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Capital Gains and Losses: A Primer (Part Two)

Thomas J. Gallagher, Jr.

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THOMAS J. GALLAGHER, JR.

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

THOMAS J. GALLAGHER, JR.**

III. SALE OR EXCHANGE

A. In General

Long- and short-term capital gain and loss are defined by section 1222 of the Internal Revenue Code (the Code) as gain or loss from the "sale or exchange" of a capital asset.¹ Fulfilling this sale or exchange requirement is crucial, for without either a "sale" or an "exchange," as opposed to some other form of disposition, the taxpayer cannot realize a capital gain or loss.² It is not enough that a certain transaction involves a capital asset; there must be a *sale or exchange* of the capital asset. Moreover, gain or loss must arise directly from a sale or exchange of the property itself, not merely as an incident to the capital asset transaction. For example, in the sale of real estate between *B* and *C*, the gain (or loss) realized by *A*—who has no legal or equitable interest in the property—which arises from his investment interest in any possible profits from the sale of the property, may well be found to be merely incidental to the "sale or exchange" of the capital asset. Thus, it would not be subject to the beneficial capital gains tax rate.³

Since capital gains and losses are accorded special tax treatment, determining whether a sale or exchange has occurred is vitally important. This generally creates no problem because the usual transactions referred to as sales and exchanges ordinarily are easily identifiable. For several reasons, however, finding a proper label for

* *Part One* of this article, 7 FLA. ST. U.L. REV. 1 (1979), analyzes the statutory requisites of the capital gains provisions, the statutory and judicial exceptions which subsequently have arisen, and related topics including stock attribution, depreciation recapture, and the consequences of selling a business. *Part Two* concludes the article with an analysis of the sale or exchange requirement, the holding period, and the mechanics of the tax.

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. I.R.C. § 1222.

2. See also Gallagher, *Capital Gains and Losses: A Primer (Part One)*, 7 FLA. ST. U.L. REV. 1 (1979) [hereinafter cited as *Part One*], section II.D., for a discussion of § 1231.

3. See, e.g., *Pounds v. United States*, 372 F.2d 342, 19 A.F.T.R.2d 514 (5th Cir. 1967). See also the discussion regarding the sale of contract rights in *Part One*, *supra* note 2, section II.J.

some transactions can prove to be difficult. Not all relevant commercial transactions are structured clearly as sales or exchanges. And even though the structure may be clear from a commercial standpoint, commercial practice and parlance is not always reflected in the Code.⁴ The Code defines neither sale nor exchange in relation to capital asset dispositions resulting in capital gain or loss.⁵ Additional complications arise from those Code provisions which treat certain specified transactions as sales or exchanges for income tax purposes even though they do not actually constitute commercial sales or exchanges.⁶ In other instances an admitted sale or exchange of a capital asset may fall within a Code provision expressly requiring that no gain or loss be recognized.⁷ It is largely because of the potential complications in questionable transactions that the sale or exchange requirement must be examined.

Finally, it is important to note that despite the occasional problems encountered in dealing with the sale or exchange requirement, its creation is not without justification. The sale or exchange requirement is consistent with the theoretical basis for according special tax treatment to capital gains. Once a capital asset is sold or exchanged, the taxpayer has terminated his investment in that property. Profit or loss arising from such a termination must be distinguished from that profit which arises from the everyday operation of his business. It is this distinction—between investment and ordinary business income—which justifies the imposition of the sale or exchange requirement on capital asset transactions.

1. *Sale, Exchange, or "Other Disposition"*

Initially, the sale or exchange requirement of section 1222 must

4. See generally Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355 (1963); Scharf, *State Law in the Tax Court—Controlling Precedents*, 26 TAX LAW. 293 (1973); Stephens & Freeland, *The Role of Local Law and Local Adjudications in Federal Tax Controversies*, 46 MINN. L. REV. 223 (1961); see also Blankenheimer, *Tax Consequences of Rescission: The Interplay Between Private and Public Law*, 42 U. CHI. L. REV. 562 (1975).

5. Generally, one must distinguish between "sale" and "exchange" only in those instances involving exchanges where the Code provides that no gain or loss shall be recognized, e.g., I.R.C. §§ 1031, 1034.

6. See generally Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Tax Event, Amount Realized and Related Problems of Basis*, 26 BUFFALO L. REV. 219 (1977); see also section III.H. *infra*.

7. See, e.g., I.R.C. § 121 (one-time exclusion from gross income of up to \$100,000 in gain from the sale or exchange of a residence by persons 55 or older); § 351 (no gain or loss recognized if property is exchanged for stock, resulting in control of the corporation); § 1031 (no recognition of income for in-kind exchanges of certain property to be used for identical purposes); § 1034 (no recognition of gain on sale of residence if a new one is purchased within 18 months).

be compared with the section 1001 requirement of a "sale or other disposition."⁸ Under section 1222 a taxpayer can have capital gain or loss upon a "sale or exchange" of the property involved. Under section 1001(2), on the other hand, ordinary gain or loss is realized upon the "sale or other disposition" of property. Section 1001(c), the recognition provision, provides that all gain or loss (as computed according to section 1001(2)) on the "sale or exchange" of property shall be recognized for income tax purposes. The basic theory underlying section 1001 is that a taxpayer will not be taxed until he has severed to a sufficient degree his interest in property.⁹ Why Congress used both "sale or exchange" and "sale or other disposition" in this seemingly contradictory manner is uncertain. However, the two phrases are apparently not coextensive. A property transfer may be a disposition without being a sale or exchange. For example, it has been held that the satisfaction of a judgment by the judgment debtor is a "disposition" of property by the judgment holder;¹⁰ yet, the transaction does not involve a "sale or exchange" on which capital gain or loss will be realized. Accordingly, *ordinary* gain or loss must be recognized.

Rarely will there be a problem determining whether a certain disposition of property also constitutes an exchange; nevertheless, the precise difference between "sale or exchange" and "sale or other disposition" is not entirely clear. Though section 1001 uses both of these phrases, it usually is interpreted to include all closed transactions. The Treasury Regulations (the Regulations) define a sale as a transfer of property for a "money consideration" and an exchange as a "reciprocal transfer of property."¹¹ Although the Code does not define sale or exchange, the Supreme Court has said that these terms should be given their "ordinary meaning."¹² Certain other

8. See generally Hacker, *What Is a "Sale or Exchange"?*, 12 W. RES. L. REV. 253 (1961); Hellowell, *Making the Disposition a Sale or Exchange*, 12 W. RES. L. REV. 271 (1961); Comment, *Income Tax—Construction of "Sale or Exchange" Clause—Section 117*, 1954 U. ILL. L.F. 340.

9. See *Eisner v. Macomber*, 252 U.S. 189, 3 A.F.T.R. 3020 (1920). See also Zarky, *Capital Gain Concepts: What is a "Capital" Asset? When Is There a "Sale or Exchange"?*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW ELEVENTH ANNUAL TAX INSTITUTE 357, 365 (J. Ervin ed. 1959). It has been posited that a combination of *Eisner's* requirement of a "severance" to realize "income" with the sixteenth amendment's tax on "incomes" suggests that taxing unrealized gain may be unconstitutional. J. JACOBS, *FEDERAL INCOME TAXATION: FEEDING THE HUNGRY BEAST* 425-27 (4th ed. 1978).

10. *Herbert's Estate v. Commissioner*, 139 F.2d 756, 31 A.F.T.R. 1133 (3d Cir.), cert. denied, 322 U.S. 752 (1943). See also *Pounds v. United States*, 372 F.2d 342, 19 A.F.T.R.2d 514 (5th Cir. 1967); Hellowell, *supra* note 8.

11. Treas. Reg. § 1.1002-1(d) (1957).

12. *Commissioner v. Brown*, 380 U.S. 563, 571, 15 A.F.T.R.2d 790 (1965); *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249, 25 A.F.T.R. 1236 (1941). See also *Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496, 17 A.F.T.R. 470 (1936); *McFeeley*

courts—notably the Fifth Circuit—¹³ have struggled to distinguish between sales, exchanges, and dispositions, but their efforts have not resulted in any definitive clarification.

The lack of a precise definition has led to some confusion. For example, where the courts determine that a particular transaction with a capital asset is not a “sale or exchange,” they may be holding that the transaction is not closed or completed, rather than deciding whether the taxpayer’s gain or loss is capital or ordinary.¹⁴ Here the capital gain and loss provisions would not apply because there was no “sale or other disposition” under section 1001(a) and not because there was no “sale or exchange” within the meaning of section 1222. Thus the taxpayer could not offset his basis against the amount received because the transaction is not closed. For example, if a purported sale is found to be a lease, the taxpayer’s receipts will be taxed as ordinary income, offset by depreciation, even though the property may be a capital asset. Here it is more accurate to hold that there has been no “sale or other disposition,” for to state that the transaction is not a “sale or exchange” may imply, incorrectly, that it is a “sale or other disposition” which fails to qualify for capital gain or loss treatment only because it does not meet the more rigorous requirements of a “sale or exchange.”

2. *Some Common Examples*

A sale or exchange can take many forms, depending on the factual setting of the transaction. The discussion in this section will center on some of those common dispositions of property whose status as either sales or exchanges is largely settled. Subsequent sections of this article will discuss other types of transactions whose tax consequences are less predictable.

A debtor’s transfer of property in satisfaction of a claim is a sale of the property.¹⁵ Satisfaction of a pecuniary bequest with appreciated property is a sale or exchange of that property, since it discharges the taxpayer’s obligation.¹⁶ So, too, is a spouse’s transfer of

v. Commissioner, 296 U.S. 102, 16 A.F.T.R. 965 (1935); Hellowell, *supra* note 8; *Income Tax—Construction of “Sale or Exchange” Clause—Section 117*, *supra* note 8.

13. See *Pounds v. United States*, 372 F.2d 342, 19 A.F.T.R.2d 514 (5th Cir. 1967).

14. On “open” transactions, see, e.g., *Burnet v. Logan*, 283 U.S. 404, 9 A.F.T.R. 1453 (1931); *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947).

15. *Riley v. Commissioner*, 37 T.C. 932, 939-41 (1962), *aff’d* 328 F.2d 428, 13 A.F.T.R.2d 654 (5th Cir. 1964). See also *Peninsula Properties Co. v. Commissioner*, 47 B.T.A. 84 (1942); Rev. Rul. 76-111, 1976-1 C.B. 214.

16. See, e.g., *Kenan v. Commissioner*, 114 F.2d 217, 25 A.F.T.R. 607 (2d Cir. 1940); *Brinckerhoff v. Commissioner*, 8 T.C. 1045 (1947), *aff’d*, 168 F.2d 436, 440, 36 A.F.T.R. 1067 (2d Cir. 1948). See also Rev. Rul. 56-270, 1956-1 C.B. 325, *modified*, Rev. Rul. 60-87, 1960-1 C.B. 286.

appreciated property in satisfaction of a release of support and marital rights in a divorce proceeding.¹⁷ However, where the purchaser of a judgment enters into a settlement with the debtor there is no sale or exchange, at least so far as the purchaser is concerned, even though he realizes a gain.¹⁸ Thus, ordinarily a distinction is drawn between the debtor and the creditor; but a transfer by a creditor for consideration to a third party usually will be treated as a sale.¹⁹

Where mortgaged property is sold through a foreclosure,²⁰ or transferred by a deed in lieu of foreclosure,²¹ the transaction is treated as a sale or exchange.²² But where the mortgagor voluntarily conveys the mortgaged property to the mortgagee in satisfaction of the obligation, the tax consequences will depend on whether the mortgagor is liable personally for the obligation. The transfer will be treated as a sale or exchange only where the mortgagor is personally liable on the mortgage.²³ The rationale underlying this distinction is simply that in the case of a personally liable mortgagor the discharged debt is something of value received by him, namely, the shedding of a liability. Without personal liability the mortgagor receives nothing which could warrant conversion of a discharge into an exchange.²⁴ However, even where the debtor is without personal liability, if he receives additional consideration, such as cash, on the voluntary conveyance, the transfer may be found to be an exchange.²⁵

The treatment of the release of contract rights has had a chequered history, both because a release was construed to be outside the meaning of a "sale"²⁶ and because the question of whether a sale

17. *United States v. Davis*, 370 U.S. 65, 9 A.F.T.R.2d 1625 (1962). *But see*, Gallagher, *A New Look at the Income Tax Consequences of a Property Division Incident to a Divorce*, 1 REV. TAX. INDIVIDUALS 9 (1977).

18. *See, e.g.*, *Green v. United States*, 113 F. Supp. 295, 44 A.F.T.R. 182 (D. Neb. 1953); *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); *accord Riddell v. Scales*, 406 F.2d 210, 23 A.F.T.R.2d 69-541 (9th Cir. 1969). *See also* Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959); Wilson, *Taxation of Debt Collection and Cancellation*, 48 CAL. L. REV. 623 (1960).

