because section 1231 provides for capital gain treatment of certain non-capital assets if these assets are disposed of at a net gain, while it allows *ordinary* loss treatment if they are sold, exchanged, or involuntarily converted at a net loss.²⁵² The determination of whether to use capital or ordinary treatment is accomplished by a comparison of the total recognized gain on the disposition of section 1231 property with the sum of the otherwise allowable losses on the same items. If the total of the individually computed gains exceeds the total of the losses on the same property, all gains and all losses are capital gains and losses. Conversely, if the losses equal or exceed the gains, all gains and all losses are ordinary gains and losses.

Section 1231 applies to depreciable property and to real property, provided that each is used in the taxpayer's trade or business.²⁵³ It excludes inventory, stock in trade, and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, as well as property included in section 1221(3).²⁵⁴ In addition, section 1231(b)(2)-(4) includes cut timber, coal, iron ore, timber royalties, certain livestock, and unharvested crops—all of which are non-capital assets and closely related to inventory property. In some instances section 1231 may include the proceeds from the involuntary conversion of capital assets.²⁵⁵ This is the only exception to the rule that section 1231 does not involve capital assets.

Section 1231 requires two separate comparisons of gains and

250. See I.R.C. § 1231.

251. I.R.C. § 1231(b)(1). Special time rules are provided in the cases of livestock, minerals, and unharvested crops sold with the land. I.R.C. § 1231(b)(2)-(4).

252. I.R.C. § 1231(a). The existence of the involuntary conversion category, of course, removes the necessity of having a sale or exchange. See *Part Two, supra* note 2 at III.A.; cf. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 25 A.F.T.R. 1236 (1941) (money received by taxpayer as proceeds of insurance on buildings and equipment destroyed by fire held not a gain from "sale or exchange" of capital assets).

253. I.R.C. § 1231(b)(1).

254. *Id.* § (b)(1)(A)&(B).

255. Section 1231(a) covers involuntary and compulsory conversions as well as voluntary ones.

losses on the disposition of certain categories of property.²⁵⁶ The first level, sometimes referred to as the "firepot," involves only gains and losses from the involuntary conversion of (1) depreciable and real property which is used in the taxpayer's trade or business, and (2) capital assets held for more than one year.²⁵⁷ Involuntary conversions are those events defined in section 165(c)(3).²⁵⁸ If the comparison of these gains and losses shows that the losses exceed the gains, then section 1231 is inapplicable and the transactions are characterized by the otherwise applicable Code provisions.²⁵⁹ However, if the gains equal or exceed the losses, then the full amount of the gains and losses enters the second comparison.

The second process of comparison under section 1231 generally is referred to as the "hotchpot."²⁶⁰ It begins by carrying over the recognized gains and losses from the involuntary conversions compared on the first level, but only where those gains equal or exceed those losses. To these items are added the gains and losses from compulsory conversions (such as condemnations) of property used in the taxpayer's trade or business and capital assets held for more than one year, plus gains and losses from the sale or exchange of property used in the taxpayer's trade or business. Thus, there should be three categories of gains and losses present in section 1231's hotchpot: (1) gains and losses from the involuntary conversions (the subject of the first comparison); (2) gains and losses from the compulsory conversion of (a) property used in the taxpayer's trade or business, and (b) capital assets held for more than one year; and (3) gains and losses from the sale or exchange of property used in the taxpayer's trade or business.²⁶¹

This second comparison merely requires that the total of all the gains be determined and then compared with the total losses. If the total gains exceed the total losses, all of the gains and all of the losses in the comparison are considered to be capital gains and capital losses. Conversely, if the gross loss equals or exceeds the

256. See I.R.C. § 1231(a).

257. *Id.*; Treas. Reg. § 1.1231-1(b) (1978) (note that the Regulation has not yet been amended to reflect the holding period change from six months to one year). Naturally, all the gains and losses must be *recognized*. The Tax Reform Act of 1969 removed any necessity to consider whether the assets used in gain seeking were insured. Pub. L. No. 91-172, § 516(b), 83 Stat. 487 (1969). See also H.R. REP. No. 782, 91st Cong., 1st Sess. 319 (1969).

258. They are "fire, storm, shipwreck, or other casualty, or . . . theft." I.R.C. § 165(c)(3). See also *id.* § 1231(a).

259. See § 165(a) (losses arising from property used in taxpayer's trade or business); § 165(c)(3) (losses arising from certain involuntary conversions). These sections still guarantee ordinary loss treatment where § 1231 otherwise would apply.

260. See Birkeland, *Section 1231: A Fading Star for the Business Taxpayer*, 60 A.B.A.J. 845 (1974); Lee, *Section 1231 Gains and Losses*, 21 (No. 6) *PRAC. LAW.* 25 (1975).

261. See Treas. Reg. § 1.1231-1(g) (1978).

gross gain, *all* of the gains and all of the losses are treated as ordinary gains and losses.²⁶² Note well: *the gains and losses are not netted.*

Once the second comparison is completed, all of the gains and all of the losses compared enter into the calculation of the taxpayer's income, characterized as capital or ordinary, according to the process described above. Thus, all of the gains and losses compared under section 1231 are aggregated with other items of the same character in the taxpayer's return which were not subject to section 1231. For example, if the section 1231 comparison shows that the gains exceed the losses, then all of those gains and all of those losses are treated as capital gains and losses and must be added to the taxpayer's "real" capital gains and losses.²⁶³ Similarly, if the comparison shows an amount of losses equal to or in excess of the gains compared, thereby treating all of the items as ordinary, the gains and losses from the hotchpot must be added to the taxpayer's ordinary gains and losses.²⁶⁴

If the taxpayer has only one section 1231 event during the taxable year, it, too, is characterized by section 1231.²⁶⁵ As a result, gain on the sale of non-inventory business property—an admittedly non-capital item—will be treated as a capital gain if that is the taxpayer's only section 1231 transaction for the year. On the other hand, if the compulsory conversion of a capital asset held for more than one year results in a loss, and the conversion is the taxpayer's only section 1231 event, the loss is ordinary rather than capital.²⁶⁶

The gains and losses to which section 1231 applies must be recognized and otherwise subject to inclusion in the computation of gross income.²⁶⁷ Thus, nondeductible losses are excluded, as are gains and losses from nontaxable exchanges.²⁶⁸ The section 1211 restrictions on the deductibility of capital losses are disregarded for purposes of making the section 1231 comparison,²⁶⁹ but the limitations on the current recognition of gain on the sale of property reported on the installment method are observed.²⁷⁰

Any gain on the disposition of section 1231 property that is subject to recapture is excluded from the section 1231 process, and is

262. I.R.C. § 1231(a); Treas. Reg. § 1.1231-1(b)(2) (1978). It is probably more accurate to view the § 1231 mechanics as a comparative rather than a netting process.

263. Treas. Reg. § 1.1231-1(b)(2) (1978).

264. *Id.*

265. *Id.* § 1.1231-1(a) (1978).

266. *Id.*

267. I.R.C. § 1231(a)(1).

268. *Id.*; Treas. Reg. § 1.1231-1(d)(1), (4) (1978).

269. Treas. Reg. § 1.1231-1(d) (1978).

270. I.R.C. § 1231(a)(1); Treas. Reg. § 1.1231-1(d)(3) (1978).

taxed as ordinary income under the usual rules applicable to recapture property.²⁷¹ However, any gain in excess of the amount subject to recapture is taken into account under section 1231, as are losses on the sale, exchange, or involuntary conversion of property that otherwise would be subject to recapture, and which is within the ambit of section 1231.²⁷²

In determining whether, for purposes of section 1231, property is used in the taxpayer's trade or business, as distinguished from being held primarily for sale to customers in the ordinary course of that trade or business, the interpretations of section 1221(1) and (2) are useful but not necessarily dispositive. Although the same language is used in both sections, the exclusions from section 1221 are broader, in the sense that they do not have to be construed strictly, than the exclusions from section 1231. For example, a court can decide that specific property is not a capital asset because it either is used in the taxpayer's trade or business or is held primarily for sale to customers in the ordinary course of that business. In the former instance the property is excluded by section 1221(1), and in the latter by section 1221(2). In either case the property simply is not a capital asset. However, such a determination is insufficient under section 1231. That section encompasses gains and losses from the sale, exchange, or involuntary conversion of property used in the taxpayer's trade or business, but excludes property that is held primarily for sale to customers in the ordinary course of that business. Thus, for purposes of ascertaining whether an item is a capital asset, it makes no difference which label is applied, or even if it is clear that the exact nature of the property was not determined. But for purposes of deciding whether an item will be treated as a capital asset under section 1231 the difference is crucial. For example, in *International Shoe Machine Corp. v. United States*,²⁷³ the court clearly removed the property from capital asset classification. However, the exclusion of the shoe manufacturing equipment involved turned on its categorization as being held primarily for sale in the ordinary course of the taxpayer's trade or business, even though only a small percentage of the taxpayer's revenues was from the sale of shoe manufacturing equipment.²⁷⁴ Had the court decided instead that the equipment was *used* in the taxpayer's business, the sales would have been included under section 1231.

271. Treas. Reg. §§ 1.1245-6(a); 1.1250-1(c)(1) (1978).

272. *Id.*

273. 491 F.2d 157, 33 A.F.T.R.2d 74-619 (1st Cir. 1974), *cert. denied*, 419 U.S. 834 (1975).

274. *Id.* The taxpayer preferred to lease the equipment but would sell "as a last resort."
Id. at 160.

In contrast, the *Corn Products* doctrine²⁷⁵ applies equally to both section 1221 and section 1231.²⁷⁶ Yet when section 1231's applicability is in question, the courts seem to give *Corn Products* a more expansive reading, thereby broadening the types of property completely excluded from capital asset treatment.²⁷⁷ The reason for this interpretation under section 1231 probably can be explained in terms of the difficulty encountered in drawing the fine lines required by section 1231(b), and by the fact that property susceptible to the *Corn Products* doctrine is not likely to exhibit the latent investment qualities that otherwise support the existence of section 1231.²⁷⁸

Section 1231 generally is favorable to the taxpayer since it makes available the best of both worlds—capital gain and ordinary loss. Therefore, it is not surprising that the section is not construed in a broadly remedial manner.

E. Options to Buy or Sell

Section 1234 provides that “[g]ain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell . . .” stock, securities, or commodities shall be considered to be of the same character as the property to which the option relates.²⁷⁹ Section 1234 does not apply to any option which is granted in the ordinary course of the grantor's business of granting options,²⁸⁰ nor does it apply to an option which otherwise is described in section 1221(1), or to a loss covered by section 1233(c).²⁸¹ Section 1234 is, however, applicable to puts, calls, and various other securities devices.²⁸²

275. See section II.B. *supra*.

276. See, e.g., *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494, 25 A.F.T.R.2d 70-788 (9th Cir. 1970), cert. denied, 400 U.S. 848 (1970). But see *Deltide Fishing & Rentals Tools v. United States*, 279 F. Supp. 661, 21 A.F.T.R.2d 470 (E.D. La. 1968).

277. By definition, almost all § 1231 property is excluded from § 1221. Therefore, if it is excluded from § 1231 as well, it is removed entirely from any capital asset consideration. In *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494, 25 A.F.T.R.2d 70-788 (9th Cir. 1970), the court reasoned that the contracts in question were the business property of the taxpayer, in the sense that they were related integrally to its business, and that the capital gain policy of according special tax treatment to gain that arises outside the routine operations of a business would be thwarted if § 1231 converted ordinary income into capital gain. However, few courts have followed the Ninth Circuit. See 23 U. FLA. L. REV. 609 (1971).

278. See 23 U. FLA. L. REV. 609 (1971).

279. I.R.C. § 1234(a)(1). See also, H.R. REP. NO. 1192, 94th Cong., 2d Sess. (1976); Estes, *Federal Income Tax Advantages to Investors in the Use of Put and Call Options*, 31 TAX L. REV. 1 (1975); Gallagher & Tarkoe, *Taxing an Option on American Business: Puts, Calls and the IRC*, 52 TAXES 481 (1974).

280. I.R.C. § 1234(b)(3).

281. *Id.* § 1234(a)(3).

282. *Id.* § 1234 (a), (b).

