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Taxation - Federal Income Tax - Capital Gain Treatment of Amount Received from Sublessee by Lessee-Sublessor for Surrender of Lease to Lessor

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TAXATION — FEDERAL INCOME TAX — CAPITAL GAIN TREATMENT OF AMOUNT RECEIVED FROM SUBLESSEE BY LESSEE-SUBLESSOR FOR SURRENDER OF LEASE TO LESSOR—The lessor and the sublessee of a valuable piece of business property sought to remove the intervening interest of petitioner, the lessee-sublessor. Petitioner agreed to release to the lessor all his right and interest in the leasehold and in consideration therefor petitioner received

a sum of money from the sublessee. The Tax Court[1] decided in a deficiency proceeding that the entire amount should be taxed as ordinary income on the ground that it was merely a substitute for future rental payments. On appeal, *held*, reversed. Since the substance of the transaction was the transfer of the leasehold from the lessee to the lessor there was a sale of a capital asset and the sum was taxable as capital gain under the predecessor of section 1231 of the Internal Revenue Code of 1954.[2] *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960).

Subchapter P of the 1954 Code[3] generally defines and delimits the area in which capital gains treatment will be applied. To be entitled to such preferential treatment[4] two requirements must be met: the object of a given transaction must fall within the Code definition of a "capital asset";[5] and, there must be a "sale or exchange" of the object. The capital-asset requirement has been considered by some authorities as the most important control point in screening the increasing flood of attempts to secure the preferential tax treatment accorded capital gains.[6] However, in the area of leaseholds and analogous interests in real property it seems settled that these interests generally qualify as "capital assets."[7]

The major interpretative problem in leasehold cases is whether a transaction constitutes a "sale or exchange." Two aspects of this problem require consideration in connection with the principal case. The first is whether the "sale or exchange" prerequisite to capital gains treatment can be satisfied by either party to a transaction involving the transfer of a leasehold interest. In 1941 the Supreme Court held that a lessor had not met the capital gains requirements when he received payment in consideration for the release of his lessee from all obligations under the lease.[8] The Court reasoned that since the lessor had not given up any

1 Metropolitan Bldg. Co., 31 T.C. 971 (1959).

2 Int. Rev. Code of 1939, § 117 (j), added by ch. 619, § 151, 56 Stat. 846 (1942).

3 The equivalent area was covered by Int. Rev. Code of 1939, § 117, ch. 2, 53 Stat. 50, as amended.

4 "The capital gains provisions in the income tax law are remedial provisions and were intended by Congress to alleviate the burden on a taxpayer where the property has increased in value over a long period of time, for having profits from sales taxed at graduated tax rates designed for a single year's income . . . ." Martin v. United States, 119 F. Supp. 468, 473 (N.D. Ga. 1954).

5 INT. REV. CODE OF 1954, §§ 1221, 1222, 1231.

6 3B MERTENS, LAW OF FEDERAL INCOME TAXATION, § 22.11 at 56 (rev. ed. 1958); see, *e.g.*, Mansfield Journal Co. v. Commissioner, 274 F.2d 284, 286 (6th Cir. 1960); Bidart Bros. v. United States, 262 F.2d 607, 609 (9th Cir.), *cert. denied*, 359 U.S. 1003 (1959). *But see* Commissioner v. Pittston, 252 F.2d 344, 350 (2d Cir.) (dissenting opinion), *cert. denied*, 357 U.S. 919 (1958).

7 See, *e.g.*, Commissioner v. Goff, 212 F.2d 875 (3d Cir.), *cert. denied*, 348 U.S. 829 (1954); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953). See generally 6 VAND. L. REV. 933 (1953).

