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A Conceptual Framework for Capital Gain

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A CONCEPTUAL FRAMEWORK FOR CAPITAL GAIN

by

Calvin H. Johnson[*]

ABSTRACT

Qualification for preferential tax rates on capital gain is "fuzzy at best and incoherent at worst." The primary governing statute provides that sale or exchange of "property" yields capital gain, with only narrow exceptions. Under traditional understanding, however, capital gain does not include income, including rent, interest, compensation, and periodic business income, even though such income is received on the sale of something reasonably considered to be "property" in nontax contexts. A conceptual framework is needed that brings both courts and congressional rules into consistency and produces principled results; this Article presents such a framework. The proposed framework assumes that the capital gain preference will remain. It draws its principles from the wisdom of current law but then criticizes some judicial and congressional results as anomalies inconsistent with those principles. The framework is organized into five strings, with each string representing a separate rationale. The Article then briefly explores three situations where there would no room for a capital gains preference: under a consumption tax, under a mark-to-market system, and under repeal of step up in basis at death.

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INTRODUCTION

The concept of capital gain arose under feudal tenures under which the land and castle, no matter what they were worth, had to be preserved for the benefit of the yet unknown male heir. Capital gain was capital, the brown or black stuff, not accessible to any living person. Living persons held the income interests and income beneficiaries had to live off the crop and harvest, that is, the green stuff. The color coding of the feudal tenures—green for income interests, and brown or black for capital interests—is embodied in the ordinary-language understanding of "capital gain" and "capital asset" as carried into current law.

The Internal Revenue Code now states that any "property" is a capital asset, with only narrow exceptions.[1] Qualification as a capital asset will give the holder access to lower tax rates on gain if the capital asset is held for more than a year and disposed of in a sale or exchange.[2] The statutory term, "property" is best read as arising from and synonymous with the traditional concept of "capital," but in the world beyond tax, "property" is and should be a broader concept. "Property" broadly defined does and should include protected rights to ordinary income. "Property" needs to be broad to protect private rights from theft, fraud, and expropriation. If the concept of "property" broader than "capital" prevails within tax, however, there is little left that cannot be made into capital gain. With a little bit of tax planning, items properly allocated to the income interest can be shoehorned into the format of sale proceeds from something reasonably called "property."

The courts have stepped in to exclude "income" from qualification as capital gain, even in transactions that are in form proceeds from the sale of something that can reasonably be called property. If the substance of the transaction is ordinary income, including compensation, rent, interest and ordinary business income, then the courts will, in general, look through the

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1. I.R.C. § 1221

2. I.R.C. § 1(a)—(e) (imposing tax brackets with rates of up to 39.6% on ordinary income); I.R.C. § 1(h)(1)(D) (imposing maximum 20% rate on adjusted net capital gain); I.R.C. § 1222(3) (defining long-term capital gain as gain from the sale or exchange of a capital asset held for more than a year); I.R.C. § 1222(11) (subtracting out capital losses to reach net capital gain).

form of sale of "property" and deny capital gain treatment to income items.[3] There are, however, bad apples among the court decisions. The Eleventh Circuit held recently that a taxpayer could get capital gain by selling a judgment, even while assuming that execution of the judgment would have produced ordinary gain from property held primarily for sale to customers.[4] Can a taxpayer with a judgment for ordinary income really get capital gain by selling the judgment? The usual rule is that judgments and settlements are taxed according to what the payment is in lieu of, so that, for example, judgments for lost wages are ordinary income.[5] Allowing capital gain on selling a judgment where there would be ordinary income if it were instead executed is not a principled result.

The qualification of a sale of property as capital gain does have exceptions, but the exceptions are too narrow. The most important exception takes away capital gain treatment from merchants selling inventory,[6] but on its face, the exception does not even reach, for example, proceeds from making things. The gain from building a house or a ship for a sale to a single customer seems literally to qualify as capital, as long as one is not also a distributor selling to many customers.[7] Compensation, including value added by the taxpayer's labor, is not supposed to be capital gain,[8] but the statutory language defining capital gain does not say that.

The vagueness of the eligible scope of "property" in the statutory definition of capital asset and the unsatisfactory understatement of the exceptions, combined with court attempts to rationalize access to capital gain,

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3. *See, e.g.*, United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (gain from sale of bond was interest); Comm'r v. Gillette Motor Transport, 364 U.S. 130 (1960) (proceeds from sale of carve-out was rent); Burnet v. Harmel, 287 U.S. 103 (1932) (periodic royalties on oil and gas lease were like business operating income, although considered a sale of property under state law), *superseded by statute*, I.R.C. § 613A; Vestal v. United States, 498 F.2d 487, 494 (8th Cir. 1974) (sale of partnership interest with zero basis was compensation, not capital gain); Bryan v. Comm'r, 16 T.C. 972, 981 (1961) (sale was compensation, not capital gain).

4. Long v. Comm'r, 772 F.3d 670 (11th Cir. 2014).

5. *See, e.g.*, Comm'r v. Schleier, 515 U.S. 323 (1995) (lost wages received through age-discrimination suit were ordinary), *superseded by statute*, I.R.C. § 104(a)(2).

6. I.R.C. § 1221(a)(1).

7. Comm'r v. Williams, 256 F. 2d 152, 155 (5th Cir. 1958) (allowing capital gain on ship built for one buyer); Gangi v. Comm'r, T. C. Memo 1987-561 (allowing capital gain on sale of condos that taxpayer built).

8. *See, e.g.*, Comm'r v. Smith, 324 U.S. 177, 181 (1945) (saying that ordinary income is broad enough to include compensation "whatever the form or mode by which it is effected").

have left the eligibility for preferential capital gain rates under current law "fuzzy at best and incoherent at worst."[9] Fuzzy or incoherent is always unjust. Law needs a rationale. If there is no defining rationale, then everyone feels entitled to the lower rates and is offended if they must pay ordinary income rates. Both Congress and the courts need a conceptual framework to provide a more principled backbone to capital gain eligibility.[10]

Restatements of the law based on principles drawn from decided cases help make court decisions consistent, but Congress needs some principled guidance as well. A conceptual framework for capital gain, proposed here, would provide principles for both court and congressional decisions.[11] This framework is drawn from the wisdom of current law, but the principles are prescriptive and lead to rejection of some current-law results as anomalies not fitting under well-justified principles. This framework is intended to be within the analytic tradition—that is, of value not just to the choir but also to those outside the fold. The framework assumes that the capital gain preference will remain, whatever might be said questioning its merits. Like all restatement projects, this conceptual framework does not start from scratch but takes as a given most of the existing framework. The hard part of any restatement project is deciding what to keep and what to prune from current law. This conceptual framework is tentative, and it does not cover every capital gain controversy, but it looks helpful and promising—at least to the author.

This conceptual framework is organized into five strings. The framework, overall, would protect the tax on ordinary income against an overly expansive interpretation of capital gain. Capital gain is enough of a complicated knot that untying it requires pulling at many of its strings. The

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9. Daniel H. Shaviro, *Commentary: Uneasiness and Capital Gains,* 48 TAX L. REV. 393 (1993).

10. Excellent current surveys of capital gain doctrine and rationales include BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 46.1–.3 (2017); MARVIN CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION § 17 (12th ed. 2012); DANIEL J. SIMMONS ET AL., FEDERAL INCOME TAXATION 815-905 (7th ed. 2017). This Article bears a family resemblance to Calvin H. Johnson, *Seventeen Culls from Capital Gains,* 48 TAX NOTES 1285 (Sep. 3, 1990), but with more culls and more comprehensive rationales.