19. *See, e.g.*, *Paine v. Commissioner*, 236 F.2d 398, 50 A.F.T.R. 10 (8th Cir. 1956).

20. *Helvering v. Hammel*, 311 U.S. 504, 24 A.F.T.R. 1082 (1941).

21. Rev. Rul. 76-111, 1976-1 C.B. 214.

22. *See generally* Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee*, 31 TAX L. REV. 193 (1976).

23. *Compare* *Commissioner v. Green*, 126 F.2d 70, 28 A.F.T.R. 1286 (3d Cir. 1942) with *Stokes v. Commissioner*, 124 F.2d 335, 28 A.F.T.R. 656 (3d Cir. 1941). *See also* Rev. Rul. 76-111, 1976-1 C.B. 214; Handler, *supra* note 22.

24. *See* *Crane v. Commissioner*, 331 U.S. 1, 14, 35 A.F.T.R. 776 (1947); Rev. Rul. 76-111, 1976-1 C.B. 214.

25. *See, e.g.*, *Blum v. Commissioner*, 133 F.2d 447, 30 A.F.T.R. 929 (2d Cir. 1943).

26. *See, e.g.*, *Commissioner v. Pittston Co.*, 252 F.2d 344, 1 A.F.T.R. 2d 874 (2d Cir. 1958).

was present frequently merged with whether the contract right was a capital asset.²⁷ More recent decisions first examine the contract right released; if it is a capital asset, the release is then treated as a sale.²⁸

Where the taxpayer grants a property interest to another in return for contingent payments linked to the grantee's use, sales production, or some similar standard, the courts and the Internal Revenue Service (the Service) have been concerned both with whether the interest granted was a capital asset and with whether the transfer was part of a sufficiently completed transaction to be treated as a sale or exchange.²⁹ Generally the transfer of an exclusive interest in a copyright or patent for the remainder of its life is recognized as a "sale" even though payment is made via royalties contingent on use, sales, or a similar standard.³⁰ However, the transfer of an interest restricted to a field of use (a geographical area smaller than the licensing country) or for a duration less than its useful life is likely to be found to be a license, not a sale.³¹ In contrast, the transfer of the right to extract minerals from a taxpayer's land will be treated as a sale, if the parties characterize it as such, even though it is limited to an area or the consideration is based on extraction.³²

Under the terms of a commercial lease the tenant usually is obligated to return the property to the landlord in the same condition as it was at the beginning of the lease term. Alternatively, the lessee may have the option to pay to have the premises restored to their prior condition.³³ Such restoration payments have been treated inconsistently, either as additional rent or as payments for the "sale"

See generally Del Cotto, "Property" in the Capital Asset Definition: Influence of "Fruit and Tree," 15 BUFFALO L. REV. 1 (1965).

27. See Part One, *supra* note 2, section II.J.

28. See, e.g., *Commissioner v. Ferrer*, 304 F.2d 125, 9 A.F.T.R.2d 1651 (2d Cir. 1962); *Eustice, Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964). A forfeited deposit, however, still remains ordinary income to the recipient. *Mittleman v. Commissioner*, 56 T.C. 171 (1971), *aff'd*, 464 F.2d 1393, 30 A.F.T.R.2d 72-5574 (3d Cir. 1972); *Smith v. Commissioner*, 50 T.C. 273 (1968), *aff'd per curiam*, 418 F.2d 573, 24 A.F.T.R.2d 69-6020 (9th Cir. 1969). Compare the tax treatment accorded on the lapse of an option at section III.H.5. *infra*.

29. See sections III.C., H.6., H.10. *infra*.

30. See Rev. Rul. 60-226, 1960-1 C.B. 26; Rev. Rul. 58-353, 1958-2 C.B. 408.

31. See sections III.C., H.6., H.10. *infra*.

32. Compare *Dann v. Commissioner*, 30 T.C. 499 (1958) and *Collins v. Commissioner*, 56 T.C. 1074 (1971) with *Ellis v. Commissioner*, 56 T.C. 1079 (1971), *rev'd without opinion*, 478 F.2d 1404 (7th Cir. 1973). See also section III.H.7. *infra*.

33. Compare *Hotel Kingkade v. Commissioner*, 180 F.2d 310, 38 A.F.T.R. 1512 (10th Cir. 1950) with *Royal St. Louis, Inc. v. United States*, 38 A.F.T.R.2d 76-5950 (E.D. La. 1976). See generally *Salter & McGowan, Tax Treatment of Payment to Lessor in Lieu of Restoration: What Sirbo Holdings, Inc., Will Decide*, 2 J. REAL EST. TAX. 145 (1975); *Salter & McGowan, What Sirbo Holdings Decided: A Postscript*, 2 J. REAL EST. TAX. 459 (1975); see also *Kem v. Commissioner*, 432 F.2d 961, 26 A.F.T.R.2d 70-5541 (9th Cir. 1970).

of the altered property.³⁴ Treating the restoration payments as proceeds from the sale of a capital asset is the more appropriate rationale since there is no obligation to pay extra amounts unless the property itself is damaged or altered. Thus the restoration payments are in the nature of capital expenditures, not substitutes for rental income.

Although restoration payments may be treated as sale proceeds, abandonment losses do not qualify as sales or exchanges.³⁵ Similarly, purchase deposits that are forfeited prior to a closing do not represent gain or loss from the sale or exchange of a capital asset.³⁶ If the default occurs after the sale, however, and the seller reacquires the property, the gain will be capital gain from a sale or exchange.³⁷

The greatest amount of difficulty with the sale or exchange requirement exists where a transaction has some features of a sale and some attributes of another type of transfer. This especially is true when the transaction has the characteristics of a sale in addition to those of a gift, a license, a loan, or a lease, or when a transaction takes the form of either a bootstrap sale or a transfer with a lease-back. These transactions are considered below.

B. Sale or Gift

Transactions frequently embrace some characteristics of both a sale and a gift. One instance in which the Service contends that the transaction comprises a sale, and not a gift, is where the amount of the gift tax paid by the donee exceeds the donor's basis in the transferred property. In this situation the Service argues that the excess of the gift tax over basis is taxable gain when the tax is paid. The nature of the gain is characterized by the property in the

34. See *Sirbo Holdings Inc. v. Commissioner*, 476 F.2d 981, 31 A.F.T.R.2d 73-1005 (2d Cir. 1973), *aff'd*, 509 F.2d 1220, 35 A.F.T.R.2d 75-568 (2d Cir. 1975); *Billy Rose's Diamond Horseshoe, Inc. v. United States*, 448 F.2d 549, 28 A.F.T.R.2d 71-5563 (2d Cir. 1971) (rent); *Boston Fish Market Corp. v. Commissioner*, 57 T.C. 884 (1972) (sale); *Bartlett, Tax Treatment of Replacements of Leased Property and of Leasehold Improvements Made by a Lessee*, 30 TAX LAW. 105 (1976); *Salter & McGowan*, *supra* note 33 at 145, 459. Where I.R.C. § 109, which excludes from gross income the value to the lessor of improvements made by a lessee, is operative, the lessor's basis is not increased, and any gain on a sale must be increased by such improvements.

35. See *Commissioner v. Hoffman*, 117 F.2d 987, 26 A.F.T.R. 486 (2d Cir. 1941) (abandonment of real property); *Rev. Rul. 57-503*, 1957-2 C.B. 139 (abandonment of personal property). See also *Beck v. Commissioner*, 8 T.C.M. (CCH) 126 (1949); *Friedman v. Commissioner*, 2 T.C.M. (CCH) 382 (1943).

36. *United States Freight Co. v. United States*, 422 F.2d 887, 25 A.F.T.R.2d 70-670 (Ct. Cl. 1970); *Smith v. Commissioner*, 50 T.C. 273 (1968), *aff'd per curiam*, 418 F.2d 573, 24 A.F.T.R.2d 69-6020 (9th Cir. 1969).

37. *Lowe v. Commissioner*, 44 T.C. 363 (1965).

donor's hands.³⁸ A similar position is espoused by the Service where the donor mortgages the property in an amount greater than its basis, makes the transfer subject to the mortgage, and pays the gift tax with the loan proceeds. Both of these arguments are predicated on the fact that the donor has realized a cash or in-kind benefit greater than the basis of the transferred property. Both have received mixed degrees of success.³⁹ But one instance where the government's argument carries more weight arises when a donor transfers property to a trust which then sells the property to pay the gift tax. The added authority for taxing the donor in this situation is section 677, since capital gains realized by the trust are used to pay the gift tax.⁴⁰

On the whole, however, the distinctions drawn by the courts between a sale and a gift are neither satisfactory nor consistent. And, in fact, the courts have recognized the problem: "Whether a donor realizes taxable income upon payment of the resulting gift taxes by the donee or out of the transferred assets is a matter that has been the subject of a tortuous course of decision, characterized by subtleties and fine distinctions."⁴¹ For example, in the typical "net gift" transaction the donor conveys property to a trust which then must pay the gift tax. If the tax is paid, and thereafter the property is disposed of, there generally will be no income to the donor; however, if the sequence is reversed the donor very well may be found to have sold the property in part.⁴²

In *Turner v. Commissioner* the donor made nine gifts of low basis securities: three to named individuals outright and six in trust.⁴³

38. See, e.g., *Johnson v. Commissioner*, 495 F.2d 1079, 33 A.F.T.R.2d 74-1102 (6th Cir.), cert. denied, 419 U.S. 1040 (1974); *Hirst v. Commissioner*, 63 T.C. 307 (1974), aff'd, 572 F.2d 427, 41 A.F.T.R.2d 78-552 (4th Cir. 1978); *Turner v. Commissioner*, 49 T.C. 356 (1968), aff'd, 410 F.2d 752, 23 A.F.T.R.2d 69-1352 (6th Cir. 1969). See also Bacas, *Gifts of Property Subject to Indebtedness*: *Johnson v. Commissioner*, 44 GEO. WASH. L. REV. 86 (1975).

39. See generally sources cited *supra* note 38; see also *First Nat'l Indus., Inc. v. Commissioner*, 404 F.2d 1182, 23 A.F.T.R.2d 69-332 (6th Cir. 1968), cert. denied, 394 U.S. 1014 (1969); *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), aff'd *per curiam*, 469 F.2d 694, 31 A.F.T.R.2d 73-460 (5th Cir. 1972).

40. I.R.C. § 677(a) states "[t]he grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is . . . (1) distributed to the grantor or [his] spouse . . ." See, e.g., *Estate of Sheaffer v. Commissioner*, 37 T.C. 99 (1961), aff'd, 313 F.2d 738, 11 A.F.T.R.2d 839 (8th Cir.), cert. denied, 375 U.S. 818 (1963); *Estate of Staley v. Commissioner*, 47 B.T.A. 260 (1942), aff'd, 136 F.2d 368, 31 A.F.T.R. 158 (5th Cir.), cert. denied, 320 U.S. 786 (1943); cf. *Estate of Morgan v. Commissioner*, 37 T.C. 981 (1962), aff'd, 316 F.2d 238, 11 A.F.T.R.2d 1231 (6th Cir.), cert. denied, 375 U.S. 825 (1963) (not taxable to donor because donee had become personally liable).

41. *Hirst v. Commissioner*, 63 T.C. 307, 310 (1974), aff'd, 572 F.2d 427, 41 A.F.T.R.2d 78-552 (4th Cir. 1978).

42. For a discussion of this point, see *Hirst v. Commissioner*, 63 T.C. 307, 310-13 (1974), aff'd, 572 F.2d 427, 41 A.F.T.R.2d 78-552 (4th Cir. 1978). See also Bacas, *supra* note 38.

43. 49 T.C. 356 (1968), aff'd, 410 F.2d 752, 23 A.F.T.R.2d 69-1352 (6th Cir. 1969).

Each transfer required the recipient to pay the resulting gift tax. The three individual donees fulfilled their obligation with available cash or the proceeds from the sale of the securities; the six trusts obtained the funds to meet their portion of the tax by a combination of loans, current income, and the sale of some of the donated stock. The Commissioner argued that each transfer was part sale and part gift, with the excess of the gift tax paid over the donor's basis constituting capital gain to the donor. Probably because of the small amount of trust income involved, the government did not invoke section 677. The court concluded that the transfer was a net gift—the value of the shares less the gift tax—a transaction without income tax consequences to the donor.⁴⁴

However, where the transfer was structured somewhat differently, the taxpayer was found to have realized a capital gain. In *Johnson v. Commissioner*,⁴⁵ the taxpayer owned securities with a fair market value of over \$500,000 and a basis of about \$11,000. With the securities as collateral he obtained a \$200,000 nonrecourse loan and then transferred the securities to a trust. The trustees substituted their note for the donor's, still secured by the stock. The donor used about \$150,000 of the loan to pay the gift tax, leaving him with \$50,000 and no obligation on the note. The court held that the transfer was part sale and part gift, with the donor realizing a capital gain measured by the excess of the loan over his basis in the securities. The court found the crucial factor to be the absence of any obligation for the donor to use the borrowed money to pay the tax.