F. Gain on Sales or Exchanges Between Related Parties

1. In General

Transfers of depreciable property between related parties have caused a significant number of tax problems for the parties involved and for the government. Related party transfers may facilitate the shifting of income without engendering a detrimental change in the pecuniary situation of the economic unit.²⁸³ Frequently the goal of such transfers is the enhancement of the parties' overall financial picture through a splitting of income and an accompanying decrease in taxes. Moreover, regardless of whether the property is income-producing, its conveyance may reduce the size of the transferor's taxable estate, effectively shift or create deductible expenses, or both.²⁸⁴ This may have the same result as income splitting. Although losses generally cannot be transferred between related parties, if the property is depreciable, the allure of potential tax benefits incident to such a transfer may be irresistible.²⁸⁵

For example, assume that *A* owns *Blackacre*, a depreciable structure with a fair market value in excess of *A*'s adjusted basis. During the term of his ownership *A* has depreciated *Blackacre* in accordance with section 167, thereby offsetting otherwise taxable ordinary income. Since *Blackacre*'s value exceeds *A*'s basis, *A* would like to be able to take depreciation deductions based on the greater value. He is not permitted to do so, however, because depreciation is derived from the owner's adjusted basis in his property.²⁸⁶ Therefore, *A* decides to sell *Blackacre* to *B*, a related party, so that *B* can depreciate the property based on his cost, its increased value. The difference between *A*'s adjusted basis and the sales price will be taxed at capital gains rates.²⁸⁷ Consequently, *A* and *B* anticipate

283. See generally, Croft & Hipple, *Planning Lifetime Property Transfers: Private Annuities, Installment Sales and Gift-Leasebacks*, 11 REAL PROP., PROB. & TR. J. 253 (1976); First, *Transactions Between Related Taxpayers—Constructive Stock Ownership Rules and Applications*, in NEW YORK UNIVERSITY SIXTEENTH INSTITUTE ON FEDERAL TAXATION 801 (1958); Gallagher, *Gain on Sales or Exchanges Between Related Parties*, 1 REV. TAX. INDIVIDUALS 136 (1977); Ginsburg, *Real Estate Transactions Between Related Taxpayers*, in NEW YORK UNIVERSITY TWENTY-SIXTH INSTITUTE ON FEDERAL TAXATION 311 (1968); Hamovit, *Disallowances of Losses and Deductions and Characterization of Gains Between Related Persons*, 15 W. RES. L. REV. 270 (1964).

284. When the transfer involves a sale and leaseback, however, the courts have been reluctant to recognize the transfer as bona fide. See generally *Frank Lyon Co. v. United States*, 536 F.2d 746 (8th Cir. 1976).

285. I.R.C. § 267; see First, *supra* note 267, at 801-05; Hamovit, *supra* note 267.

286. I.R.C. § 167(g); see Gallagher, *Fiscal Alchemy and the Crane Rule: Alternative Solutions to the Tax Shelter*, 8 CONN. L. REV. 607 (1976).

287. However, the gain on the sale of the property probably will be subject to the recapture rules of I.R.C. §§ 1245, 1250 to the extent that *A*'s depreciation exceeded straight line. Naturally, if the transfer is a gift, the donee will carry over *A*'s basis.

receiving greater depreciation deductions, to offset ordinary income, at a cost of a capital gains tax on the gain realized by A. This cost is partially represented in the downward basis adjustments caused by A's depreciation of the property. In the absence of a tightly drafted statute designed to prevent this result, the A-B transaction very well might be effective.²⁸⁸ In fact, depending on the relationship of the parties and the manner in which the transfer was effected, this often happened notwithstanding the existence of section 1239.

2. Section 1239

As originally enacted, section 1239 denied capital gains treatment on gain from the sale or exchange of depreciable property between husband and wife, or between an individual and a corporation in which the individual, his spouse, and his minor children and grandchildren owned over eighty percent of the value of the stock.²⁸⁹ The section was designed to prevent taxpayers from selling depreciable property with a market value greater than basis to relatives in order to obtain increased depreciation deductions at the cost of a capital gains tax.²⁹⁰ The House Report explained that:

The substantial differential between the capital-gains rate and the ordinary rates makes such a substitution highly advantageous when the sale may be carried out without loss of control over the asset because the corporation to which the asset is sold is controlled by the individuals who make the sale.²⁹¹

Some courts, however, in apparent contradiction to the legislative design, have held that section 1239 did not apply to gain from the sale of depreciable property between two corporations controlled by the same taxpayer or his family.²⁹² Moreover, in *Mitchell v.*

288. See *Mitchell v. Commissioner*, 300 F.2d 533, 9 A.F.T.R.2d 954 (4th Cir. 1962), discussed *infra* at text accompanying notes 293-97. See generally Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 TAX L. REV. 253 (1960); see also *Childers v. United States*, 542 F.2d 1243, 38 A.F.T.R.2d 76-6002 (4th Cir. 1976).

289. Section 1239's predecessor was enacted by § 310(a) of the Revenue Act of 1951 as § 117(o) of the 1939 Internal Revenue Code. See H.R. REP. No. 586, 82d Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 357, 376; S. REP. No. 781, 82d Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 458, 507; CONF. REP. No. 1213, 82d Cong., 1st Sess., reprinted in [1951] U.S. CODE CONG. & AD. NEWS 2121, 2135. The Service has ruled that the "value" of the stock referred to in I.R.C. § 1239 is not necessarily the same as 80% or more of the total number of shares outstanding. Rev. Rul. 69-339, 1969-1 C.B. 203.

290. Note § 1239's nonapplicability to patent transfers: *Davis v. Commissioner*, 491 F.2d 709, 33 A.F.T.R.2d 74-671 (6th Cir. 1974); *Chu v. Commissioner*, 486 F.2d 696, 32 A.F.T.R.2d 73-6022 (1st Cir. 1973).

291. H.R. REP. No. 586, 82d Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 357, 376.

292. See *Miller v. Commissioner*, 510 F.2d 230, 35 A.F.T.R.2d 75-714 (9th Cir. 1975); 10-

Commissioner,²⁹³ the court held that section 1239 did not apply where stock was held in trust for the benefit of the taxpayer's minor children. The taxpayer in *Mitchell* transferred a number of shares to an irrevocable trust for the benefit of his children. The corporation whose shares were transferred purchased a building for \$167,500 and sold it to the taxpayer for the same price one month later. Four years later the taxpayer sold the property back to the corporation for \$199,500. Since his adjusted basis at that time was approximately \$154,000, he reported a long term capital gain of almost \$45,600.

The taxpayer, his wife, and two of his minor children owned 79.54% of the corporation's outstanding stock at the time of the reconveyance. Additionally, the two minor children were beneficiaries of 12.21% of the stock. (The taxpayer's oldest child, an adult, and thus irrelevant here, owned the remainder of the stock.) Thus the taxpayer, his wife, and his minor children together owned over 90% of the stock: well above the 80% threshold.

The Commissioner asserted a deficiency, and the taxpayer petitioned the Tax Court for relief. The Service contended that the entrusted shares were owned by the taxpayer's minor children within the meaning of section 1239(b)(2), relying specifically upon Treasury Regulation section 1.1239-1, which expressly included the beneficial ownership of stock within the ambit of section 1239. By the authority of the Regulation, the Tax Court found that the eighty percent threshold had been exceeded and held against the petitioner.

The Tax Court's decision, however, was reversed on appeal. The Fourth Circuit examined the legislative history of section 1239 and concluded that neither entrusted shares nor those owned by adult children were intended by Congress to be attributed to the taxpayer. The court emphasized that the original House version of section 1239 had provided specifically that "stock owned, directly or indirectly, by or for a . . . trust, shall be considered as being owned proportionately by or for its . . . beneficiaries."²⁹⁴ Under certain

42 Corp. v. Commissioner, 55 T.C. 593 (1971), *rejecting* Rev. Rul. 69-109, 1969-1 C.B. 202 (section 1239 encompasses commonly controlled corporations). In the Supplemental Report of the Senate Finance Committee on Amendments to H.R. 10612, the Committee explained that transfers between commonly controlled corporations should have been found to be included under I.R.C. § 1239. S. REP. NO. 938, 94th Cong., 2d Sess. (Supp. Comm. Rep. 1976), 1976-3 C.B. 643, 671. *See generally*, Ellis, *Tax Problems in Sales to Controlled Corporations*, 21 VAND. L. REV. 196 (1968).

293. 300 F.2d 533, 9 A.F.T.R.2d 954 (4th Cir. 1962).

294. H.R. REP. NO. 586, 82d Cong., 1st Sess., *reprinted in* [1951] U.S. CODE CONG. & AD. NEWS 1781, 1909, *quoted in* *Mitchell v. Commissioner*, 300 F.2d 533, 536, 9 A.F.T.R.2d 954 (4th Cir. 1962).

circumstances the House bill would have attributed stock owned by designated relatives, including children, to the taxpayer.²⁹⁵ The Conference Committee, however, followed the Senate version, and deleted these provisions on the ground that they would impede transfers of depreciable property even when tax avoidance was not the motive.²⁹⁶ Therefore, due to "the design of the section as revealed by its structure and history,"²⁹⁷ the court concluded that the instant transfer was outside the purview of section 1239 notwithstanding the Treasury's interpretation to the contrary.

Like the beneficial ownership issue considered in *Mitchell*, the question of whether shares which are subject to an option or similar contract held by the taxpayer should be attributed to him for purposes of triggering the more than eighty percent test has been resolved inconsistently.²⁹⁸ For example, in *United States v. Parker*,²⁹⁹ the court applied section 1239 to deny capital gains treatment to an eighty percent shareholder who sold a building to the corporation. Pursuant to a shareholder's agreement, the taxpayer had an option to purchase the shares of the twenty percent owner in the event that the latter terminated his employment with the corporation. The taxpayer's stock was unrestricted, but the corporate articles gave the corporation a right of first refusal to the twenty percent owner's shares. Because of this restriction, the court concluded that the value of the taxpayer's eighty percent interest exceeded the eighty percent threshold.³⁰⁰ Section 1239 therefore, required that the gain be taxed as ordinary.³⁰¹

Conversely, in *Trotz v. Commissioner*,³⁰² the Tax Court refused to attribute any additional value to an option to purchase the interest of a minority shareholder. The seventy-nine percent shareholder had an option to acquire the twenty-one percent owner's interest if the latter's employment terminated, an action the majority shareholder could effectuate at will. The Tax Court found that nothing

295. H.R. REP. No. 586, *supra* note 294.

296. CONF. REP. No. 1213, 82d Cong., 1st Sess., *reprinted in* [1951] U.S. CODE CONG. & AD. NEWS 2121, 2135.

297. 300 F.2d at 538.

298. Compare *United States v. Parker*, 376 F.2d 402, 19 A.F.T.R.2d 1281 (5th Cir. 1967) with *Trotz v. Commissioner*, 361 F.2d 927, 17 A.F.T.R.2d 1262 (10th Cir. 1966).

299. 376 F.2d 402, 19 A.F.T.R.2d 1281 (5th Cir. 1967).

300. According to the Service the taxpayer actually may own, or be deemed to own, less than 80% of the total number of corporate shares and yet own more than 80% of the value of the corporation's stock. Rev. Rul. 69-339, 1969-1 C.B. 203. See also Note, *Determination of Related Parties: A Critical Discussion of the Value Test Prescribed in the Internal Revenue Code*, 9 B.C. INDUS. & COM. L. REV. 171 (1967).

301. 376 F.2d at 410.

302. 36 T.C.M. (P-H) 687 (1967), *on remand from* *Trotz v. Commissioner*, 361 F.2d 927, 17 A.F.T.R.2d 1262 (10th Cir. 1966).

was added to the value of the seventy-nine percent interest by the existence of the option, or by the fact of control, since the company had no going-concern value. The court reasoned that because a purchaser would be willing to pay only for the corporation's assets, the taxpayer owned only seventy-nine percent of the value of the company's stock.³⁰³

As a result of decisions like these, and of the gaps in section 1239's applicability, taxpayers frequently could avoid its disadvantages and obtain a stepped-up basis at the cost of a capital gains tax.

The 1976 Act amended section 1239 in an attempt to give it a more effective and expansive reach.³⁰⁴ Section 1239 still applies to the direct or indirect sale or exchange of depreciable property between related persons.³⁰⁵ However, section 1239(b) expands the term "related persons" to include (1) a corporation and an individual who owns, directly or indirectly, eighty percent or more in value of that corporation's outstanding stock, and (2) two or more corporations where the same person, directly or indirectly, owns eighty percent or more in value of the outstanding shares of each corporation.³⁰⁶ Section 1239(b)(1) continues to include spouses as "related persons."³⁰⁷

a. *Constructive Ownership Rules*

Although section 1239 no longer mentions minor children or grandchildren directly, subsection (c) incorporates the constructive ownership rules of section 318.³⁰⁸ Under section 318 an individual is treated as owning stock which is owned, directly or indirectly, by or for his spouse, parents, children, and grandchildren. Sections

303. 36 T.C.M. (P-H) at 690-91.

304. The amended version of I.R.C. § 1239 originated as § 2303 of the Senate Finance Committee's amendments to H.R. 10612. See S. REP. No. 938, 94th Cong., 2d Sess. 28 (Supp. Rep. of Comm. on Finance 1976), reprinted in 1976-3 C.B. 643, 670; H.R. REP. No. 1515, 94th Cong., 2d Sess. 365 (1976). Section 2303, by concurrent resolution of Congress was redesignated as § 2129 of H.R. 10612, the Tax Reform Act of 1976. H.R. CON. RES. 751, 94th Cong., 2d Sess. 3 (1976).

305. I.R.C. § 1239(a).

306. In *Deyoe v. Commissioner*, 66 T.C. 904 (1976), the court refused to apply the "family hostility" doctrine to § 1239. Cf. *Haft Trust v. Commissioner*, 510 F.2d 43, 35 A.F.T.R.2d 75-650 (1st Cir. 1975) (family hostility may be considered).