11. The name *Conceptual Framework* is borrowed from a project started by the Financial Accounting Standards Board (FASB) to provide a stronger theoretical underpinning for accounting standards and to focus the accounting standards on the needs of outside investors who cannot order custom analyses. The FASB Concepts Statements are not themselves binding on the reporting enterprise, on the auditing accountants, or on the standards makers, but they attempt to provide a principled basis for developing the accounting standards that are binding. *Concepts Statements*, FASB.ORG, http://www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1176156317989 (last visited June 28, 2017).

strings do overlap. Themes recur. Some things now capital gain should be ordinary income, under several of the principles. For each string, the discussion starts with a description of the principle and an example or two of results consistent with the principle. The discussion then uses the principle to question results available under current law.

A summary of the five grand strings follows:

"The Color Coding" (Part I of the Article): The concept of capital gain arose under feudal tenures which conveyed a color code: Capital gain was the land and castle, the brown and black stuff, which belonged to the yet unknown male heir, no matter what they were worth. The income beneficiaries had no access to capital but had to live off the crop and harvest, that is, the green stuff. The color coding of the feudal tenures—green for income interests, and brown or black for capital interests—is embodied in the understanding "capital gain" and "capital asset" that has carried into current law. The color coding helps to separate capital from taxable ordinary income, even under our very different non-feudal economic system. The string justifies, for instance, treating chronological carve-outs from property, where the seller keeps the remainder interest, as rents rather than sales of capital assets, and requires that we treat sale of an income interest in a trust as income, and not capital.

"Relief from Double Tax" (Part II of the Article): Capital gain is the appreciation over time of invested capital. Without capital, there is no capital gain. Tax on capital is described as a double tax, and lower capital gain rates are a partial relief from the double tax. For income from services, sale of body parts, and endorsements or good name, there is no capital invested (no brown/black stuff), no prior tax, and hence no capital gain.

"No Negative Tax" (Part III): In the ordinary understanding, capital gain reduces the tax rate but leaves it positive. Neutral tax accounting for routine transactions should never make a transaction with positive value increase in value after tax, nor make transactions with negative value before tax into transactions with positive value after tax. Negative tax is a subsidy, beyond mere exemption from tax. Subsidies need to be dealt out through a transparent, competitive budget, if at all. Thus, neither court nor Congress should allow the combination of capital gain and ordinary deduction of the related expenses or losses. The no-negative-tax principle would make both goodwill and sales of rights that increase future expenses ordinary gain in full.

"Look-Through Properties" (Part IV): Some properties are ordinary assets because they derive their character by looking through to the ordinary income that would be received instead of the sale. Thus, a judgment should not produce capital gain if execution of the judgment would have produced ordinary income. Rights to receive ordinary income remain ordinary assets if the taxpayer sells the rights instead of taking payment. A transfer by donation at death or in life, or by contribution to or out of an entity, would not change

an ordinary asset into a capital asset. Stock of a taxable C corporation is not a look-through asset, but ownership interests of partnerships and S corporations are look-through assets. The residual interest in an S corporation or partnership not traceable to a capital asset would be ordinary because going concern and goodwill values are appropriately ordinary under the no-negative-tax string.

"Treasury Must Profit" (Part V): A critical argument necessary to the adoption and affirmation of reduced rates on capital gain has been that the rate reduction would increase Treasury revenue because of increased profit taking. The scope of capital gain is limited to cases where the argument is plausible. Sales of depreciable property step up depreciable basis at too cheap a price and should not generate capital gain even when the property is sold to an unrelated party.[12] For perishables, Treasury can be expected to lose from sales subject to capital gains rates because the drop in rates hurts it more than earlier tax helps it. Rights that will expire upon death of the holder should not be capital assets.

A final section, "Without Capital Gain?" (Part VI) argues that there would be no room for capital gain preference in at least three situations: under a consumption tax, under a mark-to-market system, or under repeal of the step up in basis at death.

The statute could be simplified to incorporate the full incremental logic of all of the strings of this conceptual framework by defining capital asset more narrowly. Capital assets appropriately include fee interests in C corporation stock because, for better or worse, that is now our form of corporate integration. Capital assets also appropriately include perpetuities, non-depreciable interests (e.g., land), and look-through assets in which the underlying rights are capital assets. But depreciable property, trust income interests, intangible property created by expensed investments, and rights to receive ordinary income are not capital assets under principles of the conceptual framework. The residual interest in a partnership or S corporation would be ordinary after allocating some gain to readily marketable assets held by the entity. Stock and land are also ordinary income when they are transferred as compensation, interest, royalties, or any other ordinary income item.

This conceptual framework assumes the normal and appropriate default rule is *ordinary* income. It should not matter from what source a taxpayer gets their standard of living. Horizontal equity means that a preferential rate, without a rationale, is unjust. Congress can adjust the tax brackets applied to ordinary income, for greater tax rates for taxpayers who are more prosperous, or for less progressivity in the rate patterns. Still, the decisions made in the construction of the progressivity in the tax brackets

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12. *See* I.R.C. § 1231.

should apply universally, unless there is a principled rationale for preferential rates on the capital gain.

I. COLOR CODING

A. Historical Origin

The preferential tax rate on capital gain arises by reception of British conceptions of capital going back into feudal land tenures.[13] Under feudal land ownership, "capital," that is, the castle and manor, belonged to the male heir, no matter what the assets were worth. In 1799, when Parliament first adopted a general income tax,[14] most of the grand estates of England were held under a trust arrangement, called the "strict settlement," that imitated the feudal tenures by treating capital gain as capital—that is, part of the heir's interest.[15] Entailments to keep a family estate, and power, together had to be contingent on survival because, in an age of high mortality, no one could be sure that a competent eldest son would survive. Trusts were used to hold the estate together for one heir because both Parliament and courts had grown hostile to legal remainders to unknown heirs that prevented sales of the property to a better user.[16] A trustee could sell the underlying land that was the corpus of the strict settlement trust, but the proceeds of the sale then had to be returned to corpus for the benefit of the yet unknown male heir.

Living beneficiaries, under the strict settlement arrangement, lived off the income interest, taking "the annual produce, the grass, the apples and things of that sort."[17] Living persons had no access to capital, even if the property were sold at a gain. *Capital* gain was *capital.* Capital under both the trust instruments and, more importantly, the moral code had to be preserved for the heir.

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13. LAWRENCE H. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES 25–28 (1951) (also identifying ordinary income with harvest on entailed British estates).

14. Duties upon Income Act 1799, 39 Geo. 3 c. 13 (Gr. Brit.).

15. JOHN HABAKKUK, MARRIAGE, DEBT, AND THE ESTATE SYSTEM: ENGLISH LANDOWNERSHIP 1650–1950, at 1–5, 17 (1994). Estimates of the proportion of agricultural land held under the strict settlement arrangement range from half to "nearly all." *Id.* at 47.

16. *See, e.g.*, Scattergood v. Edge (1699) 88 Eng. Rep. 1320, 1326–27; 12 Mod. Rep. 278, 286–88.

17. WALTER STRACHAN, A DIGEST OF THE LAW OF TRUST ACCOUNTS, CHIEFLY IN RELATION TO LIFEOWNER AND REMAINDERMAN 25 (1911) (footnote and citation omitted).