Similarly, in *Malone v. United States*⁴⁶ the taxpayer transferred to a trust, property in which he had a basis of \$13,650; its fair market value was approximately \$57,000, and it was subject to a \$32,000 indebtedness. The court held that the transfer was part sale and part gift because the donor received a pecuniary benefit from the assumption of the indebtedness by the trust. The gain was the excess of the debt over the basis. The court did not consider the government's contentions that gain should be recognized regardless of whether the indebtedness was assumed by the transferee.

The question of whether a transfer was a gift or a sale was also considered in *First National Industries, Inc. v. Commissioner*.⁴⁷ There the corporate taxpayer pledged stock in which it had a \$100,000 basis as collateral for a loan of \$750,000 from an unrelated

44. 49 T.C. at 363.

45. 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079, 33 A.F.T.R.2d 74-1102 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

46. 326 F. Supp. 106, 27 A.F.T.R.2d 71-1565 (N.D. Miss. 1971), *aff'd* 455 F.2d 502, 29 A.F.T.R.2d 72-501 (5th Cir. 1972).

47. 404 F.2d 1182, 23 A.F.T.R.2d 69-332 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969).

party. The amount of the loan equaled the fair market value of the shares. After securing the loan the taxpayer gave the pledged stock to its parent, a nonprofit charitable corporation. The parent, in turn, sold the stock and pledged the note that it received as security for the taxpayer's indebtedness. After a series of intercorporate transfers, the taxpayer's obligation was discharged. At no time during the year of transfer did the parent hold the transferred property free from the donor's obligation. The court ruled that the taxpayer realized a capital gain which had to be recognized in the year of the transfer because the transaction was "basically equivalent to a sale."⁴⁸

These cases indicate clearly that there are few bright lines for determining whether a transfer is a sale, a gift, or part sale and part gift. Where the transferees discharge the donor's obligation from trust income without being required to do so, or where the transferor encumbers the property without recourse prior to the conveyance and transfers it subject to that indebtedness, the courts are likely to find the transaction to be a part sale. Perhaps the only way to avoid income-producing "gifts" is to track carefully the successful taxpayers and to skirt the arrangements of the unsuccessful litigants.⁴⁹

C. Sale or License

Determining whether there has been a sale or a license of a property interest is one of the most common and important tax problems facing the parties to a transfer of rights to a patent, franchise, trademark, or trade name.⁵⁰ Where these interests are involved a license can easily be characterized as a sale, in which case the transferor ordinarily will realize capital gain or loss.⁵¹ Conversely, where the licensing agreement is too restrictive or limiting, or where the transferor has retained substantial interests in, or rights over, the transferred property, the licensor will realize ordinary income.⁵² The crux of the problem is to cut through the boilerplate complexity of the

48. 404 F.2d at 1186.

49. See also section III.E. *infra* for a discussion of the related area of bootstrap sales.

50. See, e.g., *Dairy Queen, Inc. v. Commissioner*, 250 F.2d 503, 52 A.F.T.R. 1092 (10th Cir. 1957). See generally Hall & Smith, *Franchising Under the Tax Reform Act.*, 4 IND. LEGAL F. 305 (1970).

In the case of trade secrets and secret formulae, the dividing line between a sale and a license has been drawn by some courts according to whether the buyer is restrained from disclosing the secret. See, e.g., *E.I. DuPont de Nemours & Co. v. United States*, 288 F.2d 904, 7 A.F.T.R.2d 1107 (Ct. Cl. 1961); *Graham v. United States*, 43 A.F.T.R.2d 79-1013 (N.D. Tex. 1979).

51. See Rev. Rul. 58-353, 1958-2 C.B. 408.

52. *Cory v. Commissioner*, 230 F.2d 941, 49 A.F.T.R. 379 (2d Cir.), *cert. denied*, 352 U.S. 828 (1956).

typical licensing agreement and to determine whether it conveys merely a right to use the property in question.

1. Section 1253

Congress enacted section 1253 as part of the Tax Reform Act of 1969.⁵³ This section governs the tax treatment, to both the transferor and the transferee, of amounts paid for the transfer of a trade name, trademark, franchise, or distributorship.⁵⁴ The transferor of a section 1253 asset is considered not to have sold or exchanged a capital asset if he has retained "any significant power, right, or continuing interest" over it.⁵⁵ Under section 1253(b)(2)(F) such a retained power, right, or interest encompasses the "right to payments contingent on the productivity, use, or disposition of the [trade name], if such payments constitute a substantial element under the transfer agreement." Treasury Regulation section 1.1253-2(d)(6) provides that a significant power, right, or continuing interest includes:

A right to payments contingent on the productivity, use, or disposition of the subject matter of the transferred interest where the estimated amount of such payments constitutes more than 50 percent of the total estimated amount the transferee has agreed to pay the transferor in consideration for the transfer⁵⁶

The Regulations further elaborate upon the definition of a "significant power, right or continuing interest" by explaining that the phrase includes the right to participate in the transferee's advertising activities. However, the enumeration of "significant rights" contained in section 1253(b)(2), and the more extensive list set forth in Treasury Regulation section 1.1253-2(d), is not exclusive.⁵⁷

Where the transferor has retained a "significant right or continuing interest" in the trade name, all contingent payments made by the transferee may be deducted under section 162(a) as ordinary and necessary business expenses.⁵⁸ The Regulations define "contingent payments" to include "continuing payments, other than installment payments of a principal sum agreed upon in the transfer agreement, measured by a percentage of the selling price

53. Pub. L. No. 91-172, 83 Stat. 487 (1969).

54. See generally Hall, *Tax Aspects of Franchising Operations*, in TULANE UNIVERSITY SCHOOL OF LAW TWENTIETH ANNUAL TAX INSTITUTE 102 (H. Fuller ed. 1971); Comment, *The Dairy Queen Cases: A Suggested Approach to the Taxation of Franchise Sales*, 34 U. CHI. L. REV. 884 (1967) [hereinafter cited as *Taxation of Franchise Sales*].

55. I.R.C. § 1253(a).

56. (1971).

57. See S. REP. NO. 91-552, 91st Cong., 1st Sess. 209, 210 reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2027, 2244. See generally Reich, *A Planning Guide to Franchise Transfers in Light of Treasury's Proposed Regs.*, 36 J. TAX. 232 (1972).

58. I.R.C. § 1253(d)(1).

of the products marketed, or based on the units . . . sold"⁵⁹ Conversely, the licensor will realize a capital gain or loss where the only right retained is to contingent payments where they are not a "substantial element" of the total estimated payments.⁶⁰ To be less than a substantial part of the estimated consideration, the contingent payments must be expected to be fifty percent or less of the total payments.⁶¹

The legislative history of section 1253 indicates that, contrary to prior law, the transferred asset need not have a reasonably ascertainable useful life in the transferee's hands in order to be deductible.⁶² Moreover, section 1253 explicitly provides that even where a principal sum is stated in the agreement and is to be paid in installments, the payments are deductible by the transferee in accordance with the rules of that section; provided, of course, there has not been a sale or exchange (*i.e.*, a significant power has been retained).⁶³ Thus, section 1253 allows payments made for the outright acquisition of a trade name to be deductible. Additionally, Senate Report 91-552 makes it clear that the transferee should be given the benefit of any doubt as to the deductibility of royalty payments.⁶⁴

Section 1253 does not provide a statutory calculus of factors, any given number of which will transform a license into a sale. Instead, all the circumstances surrounding the transfer must be considered, and almost any single factor could be determinative in a given situation.⁶⁵ The more rights that are retained by the licensor, the greater the tendency to cast the agreement as a license.

2. Section 1235

Many of the elements used to characterize trade name and franchise transfers also are used to determine whether a patent license

59. Treas. Reg. § 1.1253-2(e) (1971).

60. *Id.*

61. *See id.* § 1.1253-2(d) (6).

62. S. REP. No. 91-552, *supra* note 57, at 208, 210. *Cf. Dunn v. United States*, 400 F.2d 679, 22 A.F.T.R.2d 5653 (10th Cir. 1968) (holding that no deductions could be taken because the asset transferred had no reasonably ascertainable useful life); *Graham v. United States*, 43 A.F.T.R.2d 79-1013 (N.D. Tex. 1979) (the sale of the secret formula for "liquid paper" to a § 1239 corporation did not preclude capital gains treatment because the formula had no ascertainable useful life and was, therefore, not property subject to the allowance for depreciation).

63. I.R.C. § 1253(d)(2); *see* Treas. Reg. § 1.1253-1(c)(3) (1971).

64. S. REP. No. 91-552, *supra* note 57. *See also*, J. BISCHER, *TAXATION OF PATENTS, TRADE-MARKS, COPYRIGHTS, AND KNOW-HOW* 5-8, 5-9 (1974).

65. *See* Treas. Reg. § 1.1253-2(d) (1971). *See also* Hall, *supra* note 54; *Taxation of Franchise Sales*, *supra* note 54.

is a sale.⁶⁶ License agreements frequently are used in conjunction with contingent payments to transfer patents. Often licenses are chosen because they allow the value of the patent to be measured by appropriate devices, such as use, sales, production, or some other similar standard.⁶⁷

A patent holder will realize capital gain only on the transfer of an undivided interest in or "all substantial rights" to a patent.⁶⁸ A patent license may be exclusive, nonexclusive, sole, or subject to particular restrictions such as geographic, field of use, or time. An exclusive license—one limited only to the country of the patent grant—ordinarily will be characterized as a sale.⁶⁹ The transfer of less inclusive interests may raise questions of whether "all substantial rights" have been transferred.⁷⁰ The Regulations state that the licensor may retain legal title to assure payment or performance.⁷¹ Moreover, he may reserve a security interest, a right of forfeiture upon nonperformance, or any right which is "not inconsistent with the passage of ownership."⁷² Retention of prohibitions on sub-licensing, assignment, use, or sale may help to characterize the transfer as either a sale or a license.⁷³

The Regulations provide that a license does not grant "all substantial rights" to a patent. Therefore, a transaction will constitute a license, and not a sale, when the transfer is limited either geographically within the country of issuance or for a period less than

66. See generally Hagen, *Are Capital Gains Still Available Via Patent Fragmentation? A Current Analysis*, 43 J. TAX. 78 (1975); Morreale, *Patents, Know-How and Trademarks: A Tax Overview*, 29 TAX LAW. 553 (1976).

67. See *Part One*, *supra* note 2, section I.D.; I.R.C. § 1235(a)(1), (2); S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954). See also Rogers, *Transfer of Patent Rights*, 61 A.B.A.J. 374 (1975).

68. I.R.C. § 1235(a); see Treas. Reg. § 1.1235-1(a), (b) (1957).

69. See *Busse v. United States*, 543 F.2d 1321, 38 A.F.T.R.2d 76-5984 (Ct. Cl. 1976); *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); *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); *Mros v. Commissioner*, 30 T.C.M. (CCH) 519 (1971), *rev'd*, 493 F.2d 813, 33 A.F.T.R.2d 74-996 (9th Cir. 1974); S. REP. NO. 1622, *supra* note 67, at 438.

70. See generally *Part One*, *supra* note 2, section I.D.; see also *Blake v. Commissioner*, 67 T.C. 7 (1976) and the discussion of the cases therein.

71. Treas. Reg. § 1.1235-2(b)(2)(i) (1957).

72. *Id.* § 1.1235-2(b)(2)(ii); *cf. id.* § 1.1235-1(b) (If a transfer is not one described in § 1235(a), then § 1235 has no applicability in determining whether the transfer is the sale or exchange of a capital asset. Thus, a transfer by a person who is not a patent holder, or by a holder to a related party, is not covered by § 1235.). See also *Part One*, *supra* note 2, section I.D.; *Blake v. Commissioner*, 67 T.C. 7 (1976).

Naturally, the rationale behind allowing the holder to retain such rights is to assure that the patent will be utilized. See S. REP. NO. 1622, *supra* note 67, which refers to the holder's "monopoly rights evidenced by a patent."