307. The question of whether there has been an interspousal transfer of property within the meaning of § 1239 requires an initial determination of whether the parties are spouses. This is a question of local law. See *Deyoe v. Commissioner*, 66 T.C. 904 (1976) in which § 1239 was applied to a property settlement incident to a divorce because the transfer was found to have occurred prior to the divorce. Section 318(a)(1) eliminates some of the problems in determining who are within the category of spouses by removing parties who are legally separated under a court decree. See also *Gallagher*, *supra* note 283.

308. See generally *Jetter, Katcher & Levine, Constructive Ownership Rules Under Section 318*, TAX MNGM'T (BNA) § 72-3d (1975).

318(a)(2) and (3) establish attribution rules for partnerships, estates, trusts, and corporations in which the taxpayer or his relatives hold interests. Additionally, section 318(a)(4) provides that stock which is subject to an option held by the taxpayer is considered to be owned by him. Essentially, section 318 authorizes three types of attribution: (1) between family members (collateral attribution); (2) from an entity to a person beneficially interested in it (vertical, or direct attribution) or vice versa (back attribution); and (3) from an entity to its interested parties to the interested parties' family members, or from family members to interested parties to the entity (retribution).³⁰⁹ Section 318(a)(5)(C) prohibits sidewise attribution: from an interested party to the entity, and from the entity to another interested party.³¹⁰

i. Family Attribution Rules

Section 318(a)(1) provides that an individual constructively owns the shares owned by his spouse, children, grandchildren, and parents. It does not attribute stock ownership between siblings, nor does it differentiate minor from adult children or grandchildren.³¹¹ By application of section 318(a)(5)(B), stock constructively owned section 318(a)(1) cannot thereby be constructively reattributed to another under this latter section.³¹² Under section 318(a)(1)(A)(i), the interspousal attribution rule does not apply where the spouses are legally separated under a decree of divorce or separate maintenance.³¹³

ii. Trust Attribution Rules

Section 318(a)(2)(B) provides for attribution between a trust and its beneficiaries. Stock which is owned by the trust is deemed to be owned by its beneficiaries in proportion to their respective actuarial interests in the trust.³¹⁴ These interests are determined in accordance with the estate tax regulations.³¹⁵ Thus, if X, Y, and Z each

309. *Id.*; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.21 at 9-11 (3d ed. 1971).

310. *See* Treas. Reg. § 1.318-4; S. REP. NO. 1240, 88th Cong. 2d Sess. (1964), reprinted in 1964-2 C.B. 701, 705.

311. Prior to amendment, § 1239 distinguished between minor and adult children. *See* Mitchell v. Commissioner, 300 F.2d 533, 9 A.F.T.R.2d 954 (4th Cir. 1962).

312. I.R.C. § 318(a)(5)(B).

313. Section 1239 never made this distinction, and only does so as amended by reference to § 318. *See also* Deyoe v. Commissioner, 66 T.C. 904 (1976) (section 1239 applies to property divisions incident to a divorce where the division occurs prior to the effective date of the decree).

314. Treas. Reg. § 1.318-3(b); *see* Treas. Reg. § 20.2031-7.

315. *See id.* § 20.2031-7.

have a one-third interest in a trust which owns ninety shares of corporation A, each beneficiary will be considered to own thirty shares of A. In *Mitchell v. Commissioner*, this rule would have resulted in the disallowance of capital gains treatment on the sale from the taxpayer to the corporation, even without regard to the shares owned by or for the taxpayer's adult child.³¹⁶ The taxpayer, his spouse, and his two minor children owned 91.75% of the corporation. The spouse's shares would be attributable to him under section 318(a)(1)(A)(i), and the trust's shares would be attributable to his minor children under section 318(a)(2)(B)(i) and to him under section 318(a)(1)(A)(ii). Consequently, he would have exceeded the eighty percent limit of old section 1239.

So long as the beneficiary has more than a "remote contingent interest" in the trust, section 318(a)(3)(B) requires that the shares owned by the beneficiary be considered as though they were owned by the trust. A contingent interest is remote if its maximum actuarial value is five percent or less of the value of the trust corpus. To calculate the value of a contingent interest, section 318(a)(3)(B)(i) establishes a presumption that the trustee will exercise the maximum degree of discretion possible in favor of the beneficiary.

In the case of grantor trusts, section 318(a)(2)(B)(ii) attributes the shares owned by the trust, or the portion of the trust which is considered to be owned by the taxpayer, to the grantor. Similarly, section 318(a)(3)(B)(ii) requires a "back" attribution from the grantor to the trust. Under Revenue Ruling 72-471, the grantor trust attribution rules pre-empt the trust-beneficiary attribution rules.³¹⁷

If the beneficiaries' interests are entirely discretionary, that is, where an actuarial value of each interest cannot be determined, for example in a sprinkling trust, section 318(a)(2)(B)(i) would seem to preclude the attribution of the trust's shares to the beneficiaries.³¹⁸

iii. Other Entity Attribution Rules

Under section 318(a)(2)(A), stock owned by a partnership or an estate is treated as though it were owned proportionately by its interested parties.³¹⁹ Likewise, section 318(a)(3)(A) attributes a

316. In the 1976 Senate Report, note 304 *supra*, the Finance Committee uses a transaction that is virtually identical to that considered in *Mitchell*, as an example of the situations intended to be covered by the amended version of § 1239.

317. 1972-2 C.B. 201, 202.

318. *But see* Z. CAVITCH, *TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS*, § 703[3][b][iv] at 7-33 (1978).

319. *Baker Commodities, Inc. v. Commissioner*, 415 F.2d 519 (9th Cir. 1969) (partnership

partner's or a beneficiary's stock to the partnership or estate. Section 318(a)(2)(C), as modified by section 1239(c), attributes shares owned by a corporation pro rata to its shareholders, whose stock, in turn, is considered to be owned by the corporation under section 318(a)(3)(C). Section 1239(c) applies the section 318 corporate attribution rules without regard to the fifty percent rules of sections 318(a)(2)(C) and (a)(3)(C).

For example, suppose the taxpayer owns eighty percent of corporations *A* and *B*. Assume further that to avoid section 1239 the taxpayer contributes his *B* stock to *C*—his newly formed and wholly owned holding company—and plans to have *A* sell depreciable property to *B*. Prior to the amendment of section 1239, the taxpayer, through *A*, may have realized a capital gain on the sale. However, the attribution rules now treat the taxpayer as owning the *B* stock which is owned by *C*, so that *A*'s gain on the sale will be treated as ordinary income. Moreover, in an appropriate case, the related party sale could activate an allocation of income under section 482 between the taxpayers or subject the sale to constructive dividend treatment as to the controlling shareholder.³²⁰

In the case of a sale between commonly controlled corporations, the treatment of gain as ordinary income occurs on the level of the transferor corporation which sells the property, rather than on the shareholder level. The attribution rules are used to determine whether the eighty percent stock ownership test has been satisfied, but, in effect, the gain is recharacterized as ordinary income at the corporate level. When, however, the transferor is a Subchapter S corporation, section 1373 will include the gain, which is treated as ordinary income under section 1239, in the corporation's undistributed taxable income. This amount will also be taxed to the shareholders.³²¹

iv. Option Attribution Rules

The final section 318 attribution rule treats the holder of an option to acquire stock as the owner of the optional shares.³²² Where both the family and option attribution rules can apply, section 318(a)(5)(D) gives precedence to the option rule. Therefore, stock

in process of dissolution is subject to § 318); see Treas. Reg. § 1.318-2(c); Rev. Rul. 67-24, 1967-1 C.B. 75 (application of § 318 to estate and testamentary trust). Neither the Code nor the Regulations address the question of which interest is appropriate to use when a partner's interest in income differs from that in the partnership capital. See also Z. CAVITCH, *supra* note 318, § 703[3][b][iii] at 7-27.

320. See S. REP., *supra* note 304, at 30; 1976-3 C.B. at 672 n.4.

321. 1976-3 C.B. at 671 n.3.

322. I.R.C. § 318(a)(4).

which is constructively owned by one family member under the option rule can be reattributed to another family member. The section 318(a)(5)(C) prohibition against sidewise attribution—from an interested party to an entity and then from the entity to another party—does not apply to the option rule. For example, stock owned by an interested party and attributed to a partnership, estate, trust, or corporation because the entity has an option to acquire those shares can be reattributed from the option holder to another interested party.

Although the status of contingent options is unclear, the taxpayer in *Trotz v. Commissioner*³²³ probably would have been found to have owned all the corporate shares in question for purposes of section 1239. Despite being unable to exercise his option while the twenty-one percent owner remained employed by the company, the taxpayer could discharge the employee at will. The option right was absolute, not contingent, and certainly would have triggered section 1239. The correct categorization of the corporation's right of first refusal was thus irrelevant, since the taxpayer would have exceeded the section 1239 threshold.

The option attribution rules should not cause the magnitude of problems in the ordinary section 1239 transaction that they have in other situations to which section 318(a)(4) applies.³²⁴ In a usual transfer between related parties, rarely would one party own convertible debentures, warrants, or other hybrid securities. Instead, the sort of option that is likely to trigger section 318(a)(4)'s activation of section 1239 is the buy-sell agreement between shareholders, the corporation's right of first refusal, or a similar restriction on the transferability of shares. Certainly this is a function of the size of a corporation in which Congress must be concerned about related parties owning eighty percent or more of the value of the shares. Nevertheless, the more unusual type of options now may operate to convert capital gain into ordinary income. Since section 1239 is not limited in application to either small or insubstantial corporations, its amendment may be a harbinger of contests yet to be litigated.

Section 1239 is one of a few Code provisions directed toward the character, rather than the existence, of income to be taxed on the transfer of depreciable property.³²⁵ But, like those sections which try

323. 36 T.C.M. (P-H) 687 (1967) discussed *supra* note 302.

324. See *Sorem v. Commissioner*, 334 F.2d 275, 14 A.F.T.R.2d 5131 (10th Cir. 1964) (employee stock options on unissued stock are subject to attribution). *Contra* Treas. Reg. § 1.302-3(a) (unissued stock is disregarded); Rev. Rul. 68-601, 1968-2 C.B. 124, 125-26 (warrants and convertible debentures are options within the purview of I.R.C. § 318(a)(4); *Sorem* will not be followed).

325. See, e.g., I.R.C. §§ 1245, 1250; Gallagher, *supra* note 286.

to hinder attempts by related taxpayers to shift losses³²⁶ or manipulate deductions within the economic unit,³²⁷ section 1239 tries to restrict the transferability of depreciation deductions between related parties. However, section 1239 is designed to accomplish more than a limit on deductions. It is intended to prevent the tandem advantages of depreciation-shielded ordinary income taxed at the preferential capital gains rate. Despite the significance of its purpose, section 1239 has been misconstrued on the rare occasions when it has been used. The report of the Senate Finance Committee noted that the former terms of section 1239 should have been sufficient to encompass transfers similar to that in *Mitchell*, which was "directly or indirectly" between related parties.³²⁸ The amended version should give section 1239 a new vitality, and an ominous warning to related parties whose transactions approach the statute too closely.

G. Correlation with Prior Events

The tax system attempts to equalize taxable years by matching items received or expenses incurred with the corollary rates applicable to capital or noncapital assets.³²⁹ Sometimes, however, events of one year are so closely related to events which occur in a following year that Congress and the courts have had to characterize the latter events with reference to the connected events of the prior year. For instance, section 111 is a partial codification of the tax benefit rule,³³⁰ and section 186 may be viewed as a "non-tax benefit" rule directed to the recovery of certain antitrust damages.³³¹ Similarly, section 1341 attempts to ameliorate the claim-of-right rule where repayments of amounts previously received occur under specified circumstances.³³² Other examples in the Code include sections 108

326. I.R.C. § 267(a)(1); see Hamovit, *supra* note 283.

327. I.R.C. § 267(a)(2).

328. S. REP. No. 938, 94th Cong., 2d Sess. 28, 30-31 (Supp. Comm. Rep. 1976), reprinted in 1976-3 C.B. 643, 672-73.

329. See *American Auto. Ass'n v. United States*, 367 U.S. 687, 7 A.F.T.R.2d 687 (1961); I.R.C. §§ 441, 443; Austin, Surrey, Warren & Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 HARV. L. REV. 257 (1954); Freeman, *Recognition of Gain on Yearend Stock Sales*, 30 TAX L. REV. 197 (1975).

330. See *Dobson v. Commissioner*, 320 U.S. 489, 31 A.F.T.R. 773 (1943). See generally O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215 (1972).

331. I.R.C. § 186. See, e.g., *Bresler v. Commissioner*, 65 T.C. 182 (1975), acq. 1976-2 C.B. 2 (amount received in settlement of an antitrust proceeding in part represented compensation for loss incurred in prior year when a Subchapter S corporation sold its business equipment and reported an ordinary loss. Gain recovered was ordinary income).