The strict settlement trust "was not in any essential respect the creation of the State,"[18] because it had the endorsement of neither Parliament nor the courts. Still, it described the underlying social and economic framework of England for 300 years. The courtships described by Jane Austen, not long after the adoption of the British income tax, take place within a framework in which the underlying land was not accessible to the living. The opening lines of *Pride and Prejudice*[19] set the stage by stating that "[i]t is a truth universally acknowledged, that a single man in possession of a good fortune, must be in want of a wife." The single man's good fortune was measured by income per year, not by wealth or capital because none of the living had access to the underlying land. As Mr. Bennet put it, for the sake of his daughters, he was hoping "to see many young men of four thousand a year come into the neighborhood."[20]

The 1799 British income tax gave a tax exemption to capital gain, not because Parliament said anything about an exemption,[21] but because, as one judge explained the situation as well as he could, "Income Tax . . . is a tax on income. It is not meant to be a tax on anything else."[22] In concept and word, "capital gain" was not part of taxable income because it was not part of the income interest. Even if the sale was for an "annuity," which was reached literally by the parliamentary text, the British courts found that gain from the sale of a capital asset for an annuity was tax exempt because it could not be thought of as income.[23] If they had ever thought of the issue, it is plausible that they would have considered it inappropriate to tax living persons on capital gain because it could not be spent to support standard of living. But the language did most of the policy thinking: capital gains were not taxable income because "income" did not include capital gain.

In the United States, by contrast, the concept of "income" encompassed capital gain. America never warmed up to primogenitures nor to

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18. HABAKKUK, *supra* note 15, at 18.

19. JANE AUSTEN, PRIDE AND PREJUDICE 27 (Dell Publishing 1959) (1813).

20. *Id.* at 29.

21. An anti-avoidance section of the 1799 Act doubled the tax for anyone who had "any Property yielding an Income" that fraudulently rendered it "temporarily unproductive of [s]uch Income." Income Act 1799, 39 Geo. 3 c. 13, § 92 (Eng.).

22. Attorney-Gen. v. London Cty. Council [1901] AC 26 (HL) (Lord Macnaghten).

23. Scoble v. Sec'y of State for India [1903] AC 299 (HL) (holding that annuity received for sale was not taxable even though profits from annuities were literally within the statute, because Parliament did not intend to tax capital).

the restraints on access to, use, or consumption of capital.[24] In 1921, the Supreme Court unanimously held, in *Merchants' Loan and Trust v. Smietanka*,[25] that capital gain realized in a sale was "income" under U.S. law and subject to income tax. Had capital gain been capital, as in British thinking, the Court would have exempted it from tax because, the previous year in *Eisner v. Macomber,*[26] the Court had held that the Sixteenth Amendment's tax on "income" could not reach capital. Under *Smietanka*,[27] realized capital gain was income because a sale severed the proceeds from capital.

In *Smietanka*, the gain was generated by a sale by a trust of corpus stock, and under the trust instrument, the proceeds of the sale had to be returned to corpus or capital for the benefit of the remainderman. No income beneficiary had access. The *Smietanka* trust is the kind of arrangement that excluded capital gain from income in the British conceptualization. Still, under American thinking, *Smietanka* treated the sale as just routine realization—a severance from capital—and taxable to the trust.

Within months of *Smietanka*, Congress cut the tax rate on realized capital gains from a maximum of 54% to 12.5%, that is, to less than a quarter of the rates applied under *Smietanka.*[28] The Senate Finance Committee Report said it was compromising between the "*extreme* views embodied . . . in the present American and British Law."[29] Congress apparently found the British concept of income to be more magnetic than the *Smietanka* concept of income because the 12.5% rate chosen was much closer to the British tax of zero than to the maximum U.S. ordinary income rate of 54%.[30] People think in concrete terms, even as to statutes expressed in abstract language. The core example that Congress was thinking of, from the context of both *Smietanka* and the

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24. A telling difference is how England and America thought about co-ownership. In English law, co-ownership was originally presumed to give the right of survivorship, if nothing was said in the instrument, because the courts assumed they were dealing primarily with family-owned property. In America, the default presumption was that co-ownership meant each owner could sell or pass on their fractional share separately. LAWRENCE FRIEDMAN, A HISTORY OF AMERICAN LAW 206 (1973).

25. 255 U.S. 509 (1921).

26. Eisner v. Macomber, 252 U.S. 189 (1920) (finding a constitutional immunity from tax for stock dividends).

27. The traditional subsequent cite would designate the case as *Merchants' Loan and Trust. Smietanka* is much more musical.

28. Revenue Act of 1921, Pub. L. No. 67-98, § 206(b), 42 Stat. 227, 233.

29. S. REP. NO. 67-275, at 13 (1921) (emphasis added).

30. Revenue Act of 1921 § 210, 42 Stat. at 233 (4% normal tax); *id.* § 211(a)(2), 42 Stat. at 235–37 (maximum 50% surtax for 1922 and thereafter).

British model, was gain within a trust that had to be reinvested for the benefit of the remainderman and was not accessible to any living human being for consumption.

The statute, now section 1221 of the Code, defines "capital asset" eligible for the lower tax rates as "property," subject to specified narrow exceptions. Gain from sale or exchange of a capital asset held for more than a year qualifies for the lower capital gains rates.[31] "Property" and "income" are mutually exclusive. For example, section 103(a) of the Code, in parallel to section 1221, gives an exclusion for "property" acquired by gift, bequest or inheritance," but section 103(b) denies the exclusion for gifts or inheritance of "income" and for "income" from the property. "Property," both for the purpose of defining capital asset and the purpose of defining inheritances and gifts excluded from tax is best read as synonymous with the traditional meaning of "capital." If an item is "income," it is not capital, and not capital gain.

The statutory terms for capital gains, from their first adoption in 1921, necessarily carried with them a traditional understanding of capital gain because tradition is embodied in ordinary language. Ordinary meanings are absorbed by the statute.[32] In the ordinary understanding reflected in the English language, the terms "capital gain" and "capital asset" carried with them into the statute the core of the rich and nuanced meanings derived from the historical context from which the concept arose:

> [O]ur common stock of words embodies all the distinctions men have found worth drawing, and the connexions they have found worth marking, in the lifetimes of many generations: these surely are likely to be more numerous, more sound, since they have stood up to the long test of the survival of the fittest, and more subtle, at least in all ordinary and reasonably practical matters, than any that you or I are likely to think up in our armchairs of an afternoon—the most favoured alternative method.[33]

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31. I.R.C. § 1(a)—(e) (imposing tax brackets with rates of up to 39.6% on ordinary income); I.R.C. § 1(h)(1)(D) (imposing maximum 20% rate on adjusted net capital gain); I.R.C. § 1222(3) (defining long-term capital gain as gain from the sale or exchange of capital asset held for more than a year).

32. *See, e.g.*, Helvering v. Le Gierse, 312 U.S. 531, 539 (1941) (saying that "in using the term 'insurance' Congress has identified the characteristic that determines what transactions are entitled to the partial exemption").

33. J.L. Austin, *A Plea for Excuses: The Presidential Address,* 57 PROC. ARISTOTELIAN SOC'Y 1, 8 (1956).

"Capital gain" and "capital asset" had three hundred years or more of meaning in English when Congress put them into the tax statute. They were not "arm-chair-of-an-afternoon" concepts.

There is a color coding to the traditional distinction between capital gain and ordinary income that carries over into current law. The income interests, under the arrangements that defined capital gain, got green stuff, the harvest, the grasses and other crops from the land. Capital including capital gain was brown or black stuff, that is, land or castle. Green stuff was income available to the living beneficiaries to support their lifestyle, and the brown and black stuff had to be preserved for the male heir and could not be invaded by income beneficiaries. Ordinary language incorporated the system out of which the concepts evolved when Congress adopted the rate preference.