73. *Blake v. Commissioner*, 67 T.C. 7 (1976); see Treas. Reg. § 1.1235-2(b)(3) (1957). See generally Hagen, *supra* note 66.

the duration of its remaining life.⁷⁴ Similarly, a license exists where the grant conveys less than all rights under a field of use agreement or fewer than all the claims covered by the patent.⁷⁵ Where the licensor has the right to terminate the agreement at will, the Regulations accordingly provide that no sale has occurred. These restrictions are considered to be inconsistent with the grant of an undivided interest in a patent.⁷⁶

Despite the position of the Regulations, the courts have not been uniform in sustaining their validity and have not given retained rights the same weight as has the Service.⁷⁷ So long as the interest retained by the licensor has any significant value at the time of the agreement, the courts probably will uphold the government's position that geographic or field of use restrictions transfer merely a right to use the patent.⁷⁸

D. Sale or Loan

Just as a purported sale may be determined to be a gift, a license, or a lease, a transfer may be a sale in form but a loan in substance.⁷⁹ Generally, loan proceeds, as distinguished from sale proceeds, are not taxed.⁸⁰ A sale where the transferor retains the right to reacquire the property may be treated as a secured loan and therefore not as a taxable disposition. Frequently this may occur in connection with a refinancing of property. For example, in *Blake v. Commissioner*⁸¹ the taxpayer prevented a mortgage foreclosure by transferring the

74. Treas. Reg. § 1.1235-2(b)(1)(i), (ii) (1957).

75. *Id.* § 1.1235-2(b)(1)(iii), (iv); *cf.* *Blake v. Commissioner*, 67 T.C. 7 (1976) (the court found that one field of use grant satisfied § 1235, but that another did not meet its terms).

76. Treas. Reg. § 1.1235-2(b)(4) (1957). Where the patent holder has retained such a right, it cannot be argued realistically that "all substantial rights to a patent . . . which are of value at the time [of the transfer]" have been conveyed. *Id.* § 1.1235-2(b)(1). The retention of such a right is inconsistent with the transfer of the holder's "monopoly" rights to the patent.

77. See *Blake v. Commissioner*, 67 T.C. 7 (1976), and the decisions discussed therein. Generally, the Tax Court has been more liberal in its interpretation of § 1235 than have other courts.

78. See, e.g., *Blake v. Commissioner*, 67 T.C. 7 (1976). There has been much discussion in the cases as to what constitutes "value," and whether § 1235 can be satisfied where such rights may be held by other than the grantor of the patent rights. *Cf.* *Mros v. Commissioner*, 493 F.2d 813, 816, 33 A.F.T.R.2d 74-996 (9th Cir. 1974) ("known value"); *Fawick v. Commissioner*, 436 F.2d 655, 663, 27 A.F.T.R.2d 71-381 (6th Cir. 1971) ("substantial value"), *E. I. duPont de Nemours & Co. v. United States*, 432 F.2d 1052, 1055, 26 A.F.T.R.2d 70-5636 (3d Cir. 1970) ("substantial value"); *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004, 1015, 20 A.F.T.R.2d 5153 (Ct. Cl. 1967) ("little tangible value").

79. See generally 3B J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 22.93 at 652 (J. Malone ed. 1973).

80. *But see Johnson v. Commissioner*, 495 F.2d 1079, 33 A.F.T.R.2d 74-1102 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974) (loan proceeds were used to pay the donor's gift tax when he transferred the property).

81. 8 T.C. 546 (1947).

mortgaged property to the mortgagee. The transferor retained an option to reacquire the property by paying an amount roughly equal to the unpaid balance of the purchase price. The court determined that the transfer was, in fact, a loan intended to give the mortgagor additional time to satisfy the obligation and to eliminate the complications of foreclosure if he did not meet its terms. Consequently, there was no taxable event. Where the repurchase option is not subject to the transferor's control, however, a court very well might find an executed sale.⁸² Similarly, where the taxpayer received advance payments from the transferee, the facts may indicate either a sale or a loan. The substance, and not the form, of the transfer will control the tax consequences. Thus, in *United States v. Ivey*,⁸³ payments from a selling agent to a cotton farmer were held to be loans in the year received despite the taxpayer's evidence that he actually thought a sale had occurred. The court found that the terms of the brokerage agreement indicated a loan, the proceeds of which were not taxable at the time of receipt.

E. Bootstrap Sales

The typical bootstrap sale attempts to convert ordinary business income into capital gain by having the purchase price payable out of the operating profits of the business. The transaction may take a variety of forms,⁸⁴ but generally proceeds as follows: A sells an incorporated business to B, with or without a small down payment. B agrees to pay the balance of the purchase price solely out of profits to be generated by the business. Thereafter, B liquidates the corporation and leases the business assets to C, a corporation newly formed to operate the business. A, the collective shareholders of the original business, manages the operation for C. A, in fact, may own a substantial minority interest in C. Approximately eighty percent of C's business profits are paid as rent to B, who remits ninety

82. Resthaven Memorial Cemetery, Inc. v. Commissioner, 43 B.T.A. 683 (1941).

83. 414 F.2d 199, 24 A.F.T.R.2d 69-5322 (5th Cir. 1969); see *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 23 A.F.T.R. 778 (1939) (finding the "owner-lessor" to be a mortgagee); 124 Front St. Inc. v. Commissioner, 65 T.C. 6 (1975), *nonacq.* 1976-2 C.B. 3; *Frenzel v. Commissioner*, 22 T.C.M. (CCH) 1391 (1963). See also *Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance*, 26 RUTGERS L. REV. 1 (1972); *Marcus, Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL EST. L.J. 664 (1974).

84. See, e.g., *Commissioner v. Brown*, 380 U.S. 563, 15 A.F.T.R.2d 790 (1965); *University Hill Foundation v. Commissioner*, 446 F.2d 701, 27 A.F.T.R.2d 71-1419 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972); *Allen v. Commissioner*, 34 T.C.M. (CCH) 242 (1975). See also B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.07 at 7-38 (3d ed. 1971); *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); *Llewellyn, Lewis, & Majors, Sale of a Close Corporate Business: A Transactional Approach*, 49 TEMP. L.Q. 43, 56-59 (1975); *Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295 (1962).

percent of those receipts to *A* until the purchase price is paid. *B* has no obligation to pay *A* out of any funds other than the rent paid by *C*.

Prior to 1969, the bootstrap sale was an attractive device by which *A* could sell a business to *B*, a tax-exempt organization, and have the purchase price paid out of business profits. Before enactment of the debt-financed property provisions in 1969,⁸⁵ some exempt organizations were taxable on rental income from real property to the extent the property was acquired with borrowed money. There was an exception, however, for rental income from a lease of five years or less,⁸⁶ and there was some uncertainty as to whether the tax applied to income from a tax-exempt organization's leasing of assets which constituted a going business.⁸⁷

In 1969, Congress amended the Code to provide that all exempt organizations' income from "debt-financed" property, which is unrelated to their exempt functions, is subject to tax in the proportion to which the property is financed by the debt.⁸⁸ As a result, the bootstrap sale is now less attractive, though it still retains some of its former utility.

The bootstrap sale presents two major problems with respect to capital gain. First, the Service probably will contend that the transaction really is a loan from *A* to *B* and, also, that the proceeds of the "sale" are substitutes for *A*'s ordinary business profits. Essentially, the argument posits that *A* has retained an income interest in the transferred business equal to the amount of the sales price.⁸⁹ Therefore, the government sees the transaction not as one involving a disposition of property that is a capital asset, but rather as a loan to be repaid exclusively from ordinary income.

The second problem arises when the purported sales price is uncertain or not a close approximation of the business's fair market value. Here, the Service may attempt to restructure the transaction as part loan, part gift, with the retention of an income interest equal to the sales price that is eventually determined.⁹⁰ These arguments generally are accompanied by the subsidiary contention that the

85. I.R.C. § 514.

86. Rev. Rul. 54-420, 1954-2 C.B. 128.

87. See *Allen v. Commissioner*, 34 T.C.M. (CCH) 242 (1975); S. REP. No. 91-552, *supra* note 57.

88. I.R.C. § 514(a), *as amended* by Pub. L. No. 91-172, § 121(d)(1), 83 Stat. 487 (1969).

89. See *Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654, 9 A.F.T.R.2d 1389 (10th Cir. 1962); *Ayrton Metal Co. v. Commissioner*, 299 F.2d 741, 9 A.F.T.R.2d 606 (2d Cir. 1962); *Allen v. Commissioner*, 34 T.C.M. (CCH) 242 (1975); Rev. Rul. 66-153, 1966-1 C.B.

187. See generally *Joyce & Del Cotto*, *supra* note 84; see also *Lazarus v. Commissioner*, 513 F.2d 824, 35 A.F.T.R.2d 75-1191 (9th Cir. 1975).

90. See sources collected in *Allen v. Commissioner*, 34 T.C.M. (CCH) 242 (1975).

whole transaction merely is a substitute for future ordinary income.⁹¹

F. Sale or Lease

There are a variety of ways in which a lease can be an efficacious means of effecting a sale. But since the tax consequences will vary greatly depending upon the existence of a sale or a lease, it is imperative to determine the point at which today's lease shades into tomorrow's equity.⁹² In general, the courts have employed two interconnected tests to distinguish leases from sales: the first examines the economic reality of the transaction, the second searches for an intent to purchase. If the transaction is found to be a sale under either of these tests, it is classified as a sale for all purposes involved here.

The cases and rulings have been concerned primarily with the situation in which the lessee has an option to acquire title to the leased property. The courts are careful to examine the transaction, especially when it occurs in a business setting, to see if it really is a covert attempt to convert a capital acquisition into a series of fully deductible rental payments. Where the sum of the rents plus the acquisition price equals the deferred purchase price of the property, including an interest component, the transaction almost invariably will be categorized as a conditional sale. Although other factors enter into the evidentiary calculus, where "the payments on the substituted basis of rent would produce for the lessor the equivalent of [the] normal sales price plus interest,"⁹³ the "lease" will be treated as a sale.

For instance, in *Estate of Starr v. Commissioner*, the taxpayer had an option to renew a lease on a sprinkler system which had been installed in his plant.⁹⁴ The original term of the lease was five years, with annual rent of \$1,240; the renewal term was identical, but the rent was reduced to thirty-two dollars annually. The contract was silent on the system's ownership after the two terms, but provided that the lessor had six months after the expiration of the first term to remove the system in the event that the lessee chose not to extend the lease. The taxpayer deducted the "rent" as an ordinary and necessary business expense.

Because the Commissioner thought the transaction was actually

91. See, e.g., *id.* at 261-63.

92. See *Estate of Starr v. Commissioner*, 274 F.2d 294, 294, 5 A.F.T.R.2d 572 (9th Cir. 1959) ("Yesterday's equities in personal property . . . have become today's leases.").

93. *Id.* at 296.

94. 274 F.2d 294, 5 A.F.T.R.2d 572 (9th Cir. 1959), *rev'g* 30 T.C. 856 (1958).

a sale, he allowed a deduction for depreciation, but not for rent. The Tax Court sustained the Commissioner's disallowance of the rent deductions on the ground that the rent was a capital expenditure.⁹⁵ On appeal the Ninth Circuit affirmed the Tax Court's finding that the lease actually was a sale, but reversed and remanded the decision to grant the taxpayer an interest, as well as a depreciation deduction. The court disregarded the form of the transaction because "the foreordained practical effect of the rent [was] to produce title eventually, [and therefore,] the rental agreement can be treated as a sale."⁹⁶ The appellate court simply found the entire lease to be incredible and was influenced strongly by the evidence that the lessor never, in fact, reclaimed any of its systems installed for other taxpayers. Moreover, they found the following to be decisive: (1) the rent essentially equaled the sales price of the system plus interest on the deferred payments; (2) the value of the leased property to the lessor was negligible at the expiration of the lease; and, (3) there was no reference to the property's disposition at the end of the second lease term.⁹⁷

In evaluating whether a purported lease in fact is a sale, the following elements are given varying degrees of consideration:⁹⁸

(1) Rent plus deferred acquisition price equaled the normal sales price of the property, plus interest on the deferred payout period;

(2) The lessee could acquire the property at the termination of the lease for a nominal amount;

(3) The value and/or useful life of the leased property to the lessor at the expiration of the lease term, including renewal periods, was negligible;

(4) The permanency of the leased item coupled with the uncertainty that the lessor would act to reacquire the property upon the failure of the lessee to acquire it;

95. 30 T.C. at 864.

96. 274 F.2d at 295; *cf.* *Kingsbury v. Commissioner*, 65 T.C. 1068, 1084-85 n.9 (1976), *acq.* 1975-2 C.B. 2 (lump-sum payment for the exchange of rights under an operating agreement was not a loan, but rather partial payment for the transfer of the rights in question, albeit one arranged to avoid scrutiny by local officials).

97. 274 F.2d at 296; *cf.* *Oesterreich v. Commissioner*, 226 F.2d 798, 48 A.F.T.R. 335 (9th Cir. 1955) (nominal option price held to classify "lease" as a sale); Rev. Rul. 75-563, 1975-2 C.B. 199 (an "irrevocable written option," granting immediate possession, unrestricted use, and title acquisition upon payment, constituted a sale for purposes of § 483); Rev. Rul. 57-371, 1957-2 C.B. 214 (lease of sprinkler system held to be a sale); Rev. Rul. 55-25, 1955-1 C.B. 283 (Lessee could acquire title to leased property by paying an amount which equaled the lessor's purchase price plus incremental costs, including interest. Risks of ownership were on the lessee. Rental deduction disallowed.).