332. *Missouri Pac. R.R. v. United States*, 423 F.2d 727, 25 A.F.T.R.2d 70-844 (Ct. Cl. 1970), supplemented by, 427 F.2d 727, 25 A.F.T.R.2d 70-1403, modified, 433 F.2d 1324, 26 A.F.T.R.2d 70-5812; I.R.C. § 1341; see Hendershott, *Restoration—Claim of Right—One As-*

and 1017, which permit exclusion of discharge of indebtedness income if the taxpayer consents to a basis reduction,³³³ and section 1038, which is concerned with the tax consequences of repossessing real property.³³⁴ To some extent, all the nonrecognition provisions attempt to correlate prior events with present recognition of gain or loss, as does section 1012, which requires basis adjustments to reflect past transactions.

In addition to the partial list of Code sections given above, there is a large area of judicial discretion in which courts match past and present events. For example, in *Arrowsmith v. Commissioner*, the taxpayers reported a capital gain on a corporate liquidation that took place during 1937 to 1939.³³⁵ Five years after the dissolution, a judgment was entered against the corporation and against one of the taxpayers personally. After they satisfied the judgment, the taxpayers took an ordinary loss deduction for the amount paid. The Service disallowed the deduction on the ground that the judgment was capital in nature, even though the taxpayer neither sold nor exchanged a capital asset during the year the judgment had been paid. Clearly, if the judgment had been paid in 1940, the loss would have been capital, as it would have arisen from the sale or exchange of a capital asset, and would have been entered against the taxpayers as transferees of the liquidation distribution.

The Court found the payments to be capital losses because they were inextricably related to the prior liquidation.³³⁶ Although the Court stated that it was not reopening or readjusting the prior year's returns, it reasoned that it was impossible to characterize the payments without reference to the events which gave rise to the judgment.³³⁷ Thus, *Arrowsmith* can be read to mean that an expenditure for a business purpose will not be treated as an ordinary and necessary business expense if it is sufficiently related to an earlier capital

pect of Section 1341, 48 TAXES 585 (1970). See also *United States v. Skelly Oil Co.*, 394 U.S. 678, 23 A.F.T.R.2d 69-1186 (1969), discussed at text accompanying note 339, *infra*.

333. See generally Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959); Sanders, *Debt Cancellation Without Realization of Income*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW ELEVENTH TAX INSTITUTE 565 (J. Ervin ed. 1959).

334. See generally Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee*, 31 TAX L. REV. 193 (1976); Levy, *Tax Consequences to a Mortgagee of Repossessing Real Property: A Look Back and a Look Forward*, 42 ST. JOHN'S L. REV. 330 (1968).

335. 344 U.S. 6, 42 A.F.T.R. 649 (1952). See also, *Merchants Nat'l Bank v. Commissioner*, 199 F.2d 657, 42 A.F.T.R. 749 (5th Cir. 1952); Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972).

336. 344 U.S. at 8.

337. *Id.* at 8-9..

gains transaction.³³⁸

In *United States v. Skelly Oil Co.*, the court explained and applied the *Arrowsmith* rule.³³⁹ Skelly Oil Co. repaid money which it had collected under a state minimum price order which was later declared invalid. Because of the oil depletion allowance, only 72.5% of the overcharge had been taxed as income when Skelly reported it. Upon repayment, Skelly deducted 100% of the overcharge as an ordinary and necessary business expense. The Commissioner objected and the court agreed, citing *Arrowsmith* and section 1341. Under section 1341 the deduction was limited to an "item included in gross income in the year of receipt."³⁴⁰ *Arrowsmith* was interpreted to bar the windfall which would result if income, which was taxed at a special lower rate when received, was deductible on repayment at a different and more favorable rate.³⁴¹

One frequently litigated question is whether payments made in satisfaction of an alleged securities transaction liability are deductible as ordinary expenses when capital gains were realized on the related sale. The source of the litigation is the nexus of events which occur at different times.³⁴² Generally the courts have allowed only capital losses on the repayment because of the interrelationship of the sale and the alleged liability.³⁴³

H. Depreciation Recapture

1. In General

Recapture is based on the principle that deductions from ordinary income which are attributable to the depreciation allowance under section 167 (relating to capital assets and depreciable property used in the trade or business or held for the production of income) should not be recovered later at lower capital gains rates.³⁴⁴ Depreciation

338. See, e.g., *Cummings v. Commissioner*, 506 F.2d 449, 451, 34 A.F.T.R.2d 74-6153 (2d Cir. 1974); *Anderson v. Commissioner*, 480 F.2d 1304, 32 A.F.T.R.2d 73-5167 (7th Cir. 1973).

339. 394 U.S. 678, 23 A.F.T.R.2d 69-1186 (1969).

340. *Id.* at 683.

341. *Id.* at 685. See also *Wener v. Commissioner*, 242 F.2d 938, 50 A.F.T.R. 2100 (9th Cir. 1957); *Estate of Machris v. Commissioner*, 34 T.C. 827 (1960); *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422 (1953) (ordinary loss not allowed on reimbursement pursuant to a post-sale breach of warranty where the taxpayer had been taxed on the sale proceeds at capital gains rates).

342. See *Cummings v. Commissioner*, 506 F.2d 449, 34 A.F.T.R.2d 74-6153 (2d Cir. 1974); *Anderson v. Commissioner*, 480 F.2d 1304, 32 A.F.T.R.2d 73-5167 (7th Cir. 1973).

343. See also *Freeman*, *supra* note 329.

344. See, e.g., H.R. REP. NO. 1515, 94th Cong., 2d Sess. 9 (1976), 122 CONG. REC. H9927 (daily ed. Sept. 13, 1976), explaining the reason for the 1976 changes in the recapture provisions. See generally, *Cook, Sec. 1245: Problems of Recognizing Gains Only*, 46 TAXES 507 (1968); *Geller, Depreciation on Real Estate and Its Recapture: Resolving Problems Raised by the 1969 Act*, in NEW YORK UNIVERSITY TWENTY-NINTH INSTITUTE ON FEDERAL TAXATION 1033

deductions reduce ordinary, and otherwise currently taxable, income. The basis of depreciable property is reduced, by the terms of section 1016, to reflect the allowable amount of depreciation.³⁴⁵ Absent the various recapture sections, the sale or exchange of the property would usually result in capital gain, measured by the difference between the adjusted basis of the property and the amount realized. Generally, this results because the property is a capital asset, or because the gain is treated as capital gain by virtue of section 1231. Therefore, without the recapture sections, the deductions taken from ordinary income would be reflected in the amount of the gain realized on the sale, and this amount would be taxed at the lower capital gain rate. Certainly any taxpayer would be willing to trade ordinary income for capital gain.

The ability to transform ordinary income into capital gain is accentuated by the existence of an allowance for accelerated depreciation.³⁴⁶ Under various methods of accelerated depreciation contained in the Code,³⁴⁷ the taxpayer can recoup the cost of depreciable assets over a period substantially shorter than the period during which it is economically exhausted. Hence the amount of ordinary income which can be offset by depreciation deductions is increased in the early years of the property's life, but must await recovery—even in the form of capital gains—until the subsequent disposition of the asset. In the interim, between the time the deductions are allowed and the time when they are reflected in taxable gain, the taxpayer has the use of the amounts offset by the deductions. Moreover, if the property was held until death, the asset would receive a stepped-up basis, and the pre-death gain would be ignored on a post-death sale.³⁴⁸

To eliminate conversion of ordinary deductions into capital gains,

(1971); Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy*, 12 B.C. INDUS. & COM. L. REV. 387 (1971); Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285 (1965). See also I.R.C. § 47 (investment credit recapture).

345. See also *Kingsbury v. Commissioner*, 65 T.C. 1068, 1088-90 (1976), acq. 1976-2 C.B. 2 (certain rights under the transfer of an operating agreement were § 1245 property, and would have been subject to recapture if other than straight-line depreciation had been used).

346. I.R.C. § 167. Sections 1245 and 1250 apply to "excess depreciation," or to "additional depreciation," which is the amount in excess of straightline depreciation. §§ 1245(a)(2), 1250(b)(1). Section 1245 recaptures all depreciation up to the gain realized. See generally Gallagher, *supra* note 286; Halperin, *supra* note 344.

347. See I.R.C. § 167.

348. The Revenue Act of 1978 postpones for three years the effective date of the carryover basis rules of the Tax Reform Act of 1976. Therefore, the basis of property inherited from someone dying after December 31, 1979, will be the decedent's basis prior to death, rather than the present stepped-up basis. Pub. L. No. 95-600, § 515, 92 Stat. 2763 (1978) (current version at I.R.C. §§ 1014, 1023).

Congress enacted the various recapture provisions of the Code.³⁴⁹ The two principal recapture provisions are contained in sections 1245 and 1250, and are supplemented by a number of other sections.³⁵⁰ The basic mechanism which attacks the transformation of ordinary deductions into capital gains is one by which the amount of gain realized is reduced by the specified amount of previously taken depreciation deductions. The gain is allocated between ordinary income and capital gain, based on the prior depreciation, the type of asset, the holding period, and the amount of gain, if any.

Recapture provisions are part of a comprehensive paradigm designed to match depreciation with an equal portion of the gain realized, and to treat that amount as ordinary income. Unless otherwise provided in the recapture sections all other Code sections are overridden by their provisions.³⁵¹ Furthermore, recapture is applicable even if the taxpayer who sells or disposes of the asset is not the taxpayer who benefited from the prior depreciation deductions.³⁵² In part, the recapture provisions override important nonrecognition provisions and affect virtually every characterization section and every form of taxing entity.³⁵³

2. *The Recapture Provisions*

Net gains on the sale of real property used in a trade or business generally are taxed as capital gains, and losses usually are treated as ordinary losses.³⁵⁴ Gain on the sale of depreciable real property, however, generally is "recaptured" and taxed as ordinary income to the extent that the gain represents accelerated depreciation allowed or allowable in excess of that amount computed under the straight-line method of depreciation.³⁵⁵

Depreciation recapture was enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain.³⁵⁶ The 1962 provision, section 1245, only taxed gain on a sale of "section 1245 property"—most tangible personal property—as ordinary income to the extent of post-1962 depreciation

349. See I.R.C. §§ 1245-1252.

350. I.R.C. § 1246 (foreign investment company stock); § 1248 (stock in foreign corporations); § 1249 (sale of patents to foreign corporations); §§ 1251, 1252 (farming); § 904 (foreign losses).

351. I.R.C. §§ 1245(d), 1250(i); Treas. Reg. §§ 1.1245-6(a), 1.1250-1(c).

352. I.R.C. § 1245; Treas. Reg. § 1.1250-3(a)(3), (c).

353. See generally sources cited at note 344 *supra*.

354. I.R.C. § 1231; see discussion at section II.D. *supra*.

355. I.R.C. § 1250(a).

356. Act of Oct. 16, 1962, Pub. L. No. 87-834, § 13, 76 Stat. 960 (1962), reprinted in 1962-3 C.B. 111, 173-76.

taken on the property.³⁵⁷ The recapture rules were extended to real property in 1964, by the enactment of section 1250.³⁵⁸ Under the 1964 version of section 1250, gain on the sale of real property was taxed as ordinary income to the extent of post-1963 accelerated depreciation taken on the property. If the property was held twelve months or less, all depreciation was recaptured. If the property was held for more than twelve months, only the excess depreciation over straight-line was recaptured. The amount recaptured was reduced gradually, after an initial twenty month holding period, at the rate of one percent per month. After one hundred twenty months recapture was phased out completely.

The Tax Reform Act of 1976 modified the real property recapture rules as to post-1969 depreciation.³⁵⁹ The Act retained the rule under which all depreciation, including straight-line, is recaptured if the property is held for twelve months or less, but implemented other changes. In the case of residential real property and certain low income housing, section 1250(a)(1)(C)(ii), (iii) of the old law permitted post-1969 depreciation in excess of straight-line to be recaptured fully, to the extent of gain, at ordinary income rates if the property was held for more than twelve months but less than one hundred months.³⁶⁰ For each month over one hundred months that the property was held, the amount of post-1969 depreciation recaptured decreased one percent. After two hundred months, recapture was eliminated.

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured, but only to the extent of the gain, regardless of the length of time the property is held.³⁶¹ This rule was extended by the 1976 Tax Reform Act to cover all post-1975 depreciation of residential real estate and government subsidized housing in excess of straight-line depreciation.³⁶² However, full recapture of post-1975 depreciation only applies for the first one hundred months for government subsidized housing, with a recapture phase-out over the second one hundred months.³⁶³

Under the 1976 amendments, the recapture of excess depreciation

357. See H.R. REP. No. 2508, 87th Cong., 2d Sess. 36-37, *reprinted in* 1962-3 C.B. 1129, 1164-65.

358. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 231, 78 Stat. 19 (1964), *reprinted in* 1964-1, 2 C.B. 6, 71.

359. Pub. L. No. 94-455, § 202(a), 90 Stat. 1520 (1976); see H.R. REP., *supra* note 344.

360. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 231, 78 Stat. 19 (1964) (now I.R.C. § 1250(a)).