8 Hort v. Commissioner, 313 U.S. 28 (1941).

interest in the property the payment could not be connected with a "sale or exchange" but was a substitute for future rent. Two years later, the Board of Tax Appeals settled the question as to the lessee by deciding there had been a "sale" when he transferred all his interest in the property to a third party in return for a sum of money.[9] Since the lessee is capable of achieving capital-gain status under certain circumstances the second part of the problem is whether he can realize capital gain if he gives up his interest to the lessor. Using the analogous authority of three leading cases[10] which had held that the relinquishment of life interests in trusts to the remaindermen were "sales," the Third Circuit ruled a lump-sum payment received by the lessee from his lessor for cancellation of the lease was the product of a "sale" and therefore a capital gain.[11] Subsequently, this holding was codified by Congress,[12] thereby resolving all doubts concerning the second aspect of the "sale or exchange" problem. Congress, however, specifically negated any implication that the codification was to affect the situation in which the *lessor* received the payment.[13] The primary point of contention in the principal case was whether the petitioner, the lessee-sublessor, had received the payment in his capacity as lessee or lessor. The key to this determination seems to be whether he gave up his interest in the property in consideration of the payment. If he did, he would be receiving it as a lessee. The Tax Court indicated the release of the right to future rental income was the primary purpose of the transaction; the transfer of the underlying leasehold was deemed merely incidental. The court acknowledged that if petitioner had been able to prove that a part of the sum had been received for the transfer of the leasehold, that part of the consideration could have been treated as capital gain. Since he had failed to establish such an apportionment to the satisfaction of the court, the entire payment was considered to be for the cancellation of the sublease which did not involve petitioner's relinquishment of his interest in the property, and the sum was treated as ordinary income. The court of appeals, on the other hand, concluded that since the lessor and sublessee wished to remove petitioner's intervening interest so they could enter into a mutually profitable long-term arrangement, petitioner was in a position of practical advantage and the "lease clearly had value over the amount of

9 Walter H. Sutliff, 46 B.T.A. 446 (1942).

10 Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946), *cert. denied*, 330 U.S. 828 (1947); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943).

11 Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

12 INT. REV. CODE OF 1954, § 1241.

13 S. REP. No. 1622, 83d Cong., 2d Sess. 444 (1954).

rentals due . . ."[14] under the sublease. Therefore, the court reasoned that the transfer covered the entire leasehold and the payment to petitioner was received by him in his capacity as a surrendering lessee. The fact that the payor was the party who was being relieved of the obligation to pay rent was not a sufficiently important factor to convince the court that the amount paid was merely a substitute for rent. Once it is determined that the petitioner has received payment in his capacity as a lessee, the statutory provision becomes applicable and the payment is treated as the product of a "sale" and is a capital gain.

It appears that the view taken by the court of appeals was more realistic than that of the Tax Court. The mere cancellation of the sublease and the accompanying liquidation of the right to future income was not the essence of the agreement. Obviously, the parties' purpose would have been frustrated had there been no transfer of the underlying leasehold. No matter how it was measured and who was paying it, the sum given to petitioner was in consideration of the disposition of his entire interest in the income-producing property.[15]

However, it might be argued that in the principal case there were two transactions—a payment in lieu of rent, and a "sale" of the leasehold. Arguably, that part of the total amount which was a substitute for future rent due under the sublease could be ordinary income, and only the excess capital gain. The proof problems implicit in this approach may be troublesome, but they seem surmountable. The total amount of rent due is clearly calculable since the length of the sublease and the amounts of all future payments were fixed. This figure could be adjusted to take into account the accelerated method of payment and the balance would represent the amount to be treated as capital gain. As the Tax Court mentioned in dictum, this appears to be a legitimate approach and it would serve to limit the application of preferential tax treatment to that sum which represents the "sale" price of the capital asset. Militating against this approach, however, is the recent decision of the Third Circuit which provided that "for tax purposes such anticipated earnings . . . are treated as merely enhancing the value of the income producing property and, therefore, are not differentiated from the capital gain realized in the sale of the underlying capital asset."[16] In view of the fairly general acceptance of this view[17] and of the judicial trend to expand the application of the capital gains provisions, the court's conclusion in the principal case, at least as a technical matter, seems to be the more

14 Principal case at 594.

15 *Ibid.*

16 Rosen v. United States, 288 F.2d 658, 661 n.2 (3d Cir. 1961).

17 See Levy, *The Line Between a Sale of Property and the Anticipation of Ordinary Income*, N.Y.U. 7TH INST. ON FED. TAX 399 (1949).

sound. Whether this result accords with the best public policy is a question better suited, at this advanced stage in the judicial treatment of the area, to legislative consideration.[18]

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[18] See generally 2 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM 1193-1301 (1959).