98. See *Estate of Starr v. Commissioner*, 274 F.2d 294, 5 A.F.T.R.2d 572 (9th Cir. 1959); sources cited *supra* note 97.

- (5) Rents paid being credited against the purchase price as computed under the applicable formula;
- (6) Absence of any reference to the disposition of the property in the event that the lessee did not purchase it;
- (7) Certainty that the lessee would acquire the property, especially where the lessee has improved the property, etc.;
- (8) Whether the rent was in excess of the fair rental value of the property at the time that the lease was executed;
- (9) Whether the lessor actually owned the property prior to the arrangement under which it was leased to the lessee, or whether the lessor was acquiring equity in the property contemporaneously with the lessee's payments;
- (10) Obligation that the lessee maintain insurance on the property equal to the outstanding rent plus the amount necessary to acquire the property;
- (11) An uneven schedule of rental payments;
- (12) Financial ability of the lessee to have acquired the property at the commencement of the lease term;
- (13) The presence of benefits to the lessor other than tax benefits, and the presence of a tax indemnity clause;
- (14) Relationship of rental payments to acquisition cost and to fair rental value;
- (15) Risk of loss provisions, assignment of warranty provisions to the lessee;
- (16) Ability of the lessee to acquire the property at any time other than upon the termination of the lease, and the terms upon which this could occur;
- (17) Whether the fair market value of the property at the time it could be acquired was arrived at by reference to the manufacturer's sale of similar used property.

The cases frequently stress the fact that the terms of the particular contract obligate the lessee to pay rent substantially equal to the value of the property and give it the option to acquire ownership subsequent to the payment of these amounts. In some cases the option price is nominal, and in others it approximates the fair market value of the property at the time the option may be exercised. In the former instance, the lease is certainly a sale; in the latter, it very well may be found to be a sale depending upon the aggregate weight given to the various factors listed above. For example, in *Northwest Acceptance Corp. v. Commissioner*,⁹⁹ the court sustained the taxpayers' contentions that certain transactions constituted

99. 58 T.C. 836 (1972), *aff'd per curiam*, 500 F.2d 1222, 34 A.F.T.R.2d 74-5600 (9th Cir. 1974).

leases rather than conditional sales. The particular contracts in question contained many of the provisions generally thought to indicate the presence of a sale, including third party guarantees of the lessee's rental obligation and of any options exercised, as well as myriad clauses designed to minimize the lessor's risk of loss. Nevertheless, the court found that the facts did not lead to the conclusion that the transactions were sales. The guarantees did not obligate the lessees to purchase the equipment, nor was the lessor bound to sell it. Instead, the court reasoned, the lessor attempted to minimize all risks and efforts on its part, including the downside risk of a deflated residuary value.¹⁰⁰ The *Northwest Acceptance* court was impressed by the fact that the lessor had entered into a large number of equipment sales and rentals but had always differentiated between the two types of transactions. Even where the contract was designated a "lease," the lessor treated it as a sale if it in fact was a conditional sale. Consequently, the facts and circumstances did not evidence an intention to effectuate a sale at the time the lease was executed.¹⁰¹

Similarly, in *Western Contracting Corp. v. Commissioner*,¹⁰² the taxpayer actually paid a substantial amount to acquire the property at the termination of the lease. Upon entering into the lease, the lessee had no ability under the contract to acquire the property. In addition, the evidence showed that the taxpayer was unable financially to have acquired the property at the time it entered into the lease. Accordingly, the court determined that the transaction was a bona fide lease, not a conditional sales contract. The court further stated that an intention to acquire the lease property at the time the parties entered into the contract would be decisive in categorizing the contract as a sale rather than as a lease.

In *LTV Corp. v. Commissioner* the Tax Court held that the transaction was a bona fide lease of an IBM computer.¹⁰³ The court emphasized that the acquisition price was based on the charge the manufacturer would require for the purchase of a similarly used computer. Moreover, the court found that it was reasonable to require the lessee to insure the equipment for the amount of the outstanding rent plus the amount necessary to exercise the option.¹⁰⁴

100. 58 T.C. at 848. See also *Lockhart Leasing Co. v. Commissioner*, 54 T.C. 301 (1970), *aff'd*, 446 F.2d 269, 27 A.F.T.R.2d 71-1508 (10th Cir. 1971).

101. Cf. *American Realty Trust v. United States*, 498 F.2d 1194, 34 A.F.T.R.2d 74-5308 (4th Cir. 1974) (jury verdict finding an intention to effectuate a "good faith" sale and lease-back, but not a tax avoidance "financial arrangement," upheld as not clearly erroneous); *Breece Veneer & Panel Co. v. Commissioner*, 232 F.2d 319, 49 A.F.T.R. 895 (7th Cir. 1956) (the "economic reality" did not evince an intention to sell the property).

102. 271 F.2d 694, 4 A.F.T.R.2d 5753 (8th Cir. 1959).

103. 63 T.C. 39, 49-50 (1974).

104. *Id.* at 50.

The facts provided an advantageous setting for the taxpayer's contentions that a lease, not a conditional sale, existed: the rentals were reasonable in relation to the fair rental value of the computer, the option was exercisable only at full market value at the expiration of the lease, and the lessee used the equipment extensively in its business. Furthermore, owing to computerware's characteristic of rapid obsolescence, the court readily accepted the taxpayer's contention that renting the computer was a better business decision than outright acquisition would have been. Finally, the taxpayer indicated that the terms of the lease with the lessor, who was not the manufacturer, were more beneficial than those which it could have received from IBM. The lessor charged the lessee according to time period, while the manufacturer would have extracted a fee based entirely on usage. Since the computer was to be in continual use, the latter terms would have cost the taxpayer substantially more than the former.

The *LTV* court relied heavily upon *Northwest Acceptance and Lockhart Leasing v. Commissioner*,¹⁰⁵ but in doing so rejected the distinction proposed by the taxpayer between the tax treatment accorded to "commercial" vis-a-vis "financing" leases.¹⁰⁶ It did acknowledge, however, that the latter sort of contract might be more easily classified as a conditional sale since it frequently would lack economic substance.¹⁰⁷

The question of whether a transaction is a lease or a sale is one with which the courts and the Service have had a great deal of experience. As a result, they have established a fairly comprehensive list of factors to distinguish equity payments from rent payments.¹⁰⁸

105. 54 T.C. 301 (1970), *aff'd*, 446 F.2d 269, 27 A.F.T.R.2d 71-1508 (10th Cir. 1971).

106. 63 T.C. at 51.

107. *Cf. Frank Lyon Co. v. United States*, 435 U.S. 561, 41 A.F.T.R.2d 78-1142 (1978) (lessor in a sale-and-leaseback transaction was allowed deductions for depreciation and interest).

It should be noted that the aforementioned decisions represent a substantial deviation from the guidelines announced in Rev. Proc. 75-21, 1975-1 C.B. 715, *as clarified* by Rev. Proc. 75-28, 1975-1 C.B. 752. In attempting to have a contract's self-classification as a lease sustained, however, its utility is questionable. The Procedure itself states that it is not intended to "define, as a matter of law, whether a transaction is or is not a lease for Federal income tax purposes" *Id.* It seldom has been referred to by the courts; *see, e.g.*, *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 38 A.F.T.R.2d 76-6164 (9th Cir. 1976). Further, in *Frank Lyon Co.*, 435 U.S. at 579 n.14, the Supreme Court stated that "[t]hese guidelines are not intended to be definitive, and it is not clear that they provide much guidance in assessing real estate transactions." *See Rosenberg & Weinstein, Sales-Leasebacks: An Analysis of These Transactions After the Lyon Decision*, 45 J. TAX. 146 (1976). *See generally* Gallagher, *Shifting Professional Service Income Within the Family*, 1 REV. TAX. INDIVIDUALS 237 (1977); Gallagher, *The Short-Term Trust as an Income-Shifting Device*, 1 REV. TAX. INDIVIDUALS 343 (1977).

108. *See* text accompanying note 98 *supra*. *See also* *Kingsbury v. Commissioner*, 65 T.C.

G. Transfers and Leasebacks

A transfer and leaseback may be arranged in a variety of ways, each structured to meet the needs and expectations of the parties.¹⁰⁹ The basic pattern, however, remains the same: A transfers property to B, and B, in turn, leases it back to A. The transfer from A to B could be a sale, a gift, or a security device, depending upon the intentions of the parties and the relevant circumstances.¹¹⁰ Naturally the tax results that flow from the transaction will be contingent on the character of the transfer itself.

Whether a transfer and leaseback amounts to a sale or exchange necessitates a close examination of all the surrounding facts and circumstances, including the alternative possibilities that the transfer is a gift, a lease, or a loan. Many of the factors used to distinguish a sale from the latter transfers are also used to determine the character of the transfer and leaseback arrangement. The leaseback, however, frequently requires an examination of some facts not discussed previously in relation to gifts, leases, and loans. Moreover, the determination of whether a sale has taken place will link various factors together in novel combinations which often are as subtle as the transaction under examination.¹¹¹

In *Frank Lyon Co. v. United States*,¹¹² the Court was faced with the question of who was the owner of a building, for purposes of taking depreciation and interest deductions, where the property was transferred from a bank (A) to the taxpayer (B) and then leased back to A under a long-term lease. A wanted to construct a bank building on newly acquired land. It drew up the plans, entered into construction contracts, and anticipated financing the structure it-

1068, 1087 (1976), *acq.* 1976-2 C.B. 2 (court discussed the application of I.R.C. § 1241, after the interest involved was determined to be "property" which could give rise to capital gain through the application of § 1231); I.R.C. § 1241 ("Amounts received by a lessee for the cancellation of a lease . . . shall be considered as amounts received in exchange for such lease . . .").

109. See generally Fox & Halperin, *Tax Considerations in Refinancing Real Estate: The Wrap-Around Mortgage and the Sale and Lease-Back*, 1 J. REAL EST. TAX. 17 (1973); Marcus, *supra* note 83; Mihlbaugh, *Sale-Leaseback Financing*, 36 OHIO B. 253 (1963); 42 NOTRE DAME LAW. 557 (1967).

110. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 41 A.F.T.R.2d 78-1142 (1978); *cf.* *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 23 A.F.T.R. 778 (1939) (owner-lessor was mortgagee). See generally Joyce & Del Cotto, *supra* note 84; Marcus, *supra* note 83; Tuggle, *Sale-and-Leaseback v. Mortgaging of Property: Tax Analysis of User's Position*, 8 TAX. FOR ACC'TS 260 (1972).

111. See Joyce & Del Cotto, *supra* note 84; *cf.* Rollyson, *Eighth Circuit Strikes Down Sale-Leaseback; Strikes Out on Judicial Reasoning*, 4 J. REAL EST. TAX. 85 (1976) (criticizing the Eighth Circuit in *Frank Lyon Co. v. United States*, 536 F.2d 746, 38 A.F.T.R.2d 76-5060 (8th Cir. 1976), *rev'd*, 435 U.S. 561, 41 A.F.T.R.2d 78-1142 (1978)).

112. 435 U.S. 561, 41 A.F.T.R.2d 78-1142 (1978), *rev'g* 536 F.2d 746, 38 A.F.T.R.2d 76-5060 (8th Cir. 1976).

self. However, banking regulations prevented *A* from carrying such an expensive asset on its books. Eventually, *A* entered into an arm's length agreement with *B* pursuant to which *B* would supply \$500,000 of the \$7.5 million needed for the construction. The balance of the financing had been secured in advance by *A* from an institutional investor. *A* sold the building to *B* and leased it back for a primary term of twenty-five years with renewal options that could extend the term for another forty years. *A* retained the option to repurchase the structure at designated times and for specified prices. *B*'s \$500,000 investment was to bear six percent interest. All rights and interests were assigned to the mortgage. *A*'s annual rent for the primary lease period equaled the exact amount necessary to amortize completely the institutional mortgage. If *A* exercised its repurchase option prior to the end of the mortgage term, it was to assume the unpaid balance and pay *B* an amount exactly equal to *B*'s investment, compounded at six percent per annum.

The United States Court of Appeals for the Eighth Circuit, reversing the district court,¹¹³ found that *A* (the bank) was the owner of the building, and that *B* (the taxpayer) in effect merely loaned *A* the \$500,000.¹¹⁴ In arriving at this conclusion the court stated that *B* entered the transaction simply for the tax benefits,¹¹⁵ and that the arrangement was without economic substance notwithstanding that the parties *intended* a sale and a lease and labeled the documents accordingly.¹¹⁶ Moreover, the court noted the following seven factors which decisively influenced its determination:¹¹⁷

(1) Lessee (*A*) retained tax benefits of investment credit and deduction for sales tax paid on materials purchased by the lessor for the building's construction;

(2) Lease restricted the lessor's (*B*) right to profit from a transfer of the property by giving lessee (*A*) the right to purchase in the event of a transfer of the ownership of the lessor company;

(3) Appreciation realized as the result of the destruction or con-

113. *Frank Lyon Co. v. United States*, 36 A.F.T.R.2d 75-5154 (E.D. Ark. 1975), *rev'd*, 536 F.2d 746, 38 A.F.T.R.2d 76-5060 (8th Cir. 1976), *rev'd*, 435 U.S. 561, 41 A.F.T.R.2d 78-1142 (1978).