361. I.R.C. § 1250(a)(1)(B)(v), (2)(B)(v).

362. *Id.* § 1250(a)(1)(A).

363. *Id.* § 1250(a)(1)(B).

on residential rental property may require three computations. First, all post-1975 excess depreciation must be completely recaptured.³⁶⁴ If the amount recaptured here is equal to the gain, then no further calculations are necessary. If the post-1975 recapture is less than the gain, excess depreciation taken after 1969 and before 1976 may be partially or completely recaptured. The amount recaptured here will be the lesser of the remaining unrecaptured gain or some percentage of the 1970-1975 excess depreciation.³⁶⁵ The percentage just referred to is one hundred percent for housing held for more than twelve months but less than one hundred and one months. This percentage decreases by one percent for each month that the property has been held over one hundred months. After sixteen years and eight months there is no recapture. Finally, excess depreciation taken from 1964 to 1969 may be recaptured in part or in full if the gain exceeds the prior amounts recaptured.³⁶⁶ The pre-1970 recapture will be a percentage of the 1964-1969 excess depreciation, or the unrecaptured gain, whichever is less. For real property held for more than twelve months but less than twenty-one months, the recapture will be one hundred percent. The percentage is reduced one percent for each month that the property has been held over twenty months.

The recapture provisions apply to all "dispositions" of section 1245 or section 1250 property, except as otherwise provided in those sections.³⁶⁷ For example, recapture applies to corporate distributions to shareholders,³⁶⁸ corporate sales constituting part of a section 337 liquidation,³⁶⁹ and to dispositions of certain partnership interests. Although recapture generally will override the nonrecognition provisions,³⁷⁰ the amount recaptured cannot exceed the gain realized, or the excess of the fair market value over the adjusted basis of the property.³⁷¹ When the recapture sections do not override a nonrecognition provision, they do cause gain to be recognized on the receipt of "boot."³⁷² Similarly, they do not limit the amount of ordinary

364. *Id.* § 1250(a)(1)(A).

365. *Id.* § 1250(a)(2)(A).

366. *Id.* § 1250(a)(3)(A).

367. *Id.* §§ 1245(a)(1), 1250(a)(1), (2).

368. Treas. Reg. §§ 1.1245-4(c), 1.1250-3(c). See generally Cohen, *Coping with Recapture Problems in Taxable Sales of Corporate Assets*, 29 J. TAX. 130 (1968).

369. Treas. Reg. §§ 1.1245-6(b)(1965), 1.1250-1(c)(2)(1971). See also B. BITTKER & J. EUSTICE, *supra* note 309, at 11-72.

370. See, e.g., Clayton v. Commissioner, 52 T.C. 911 (1969); Treas. Reg. § 1.1245-1(a)(1).

371. I.R.C. §§ 1245(a)(1)(B); 1250(a)(1)(B), (2)(A)(ii).

372. "Boot" is simply a cash payment which is part of the consideration in a business transaction. See, e.g., Crane v. Commissioner, 331 U.S. 1, 3, 14, 35 A.F.T.R. 776 (1947); cf. Rev. Rul. 69-487, 1969-2 C.B. 165 (no boot was received so no gain was recognized on conversion of business automobile to personal use).

income characterized by section 1239 if that is a greater amount than the amount subject to recapture.³⁷³ Moreover, the amount recaptured never enters the section 1231 hotchpot, but any gain in excess of that amount is taken into account.³⁷⁴ If the taxpayer sells property on the installment method, the regulations provide that recapture income must have been taken into account prior to any other portion of the recognized gain.³⁷⁵

I. Sale of a Business

1. In General

The sale of a business is an important commercial transaction which raises a number of tax and non-tax questions. Some of these questions concern the nature of the entity sold, the manner of effecting the transfer, and the resulting allocation of capital gain and ordinary income. The last of these considerations requires a characterization of the property sold, which, in turn, depends on the nature of business and the form of the sale.³⁷⁶

2. Sole Proprietorship

Under the rule of *Williams v. McGowan*,³⁷⁷ the sale of a sole proprietorship is not treated as the sale of a single asset; instead, it is considered to be a sale of each individual asset, which only in the aggregate constitutes the business.³⁷⁸ Therefore, the purchase price must be allocated among the items constituting the business sold in order to determine the character, and the amount, of the gain or loss from the sale of the individual assets. Naturally, this allocation requires consideration of all relevant Code provisions regarding the sale of the asset.

373. Treas. Reg. §§ 1.1245-6(f), 1.1250-1(c)(4).

374. Treas. Reg. §§ 1.1245-6(a), 1.1250-1(c)(1).

375. *Dunn Constr. Co. v. United States*, 323 F. Supp. 440, 27 A.F.T.R.2d 71-802 (N.D. Ala. 1971); Treas. Reg. §§ 1.1245-6(d), 1.1250-1(c)(6).

376. See generally Childs, *Buying and Selling the Subchapter S Corporation*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW TWENTY-SIXTH TAX INSTITUTE 347 (D. Lang chairman 1974); Joseph, *Considerations in Applying the Rule of Williams Versus McGowan*, 13 TAX L. REV. 369 (1958); Vaughn, *How to Acquire a Closely-Held Business*, 22 (No. 1) PRAC. LAW. 11 (1976).

377. 152 F.2d 570, 34 A.F.T.R. 615 (2d Cir. 1945).

378. See *Watson v. Commissioner*, 345 U.S. 544, 43 A.F.T.R. 621 (1953) (citing with approval *Williams v. McGowan*, 152 F.2d 570). See also Murphy, *Sale of a Sole Proprietorship—An Irrationale in Three Parts*, 9 TAX L. REV. 309 (1954); Saltoun & Block, *Tax Consequences of Asset Valuations in Arm's Length Agreements Between Unrelated Parties*, 27 TAX L. REV. 145 (1971).

3. Partnership

When a business is operated in the form of a partnership the tax consequences of a sale of the business depend upon what is sold.³⁷⁹ The partners can sell their interests in the partnership, or they can cause the partnership to sell its assets.

Where a partnership sells its assets, the resulting gain or loss is computed in the same manner as the sale of a sole proprietorship.³⁸⁰ If the partners sell their interest in the partnership, however, the sale generally will be treated as the sale of a capital asset.³⁸¹ The difference in treatment between the sale of a partnership interest and the sale of a sole proprietorship is due to the entity theory of Subchapter K.³⁸²

To prevent the conversion of ordinary income into capital gain where a partnership interest is sold, the Code provides that the amount of gain or loss which is attributable to certain designated ordinary income assets owned by the partnership must be treated as ordinary income or loss to the selling partner. These items are substantially appreciated inventory, unrealized receivables, and recapture property.³⁸³ But since some inventory with a value exceeding basis is not "substantially appreciated,"³⁸⁴ some gain attributable to inventory may be capital gain on the sale of a partnership interest where it would be ordinary income if the partnership sold the items.

"Unrealized receivables" are defined by section 751(c) to include contractual and other rights to payment for goods or services to be delivered or rendered in the future. They include, additionally, the well-known accounts receivable which are not reported by the cash basis taxpayer until paid. Gain attributable to unrealized receivables is taxed as ordinary income when a partnership interest is sold.³⁸⁵

4. Corporation

There are several ways in which a corporate business may be sold. The shareholders can liquidate the corporation,³⁸⁶ and pay a capital gains tax on the excess of the value of the assets over their basis in

379. See generally A. WILLIS, *PARTNERSHIP TAXATION* (2d ed. 1976); Morris, *Disposition of Partnership Interests: Achieving Capital-Gains Treatment*, 25 *TAX LAW.* 473 (1972).

380. See generally Morris, *supra* note 379.

381. I.R.C. § 741.

382. See generally A. WILLIS, *supra* note 379, at § 2.01-.04.

383. I.R.C. § 751.

384. See *id.* § 751(d).

385. *Id.* § 751(c).

386. *Id.* § 331.

the stock. Since the shareholders' basis for the assets then will be fair market value, they can effectuate a sale without further tax, and the buyer will obtain a basis equal to cost.³⁸⁷

Alternatively, the shareholders can sell stock. A stock sale will result in a capital gains tax, and may qualify for installment sale treatment under section 453. When the purchaser liquidates the corporation, his basis for the property will be his cost for the stock,³⁸⁸ with no realization of gain on the liquidation.

The possible variations of these two means of selling a corporate business are numerous. For example, the corporation can adopt a plan of liquidation under section 337, sell its assets, and liquidate within twelve months of adopting the plan. Gain is realized by the shareholders only on the subsequent liquidation.³⁸⁹ Other possibilities, explained more completely elsewhere, include a section 333 one month liquidation,³⁹⁰ a reorganization,³⁹¹ and a part sale and part redemption of stock.³⁹² The shareholders must be careful to observe the necessary requirements to qualify the transaction, however, or unexpected results are likely to occur—not the least important of which is the finding of a dividend.³⁹³

In any sale of a corporate business, the assets may be subject to recapture. In considering how the sale is to be structured, the parties undoubtedly must consider who will bear the tax.

5. Allocation

Ultimately, the buyer and seller should allocate the purchase price among the assets sold, not only for determining the character and amount of gain or loss, but also to establish the purchaser's basis in particular assets.³⁹⁴ However, they have opposing interests in the allocation. The seller wants a greater amount attributed to capital assets, goodwill, and section 1231 assets to the extent that gain on his sale will not constitute recapture income. Conversely, the buyer wants the bulk of the purchase price allocated to depreciable property, inventory, and any covenant not to compete.³⁹⁵ Due to

387. See generally B. BITTKER & J. EUSTICE, *supra* note 309, at ¶¶ 11.01-.06.

388. Cf. I.R.C. § 334(b) (basis equal to that of the transferor, except when certain time limitations are met the basis shall be equal to the adjusted basis of the stock).

389. See B. BITTKER & J. EUSTICE, *supra* note 309 at ¶ 11.64.

390. *Id.* at ¶¶ 11.20-.24.

392. *Id.* at ¶¶ 14.01-.57.

392. *Id.* at ¶¶ 9.01-.65.

393. See B. BITTKER & J. EUSTICE, *supra* note 309.

394. See section II.I.2. *supra*.

395. See generally Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 *TAX LAW.* 251 (1975); Morris, *supra* note 379; Murphy,

this adversariness of interests, the Service generally will accept a reasonable allocation that is explicitly stated in the agreement, but will challenge one which lacks economic substance.³⁹⁶ In all but the most unusual case,³⁹⁷ the courts will reject a party's attempt to set aside an express allocation.³⁹⁸ If the purchase agreement does not allocate the sales price among the assets, the parties must allocate the sales price to reflect the respective items on their tax returns. Here, inconsistent reporting most likely will result in an audit of both returns.

The problem that is most likely to surface in the sale of a business is what portion of the purchase price, if any, is allocable to goodwill as opposed to a covenant not to compete.³⁹⁹ The cost of a business can be increased by either. However, as noted elsewhere,⁴⁰⁰ goodwill is a nondepreciable capital asset, while a covenant not to compete is similar to compensation. Therefore, goodwill generates no current deductions for the buyer, and its sale results in capital gain to the seller; on the other hand, payments made for a covenant not to compete are deductible to the purchaser and taxable as ordinary income to the seller. But because both goodwill and the covenant are intended to transfer the going-concern value of the business, the absence of an express allocation, once again, may cause inconsistent reporting and a resulting audit.⁴⁰¹

J. Receipt or Disposition of Income-Related Items

1. In General

Transactions involving the receipt or disposition of income-related items, such as contracts, leases, and life estates, have caused much litigation over whether the taxpayer's gain is capital gain or ordinary income. Certainly the issues that arise most frequently are exemplified by the diverse interests involved, the manner in which

supra note 378; Saltoun & Block, *supra* note 378; Comment, *Depreciability of Going Concern Value*, 122 U. PA. L. REV. 484 (1973).

396. See *Blackstone Realty Co. v. Commissioner*, 398 F.2d 991, 22 A.F.T.R.2d 5156 (5th Cir. 1968); *Particelli v. Commissioner*, 212 F.2d 498, 45 A.F.T.R. 1454 (9th Cir. 1954).

397. See *Schmitz v. Commissioner*, 51 T.C. 306 (1968), *aff'd sub nom. Thronson v. Commissioner*, 457 F.2d 1022, 29 A.F.T.R.2d 72-864 (9th Cir. 1972). See also Saltoun & Block, *supra* note 378.

398. See *Commissioner v. Danielson*, 378 F.2d 771, 19 A.F.T.R.2d 1356 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (particular Third Circuit standard, requiring more than "strong proof").

399. See, e.g., *Wilson Athletic Goods Mfg. Co. v. Commissioner*, 222 F.2d 355, 47 A.F.T.R. 858 (7th Cir. 1955); *cf. Rev. Rul. 70-45, 1970-1 C.B. 17* (sale of goodwill on the admission of a partner to a professional practice).