It is probably too radical within a restatement of current law to argue from its roots that real capital gain is capital that is never accessible to any living individual and cannot be consumed. The argument that real capital gain must be reinvested and that consumed capital gain is not capital nor "capital gain" eligible for lower tax is reasonable. The inaccessibility of capital gain to support the standard of living of any living individual is a plausible explanation for the original British exemption. The inaccessibility of the *Smietanka* corpus to income beneficiaries, even after the realization of gain within the trust, makes *Smietanka* such a plausible, vulnerable target to overrule. In 1965, the British Parliament saw that capital gain supported individual spending just like any other income, and it concluded therefore that the exemption for capital gain was unjust and repealed the British tax exemption.[34] I have argued elsewhere that consumed capital gain is not capital and not appropriately eligible for the lower rates and will undoubtedly argue it again.[35] Neither Congress nor court has, however, heretofore taken up the argument and carried it to victory. The argument that real capital gain is capital that is not available for the consumption of any living individual has and will be made elsewhere and will not be repeated here.

Still, while capital gain seems now to include amounts that can be and are consumed, "capital asset" continues to exclude "income" belonging to the

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34. 716 Parl Deb HC (5th ser.) (1965) col. 794–95 (UK) ("[I]t is wholly unjust and unfair that the small man who has to pay tax on every penny which reaches his pocket before he spends it, should be in a different position from his wealthier neighbour who has not had to pay tax on his capital gains."); *see also id*. at col. 920 (saying that the "basic principle . . . is that it means that people will now be taxed on a basis according to their means and irrespective of the origin of those means, whether it be capital appreciation or income").

35. Calvin H. Johnson, *Taxing the Consumption of Capital Gains,* 28 VA. TAX REV. 477 (2009); Calvin H. Johnson, *Fixing Capital Gains at the Core,* 125 TAX NOTES 1221 (Dec. 14, 2009).

income beneficiaries. The United States government has a claim on "income" by its income tax. An overly expansive definition of capital should not usurp the government claim. "Capital asset" continues to mean things analogous to brown or black land and castle preserved for the male heir. Ordinary income continues to include things analogous to crops and harvests, which was all that living persons had access to. Under the ordinary language of English, capital gain does not include rent, interest, and compensation, even if embodied in property, because they belong to the income interests and are not capital, the kind of thing that had to be preserved for the male heir under the tradition that defines capital gain. The statutory term "property" does not carry the necessary load, unless you read "property" as meaning "capital" and carrying the tradition that defines "capital" into the requirement that gain eligible for lower rates must be a "capital asset." The color coding explains the core cases.

The color coding is also consistent with other articulations of what an income tax reaches. A comprehensive income tax is said to be a tax on the harvest or crop from the national economy[36]—which is another way of saying that green stuff is ordinary income in the understanding of plain English. What is green stuff, crop, on a national level, is also green stuff, income, subject to an income tax on the individual level.

B. *Carve-Outs*

1. *Principle Illustrated:* Gillette Motor *and* Hort

The traditional meaning of capital supports the result, reached by the courts, that if an owner of property retains the reversion or residual cash flows from the property but sells the interim income, the sale is not of a capital asset and yields ordinary income. Payments received for a chronological carve-out of an ownership interest are considered to be payments for use of property, in the nature of prepaid rent, and not payments for sale of the underlying capital interest in property. The heir's interest—capital—resides in the remainder. The interim income belongs to the living income beneficiaries who may use it to support their standard of living without invading capital. Rents belong to the income beneficiaries. The conclusion that sale of interim income is ordinary is consistent with the traditional meaning embodied in the language "capital gain," but it is more or less independent of the statutory language of a capital asset as a sale of "property," or at least it interprets the word "property" to reach the traditional meaning of capital.

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36. Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1085 (1980).

In *Commissioner v. Gillette Motor Transport*,[37] for example, the government seized use of the taxpayer's airfield to train pilots during World War II. The taxpayer was considered to have sold "property" within the meaning of the Constitution because the government's seizure was subject to the constitutional requirement that no "private *property* be taken for public use, without just compensation."[38] Still, the Supreme Court said, "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset,"[39] and the Court held that the government's payments to the taxpayer produced ordinary income, in the nature of prepaid rent for land, and without offset from basis. The taxpayer had a sale of a carve-out because it would get the airfield back at the end of the war, whenever that would prove to be. The interest kept was the heir's interest, the brown or black stuff. The interest sold was not a capital asset in the ordinary language because it was the living income beneficiaries' share, green stuff, and did not have to be preserved for an unknown heir. To quote the Sixth Circuit in an analogous situation, the taxpayer had assigned "a portion of the income derived from income producing property,"[40] but the taxpayer had retained the income-producing property.

The rule that carve-outs are not capital gain is supported by the cases holding that basis may not be used against carve-outs because they are rent. In the Supreme Court's *Hort v. Commissioner*,[41] the Great Depression made it impossible for the tenant bank to profit from its occupancy of the taxpayer's building. The tenant paid the taxpayer-landlord to terminate the lease, giving up use of the premises, and avoiding further rent. The landlord claimed a tax loss on the ground that the basis allocated to the lease, according to its fair market value when the taxpayer acquired the building, was larger than the termination payment received from the tenant.[42] The Supreme Court denied

37. 364 U.S. 130 (1960).

38. U.S. CONST. amend. V (emphasis added).

39. 364 U.S. at 134.

40. Estate of Stranahan v. Comm'r, 472 F.2d 867, 869 (6th Cir. 1973) (agreeing with taxpayer's argument that sale of dividend stream from stock was ordinary); *see also* Reggio v. United States, 151 F. Supp. 740, 741 (Ct. Cl. 1957) (payments received from bond issuer were in lieu of interest and not a reimbursement for loss of bonds, because the taxpayers kept the bonds).

41. 313 U.S. 28 (1941).

42. *Id.* at 30. The taxpayer's theory might have produced a capital gain if the value of the lease when acquired was lower than the termination payment the tenant paid. The Court's resolution that the taxpayer's basis resided in the building and not the lease denied use of basis and made the entire termination payment ordinary income as prepaid rent.

the loss and simultaneously treated the payment as ordinary income in full, without offset by recovery of basis, because it was not capital but in the nature of prepaid rent.[43] The landlord recovered full occupancy of the building after the transaction, and its basis had not been lost by reason of the cancellation of the lease but remained in the building. The owner of a building is allowed to recover its costs for the building by way of annual depreciation deductions on the building, or upon sale of the building, but was not also allowed to use basis against the terminating payments from the tenant. The taxpayer-landlord got or retained the building, the brown or black stuff, and the cash was for the rents, the green ordinary income.

Going beyond rents to an analogous situation, a chronological carve-out of the taxpayer's full interest in stock is more generally not the occasion to use its basis or capital invested and is not a capital asset when sold.[44]

Sometimes the interim income that is sold can be quite long in duration and uncertain in amount. Sometimes the interim cash flows have increased in value due to market forces beyond the owners' control. Sometimes the sale of interim cash flows represents a bunching of many years' income into a single year, subjecting the sale to higher tax brackets than the interim cash flows would be subject to if not sold.[45] The right to rents might itself be considered "property," an interest in the estate somewhat akin to a fee. Still, the interim cash flows are the income interest and not capital assets, within the traditional meaning of capital gain.

2. *Principled Corrections*

a. Supply Contracts. The color coding arising out of traditional concepts, and the doctrinal exclusion of carve-outs from capital gain would reject a Technical Advice Memorandum[46] and similar Private Letter Ruling,[47] in

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43. *Id.* at 31–33.

44. *See, e.g.*, Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 266 (1958) (consideration received for the right to receive future oil income); Estate of Carter v. Comm'r, 298 F.2d 192, 195–96 (8th Cir. 1962) (payments received in settlement of antitrust suit were for interference with theater business and were ordinary income because received for interrupted use of property, not for capital interest in the property).

45. For the argument that capital gain requires bunching of income into a single year, see Burnet v. Harmel, 287 U.S. 103, 106 (1932) ("[A]bstraction [of oil and gas] from the soil is a time-consuming operation, and the payments made by the lessee to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.").