114. *See* 536 F.2d at 754.

115. *Id.* at 753; *cf.* *Commissioner v. Lester*, 366 U.S. 299, 306, 7 A.F.T.R.2d 1445 (1961) ("parties may for tax purposes act as their best interests dictate").

116. 536 F.2d at 751. For decisions indicating that the parties' intention upon entering the agreement must be given due consideration, *see generally* *Leslie Co. v. Commissioner*, 539 F.2d 943, 38 A.F.T.R.2d 76-5458 (3rd Cir. 1976); *American Realty Trust v. United States*, 498 F.2d 1194, 34 A.F.T.R.2d 74-5308 (4th Cir. 1974); *American Nat'l Bank v. United States*, 421 F.2d 442, 25 A.F.T.R.2d 70-482 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); *Western Contracting Corp. v. Commissioner*, 271 F.2d 694, 4 A.F.T.R.2d 5753 (8th Cir. 1959); *Oesterreich v. Commissioner*, 226 F.2d 798, 48 A.F.T.R. 335 (9th Cir. 1955).

117. 536 F.2d at 752-53. *See also* *Rosenberg & Weinstein*, *supra* note 107.

demnation of the building accrued to the lessee;

(4) Purchase-option price was geared to the unpaid mortgage balance plus the lessor's initial investment plus six percent compound interest—no provision was made for an appraised value, and neither appreciation nor inflation was taken into account;

(5) Final option price equaled the lessor's initial investment, compounded at six percent—the present value of the future net rentals, discounted at six percent, equaled the lessor's investment;

(6) Lessee retained effective control of the disposition of the building through its purchase options for sixty-five years and its ownership of the land thereafter;

(7) During the first twenty-five years of the lease the lessee had all ownership risks, while the lessor merely served as a conduit for the mortgage payments.

The court, relying heavily on the factually similar *Helvering v. F. & R. Lazarus & Co.*,¹¹⁸ concluded that the benefits, risks, and burdens assumed or incurred by the taxpayer were too insubstantial to establish its ownership of the building. However, it expressly discounted any implication that the bank was the owner of the leased property (though it did find that the bank was the real party in interest). In addition, the court reasoned that the taxpayer merely served as a conduit for the bank's mortgage payment to the institutional lender.¹¹⁹ As a result of these conclusions, there could have been no sale of the property from the bank to the taxpayer, and the taxpayer was not allowed to take the interest and depreciation deductions.

The Supreme Court granted taxpayer's petition for a writ of certiorari and reversed the Eighth Circuit.¹²⁰ The Court initially noted its adherence to substance over form: "taxation is not so much concerned with the refinements of title as it is with actual command over the property"¹²¹ Because Lyon was solely liable on the notes, Lyon should receive the deductions. Significantly, the Court distinguished *Lazarus* on the basis that in that case only two parties were involved in the transaction.¹²² Here, however, there were three parties: Lyon, the bank, and independent investors interested in the transaction who would have entered the arrangement if Lyon had not. This addition to the economics of the circumstances was sufficient to remove *Lazarus* as controlling authority.

The Court recognized that the position taken by the government

118. 308 U.S. 252, 23 A.F.T.R. 778 (1939).

119. 536 F.2d at 754.

120. 435 U.S. 561.

121. *Id.* at 572.

122. *Id.* at 575.

and the Eighth Circuit—that the bank should be regarded as the true owner of the building and nothing more than the recipient of a \$500,000 loan—was “not without superficial appeal.”¹²³ It felt, however, that neither of the parties was the owner “in any simple sense.” In justification of its decision that Lyon was entitled to the deductions, the Court compiled an exhaustive list of factors indicating that the taxpayer had “actual command” over the property and that the transaction was not merely a tax avoidance sham. Some of the more important of these factors included:¹²⁴ Lyon’s sole liability on successive notes to two different financial institutions; Lyon’s independence from the bank, and Lyon’s “substantiality,” meaning its separate, significant position in the business world; the bank’s inability, because of legal restrictions, to secure conventional funding; the requirement by the federal regulator that an independent third party own the building; the presence of numerous financial institutions interested in the transaction, as well as the submission of formal proposals by several of them; the fact that Lyon’s ordinary business was unconcerned with financing; the three-party aspect of the circumstances mentioned above (the distinguishing factor from *Lazarus*); the absence of agreement between Lyon and the bank that the bank would exercise its purchase options; and the “inescapable fact” that Lyon definitely would be the owner of the building if the building lease were not extended.

In conclusion, the Court stated that genuine, multi-party transactions of economic substance, which are compelled or encouraged by regulatory or economic realities, should be honored by the government when entered into for tax-independent purposes, but not where they are “shaped solely by tax avoidance features that have meaningless labels attached”¹²⁵ In other words, if the lessor retains significant, genuine attributes ordinarily retained by lessors, the form of the transaction adopted by the parties should not be disturbed. What the relevant attributes are will depend upon the facts in each case.

The court in *Leslie Co. v. Commissioner*¹²⁶ reached a decision identical to that in *Frank Lyon Co.* In *Leslie* the taxpayer (A) agreed to sell a factory to an insurance company (B) for the lesser of 2.4 million dollars or the land and construction costs. A and B executed a long-term lease under which A retained several renewal options and a repurchase privilege. The costs substantially exceeded the 2.4

123. *Id.* at 581.

124. *Id.* at 582-83.

125. *Id.* at 584.

126. 539 F.2d 943, 38 A.F.T.R.2d 76-5458 (3d Cir. 1976), *aff'g* 64 T.C. 247 (1975).

million dollar price, and following the sale to B, A took a capital loss. The Service contended that the A/B transaction was not a sale, but rather a section 1031 nonrecognition exchange of like-kind property.¹²⁷ The Tax Court ruled in favor of Leslie stating that the transfer was not an "exchange," which would have required a "reciprocal transfer of property," but was rather a sale—a transfer of property for a "money consideration."¹²⁸ Interestingly, despite finding that Leslie would not have entered the arrangement without the leaseback (suggesting something other than a sale), the court declared that this, alone, was not dispositive of the issue.¹²⁹

The Third Circuit affirmed, explaining that the taxpayer's actions objectively evidenced an intent to execute a sale and that the facts did not support the prerequisites of an exchange under Treasury Regulation section 1.1002-1(d).¹³⁰ Moreover, in transferring the premises the company severed its ownership rights, and the mortgagee, in effect, assumed these benefits, burdens, and risks.¹³¹

Leslie and Frank Lyon Co. clearly show the difficulties that taxpayers have encountered in attempting to establish that a transfer and leaseback actually involved a sale.¹³² *Leslie* shows the additional problems that may be incurred in proving not only that the transfer was a sale, but that it was not an exchange covered by one of the nonrecognition provisions of the Code.¹³³

H. Statutory Sales or Exchanges

A number of events are treated as sales or exchanges by the Code even though they do not involve commercial or technical sales or exchanges. Some of these events are discussed briefly in the following paragraphs.¹³⁴

127. 64 T.C. at 250-52, noted in 21 VILL. L. REV. 332 (1976).

128. 64 T.C. at 252 (citing Treas. Reg. § 1.1002-1(d) (1957)).

129. 64 T.C. at 250.

130. 539 F.2d at 949 (citing *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 4 A.F.T.R.2d 5341 (2d Cir. 1959) (sale and leaseback was a sale on which a loss was recognized)). The Service had relied on *Century Electric Co. v. Commissioner*, 192 F.2d 155, 41 A.F.T.R. 205 (8th Cir. 1951) (sale and leaseback was a § 1031 like-kind exchange on which no gain or loss was recognized), cert. denied, 342 U.S. 954 (1952).

131. 539 F.2d at 949.

132. See generally sources cited note 109 *supra*.

133. Compare *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 4 A.F.T.R.2d 5341 (2d Cir. 1959) with *Century Electric Co. v. Commissioner*, 192 F.2d 155, 41 A.F.T.R. 205 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952).

134. Note that I.R.C. § 1235, discussed in section III.C.2. *supra*, treats a transfer of substantial rights to a patent (or an undivided interest therein) as a sale or exchange. And I.R.C. § 1253, discussed in section III.C.1. *supra*, provides that a transfer of a franchise, trademark, etc., shall not be treated as a sale or exchange if any significant power, right, or continuing interest is retained.

1. *Bad Debts and Worthless Securities*

A business bad debt is characterized as an ordinary loss under section 166(a),¹³⁵ while section 166(d) considers a nonbusiness bad debt a loss from the sale or exchange of a capital asset held for less than one year—that is, a short-term capital loss.

Where a security that is a capital asset becomes worthless during the taxable year, section 165(g) treats the loss as one from the “sale or exchange” of a capital asset on the last day of the year.¹³⁶ Hence, there is no need to determine the exact date the security became worthless, or to establish the occurrence of an actual sale or exchange. The taxpayer need only demonstrate that it was a “security,” as defined in section 165(g)(2), (3), that became worthless. Section 166(e) provides that a debt evidenced by a security within the meaning of section 165(g)(2)(C) comes under section 165(g), allowing, thereby, sale or exchange treatment.

2. *Stock Redemptions, Corporation Liquidations, and Deficit Distributions*

Under the rules of section 302, stock redemptions are treated as sales or exchanges of the stock.¹³⁷ Similarly, section 331 treats the receipt of cash or assets for stock in a partial or complete corporate liquidation as an exchange of the stock.¹³⁸ Section 301(c)(3) treats a shareholder's gain from a distribution in excess of his stock's basis as gain from the sale or exchange of property.¹³⁹

3. *Retirement of Bonds*

As previously noted, the collection of a claim is not a sale or exchange.¹⁴⁰ Similarly, since a bond is a debt of the obligor, its retirement at face value would not constitute a sale or exchange in the absence of a statutory modification. Where a corporate or gov-

135. See *United States v. Generes*, 405 U.S. 93, 103-05, 29 A.F.T.R.2d 72-609 (1972) (a “business” debt occurs when the motivation for incurring that debt had business purposes which were “dominant,” not merely “significant”).

136. Section 165(g)(2) defines security to include corporate stock, the right to receive same, or an evidence of indebtedness. See generally Bersch & Lonie, *When Does Moratorium Lead to Deductible Tax Loss for New York City Noteholders*, 45 J. TAX. 20 (1976); Spiegel & Buell, *New York City Notes—Are Taxpayers Who Did Not Exchange Notes for Big MAC Bonds Entitled to Loss Deduction?*, 54 TAXES 468 (1976).

137. See B. BITTKER & J. EUSTICE, *supra* note 84, ch. 9, for an excellent discussion of stock redemptions.

138. See B. BITTKER & J. EUSTICE, *supra* note 84, ¶¶7.60-9.65 and ch. 11, for an analysis of partial and complete liquidations.

139. This only applies to that portion of the distribution which is not from current or accumulated earnings.

140. See text accompanying note 18 *supra*.

ernment bond or obligation otherwise is a capital asset, section 1232(a)(1) provides that its retirement is considered to be a sale or exchange.¹⁴¹ Thus, section 1232 attempts to equalize the tax consequences of a bond's collection on retirement with a preretirement sale of the same bond. However, any amount of the gain attributable to unreported original issue discount is characterized as ordinary income by section 1232(a)(3).¹⁴²

4. *Involuntary Conversions and Sales and Exchanges of Business Property*

A partial or entire involuntary conversion of property by condemnation, destruction, seizure, or theft, or a forced disposition of the property under one of these conditions, will be treated as a sale of the property by section 1033. However, the taxpayer may elect to forego the recognition of gain by using the proceeds of the involuntarily converted property to acquire similar assets or property related in service or use to that which was converted.¹⁴³ Property that is used in a trade or business (as defined in section 1231(b))¹⁴⁴ and capital assets held for more than one year which are involuntarily converted enter the section 1231 hotchpot.¹⁴⁵ If the recognized gains from such property plus the recognized gains from the sales or exchanges of business property exceed the recognized losses, then both the gains and the losses are considered to be gains and losses from the sales or exchanges of capital assets held for more than one year.¹⁴⁶ On the other hand, if the losses exceed the gains, then the losses and gains will be considered ordinary.

5. *Options To Buy or Sell*

Under section 1234, gain or loss from the sale, exchange, or expiration of an option to buy or sell property is considered to be gain or loss from the sale or exchange of an asset which has the same char-

141. See *Jamison v. United States*, 297 F. Supp. 221, 23 A.F.T.R.2d 69-467 (N.D. Cal. 1968), *aff'd per curiam*, 445 F.2d 1397, 28 A.F.T.R.2d 71-5550 (9th Cir. 1971).