400. See section I.C.1. *supra* as to the nondepreciability of goodwill.

401. See generally Saltoun & Block, *supra* note 378.

the interests arise, and the way in which the rights to these items are transferred.⁴⁰²

Contract rights are property rights under state law, but may or may not be "property" within the meaning of section 1221. Moreover, a contract usually will involve elements of personal service, as well as other ingredients which may not be a substantial property interest akin to a capital investment. In short, the rights and interests involved are hybrid, a complex bundle of interests some or all of which may qualify as capital assets.⁴⁰³ However, owing to the complexity and divisibility of these interests, it is easier for the taxpayer to transfer less than the entire interest, or to transfer the full interest when that interest is more than the capital investment. For example, the taxpayer's personal services may have enhanced the value of corporate shares, or created a significant goodwill increment, which is realized in the form of a gain in excess of the investment when the business is sold. Also, market fluctuations or changed circumstances may increase or decrease the value of a contract or lease, resulting in one party paying a premium for its termination. Alternatively, a third party may want to acquire the rights, at a premium, because of their favorable nature. The question faced by the courts in these situations is whether the interest, or some part of it, is property within the meaning of section 1221.

2. *Life Estates and Similar Terminable Interests*

Generally, the owner of a life estate or other similar terminable interest has the right to use the property for the duration of the term. This right of use usually includes the right to income from, as well as the emblements and estovers of, the property.⁴⁰⁴ The holder of such an interest may alienate it, but ordinarily may not transfer the larger property itself. Since the tenant only has the right to use the property and to receive the proceeds generated by it, the Service has contended that the sale of a life estate or other similar terminable interest in property results in the receipt of ordi-

402. See generally Del Cotto, "Property" in the Capital Asset Definition: Influence of "Fruit and Tree," 15 BUFFALO L. REV. 1 (1965); Eustice, *Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case*, 20 TAX L. REV. 1 (1964); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295 (1962); Parnell, *Sale of Contracts: When Capital Gains Treatment is Available to the Seller*, 43 J. TAX. 200 (1975); Note, *Capital Gains Treatment of an Interest in Future Profits*, 21 SW. L.J. 815 (1967).

403. See, e.g., *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 1 A.F.T.R.2d 1394 (1958); *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 12 A.F.T.R.2d 5895 (5th Cir. 1963); Note, *Professional Organization and Unrealized Receivables*, 14 ARIZ. L. REV. 853 (1972) [hereinafter cited as *Professional Organization*].

404. C. MOYNIHAN, *INTRODUCTION TO THE LAW OF REAL PROPERTY* 58-62 (1962).

nary income rather than capital gain or loss.⁴⁰⁵ However, in *Bell's Estate v. Commissioner*⁴⁰⁶ and in *McAllister v. Commissioner*,⁴⁰⁷ the Eighth and Second Circuits, respectively, held that a life interest is a capital asset and therefore that any gain or loss upon sale is capital. In both cases the courts distinguished *Hort v. Commissioner*⁴⁰⁸ from *Blair v. Commissioner*.⁴⁰⁹ In *Blair* the Supreme Court ruled that an assignment of a life estate was a transfer of an interest in the underlying asset itself, and not merely an assignment of income.⁴¹⁰ Relying on this rationale, both *McAllister* and *Bell's Estate* held that the transfer of the interests was not a transfer of the "naked rights to receive income,"⁴¹¹ but rather of property which was a capital asset. The court in *McAllister* explained that:

[T]he line of demarcation between the Blair and the Hort principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all would agree that there is some distinction between selling a life estate in property and anticipating income for a few years in advance. . . . The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate at least is.⁴¹²

Under this reasoning the interest was found to be a capital asset.

Although both *McAllister* and *Bell's Estate* held, on the authority of *Blair*, that the life interest was a capital asset which would generate capital gain on its sale, neither court addressed an essential difference between their respective situations and *Blair*. In *Blair* the issue was not the character of the property transferred; it was the

405. See generally Andrews, *Disposition of a Life Estate in Realty: What are the Implications of Rev. Rul. 72-601?*, 40 J. TAX. 26 (1974); Dean, *Capital Gain and Ordinary Income—Problems in Transmutation*, in NEW YORK UNIVERSITY TWENTY-FOURTH INSTITUTE ON FEDERAL TAXATION 1291 (H. Sellin ed. 1966); Joyce & Del Cotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests*, 31 TAX L. REV. 121 (1976); Note, *Federal Income Tax Law in Future Interest Transactions*, 46 DEN. L.J. 286 (1969); Note, *Capital Gains Treatment of an Interest in Future Profits*, 21 SW. L.J. 815 (1967).

406. 137 F.2d 454, 31 A.F.T.R. 411 (8th Cir. 1943).

407. 157 F.2d 235, 35 A.F.T.R. 91 (2d Cir.), cert. denied, 330 U.S. 826 (1946), acq. Rev. Rul. 72-243, 1972-1 C.B. 233.

408. 313 U.S. 28, 25 A.F.T.R. 1207 (1941).

409. 300 U.S. 5, 18 A.F.T.R. 1132 (1937).

410. See Del Cotto, *supra* note 402, at 7-10, 27-33; Lyon & Eustice, *supra* note 402, for a discussion of *Blair* and the assignment of income doctrine.

411. 137 F.2d at 458.

412. 157 F.2d at 237.

question of to whom the trust income should be taxed. For purposes of selecting the appropriate taxpayer, the life estate in *Blair* was "property." When this "property" was transferred, the obligation to pay tax on the income therefrom also shifted.⁴¹³ *Blair* was not concerned with whether the interest was a capital asset since the transfer was gratuitous. Conversely, the issue in *McAllister* and *Bell's Estate* was not the selection of the proper taxpayer, but whether the transfer was one of a capital asset. The questions focus on different facets of the transaction, although they both implicitly involve the conclusion that there has been an effective transfer of some interest.⁴¹⁴

The purchaser of a life estate can amortize the cost basis obtained over the expected duration of the interest, but the recipient of a gift or bequest of a life or term interest is precluded, by section 273, from amortizing any basis against receipts.⁴¹⁵ Moreover, under section 1001(e) the basis of a life or term interest acquired by gift or bequest is disregarded in the case of a sale of the interest.⁴¹⁶ Therefore, gain is taxable in full, but it remains capital gain. The grantee or devisee of the life or term interest continues to have a basis in the interest under section 1014, but the basis is taken into account only when the tenant joins with the remainderman in selling the entire property in a single transaction.⁴¹⁷

The distinction drawn in *McAllister* between the "anticipation of income payments" and the "out-and-out transfer of a substantial and durable property interest" raises the question of whether receipts from the sale of a term interest will remain capital gain where the purchase price is paid in installments or on a contingent basis, such as by a private annuity.⁴¹⁸ In *Evans v. Commissioner*⁴¹⁹ the Service argued that there was no sale where the tenant transferred her life interest for an annuity. The Tax Court rejected the government's argument that the taxpayer merely was receiving the income from the transferred interest and held that the sale generated capital gains. The payments were fixed, and were not dependent on the income of the transferred property.⁴²⁰ However, in *Hrobon v.*

413. See *Irwin v. Gavit*, 268 U.S. 161, 5 A.F.T.R. 5380 (1925); I.R.C. § 102(b).

414. See *Del Cotto*, *supra* note 402, at 27-33.

415. See *Treas. Reg. § 1.1014-5* (1978); *Andrews*, *supra* note 405.

416. See *Andrews*, *supra* note 405; *Capital Gains Treatment of an Interest in Future Profits*, *supra* note 402.

417. See *Andrews*, *supra* note 405; *Capital Gains Treatment of an Interest in Future Profits*, *supra* note 402.

418. *But cf. Lazarus v. Commissioner*, 513 F.2d 824, 35 A.F.T.R.2d 75-1191 (9th Cir. 1975) (court recharacterized an attempted private annuity transaction with a foreign trust as a transfer with a reserved life estate and gift of the remainder).

419. 30 T.C. 798 (1958).

420. *Id.*

*Commissioner*⁴²¹ the same court, distinguishing *Evans*, held that where the taxpayer assigned to her husband a life estate in a trust in return for an annuity with annual payments equal to sixty percent of the trust income, the transaction merely was a gift of forty percent of the life estate, and that no sale occurred.⁴²²

It should be evident that if a life estate is a capital asset, a remainder interest is a capital asset as well. Where the remainderman purchases the preceding life interest, he does not have to wait for a sale of the property to recover his investment.⁴²³ Rather, he may amortize his cost, under section 167, over the life expectancies of the sellers. Indeed, because the amortization deduction is authorized by section 167, the court in *Manufacturers Hanover Trust Co. v. Commissioner*⁴²⁴ allowed a full deduction although over ten percent of the trust income consisted of tax-exempt interest. The court rejected the Service's contention that section 265 precluded the deduction, noting that section 265 denies section 212 expenses but not those under section 167.⁴²⁵

Although a remainder is a capital asset, gain on the sale of a purchased remainder may be ordinary income in part if the purchaser bought the interest at a discount.⁴²⁶ If gain on the sale of a remainder is due to appreciation, however, it should be capital in nature.

Because remainders, life estates, and other term interests represent less than the entire amount or duration of a larger property interest, the decisions in which the question is raised as to whether they are capital assets tend to be cloudy and inconsistent. It often appears that the courts are confusing the assignment of income doctrine with the capital asset question.⁴²⁷ The murky reasoning seems to exist because a partial interest in a larger piece of property may closely resemble "fruit," while the underlying asset itself resembles the "tree."⁴²⁸ However, assignment of income principles are concerned with who is the taxpayer; capital asset rules are concerned with the characterization of property and gain or loss resulting from its sale or exchange. The questions are different, and it is

421. 41 T.C. 476 (1964).

422. *Id.* See also *Lazarus v. Commissioner*, 513 F.2d 824, 35 A.F.T.R.2d 75-1191 (9th Cir. 1975).

423. *Bell v. Harrison*, 212 F.2d 253, 45 A.F.T.R. 1403 (7th Cir. 1954). See generally *Danzis, The Favorable Tax Treatment of Remainder Interest Investments*, 24 TAX L. REV. 527 (1969).

424. 431 F.2d 664, 26 A.F.T.R.2d 70-5502 (2d Cir. 1970).

425. I.R.C. § 265(1).

426. *Jones v. Commissioner*, 330 F.2d 302, 13 A.F.T.R.2d 1153 (3d Cir. 1964); see *Danzis, supra* note 423.

427. See generally *Del Cotto, supra* note 402.

428. For a discussion of the "Fruit and Tree" doctrine, see *Del Cotto, supra* note 402.

not beneficial to deny the existence of the sale of a capital asset when that is what has occurred.

Once having recognized that, in fact, a partial interest in a larger whole may be sold as a capital asset, the courts would be wise to acknowledge that gain—or income—can be attributed to the transferor, even when it is received by the transferee. The transaction simply may run afoul of the assignment of income rules, despite an effective sale of a capital asset.⁴²⁹ Moreover, the fact that the purchase price is satisfied by deferred payments, rather than in a lump sum, should not be dispositive of the case without further inquiry.

3. *Anticipatory Disposition of Future Income*

The anticipatory disposition of future income is a concept that is inextricably intertwined with the assignment of income doctrine, yet one which permeates the capital asset area.⁴³⁰ For example, if property is sold which includes a right to ordinary income, or if the right to the income itself is sold, the gain or receipts most likely will be characterized as ordinary income.⁴³¹ The sale simply is not one of a capital asset. Therefore, accounts receivable sold with a business will give rise only to ordinary income.⁴³² Similarly, the purchase price of an obligation sold between interest dates will reflect the accrued but unpaid interest, which in turn will be taxed as ordinary income. The seller cannot convert interest into capital gain, even though the value of the underlying investment property lies in its ability to produce recurring receipts.⁴³³ Moreover, it has long been established that the right to the income component itself cannot be alienated as an independent property right which, when sold, results in capital gain. Hence, in *Rhodes' Estate v. Commissioner*⁴³⁴ the court held that a sale of an accrued dividend resulted in ordinary income to the stockholder.

However, for reasons of uniformity and administrative conven-

429. *But see* *Salvatore v. Commissioner*, 434 F.2d 600, 26 A.F.T.R.2d 70-5857 (2d Cir. 1970).

430. *See generally* *Del Cotto, supra* note 402; *Lyon & Eustice, supra* note 402.

431. *See, e.g.,* *Estate of Stranahan v. Commissioner*, 472 F.2d 867, 31 A.F.T.R.2d 73-710 (6th Cir. 1973).

432. I.R.C. § 1221(4). *See also* *Drybrough v. Commissioner*, 45 T.C. 424 (1966), *aff'd*, 384 F.2d 715, 20 A.F.T.R.2d 5678 (6th Cir. 1967).

433. *Compare* *Hort v. Commissioner*, 313 U.S. 28, 31, 25 A.F.T.R. 1207 (1941), where Mr. Justice Murphy, speaking for the Court, argued that the amounts received were essentially substitutes for "rental payments which [§ 61(a)(5)] expressly characterizes as gross income . . ." with *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 59, 12 A.F.T.R.2d 5895 (5th Cir. 1963), where Judge Cameron distinguished the right "to earn" income from the right to "earned" income.