46. T.A.M. 2000-49-009 (Aug. 9, 2000).

47. P.L.R. 2002-15-037 (Jan. 14, 2002).

which the IRS held that a supplier's sale of a long-term supply contract yielded capital gain. The sale was a sale of a chronological carve-out, that is, green stuff, and should have been treated as ordinary.

In both rulings, the taxpayer owned an electricity-generating power plant and had entered into a long-term, 20- to 30-year contract to supply electricity to a public utility, which in turn distributed electricity to the general public. The contract fixed the price for the electricity to be provided for the duration of the contract and obligated the utility to buy the full output of the taxpayer's power plant, working at full capacity.

During the course of the contract, the wholesale market price for electricity dropped. A drop in the market price for electricity might be explained by a host of factors, including a drop in the price of oil or the introduction of new competing technologies for generating electricity. With the drop, the long-term contract was producing a premium price for the supplier when compared with the spot market price of electricity.[48] The taxpayer sold the contract for its value, the net present value of the expected premium generated by the contract price terms. The buyer apparently was an affiliate of the utility. In connection with the sale of the old contract, the old contract disappeared, and the taxpayer and utility entered into a replacement, fixed-price output contract, but at a lower price. It is plausible that a sale of the contract was used, instead of a payment by the utility to cancel the contract or renegotiate the price, just so that the transaction could qualify as a sale or exchange to the taxpayer, which is one of the statutory requirements for capital gain.

The IRS ruled that the money received was for a capital asset, but it should not have. The electricity produced by the power plant was inventory, the crop of the power plant, its ordinary operating income. The contract was just the sale of the crop. The crop was ordinary income whether the price was high or low and whether sold through a long-term contract or spot market or both combined. The taxpayer kept the productive capital, the power plant, selling the golden eggs but keeping the goose. The taxpayer, of course paid ordinary income tax on the receipts from the contract absent the sale, no matter what they were worth. The taxpayer had assigned "a portion of the income derived from income producing property," [49] but the taxpayer had retained the power plant, which was the income-producing property. That the taxpayer's

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48. A drop in price of electricity that arose because coal or oil prices dropped could also mean the taxpayer could supply the electricity more cheaply than anticipated by the original contract.

49. Estate of Stranahan v. Comm'r, 472 F.2d 867, 869 (6th Cir. 1973) (agreeing with taxpayer's argument—useful to the taxpayer to soak up losses—that sale of dividend stream from stock was ordinary).

receipt for crop was embodied in a contract that was sold did not change the character. The contract was a look-through asset that derived its character from the underlying crop.[50] The contract was green stuff, not anything that would be preserved for the heir, and gain from its sale was ordinary.

Just as a side comment that does not fit into any string, capital gain can sometimes serve as an incentive to transfer productive property to other hands who could run the plant more efficiently. Here, however, the same taxpayer kept and ran the power plant and indeed continued to sell the same annual capacity to the same utility, albeit at lower prices. There was no disposition of capital, the brown or black interest, and no reason to give capital gain preference to the sale.

b. Income Interests in Trusts. Capital assets do not disappear at death. This conceptual framework would treat sale of income interests in trusts as per se ordinary income. In McAllister v. Commissioner,[51] the taxpayer inherited an income interest for life in a trust, but not the remainder. The taxpayer thereafter sold all the income interest to the holder of the remainder interest and claimed capital gain rates on the sale. The Second Circuit held that the taxpayer's right to the income interest was a right in the estate itself, akin to an interest in property in fee, and allowed the taxpayer's claim to capital gain on the sale.[52]

This Article's framework rejects *McAllister.* McAllister had an interest in the estate, but it was an income interest, green stuff, crop-like, and available for consumption by income beneficiaries. McAllister never held any brown or black stuff nor any responsibility to preserve his interest for the remainderman.

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50. See *infra* Part IV.A.

51. 157 F.2d 235 (2d Cir. 1946), *acq.*, Rev. Rul. 72–243,1972–1 C.B. 233. *McAllister* relied on *Blair v. Commissioner*, 300 U.S. 5 (1937), in which the court upheld the donative assignment of an income interest in a trust because the assignment was valid under state law. Conceptually, the right to assign tax incidence and capital gain are linked because, if a donor gives away the capital, the fruit will be taxed to the donee. Beyond the intellectual history, however, the issues are not linked. Looking through an assignment of income is usually taxing the donor who retains too much power over the gift and is doling out an allowance or making the gift terminable if the donee misbehaves. Capital gain issues only rarely involve too many hooks retained by the transferor and then only under the "sale or exchange" issue, rather than "capital asset" issue. As a matter of this conceptual framework for capital gain, an income interest in a trust is income, whether the beneficiary awaits payment or anticipates by sale.

52. 157 F.2d at 237.

The judicial work in cases like *Hort* or *Gillette Motor* is to identify the interests that are akin to an income interest of a trust. Trusts with income and capital interests were the concrete model for Congress when it adopted capital gains rates. When, however, the taxpayer sells an income interest in a trust, labeled as such, as in *McAllister,* there is no need to work to ascertain that the interest is sufficiently akin to an income interest under substance or economics: it is an income interest on its face. Income interests have always been accessible to and consumable by the income beneficiaries as they come in. They are ordinary income, green stuff, whether the beneficiary awaits collection of the payout from the trusts or anticipates the future payments through a sale.[53]

c. Summary. Taxpayers can achieve capital gain status on the sale of only a fractional part of what they own if they divide property along any line other than chronologically. As long as the interest sold is perpetual, the taxpayer may sell only some acres of land, air rights, a perpetual easement to let a pipeline or path cross the land, mineral rights, or only some small slice of the bundle of rights that constitutes fee ownership and get capital gain and use of basis. If the interest is perpetual, then basis is allocated among all the units according to the market value of the part sold and retained. The allocated basis for the part sold is allowed against the sales proceeds for the part sold.[54] Selling only some shares of corporate stock the taxpayer owns generates capital gain or loss. A taxpayer may not, however, get either use of basis or capital gain by dividing ownership chronologically and selling some share of the time. A chronological subdivision of the property, keeping the remainder, is a sale of the use of property in the nature of rent rather than a sale of underlying property.

The division between green and brown stuff is also made easier by another string of the conceptual framework project under which property depreciable by the buyer does not qualify as a capital asset.[55] Capital gain rates for the sale of depreciable property steps up depreciable basis for the buyer at too cheap a price. The Treasury can be expected to lose revenue on every sale of depreciable property because increases in ordinary depreciation deductions hurt the Treasury more than the sale price helps. A critical premise for the

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53. Interests that expire upon the death of the holder are also ordinary, under another string of this conceptual framework, because Treasury cannot be expected to profit from a lower, fire-sale-price tax to induce early gains unless the taxpayer is giving up the possibility of exemption upon death. See discussion *infra* Part V.C.

54. *See, e.g.*, Fasken v. Comm'r, 71 T.C. 650, 655–56 (1979) (allocation of sales proceeds to basis on a fractional sale).

55. *See infra* Part V.A.

adoption of capital gain preferential rates was that Treasury would come out ahead with greater volume of sales (less lock in), and that premise is violated as to depreciable property. Chronological carve-outs have a limited life and hence are also depreciable to the buyer. Brown stuff needs to be a perpetuity.

II. RELIEF FROM DOUBLE TAX DISTORTION

Capital gain is the product of invested capital. If there is no capital generating the gain, there is no capital gain. The lower rates accorded to capital gain are plausibly a relief from double tax under which both the investment and the income from the investment are taxed. The double tax distortion argument was not part of the congressional consideration of lower capital gains rates, as far as I can find, but it is an old argument that predates the capital gain preference and it is plausible.[56] Thus, compensation is not supposed to be eligible for capital gain, even if achieved by sale of property, because compensation is not a product of invested capital and not subject to the double tax distortion applicable to capital. Sale of blood and other body parts is also not supposed to be capital gain because they are not considered products of capital subject to double tax.