142. See *Part One*, *supra* note 2, section I.F.

143. I.R.C. § 1033(a).

144. Here, the term does not include inventory, property held for sale primarily to customers, or § 1221(3) property (copyrights, compositions, etc.).

145. Of course, the taxpayer cannot have made a nonrecognition election under I.R.C. § 1033(a). See *Part One*, *supra* note 2, section II.D. See also I.R.C. §§ 1071, 1081; Lee, *Supreme Court's Central Tablet Decision Limits Use of 337 for Involuntary Conversions*, 41 J. TAX. 130 (1974); McLean & Roberts, *Tax Aspects of Condemnation and Involuntary Conversion*, 9 (no. 6) PRAC. LAW. 37 (1963); Schaff, *Tax Consequences of an Involuntary Conversion*, 46 TAXES 323 (1968).

146. I.R.C. § 1231(a); see *Part One*, *supra* note 2, section II.D.

acter as the property to which the option relates.¹⁴⁷ If loss is attributable to failure to exercise the option, the option is deemed to have been sold or exchanged on the day it expired.¹⁴⁸ In the case of a grantor of an option for stock, securities, or commodities, section 1234(b) treats gain or loss from a closing transaction regarding the option and gain on the lapse of the option as gain or loss from the sale or exchange of a capital asset held less than one year.¹⁴⁹

6. Mineral and Timber Interests

Section 631 treats the disposition of certain mineral and timber interests, in return for a royalty, as a sale; section 1231(b)(2) brings such sales within section 1231's capital gain—ordinary loss rules.¹⁵⁰

7. Cancellation of Lease or Distributor's Agreement

Under section 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement, are considered as amounts received in exchange for the lease or agreement. Section 1241 does not apply to lessors or to suppliers, nor does it characterize the lease or distributorship agreement as a capital asset—it only qualifies the cancellation as an exchange. The Regulations define a cancellation as the complete termination of all contractual rights of a lessee or a distributor, other than by expiration, with respect to a particular premises, distributorship, or severable economic portion of it or its duration.¹⁵¹ Payments made for other modifications do not qualify the cancellation as an exchange.¹⁵² Personal service distributorships do not come under section 1241 which applies only to marketing, or marketing and servicing of goods.¹⁵³ In addition, the distributor must have a substantial capital investment in the distributorship, which is re-

147. See Part One, *supra* note 2, section II.E.; cf. *United States Freight Co. v. United States*, 422 F.2d 887, 25 A.F.T.R.2d 70-670 (Ct. Cl. 1970) (forfeiture of a purchaser's down payment as liquidated damages on default held not to be the expiration of an option under § 1239).

148. I.R.C. § 1234(a)(2).

149. A "closing transaction" is any termination of the grantor's obligation other than through the exercise or lapse of the option. I.R.C. § 1234(b)(2)(A).

150. See Gallagher, *Christmas Tree Taxation*, 5 J. REAL EST. TAX. 213 (1978).

151. Treas. Reg. § 1.1241-1(b) (1957). See generally, Schlosberg, *Income Tax Consequences of the Assignment or Cancellation of a Leasehold*, 10 TAX L. REV. 257 (1954).

152. Treas. Reg. § 1.1241-1(b) (1957).

153. *Id.* Until rendered obsolete by the Tax Reform Act of 1976, I.R.C. § 1240 treated a limited category of employment termination payments as sales or exchanges of capital assets. See L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 156-57 (1961) for a discussion of the initiation of this special tax treatment for the benefit of Louis B. Mayer, of Hollywood fame. See also S. REP. No. 781, 83d Cong., 1st Sess. 50 (1951).

flected in physical assets actually used in and comprising a significant part of the distributorship's operations.¹⁵⁴

IV. THE HOLDING PERIOD

A. *In General*

The length of time a taxpayer has held a capital asset will determine whether gain or loss on a sale or exchange will be "long-term" or "short-term."¹⁵⁵ This, in turn, will affect the tax treatment accorded to the resulting gain or loss.¹⁵⁶ Subsection (3) of section 1222 defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year; subsection (4) defines long-term capital loss in the same way. Short-term capital gains and losses result from sales and exchanges of capital assets held for one year or less.¹⁵⁷

Ordinarily, the length of time the property has been held is clear, so that there will be no problem in determining whether gain or loss is long- or short-term. In any event, the holding period must be known. In close questions it is important to determine, in months and days, when the asset was acquired and when it was sold or exchanged. For example, in computing a period of years or months, commencing with a specified day, date, or act, unless it appears otherwise, the specified day is excluded and the last day of the period is included.¹⁵⁸ If property is acquired on the last day of a month, regardless of the number of days in that month, it must be held at least until the first day of the thirteenth month following the acquisition to have been held for *more* than one year. Thus to satisfy this requirement an asset acquired on June 30 of one year must not be sold or exchanged before July 1 of the following year.¹⁵⁹

Occasionally it may not be clear exactly when property was acquired. There is no problem where the known holding period definitely exceeds one year, but complications could arise if it is not precisely known which dates constitute the beginning or ending of the holding period. For example, in Revenue Ruling 66-97 the taxpayer requested advice on whether there was a difference for holding period purposes between a trade on a registered securities exchange

154. Treas. Reg. § 1.1241-1(b) (1957).

155. See generally Holzman, *The Holding Period*, 46 TAXES 110 (1968); Sultan, *The Capital Gains "Holding" Dilemma*, 16 VAND. L. REV. 535 (1963). See also Fredland, Gray, & Sunley, *The Six Month Holding Period for Capital Gains: An Empirical Analysis of its Effect on the Timing of Gains*, 21 NAT'L TAX J. 467 (1968).

156. See section V, *infra*, for a discussion of the mechanics of the capital gains tax.

157. I.R.C. § 1222(1), (2).

158. Rev. Rul. 66-7, 1966-1 C.B. 188.

159. See *id.*

and a trade in an over-the-counter market.¹⁶⁰ This question raised the distinction between the "trade" date, the day on which a purchase-sale contract is executed, and the "settlement" date, the time for delivery and payment. In some securities transactions the settlement date is a specified number of days following the trade; in bond, note, and indebtedness transactions the securities are considered transferred on the trade date. The Treasury responded that the holding period excluded the acquisition day but included the sale day regardless of whether the trade occurs on a registered exchange or over the counter.¹⁶¹

Fewer close questions arise concerning the holding period of realty since it generally is held for a more extended time period. Nevertheless, the numerous ways in which title to realty can pass present a wide variety of times at which a holding period could begin or end, such as the date of an enforceable contract or the passing of title, possession, or risks of ownership. Where there is an unconditional contract of sale, the holding period is measured from the earlier of the passage of title or the delivery of possession and the attributes of ownership.¹⁶² The duration of an installment or conditional sales contract will depend upon the particular facts and circumstances of the transaction.¹⁶³ And, even though a purchase option contract will not begin or end a holding period, if, practically speaking, the burdens and benefits of ownership have been transferred,¹⁶⁴ the contract itself may be found to be a sale which, in turn, *will* measure the period.¹⁶⁵

A special holding period rule applies to newly constructed property sold shortly after completion. Rather than simply measuring

160. 1966-1 C.B. 190.

161. *Id.*

162. *Boykin v. Commissioner*, 344 F.2d 889, 15 A.F.T.R.2d 807 (5th Cir. 1965); *Hoven v. Commissioner*, 56 T.C. 50 (1971); *accord*, *Bradford v. United States*, 444 F.2d 1133, 28 A.F.T.R.2d 71-5228 (Ct. Cl. 1971); *Clodfelter v. Commissioner*, 426 F.2d 1391, 25 A.F.T.R.2d 70-1254 (9th Cir. 1970); *Rev. Rul. 71-265*, 1971-1 C.B. 223; *cf. Rev. Rul. 75-563*, 1975-2 C.B. 199 ("irrevocable written option" to purchase land contained all of the indicia of a sale, irrespective of optionee's right to terminate by refusal to pay installments). *See generally* *Becker v. Commissioner*, 378 F.2d 767, 19 A.F.T.R.2d 1642 (3d Cir. 1967); *see also* *Helvering v. San Joaquin Fruit v. Inv. Co.*, 297 U.S. 496, 17 A.F.T.R. 470 (1936); *Chemetron Corp. v. Commissioner*, 299 F.2d 644, 9 A.F.T.R.2d 507 (7th Cir. 1962); *Rev. Rul. 54-607*, 1954-2 C.B. 177.

163. *See Kanter, Using Revaluation Clauses to Avoid Gifts Under Holding Company Plans*, 116 Tr. & Est. 388 (1977); *cf. Rev. Rul. 76-42*, 1976-1 C.B. 102 (the return of escrowed shares of the acquiring corporation owing to the failure of the acquired corporation to attain the specified earnings level does not result in gain or loss by the shareholder creating the escrow); *Rev. Proc. 76-1*, 1976-1 C.B. 542 (the Service will not rule on redemptions where purchase price is based on a promise to pay an amount contingent on earnings).

164. *See Rev. Rul. 71-265*, 1971-1 C.B. 223.

165. *See Rev. Rul. 75-563*, 1975-2 C.B. 199.

the holding period from the date of either the beginning or completion of the construction, the courts measure back one year from the date of sale of the building (or other property) and allow long-term capital gain or loss treatment for "the cost of that part of the building which was erected as of that date."¹⁶⁶ For example, suppose a taxpayer began construction of a building on January 1, 1975, completed construction on January 1, 1976, and sold the building on February 1, 1976. The court would count back one year from the date of sale to February 1, 1975, and then allow long-term treatment for the actual costs of construction up to that date. Significantly, it is not the expenditures for construction which the court considers, but rather the actual cost of constructing the building as it existed one year prior to sale.

In successful exploratory ventures a rule analogous to the newly constructed property rule applies. This rule begins one holding period for the newly discovered property, but continues the taxpayer's holding period as to property held prior to the discovery.¹⁶⁷ The property located is treated as a new asset, with a new holding period measured from the time of discovery.

Under section 631(a) a taxpayer may elect to treat the sale of cut timber that he has owned for the statutory time as a sale or exchange of a capital asset. Here, however, instead of the regular acquisition/exclusion, disposition/inclusion rule, the sale day is excluded from the holding period and the day of purchase is included.¹⁶⁸

B. Tacking

Section 1223 contains a number of rules covering the "tacking" of holding periods. In certain instances one taxpayer can add the period he has held the property to the time his predecessor held it to increase the holding period and thereby receive capital gain treatment.¹⁶⁹ For example, in nonrecognition transfers the periods for

166. Paul v. Commissioner, 206 F.2d 763, 766, 44 A.F.T.R. 319 (3rd Cir. 1953); see e.g., Williams v. Commissioner, 285 F.2d 582, 585, 7 A.F.T.R.2d 458 (5th Cir. 1961); Dunigan v. Burnet, 66 F.2d 201, 12 A.F.T.R. 965 (D.C. Cir. 1933); R. O'Brien & Co. v. United States, 51 A.F.T.R. 1249 (D. Mass. 1956); Aagaard v. Commissioner, 56 T.C. 191, 207-08 (1971); Draper v. Commissioner, 32 T.C. 545 (1959).

167. Petroleum Exploration v. Commissioner, 193 F.2d 59, 41 A.F.T.R. 453 (4th Cir. 1951); cf. Harris v. Commissioner, 2 B.T.A. 156 (1925) (taxpayer did not acquire an "exploration" property upon a play becoming successful).

168. Rev. Rul. 66-6, 1966-1 C.B. 160.

169. See, e.g., Helvering v. Gambrill, 313 U.S. 11, 25 A.F.T.R. 1226 (1941). Under § 1223(6) the time an option is held is not tacked to the holding period of the property subject to the option. See also Estes, *Selected Holding Period and Timing Problems and Opportunities of Investors in Securities—Possibilities for the Utilization of Put and Call Options*, in

which the transferor and transferee have held the property will be aggregated to determine the transferor's holding period.¹⁷⁰ Likewise, holding periods are tacked in like-kind exchanges under section 1031 and in certain exchanges of securities.¹⁷¹ Section 1223(7) provides that after a section 1034 nonrecognition acquisition of a new residence, the holding period of the old residence is tacked on. Tacking also occurs where property is received as a gift or as a testamentary transfer.¹⁷² Generally speaking, all of the section 1223 rules relate to tax-free acquisitions or exchanges and are correlatives to the rules governing substitution of basis.¹⁷³

The term "held" generally is equated with "acquired," which is construed as "ownership."¹⁷⁴ Normally, ownership commences in the year in which title passes, but it may be considered to have begun at an earlier time.¹⁷⁵ For example, the passage of title may be treated as a mere formality where the purchaser has the indicia of ownership, such as its benefits and burdens, and is in possession of the property, or where all the conditions of an executory contract have been satisfied.¹⁷⁶ Similarly, the holding period may begin, under certain circumstances, on the exercise of a purchase option.¹⁷⁷ Thus, it is important to determine when the sale has occurred, especially when a Code section, such as section 337, makes action in that year pivotal.