434. 131 F.2d 50, 30 A.F.T.R. 220 (6th Cir. 1942).

ience, the entire gain or loss on the sale of shares is taxed as capital gain or loss. This is so even where the stock is sold after the declaration of a dividend, but before the record date, when the price of the share presumably reflects the right to the dividend.⁴³⁵

4. *Substitutes For Ordinary Income*

There are many ways in which a right to, or a claim for, ordinary income can be structured so that it appears to be "property" from which capital gain can be realized.⁴³⁶ By expressly providing that accounts receivable for section 1221(1) items, or on account of personal services, are not within the definition of capital assets,⁴³⁷ the Code implicitly acknowledges that ordinary income items can be dressed up to appear to be capital assets. Similarly, the bulk sale of inventory will not convert the proceeds into capital receipts. It is possible, however, that subdivided realty may be sold as a single tract with the proceeds being capital gains⁴³⁸—a reverse variation on the investment "liquidation" cases.⁴³⁹

The more the otherwise ordinary income items take on the appearance of a recognized property right under state law, the more difficult it is for the courts to distinguish those items which fall within the congressional design for capital assets from those which retain the attributes of ordinary income.⁴⁴⁰ In some instances the ultimate distinction may rest primarily on who holds and who sells the item. A purchaser of an account receivable may achieve the status of an investor and be accorded capital gains on the sale or exchange of the receivable,⁴⁴¹ where the initial holder of the account or note may have received only ordinary income on its satisfac-

435. Treas. Reg. § 1.61-9(c)(1978).

436. See section II.1. *supra*; Part Two, *supra* note 2, section III.C. See generally Parnell, *supra* note 402; see also *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 12 A.F.T.R.2d 5895 (5th Cir. 1963); *Kingsbury v. Commissioner*, 65 T.C. 1068 (1976), *acq.* 1976-2 C.B. 2 (payments were not substitutes for the taxpayer's ordinary income even though they were based on a percentage of the "lessee's" gross receipts from the assignment of a cardroom license); *Guggenheim v. Commissioner*, 46 T.C. 559, 569 (1966).

437. I.R.C. § 1221(4).

438. I.R.C. § 1237.

439. See section I.B.3.c. *supra*.

440. See *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 10 A.F.T.R.2d 5569 (5th Cir. 1962). See also Note, *Tax Consequences of Rescission: The Interplay Between Private and Public Law*, 42 U. CHI. L. REV. 562 (1975).

441. See *Pounds v. United States*, 372 F.2d 342, 348, 19 A.F.T.R.2d 514 (5th Cir. 1967) where the court found that Pounds was in fact an investor, but denied him capital gains treatment because it could find no sale or exchange. Judge Wisdom, for the court, stated: "If Pounds' interest were considered a capital asset and if it had been sold to a third party shortly before Gilson disposed of the real estate, the income realized from the sale should be taxable at capital gains rates." *Id.* at 351.

tion.⁴⁴² The latter taxpayer could not assert a claim to investor status since the note or account probably would have arisen in the ordinary course of the trade or business. The real distinction between the two taxpayers is not, in the language of *Hudson v. Commissioner*,⁴⁴³ that the original holder's claim "vanished" upon payment while the purchaser "sold or exchanged" the purchased claim, but rather that the original holder simply did not have a property interest that was within the design of the capital asset provisions. The purchaser, who probably acquired the claim at a discount, had the characteristics of an investor which came within the legislative design.⁴⁴⁴ To premise the distinction on the absence of a sale or exchange, or to say that the claim "vanished," is artificial, and obfuscates the issue. The original holder's receipts in satisfaction of the obligation is as much a "sale or exchange" as if the proceeds were received in the transaction from which the indebtedness arose (provided, of course, that it did not originate in a loan or in an obligation to pay for services). Naturally, if the purchaser was a dealer in such accounts, the amounts received would be ordinary income from the trade or business of dealing in those accounts.

Compensation for services is ordinary income. When it is received contemporaneously with the rendition of the services there generally is no question that the fee, salary, or wage is not an amount paid for the sale or exchange of "property," *i.e.*, the services. Nevertheless, the performance of personal services may culminate in the creation of property or give rise to a claim for payment. For example, the taxpayer's activities may result in: a claim for a fee for professional services; an increased value in the shares of a closely-held corporation; or the creation of an artistic work or one which is subject to the copyright or patent laws. Moreover, compensation may be received partially in the form of property, the right to acquire property (whether at fair market value, at a discount, or subject to restrictions), or in other forms of deferred or executive compensation.⁴⁴⁵ Clearly the argument for capital gains becomes more

442. See *Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub nom.* *Ogilvie v. Commissioner*, 216 F.2d 748, 46 A.F.T.R. 1089 (6th Cir. 1954).

In a hypothetical case, if the judgment had been transferred to someone other than the judgment debtor, the property transferred would still be in existence after the transaction was completed. However, as it actually happened, when the judgment debtor settled the judgment, the claim arising from the judgment was extinguished without the transfer of any property or property right to the judgment debtor.

20 T.C. at 736.

443. 20 T.C. 734, 737 (1953), *aff'd sub nom.* *Ogilvie v. Commissioner*, 216 F.2d 748, 46 A.F.T.R. 1089 (6th Cir. 1954).

444. See *Pounds v. United States*, 372 F.2d 342, 348 (5th Cir. 1967).

445. See generally *Anderson, Traditional Forms of Compensation (Options, Stock, and Cash) After the Tax Reform Act*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW

persuasive, and more difficult to deal with, when the value of personal services becomes intertwined with these and other salable property interests and rights.⁴⁴⁶ The task of distinguishing ordinary from capital gain is not made noticeably easier by the many Code sections, including section 1221, which address the problem.⁴⁴⁷

The installment method of reporting under section 453 applies only to gain on the sale or other disposition of property; it does not apply to compensation for services. Obviously, making this distinction can be difficult, but the Service has considered the problem. In Revenue Ruling 73-438, the Service ruled that a builder of custom homes for lot owners could not elect the installment method of reporting because he was being paid for services, not for the sale of property.⁴⁴⁸

Section 1221(4) attempts to prevent the conversion of a claim for payment for personal services already rendered into a capital asset.⁴⁴⁹ Nevertheless, the possibility remains that such a claim, when sold, could become a capital asset.⁴⁵⁰ But payments received by an employee for the release of his employer from the terms of an employment contract usually will be ordinary income—even where the release is structured as a sale.⁴⁵¹ For the purposes of the capital asset provisions, the term “property” does not include the expectation of receiving compensation for services to be performed in the future. Nor does it include the right to receive renewal commissions

TWENTY-FOURTH TAX INSTITUTE 547 (R. Forster ed. 1972); Metzger, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525 (1974); Stanger, *The Interplay of Section 83 and Section 305*, 54 TAXES 235 (1976).

446. See Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 MINN. L. REV. 1 (1964); Eustice, *supra* note 402; *Professional Organization*, *supra* note 403.

447. I.R.C. §§ 1221, 1231-37, 1239, 1242-46, 1249-53. See also *Professional Organization*, *supra* note 403.

448. Rev. Rul. 73-438, 1973-2 C.B. 157 (which superseded Rev. Rul. 59-250, 1959-2 C.B. 134, because the latter erroneously implied that custom home builders commonly keep inventories of materials); cf. Rev. Rul. 73-437, 1973-2 C.B. 156 (seller of “shell homes” can qualify as a dealer in personal property by § 453(a)). See *Town and Country Food Co. v. Commissioner*, 51 T.C. 1049 (1969); cf. *Realty Loan Corp. v. Commissioner*, 54 T.C. 1083 (1970), *aff'd* 478 F.2d 1049, 31 A.F.T.R.2d 73-1183 (9th Cir. 1973) (taxpayer sold a mortgage servicing company, from which his right to future income was held not to be compensation for services: § 453 treatment allowed).

449. See *Vestal v. United States*, 498 F.2d 487, 33 A.F.T.R.2d 74-1240 (8th Cir. 1974); *Freeze v. United States*, 455 F.2d 1146, 29 A.F.T.R.2d 72-600 (10th Cir.), *cert. denied*, 409 U.S. 879 (1972); *O'Neill v. Commissioner*, 33 T.C.M. (P-H) 7 (1964).

450. See *Pounds v. United States*, 372 F.2d 342, 19 A.F.T.R.2d 514 (5th Cir. 1967), *noted in* 21 Sw. L.J. 815 (1967); cf. *Strauss v. Commissioner*, 168 F.2d 441, 36 A.F.T.R. 1072 (2d Cir.), *cert. denied*, 335 U.S. 858 (1948) (compensation in the form of a percentage of royalties, an interest to such having been assigned to the spouse, was nonetheless taxable to the person who rendered the services).

451. *McFall v. Commissioner*, 34 B.T.A. 108 (1936).

in the future.⁴⁵² But Congress has provided some statutory exceptions for certain types of compensation, including specified stock options⁴⁵³ and some distributions from qualified pension plans.⁴⁵⁴

Where "property," other than that directly related to the compensation for past, present, or future services, is created by personal services, the resultant interest stands a better chance of being categorized as a capital asset. For example, goodwill created by the personal efforts of the taxpayer may increase the value of the business or the price of corporate shares. That portion of the purchase allocable to these efforts, through the enhanced value, generally will be classified as capital gain.⁴⁵⁵

5. Sale of Contract Rights

The issues raised incident to the release, surrender, termination, or sale of contract rights are closely related to the problems discussed previously concerning the receipt or disposition of income-related items.⁴⁵⁶ The tension here, however, arises because contract rights generally are recognized property rights under state law, (indicating capital gain or loss), even though these rights may relate explicitly to the performance of services or the supplying of goods which, under the income tax, will result in ordinary income. The disposition of enforceable contract rights, especially when it is in return for a payment from the other party to the contract, forces the courts to consider whether any gain should be characterized as ordinary income on the premise that the consideration received is a substitute for future ordinary income which would have been earned had the contract continued. For example, in *United States v. Woolsey*, the court stated that: "[c]lose scrutiny is required if the consideration received [for the disposition of the contract rights] is actually a present substitute for what would have been ordinary earned income in the hands of the assigning taxpayer, if the assignment or transfer had not been made."⁴⁵⁷

452. *Foxe v. Commissioner*, 53 T.C. 21 (1969).

453. I.R.C. § 422.

454. I.R.C. § 402. See also I.R.C. § 1240 which, until rendered obsolete by the Tax Reform Act of 1976, permitted certain amounts received by an employee on the termination of a long term employment agreement to be reported as capital gains, under limited circumstances.

455. *Johnson v. Commissioner*, 53 T.C. 414 (1969); accord, *Kelly v. Commissioner*, 39 T.C.M. (P-H) 1191 (1970). But see I.R.C. § 341 (collapsible corporations); I.R.C. § 1221(3) (copyrights, compositions, memoranda, etc.). See also *Professional Organization*, supra note 403.

456. See section II.J.1.-4. supra. See generally *Eustice*, supra note 402; *Parnell*, supra note 402.

457. 326 F.2d 287, 291, 13 A.F.T.R.2d 311 (5th Cir. 1963).

Alternatively, the gain may be characterized as capital in nature, on the basis that the rights disposed of constituted a capital asset. That is, the contract rights terminated were "property," within the meaning of the capital asset provisions, and had value because they would produce future income. In *United States v. Dresser Industries, Inc.*, the court explained that:

[a]s a legal or economic position . . . [t]he 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.

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.⁴⁵⁸

Drawing this line clearly is the crux of the problem.⁴⁵⁹

Transactions in, and those relating to, the entertainment industry have caused a particularly noticeable amount of litigation, involving, *inter alia*, collapsible corporations,⁴⁶⁰ personal holding companies,⁴⁶¹ and film production companies.⁴⁶² In *Benny v. Commissioner*⁴⁶³ the taxpayer and some associates formed a corporation which contracted with a sponsor to produce a radio program.

458. 324 F.2d 56, 59, 12 A.F.T.R.2d 5895 (5th Cir. 1963); see Del Cotto, *supra* note 402. See also *Commissioner v. Pittston Co.*, 252 F.2d 344, 1 A.F.T.R.2d 874 (2d Cir.), *cert. denied*, 357 U.S. 919 (1958).

459. See Del Cotto, *supra* note 402; Eustice, *supra* note 402.

460. I.R.C. § 341; Rosenbaum, *Entertainer's Corporations and Capital Gains*, 12 TAX L. REV. 33 (1956). See B. BITTKER & J. EUSTICE, *supra* note 309.