The double tax argument holds that taxation of income or gain from investment savings is a double tax on top of the previous tax on labor income. The most effective statement of the argument is that tax on savings is like a selective commodity or excise tax on one kind of consumption but not the other. Like other such commodity taxes, it causes damage by shifting purchases away from a preferred commodity in addition to reducing the reward to labor.[57]

To illustrate, suppose that a small island will collect $1,000 from taxpayer Jane Doe. There are only two foods, fish and coconuts, and no way to save, so that all of the taxpayer's wage income will be spent on either fish or coconuts. Doe will adjust her spending on fish and coconuts so that no shift to more fish and less coconuts (or the reverse) would improve her happiness. If we impose a $1,000 tax on Doe's wages or a $1,000 tax, collected at a uniform rate, on her consumption of fish and coconuts, she can still optimize her spending, although she will have a smaller amount available to spend because the tax reduces her reward from working. Whether on consumption

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56. The double tax argument goes back to at least Irving Fisher, *The Role of Capital in Economic Theory,* 7 ECON. J. 511, 533 (1897) (arguing that Congress cannot tax both the orchard and the harvest).

57. I take this variation of the double tax argument from Joseph Bankman and David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1418 (2006).

or wages, the tax suppresses her reward from working but leaves intact her choice between fish and coconuts.

Now adjust the tax so that coconuts carry a higher consumption tax rate than fish and assume that the needed tax from Doe remains $1,000. Now, however, the consumption tax both suppresses the reward for working by $1,000 and also distorts her choice between coconuts and fish. Shifting to the uneven tax away from the simple wage tax or uniformly imposed consumption tax has done unnecessary additional damage by distorting her choice among consumables, *on top of* the $1,000 burden paid for from her wages.

A tax on savings is akin to the higher tax on coconuts. Assume now, for instance, that all the existing coconuts have been eaten and that one must plant coconut palms to get any more coconuts. Assume also that planting coconut palms and nurturing them to maturity is the only way to save on the island. Again, assume the same total tax burden is $1,000, but that the profit from investing in coconut palms is included in the tax base. The tax burden on coconuts is therefore higher than the tax on fish by the extra tax on investment profit. The tax on gain from investing in coconut palms will distort the choice between coconuts and fish without altering the $1,000 reduction to Doe's reward from working. The decision is not *between* a tax on labor and a tax on savings, looking to see which is more elastic. The $1,000 tax on labor remains; the distortion caused by a higher tax on coconuts than on fish is *on top of* the distortion of the tax on labor, not instead of it.

Under current law, the preferential tax rate on capital gain reduces the tax on the returns from capital without exempting them from tax. Not all profits from savings qualify as capital gain: Capital gain rates require a sale or exchange so that returns from investment of capital including rents, interest, inventory gains, and royalties that do not qualify as sale or exchange gains do not get a lower rate. If the coconuts on our small island are sold to customers, the gain would probably be ordinary gain from sale of inventory. The author is a skeptic as to whether the double tax argument presents a robust economic case for reducing the tax on capital.[58] Still the double tax argument has a strong

58. The incentive case for reducing tax on capital is not very strong. We have a global glut in capital. *See, e.g.*, Ben S. Bernanke, *The Global Saving Glut and the U.S. Current Account Deficit*, FEDERALRESERVE.GOV (March 10, 2005), http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm. The best evidence of glut is that people are willing to lend to the federal government at risk-free interest rates that are below current inflation:

Term	1 mo.	6 mos.	1 yr.	2 yrs.	5 yrs.	10 yrs.
Nominal Treasury interest	0.29%	0.5%	0.68%	0.85%	1.31%	1.83%

negative implication. If the tax on the gain is not introducing a second distortion, on top of the tax on labor, then the gain is not a capital gain, no matter what form the gain takes. A tax on labor input does not cause a double distortion subject to the argument and should never qualify as capital gain, no matter by what form it is realized.

A. Compensation

Ordinary income, the Supreme Court has said, "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[59] The courts have found that a contract was compensation when sold because the taxpayer who provided the services had a zero basis in the

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After consumer price index at 1.4%	-1.11%	-.09%	-0.72%	-0.53%	-0.27%	0.43%

The longer term borrowings, where borrowing cost after inflation is positive, are just the reaction of creditors to risks of higher inflation in the future. The free market is telling investors that capital has a negative value. If the market for capital is negative value, then capital is not something that should be prized or subsidized.

Treasury interest is from *Daily Treasury Yield Curve Rates*, TREASURY.GOV, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2016 (last visited June 30, 2017) (using March 1, 2016, as the date for calculating nominal treasury interest rate). Consumer price index inflation at 1.4% is from U.S. Labor Dep't, Bureau of Labor Statistics, *Consumer Price Index—January 2016*, BLS.GOV, https://www.bls.gov/news.release/archives/cpi_02192016.pdf (using January 2016 as the date for calculating consumer price index inflation).

An increase in a uniform tax on capital, moreover, might plausibly *increase* savings. Target savers reduce their savings when a lower tax on capital makes their goals easier to reach and increase their savings when high tax makes their goal harder to reach. The role of target savers, in the wrong direction, makes the total reaction of savings to tax incentives small or even in the wrong direction. *See, e.g.*, JANE G. GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., TAX RATES AND ECONOMIC GROWTH 7 (2011) (reviewing studies and concluding that the savings reactions to taxes were small in magnitude and uncertain in direction); Robert E. Hall, *Intertemporal Substitution in Consumption*, 96 J. POL. ECON. 339 (1988) (finding no savings response to increased interest returns and disputing apparent findings that savings respond positively to increased interest). An ineffective, possibly counter-productive subsidy on a commodity we do not need does not present a strong case for incentive.

59. Comm'r v. Smith, 324 U.S. 177, 181 (1945) (options were compensation even if intended to give employee an ownership interest in the employer corporation).

contract.[60] Without basis, the proceeds from the sale of the contract to the taxpayer's employer was compensation, not explained by the investment or as a fluctuation of capital.

Capital gain, under this conceptual framework, does not include compensation, including compensation achieved by making or improving property that is then sold. Capital gain is supposed to be the appreciation of an investment due to forces beyond the taxpayer's control over more than a year and not from labor input of the taxpayer. If the taxpayer has no recognized capital invested, then the gain cannot be due to the appreciation of capital. If the taxpayer's labor contribution to the gain is significant, moreover, and cannot be separated out with reasonable effort, then material labor input taints the entire gain and makes it ordinary.

Treating compensation as not the product of capital studiously ignores the contribution that unreimbursed educational tuition payments make to higher salaries. Current law treats education incurred before a taxpayer has entered into business as a personal cost, allowed neither as a deduction nor as basis in some investment.[61] That might make some sense as to primary school—a citizen needs to read and write even if they will never earn labor income—but ignoring the investment value of school becomes increasingly silly for later schooling. It is difficult to think of say, business school or air-conditioner-repair classes, as anything but profit-motivated investments. For education arising from time and effort, there is no double tax distortion because neither the time nor effort is a taxed investment. If tuition is reimbursed by scholarships or tax benefits, there is also no double tax. Still, unreimbursed tuition payments, at some point in schooling, yield the double tax distortion. This conceptual framework, awkwardly, follows the current convention that tuition payments have no investment element, without defending it. The awkwardness will probably never make a difference, however, since effort is a material cause of compensation, even with the background of a high-tuition education. Under the framework as explained below,[62] if labor input is the material cause of the return and cannot be separated out from the causal contribution of capital, then the labor input taints the entire asset and makes it ordinary

60. Vestal v. United States, 498 F.2d 487, 494 (8th Cir. 1974) (the sale of a partnership interest with zero basis was compensation, not capital gain); Bryan v. Comm'r, 16 T.C. 972, 981 (1951) (saying that "an item of income cannot be converted into a capital asset, having a cost basis, until it is first taken into income").