C. Escrows

When property is sold, gain or loss generally is realized in the year of the sale. A sale usually is considered to be completed when title passes.¹⁷⁸ However, a sale is not completed if delivery is to an escrow

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170. I.R.C. § 1223(2)-(3).

171. *Id.* § 1223(3).

172. *Id.* § 1223(1), (11).

173. *Id.* § 1223(1).

174. See *McFeely v. Commissioner*, 296 U.S. 102, 107, 16 A.F.T.R. 965 (1935) ("In common understanding, to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding."); *Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496, 499, 17 A.F.T.R. 470 (1936) ("The word 'acquired' is not a term of art in the law of property but one in common use.").

175. Rev. Rul. 71-265, 1971-1 C.B. 223.

176. *Id.* See also Note, *Taxation: Use of Escrow Arrangements in Installment Sales*, 27 OKLA. L. REV. 543 (1974).

177. See *Koch v. Commissioner*, 67 T.C. 71 (1976).

178. *Morco Corp. v. Commissioner*, 300 F.2d 245, 9 A.F.T.R.2d 381 (2d Cir. 1962); *Commissioner v. Segall*, 114 F.2d 706, 709, 25 A.F.T.R. 698 (6th Cir. 1940), *cert. denied*, 313 U.S. 562 (1941). See generally *McFeely v. Commissioner*, 296 U.S. 102, 16 A.F.T.R. 965 (1935).

agent and the obligations to buy and sell are not established unconditionally by the agreement.¹⁷⁹ It is only on the fulfillment of the condition or the happening of the event that gain or loss is realized and must be reported.¹⁸⁰ Conversely, the sale will be completed on delivery of the property to the escrowee where the obligations of the parties are fixed unconditionally by the agreement. The use of an escrow agent as a security device to insure the performance of the parties' respective obligations will not prevent the completion of the sale under these circumstances.¹⁸¹

Differentiating a security from a conditions escrow arrangement may be difficult, since the difference will be evidenced by the facts of the transaction together with the intention of the parties as manifested in the agreement. Placing the deed or purchase price in escrow may not defer taxable gain or deductible loss if the setting of the transaction indicates that a sale has been effected. Thus the retention of the deed in escrow may be treated as a security device if the purchaser is in possession of the property or otherwise has the indicia of ownership.¹⁸² The intention of the parties should be expressed clearly.

Since an escrow arrangement can defer the time of the sale, it can be used to expand the seller's holding period so as to qualify for long-term capital gain.¹⁸³ In addition, an escrow can be used to shift a sale from one year to another, provided a business purpose can be shown. Where such a purpose is absent, the taxpayer faces the possibility of having the escrow characterized as a sham.¹⁸⁴

In using an escrow arrangement for deferment, the parties must consider its ancillary effects, such as any additional costs involved, and the possibility of having the sale fall through. Another important element that must be considered in deciding whether to use an

179. See generally *Koch v. Commissioner*, 67 T.C. 71 (1976); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), *aff'd*, 544 F.2d 1045, 38 A.F.T.R.2d 76-6164 (9th Cir. 1976); Note, *The Effect of Escrow Arrangements on Federal Income Tax Liability*, 59 HARV. L. REV. 1292 (1946); see also Rev. Proc. 76-26, 1976-2 C.B. 643 (conditional escrow of shares pursuant to a tender offer); Bogaard, *Corporate Reorganizations*, 2 J. CORP. TAX 377 (1975).

180. See *Dyke v. Commissioner*, 6 T.C. 1134 (1946).

181. *Merrill v. Commissioner*, 40 T.C. 66 (1963), *aff'd per curiam*, 336 F.2d 771, 14 A.F.T.R.2d 5703 (9th Cir. 1964); *Consolidated Gas & Equip. Co. v. Commissioner*, 35 T.C. 675 (1961); *Dyke v. Commissioner*, 6 T.C. 1134 (1946); *The Effect of Escrow Arrangements on Federal Income Tax Liability*, *supra* note 179. See also Rev. Rul. 75-563, 1975-2 C.B. 199, 200; Rev. Rul. 71-265, 1971-1 C.B. 223.

182. See Rev. Rul. 75-563, 1975-2 C.B. 199.

183. *First Am. Nat'l Bank v. United States*, 209 F. Supp. 902, 10 A.F.T.R.2d 5650 (M.D. Tenn. 1962); *Watson v. Commissioner*, 18 T.C.M. (P-H) 308 (1949). But see *Howell v. Commissioner*, 140 F.2d 765, 31 A.F.T.R. 172 (5th Cir.), *cert. denied*, 322 U.S. 735 (1944). See generally *Estes*, *supra* note 169; *Hoffman, How to Freeze Stock-Trading Profits, Get Capital Gain, with a Call and Short Sale*, 16 J. TAX. 110 (1962); *Sultan*, *supra* note 155.

184. See *Dyke v. Commissioner*, 6 T.C. 1134 (1946).

escrowee is the determination of who will be taxable on any income generated from the property held in escrow. Generally this is covered in the agreement. Where, however, the agreement is silent, the party who finally receives the income is taxable on it, either in the year it is received or the year in which all rights to it become fixed.¹⁸⁵ The party entitled to the income need not be the party with the right to the property. Since the escrow agent merely is a stakeholder, he realizes no taxable income from the property.

D. Options To Buy or Sell

In the case of an option covered by section 1234,¹⁸⁶ section 1234(b) (1) provides that gain or loss from a closing transaction with respect to, and gain on the lapse of, such an option shall be treated as gain or loss from the sale or exchange of a capital asset held for less than one year.¹⁸⁷

V. MECHANICS OF THE TAX

A. In General

Capital gains and losses are divided by the holding period into two categories, long- and short-term. Long-term capital gains (LTCG) are taxed at a lower rate than that applicable to ordinary income and to short-term capital gains (STCG). This favorable treatment of capital gains is distinguished from the unfavorable capital loss treatment: long- and short-term capital losses (LTCL and STCL) are restricted in their ability to offset ordinary income.

B. Noncorporate Taxpayers

Once all of the taxpayer's capital transactions are separated from the ordinary transactions, the long-term gains and losses and the short-term gains and losses must be netted within their respective categories. The net of the short-term transactions will be either a net short-term gain or a net short-term loss.¹⁸⁸ Similarly, the net of the long-term transactions will be either a net long-term gain or a net long-term loss.¹⁸⁹ If the net short-term capital gains exceed the

185. *Chaplin v. Commissioner*, 136 F.2d 298, 31 A.F.T.R. 124 (9th Cir. 1943); Rev. Rul. 70-567, 1970-2 C.B. 133; Barton, *Taxation of Interim Income in Agreements of Sale*, in UNIVERSITY OF SOUTHERN CALIFORNIA SCHOOL OF LAW TENTH ANNUAL TAX INSTITUTE 689 (J. Ervin ed. 1958).

186. See *Part One*, *supra* note 2, section II.E. for further discussion of options to buy and sell.

187. See also *Estes*, *supra* note 169.

188. I.R.C. § 1222(5)-(6).

189. *Id.* § 1222(7)-(8).

net short-term capital losses, the excess is taxable in full at ordinary income rates.

Where the net long-term capital gains exceed the net short-term capital losses, section 1202 provides that individual taxpayers may deduct sixty percent of the excess from gross income: the full amount of the excess is included in gross income, but sixty percent is excluded from adjusted gross income.¹⁹⁰ As a result, the exclusion has the same effect as applying only two-fifths of the taxpayer's highest marginal rate to the entire gain. Generally, therefore, the highest rate at which long-term capital gains will be taxed is twenty-eight percent—two-fifths the maximum tax rate of seventy percent.¹⁹¹

1. Net Long-Term or Short-Term Capital Loss Only

Where the taxpayer has only a net long-term capital loss, section 1211(b) provides that one-half of it (up to \$3,000) is applied against ordinary income.¹⁹² Any excess of the long-term capital loss from that actually applied against gross income for the principal taxable year becomes a long-term capital loss carryover under section 1212(b), whereby up to \$6,000 will be applied to the next taxable year.¹⁹³ If the taxpayer has only a net short-term capital loss, however, up to \$3,000 of that loss may be applied in full against ordinary income; any excess becomes a short-term capital loss carryover to future years. There is no limit on the number of years to which an individual's capital losses may be carried forward, but they may not be carried back to a prior year.

Subject to some significant differences, both long- and short-term capital losses are treated similarly in that each may offset ordinary income. Under section 1211(b)(1)(C)(i) short-term losses offset ordi-

190. Previously, the deduction from gross income was 50%. Int. Rev. Code of 1939, § 117(b), 53 Stat. 47 (1939). The Revenue Act of 1978 increased the deduction for transactions occurring after October 1978 to 60%. Pub. L. No. 95-600, § 402(a), 92 Stat. 2763 (1978).

191. The only instances in which the 28% maximum rate will be deviated from are those which result from application of I.R.C. §§ 56, 57, 58—the Minimum Tax for Tax Preferences—which may increase the maximum rate slightly. The minimum tax was amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 421, 92 Stat. 2763 (1978) by the addition to the Code of I.R.C. § 55—the Alternative Minimum Tax—effective beginning 1979.

Noncorporate taxpayers formerly had available to them the alternative tax of I.R.C. § 1201(b). Applied to the taxpayer as three separate, partial taxes, it basically resulted in a flat 25% rate on the first \$50,000 of net long-term capital gain. This noncorporate alternative rate never produced more than a \$500 tax saving, and this amount could be realized only by higher-bracket taxpayers. It was repealed by the Revenue Act of 1978, Pub. L. No. 95-600, § 401(a), 92 Stat. 2763 (1978). The alternative tax for corporate taxpayers—I.R.C. § 1201(a)—still exists.

192. I.R.C. § 1211(b)(2)(B).

193. *Id.* § 1212(b)(2)(B)(i), (ii).

nary income dollar for dollar; under section 1211(b)(1)(C)(ii), two dollars of long-term loss are needed to offset one dollar of ordinary income. Section 1202(b)(2) requires that short-term losses be offset prior to the offset of any long-term loss. This two-to-one ratio of long-term losses to ordinary income, which was enacted in 1969,¹⁹⁴ is intended to counter the special treatment accorded long-term capital gains whereby three dollars of gain are taxed like two dollars of ordinary income.

2. *Net Long-Term and Short-Term Losses*

Where the taxpayer has both net long-term and net short-term capital losses, one-half of the long-term loss is combined with the short-term loss for application against up to \$3,000 of ordinary income. Any excess losses are computed under section 1212(b) for purposes of the carryover. When the losses are carried over, they retain their respective characterization as either long- or short-term.

3. *Net Long-Term Gain over Short-Term Loss*

If the net long-term capital gain exceeds the net short-term capital loss, the procedure described previously in section V.A. is followed. The only change is that in determining the section 1202 deduction, the taxpayer will use the *excess* of the net long-term capital gain over the net short-term capital loss. Conversely, if the net short-term loss exceeds the net long-term gain, the gain is eliminated, and any excess loss is applied against the \$3,000 of ordinary income in accordance with section 1211(b). Any further short-term capital loss is carried over under section 1212(b).

4. *Net Long-Term Loss over Short-Term Gain*

Where the net long-term capital loss exceeds the short-term gain, the gain is eliminated. One-half of any remaining loss is applied to \$3,000 of ordinary income. Any remaining loss (over \$6,000) is carried over under section 1212(b) to subsequent years as long-term capital loss. However, if the short-term gain exceeds the long-term loss, the excess is taxed along with ordinary income at the applicable section 1 rates.

C. *Corporate Taxpayers*

The same netting process which applies to noncorporate taxpayers must be used to determine the net gains and losses of corporate

194. Pub. L. No. 91-172, § 513(a), 83 Stat. 487 (1969).

taxpayers. Additionally, they are accorded similar preferential tax treatment for long-term capital gains by the section 1201 alternative tax. Corporate taxpayers are not entitled to the section 1202 deduction used by their noncorporate counterparts.

The alternative tax is twenty-eight percent of the entire excess of net long-term gain over net short-term capital loss.¹⁹⁵ However, in many instances the alternative tax will not be used because the section 11 corporate tax rate will be less than twenty-eight percent. In addition, the alternative tax applies only to net long-term gains; net short-term gains are taxed at ordinary rates.

Under section 1211, corporations may offset capital losses only against capital gains. Corporate capital losses can be carried back three years, and carried over five years, but only as short-term capital losses. Losses must be carried back to the earliest year allowable and then carried forward until either they are exhausted or the time expires.

195. Prior to 1979, the corporate alternative tax rate was 30%. The Revenue Act of 1978 reduced it to 28%. Pub. L. No. 95-600, § 403(a), 92 Stat. 2763 (1978).