461. I.R.C. § 543; see B. BITTKER & J. EUSTICE, *supra* note 309. See also Emory, *The Personal Holding Company Tax and Intercompany Transactions with Members of an Affiliated Group—New Difficulty with an Old Misconception*, 30 TAX L. REV. 283 (1975). •

The Tax Reform Act of 1976 modified the personal holding company provisions in two principal respects. First, § 543(a)(5)(B) was changed to ensure that "produced film rents" did not require the finding of a depreciable interest in the property, as was the Service's position following *Carnegie Prod., Inc. v. Commissioner*, 59 T.C. 642 (1973). S. REP. NO. 94-938, 94th Cong., 2d Sess. 79-81, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3515, 3516. Second, it amended § 543(a) to differentiate between "rents" and "royalties" in the leasing of intangibles. This was intended to modify the Service's position in Rev. Rul. 71-596, 1971-2 C.B. 242. S. REP. NO. 94-938, 94th Cong., 2d Sess. 409, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3838, 3838. H.R. REP. 94-658, 94th Cong., 1st Sess. 334-37 (1975).

462. See Appel, *The Motion Picture Service Company: A Service to the Motion Picture Industry?*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW TWENTY-SEVENTH TAX INSTITUTE 559 (D. Lang chairman 1975); Blanc, *Current Income Tax Developments of Interest to the Entertainment Industry*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW TWENTY-SIXTH TAX INSTITUTE 1083 (D. Lang chairman 1974); cf. Ardi, *Tax Planning for Foreign Entertainers Who Perform Within the United States*, 32 TAX LAW 349 (1979).

463. 25 T.C. 197 (1955), acq. 1959-2 C.B. 4.

Thereafter the stock was bought by CBS, and the gain was taxed as capital gain. The Service subsequently acquiesced, and announced that *Benny* would be followed where the facts showed that the consideration received "represented payment for the property transferred and no part represented payment for future services."⁴⁶⁴

Despite the Service's announcement that *Benny* would be followed only where *no* part of the consideration received represented payment for future services, the courts have indicated a tendency to permit an allocation of the payments between ordinary service income and capital gains. For example, in *Commissioner v. Ferrer*,⁴⁶⁵ the Second Circuit held that there should be an apportionment between those amounts attributable to Ferrer's "equitable property interest" in the play and those allocable to his right to receive a percentage of the film proceeds. The *Ferrer* rationale was followed by the Fifth Circuit in *Bisbee-Baldwin Corp. v. Tomlinson*.⁴⁶⁶ There, the taxpayer sold its contractual rights to act as a mortgage-servicing agent. The court held that the transaction was partly a sale of future commissions, taxable as ordinary income, and partly a sale of goodwill, files, and equipment, taxable as capital gain.⁴⁶⁷ Conversely, in *Commissioner v. Pittston Co.*,⁴⁶⁸ a coal distributor was found to have realized ordinary income on the payment received for the surrender of its contract rights to purchase all of the coal extracted by another company for a specified period. The court reasoned that the taxpayer surrendered a "naked contract right" and received a substitute for ordinary income in the form of the consideration. However, its decision turned on its inability to find a sale or exchange, not on a finding that the contract was not a capital asset—a conclusion which would have been difficult to defend in the presence of a rising market.⁴⁶⁹

A recurring theme in the sale-of-contract-rights cases is the substitute-for-ordinary-income concept. For example, a lump-sum payment for the cancellation of an insurance agency contract was

464. Rev. Rul. 59-325, 1959-2 C.B. 185; see Rosenbaum, *supra* note 460. See also Del Cotto, *supra* note 402, on assignment of income.

465. 304 F.2d 125, 9 A.F.T.R.2d 1651 (2d Cir. 1962); see section I.D.1. *supra*. See also Eustice, *supra* note 402.

466. 320 F.2d 929, 12 A.F.T.R.2d 5025 (5th Cir. 1963).

46. *But see* Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897, 10 A.F.T.R.2d 5569 (5th Cir. 1962).

468. 252 F.2d 344; *accord*, General Artists Corp. v. Commissioner, 205 F.2d 360, 44 A.F.T.R. 72 (2d Cir.), *cert. denied*, 346 U.S. 866 (1953); Commissioner v. Starr Bros., Inc., 204 F.2d 673, 43 A.F.T.R. 972 (2d Cir. 1953); Commercial Solvents Corp. v. United States, 427 F.2d 749, 25 A.F.T.R.2d 70-1374 (Ct. Cl.), *cert. denied*, 400 U.S. 943 (1970).

469. Compare World Publishing Corp. v. Commissioner, 299 F.2d 614, 9 A.F.T.R.2d 819 (8th Cir. 1962) with Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592, 6 A.F.T.R.2d 5493 (9th Cir. 1960). See also Del Cotto, *supra* note 402; note 479 and accompanying text *infra*.

characterized as ordinary income in *Elliott v. United States*.⁴⁷⁰ The court held that the consideration was a substitute for the ordinary income that *would have been earned* if the contract had not been cancelled.⁴⁷¹ Similarly, the Tenth Circuit held in *Wiseman v. Halliburton Oil Well Cementing Co.*⁴⁷² that the taxpayer realized ordinary income on the sale of an exclusive license to use and to sublicense a patented process. But in *United States v. Dresser Industries, Inc.*, the court held that the sale of an exclusive license to use a patented process resulted in capital gain.⁴⁷³ Although *Dresser* appears to be the better decision, it attempted to distinguish *Wiseman* on the basis that the sales price in that case was attributable solely to the oil company's right to *sublicense* the process—a substitute for ordinary royalty income.⁴⁷⁴ Clearly, some portion of the purchase price in *Wiseman* was attributable to the taxpayer's exclusive license, and gain on the sale may have been due partially to market forces. These factors should have been given greater consideration by the respective courts.⁴⁷⁵

The effect of market fluctuations on contract values can result in capital gain if the contract is sold at a gain, even if the contract is one for the delivery of goods and the performance of services. In *Estate of Shea v. Commissioner*,⁴⁷⁶ the taxpayer realized a substantial gain on the sale of a ship's charter granting the right to perform designated ocean hauls for a specified term and rate. The gain was due to the excess of the rate in the taxpayer's charter over the prevailing market rate for new charters.⁴⁷⁷ The Tax Court held that the gain was capital gain, rejecting the Service's argument that the charter was only the right to earn future income, rather than property within the design of the capital gain provisions.

The attempt to distinguish the sale of the right to future earnings from the sale of the right to past earnings to be received in the future has resulted in a legion of apparently inconsistent decisions. While the uncertainty is greatest when the rights surrendered involved elements of personal service, it is also evident when the value of

470. 431 F.2d 1149, 26 A.F.T.R. 2d 70-5473 (10th Cir. 1970); see *Vaaler v. United States*, 454 F.2d 1120, 29 A.F.T.R.2d 72-481 (8th Cir. 1972).

471. *Accord*, *United States v. Eidson*, 310 F.2d 111, 10 A.F.T.R.2d 6034 (5th Cir. 1962), *modified*, 312 F.2d 744, 11 A.F.T.R.2d 701 (5th Cir. 1963) (sale of rights to act as general life insurance agent held to result in ordinary income).

472. 301 F.2d 654, 9 A.F.T.R.2d 1389 (10th Cir. 1962).

473. 324 F.2d 56, 12 A.F.T.R.2d 5895 (5th Cir. 1963).

474. *Id.* at 59.

475. See generally *Part Two*, *supra* note 2, section III.H.6. for the considerations used to determine whether all "substantial rights" to a patent have been sold.

476. 57 T.C. 15 (1971).

477. See *id.* at 24-25.

such rights has been enhanced by some other factor, such as scarcity, and even where the rights concerned traditionally have been considered proprietary.

The distinction between the sale of the right to future earnings and the sale of the right to past earnings to be received in the future requires concise analysis. The value of the right to earn income in the future may be fairly predictable, but it is always uncertain. It is a property right which will have a basis equal to the purchaser's cost, and the seller's proceeds should be capital gain. Conversely, the right to receive income in the future that is earned presently is merely an attempted assignment of income, and is rightly taxed as ordinary income.⁴⁷⁸

Cancellations and terminations of leases have caused a substantial amount of litigation, both as to the characterization of the proceeds and as to the tax treatment of the purchaser. Initially, it must be determined who has what rights, and by whom payments are made, as well as the purpose for which they are made, *i. e.*, cancellation or acquisition of the leasehold interest.⁴⁷⁹ Unfortunately, these questions frequently merge into each other, and thereby result in little consistency over a line of what should be consistent cases. Generally, the courts have placed too much emphasis on the formal requirements of a "sale or exchange," holding that a lessor cannot acquire the leasehold from the lessee by purchase because the interest simply vanishes upon its return to the fee.⁴⁸⁰ Instead of taking such a view, the lease cases should be considered in terms of whether the transaction meets the requirements of the capital asset provi-

478. See *Dresser Indus., Inc.*, 324 F.2d 56.

479. See *Del Cotto*, *supra* note 402, at 10-17. See also *Commissioner v. Golonsky*, 200 F.2d 72, 42 A.F.T.R. 914 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953); *Kingsbury v. Commissioner*, 65 T.C. 1068 (1976) *acq.* 1976-2 C.B. 2 (the right to operate a card room was a lease, the disposition of which came within the scope of § 1231); *Morris*, *Taxation of Leases: Profits and Pitfalls*, 30 Sw. L.J. 435 (1976).

In *Kingsbury*, the court emphasized the following facts that indicated that the transaction constituted a lease rather than the disposition of some sort of other nonqualifying property rights:

- (1) The taxpayer was granted the exclusive right to operate the business on the lessor's premises;
- (2) The lessor had no effective control over the taxpayer;
- (3) The taxpayer had an unqualified option to renew the agreement for two additional terms;
- (4) The operating agreement was to terminate upon the death of the taxpayer, and not upon the death of the lessor;
- (5) The taxpayer could retain all gross receipts after the payment of a fixed monthly fee to the lessor;
- (6) The taxpayer made a lump-sum payment to the lessor for the rights under the agreement.

65 T.C. at 1083-85.

480. For several examples, see *Del Cotto*, *supra* note 402, at 10-17.

sions and can be distinguished from a routine business transfer.⁴⁸¹

Whether an assignment or cancellation of a contract or lease results in capital or ordinary gain or loss generally depends on whether the payment received is characterized as a substitute for future income. For example, the amount received by a lessor for the cancellation of a lease usually is deemed a replacement for rent; nevertheless, courts sometimes regard lease-cancellation payments not as substitutes for future income, but as capital gain. In *Hort v. Commissioner*, the Supreme Court held that the consideration received by the owner of a building for the cancellation of a lease was not a return of capital but "merely a substitute for the rent reserved in the lease";⁴⁸² as a result, the taxpayer realized ordinary income. However, in *Metropolitan Building Co. v. Commissioner*,⁴⁸³ the Ninth Circuit allowed the taxpayer-lessee capital gain status on amounts received from the sublessee for the lessee's release to its landlord of all rights and interests in the leasehold. The court distinguished *Hort* on the basis that the *Metropolitan Building Co.* lessee, in the sale of its entire leasehold interest, sold the income producing property itself.⁴⁸⁴ In contrast, the landlord in *Hort* retained the capital asset—the building—and merely accelerated future rents.⁴⁸⁵

In order to distinguish between the two situations it must be determined whether the asset involved is "property" of the type which is a capital asset under section 1221, whether there has been a sale or exchange, and whether the payment received upon the assignment, cancellation, novation, or release of contract rights is a substitute for future ordinary income.⁴⁸⁶ Moreover, the present sale of the future right to *earned* income must be delineated clearly from the present sale of the future right to *earn* income.⁴⁸⁷

481. See *Dresser Indus., Inc.*, 324 F.2d 56; *Del Cotto*, *supra* note 402, at 59-60.

482. 313 U.S. 29, 31, 25 A.F.T.R. 1207 (1941).

483. 282 F.2d 592, 6 A.F.T.R.2d 5493 (9th Cir. 1960).

484. *Id.* at 594; *accord*, *Commissioner v. Golonsky*, 200 F.2d 72, 42 A.F.T.R. 914 (3d Cir. 1952).

485. See *Del Cotto*, *supra* note 402, at 15-17. See also I.R.C. § 1241, which treats the cancellation or termination of a lease as a sale or exchange as to the lessee. It does not apply to the lessor, nor does it classify the receipts as capital gain or loss. Rather, it simply supplies the sale or exchange needed for capital gains treatment.

486. See *Dresser Indus., Inc.*, 324 F.2d 56; *Commissioner v. Golonsky*, 200 F.2d 72, 42 A.F.T.R. 914 (3d Cir. 1952).

487. See *Dresser Indus., Inc.*, 324 F.2d 56; *cf. Lazarus v. Commissioner*, 513 F.2d 824, 35 A.F.T.R.2d 75-1640 (9th Cir. 1975) (purported private annuity transaction was in fact the transfer of a remainder with a reservation of a life estate). See generally Chirelstein, *supra* note 446; Eustice, *supra* note 402; Grayck, *Taxing Income That is Applied Against the Purchase Price*, 12 TAX L. REV. 381 (1957); Joyce & Del Cotto, *supra* note 405; Note, *Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are Sold*, 69 HARV. L. REV. 737 (1956); Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964); see also *Part Two*, *supra* note 2, section III.E. and the sources cited therein as to bootstrap sales and the payment of the purchase price from the business's current income.