61. *See, e.g.*, Reg. § 1.162–5(b)(1) (treating educational expenses, not for taxpayer's existing trade or business, as personal expenses or an "inseparable aggregate of personal and capital expenditures").

62. See discussion in text accompanying notes 79–82, *infra*.

1. Principle Illustrated: Section 83

Section 83 of the Code reflects the norm that compensation, absent a loophole, is taxed as ordinary income. Section 83 requires that a person who provides services has ordinary income when they have a non-forfeitable right to property transferred in connection with those services. Section 83 was enacted specifically to take away capital gain that executives were achieving on their stock compensation under prior law. In two Tax Court cases decided within a year of each other, the Tax Court gave executives capital gain, if any tax at all, on stock transferred as compensation but subject to restrictions on sale that were later released. *Kuchman v. Commissioner* held that executives did not have to pay tax on stock transferred to them as compensation but restricted as to sale because, without access to the market, the stock had no fair market value.[63] *Lehman v. Commissioner* held that there was no compensation when the sale restriction later lapsed.[64] With the two-step of a sale restriction and then release, the executive had compensation neither when nonsalable stock was transferred nor when the sale restriction terminated. Executive tax on the stock would be capital gain, and only when and if the stock was sold before death. Section 83 was enacted to take away capital gain from executive compensation achieved without a prior tax on the capital that appreciated.[65] Capital gain on compensation, if available, is always a loophole that needs to be fixed.

Congress in drafting section 83 was aggressive in preventing capital gain for compensation, indeed reaching beyond value received. Section 83 allows tax deferral for earn-outs, under which the executive keeps the stock only by working to keep it, but otherwise the section ignores restrictions and taxes the stock on its public market value when the stock was received. Stock has the same fundamental present value of expected future cash flows whether or not the stock can be sold. Still, restrictions on sale do undercut the value of highly volatile stock to a holder because they take away the ability to bail out when losses are on the horizon. Investing without the ability to sell volatile property buys the property only with a steep discount from market value. Under section 83, however, the restrictions preventing sale are ignored, both

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63. 18 T.C. 154, 163 (1952).

64. 17 T.C. 652, 654 (1951).

65. *See* Walter J. Blum, *Restricted Stock Arrangements Reconsidered*, 46 TAXES 598, 604–05 (1968). Although the Blum article is not cited in the legislative history, it is plausible that it was the direct cause for the enactment of section 83 by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 487, 588–90.

in the timing of the tax and in valuation.[66] Section 83 prohibits gain from property given to the service provider in connection with the performance of services from being converted into capital gain until after the property is taxed to the service provider as ordinary income and thereby becomes an investment.[67] Paying tax on the full value is treated the same as buying the stock, without a bargain, at value and transforms the stock into capital investment. Capital gain is appreciation of invested capital. Optimistically, section 83 was supposed to be the end of Mickey Mouse tax planning, converting executive compensation into capital gain.[68]

The Treasury regulations under section 83 deny capital gain if there is no possibility of tax loss. An employee has no tax loss if they have no basis, thus no capital invested,[69] and denial of capital gain then makes sense. The regulations seem to go further and defer tax and prohibit capital gain if the employer protects the employee from loss. The employee is not considered to be the beneficial owner of stock entitled to capital gain and transferred by the employer if the employee has "has not incurred the risks of a beneficial owner that the value of the stock will decline."[70]

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66. I.R.C. § 83(a)(1) (The tax on fair market value of compensatory property is "determined without regard to any restriction other than a restriction which by its terms will never lapse.").

67. Reg. § 1.83–1(b).

68. "Optimistically" is used ironically, given the subsequent success of tax planners in achieving capital gain for services using partnership interests. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008). Treasury's facilitation of capital gain in carried interests, without an investment by the employee, is the sad end of a 60-year endeavor by Treasury to prevent premature compensation events taxed falsely at zero value from transforming the property from compensation into capital gain. *See, e.g.*, Reg. § 1.83–7 (2004) (stock options are taxable at issue usually only if sold on established market); *see also* Reg. § 1.83–3(a)(6); Reg. § 1.83–3(a)(7), Exs. 2 & 4.

69. *See* Comm'r v. Smith, 324 U.S. 177, 181–82 (1945).

70. Reg. § 1.83–3(a)(7), Ex. 2 (nonrecourse liability to pay for the stock means the employee has no risk of decline); *see also* Reg. § 1.83–3(a)(6) (indication that no transfer has occurred is that employee does not bear risk of an owner); Reg. § 1.83–3(a)(7), Ex. 4 (buyback guarantee at a price at least equal to the value of stock initially means the employee has no risk of decline). The author is skeptical that an employer arrangement protecting an employee from loss should be allowed to defer tax on the employee compensatory stock if there is a substantial amount that could be taxed. The loss prevention seems to be a benefit on top of ownership, not a denial of ownership.

2. *Principle Illustrated: Payments for Not Working*

Money received for not working is categorized in the same pigeonhole as money received for working. Employers and purchasers of a business, for instance, commonly negotiate a non-competition clause, prohibiting the employee or the seller from going into competition with the business for some period of time. Amounts received for a covenant not to compete are considered to be compensation taxed as ordinary income.[71] So similarly, taxpayers with contractual rights to earn future fees or commissions from the sale of some product, who receive payments on termination of such contractual rights have ordinary income. The receipt is treated as ordinary income, for example, for termination of a contract to be an actor's agent,[72] of a contract to provide mortgage-servicing,[73] and for contracts to earn commissions on sales of insurance,[74] of coal,[75] of fast-food franchises,[76] and of vitamins.[77] A receipt for termination of rights to make a professor's salary is ordinary. In *Foote v. Commissioner*, a university bought the tenure rights of a professor and then

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71. Cox v. Helvering, 71 F.2d 987, 988 (D.C. Cir. 1934); Schmitz v. Comm'r, 51 T.C. 306, 313 (1968), *aff'd sub nom*, Throndson v. Comm'r, 457 F.2d 1022 (9th Cir. 1972); Black River Sand Corp. v. Comm'r, 18 B.T.A. 490, 498–99 (1929).

72. Gen. Artists Corp. v. Comm'r, 205 F.2d 360, 361 (2d Cir. 1953) (turned on finding of no sale).

73. Vaaler v. United States, 454 F.2d 1120, 1123 (8th Cir. 1972) (termination payments to general insurance agent measured by fraction of increase in premiums since start of the contract); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929, 934 (5th Cir. 1963) (also finding no distinction between mortgage fees already earned and mortgage fees to be earned).

74. Foxe v. Comm'r, 53 T.C. 21, 27 (1969) (insurance agent's receipt for termination of interest in renewal commissioners was ordinary income because whether the "case is viewed as involving the transfer of property which is not a capital asset or as involving an anticipatory assignment of income, the result is the same"); Brown v. Comm'r, T.C. Memo 1969-257, 1969 WL 1239; Luna v. Comm'r, 42 T.C. 1067, 1079 (1964) (payment for termination of right to receive extended payments of commissions on prior sales of life insurance was employment compensation); Brown v. Comm'r, 40 T.C. 861, 866–68 (1963); Turner v. Comm'r, 38 T.C. 304, 308 (1962) (sale of future commissions was "the sale of naked rights to future income . . . .").

75. Md. Coal & Coke Co. v. McGinnes, 350 F.2d 293, 294 (3rd Cir. 1965).

76. Michot v. Comm'r, T.C. Memo 1982-128, 1982 WL 10423.

77. Flower v. Comm'r, 61 T.C. 140, 150–51 (1973), *aff'd mem.*, 505 F.2d 1302 (5th Cir. 1974).

fired him; the payment received by the professor for giving up tenure was ordinary income, not capital gain.[78]

Ordinary taxation of payments for not working does not follow from ordinary compensation for working. Not working is the negation of working. How can both working and not working yield the same conclusion? Payments for salary increase when the worker's services become more valuable, but payments for not working often become more valuable because the worker has become less valuable. Still the common rationale is that neither is subject to double tax distortion. The future salary and the payments received for termination of that salary were not returns attributable to the fluctuation of investment of capital and neither is subject to double tax.

3. *From Both Labor and Capital*

Under court-made law, a major factor in determining whether real estate falls within the section 1221(a)(1) exception for holding for sale to customers is whether the seller has improved the property.[79] The doctrine tolerates small improvements that caused some of the reported gain.[80] There is a statutory safe harbor that allows subdivision of real estate into plots, and addition of roads, water, and sewage pipes, but only if the property has been held for more than five years, no more than five lots are sold, and there have otherwise been no substantial improvements.[81] Beyond the safe harbor, the seas become stormy. When the improvements become material, the entire gain is tainted and becomes ordinary, including gain that is attributable to market forces over time and beyond the taxpayer's control.[82] The conceptual

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78. 81 T.C. 930, 934–36 (1983).

79. *See, e.g.*, Biedenharn Realty Co. v. United States, 526 F.2d 409, 422–423 (5th Cir. 1976) (listing factors yielding capital gain, including improvements)*;* Long v. Comm'r, T.C. Memo 2013-233, 2013 WL 5708408, at *7–10 (developer hiring architect, applying for zoning relief, printing brochures, and taking deposits on 20% of units was enough development to make land an ordinary asset), *aff'd in part, rev'd. in part, per curiam*, 772 F.3d 670 (11th Cir. 2014) (ostensibly reversing Tax Court on another issue, which was that taxpayer sold a judgement rather than the not-yet-purchased land); Adam v. Comm'r, 60 T.C. 996, 1003–04 (1973) (holding that taxpayer was a passive investor, not improver).

80. Phelan v. Comm'r, T.C. Memo. 2004-206, 2004 WL 2051108, at *9–10; *see also Adam*, 60 T.C. at 1003–04 (taxpayer made no improvements); *cf.* I.R.C. § 1237 (allowing capital gain for property held for five years, if the taxpayer has subdivided the property but made no substantial improvements).

81. I.R.C. § 1237.

82. *See, e.g.*, Boree v. Comm'r, 837 F.3d 1093, 1104 (11th Cir. 2016) (market appreciation taxed as ordinary gain by reason of taxpayer improvements to the property).

framework follows current law in not trying to allocate between gains from passively riding market forces and returns from taxpayer effort when there is no separate market for taxpayer effort. Any allocation between market forces and taxpayer contributions would be a complex, counterfactual fiction. The compensation element, once material, now poisons any capital gain and makes it all ordinary.

Sometimes allocation between labor and capital inputs might be possible. If there is a readily established market that generates reliable prices for the contribution that capital made to a return or if there is arm's length bargaining adverse as to price that gives a reliable valuation separating a capital from an ordinary asset, then capital gain might reasonably be segregated from ordinary income. Absent a market or adverse-bargain source, a material amount of labor input would make the whole gain ordinary.

The framework would continue the current law rule that when accrued income is sold as part of the sale of the underlying capital asset, the sale price attributable to the earned-but-not-previously-taxed income is separated out from capital gain and treated as ordinary income.[83] Separately identifiable accrued income would not, however, poison otherwise eligible capital gain.

4. *Principled Correction: Making Things*

Notwithstanding the accepted principle that capital asset treatment does not cover compensation, the statute leaves much to be desired, especially when the taxpayer makes property. Section 1221(a)(1), the most general exception to the statutory language that all property is a capital asset, provides that property held "primarily for sale to customers in the ordinary course of a trade or business" is ordinary. "Held primarily for sale" is a subjective test about the taxpayer's state of mind. Subjective tests, including section 1221(a)(1), are always unsatisfactory because we have not perfected mind-reading machines. Taxpayers lie about their subjective intent if it will yield good monetary outcomes and indeed warp their subjective intent for a good monetary result. We thus collect a boxcar of information to try to ascertain subjective intent, notwithstanding the taxpayer's stated intent. Subjective tests are never simple, straightforward, nor accurate.

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83. *See* Storz v. Comm'r, 583 F.2d 972, 976–77 (8th Cir. 1978) (compensation from incomplete underwriting contract was ordinary and carved out from sale of entire business); *cf.* Watson v. Comm'r, 345 U.S. 544, 550–53 (1953) (excluding from capital gain amount attributable to sale of inventory); I.R.C. § 751 (discussed *infra* Part IV.A.2).

Moreover, section 1221(a)(1), once you cut through the terrible subjective standard, is directed at merchants selling inventory and not at adding value by making or improving things. "Customers" have to be plural. In *Commissioner v. Williams*, for example, the court gave the taxpayer capital gain when his employees reconstructed a large ship, based upon the argument that there was no trade or business because the taxpayer anticipated no other ship construction or sale.[84] The taxpayer only built one big ship for one customer. Even had the court found the taxpayer was in business, which is a natural finding for the heavy industry of ship building, the section 1221(a)(1) exception on its face depends upon merchant activity, the selling or distribution to [plural] customers, and not upon the value added by the manufacturing activity. Large improvements do not, on the face of the statute, mean loss of capital gain treatment so long as there is no selling or distribution. Similarly, in *Commissioner v. Gangi*, the taxpayers built condominiums, rented them for a while and then sold them. The Tax Court gave the taxpayer capital gain looking only to the manner of the sale, without noting that these were properties the taxpayers had built and that the material part of their gain was in the nature of compensation.[85] The courts have stepped into the breach and creatively treated improvements as evidence of "holding for sale," so that adding value by making, as well as by merchandizing, sometimes yields ordinary income.[86] The statute itself, however, allows the interpretation made by *Williams* and *Gangi* that sales of property, not within the merchants-holding-for-sale exception, are capital gain. That interpretation of the statute creates a loophole and misstates the consensus understanding of the plain English words "capital gain." Capital gain does not include compensation, no matter what the form.

Before the enactment of the predecessor to section 1221(a)(3) of the Code in 1950, famous authors got capital gain on compensation for their services for one book, on the argument that for one book, they were mere amateurs not having established a business for the asset sold. If they sold to one publisher and did not undertake the distribution, they were not the statutorily stigmatized *merchants*. General Dwight Eisenhower wrote a best-selling book, *Crusade in Europe*, describing his role as Allied Commander in World War II. The IRS ruled he had capital gain from the selling to one

84. 256 F.2d 152, 155 (5th Cir. 1958).
85. Gangi v. Commissioner, T.C. Memo 1987-561.
86. See cases cited *supra* notes 79–80.

publisher because he was an amateur as an author.[87] Actor Fred MacMurray got capital gain on a mere "transitory" sale of one story.[88]

Section 1221(a)(3) was adopted to close the "loophole" represented by cases like Eisenhower's and Fred MacMurray's, in recognition that gain on self-produced assets was a product of work and not capital and was supposed to be ordinary income.[89] Ordinary gain for sale of a book was a "loophole" before the change because it violated the accepted principle that compensation is ordinary, even if achieved by selling a property. It violates equal horizontal treatment to give some compensation high ordinary rates while giving other taxpayers lower rates because they make their compensation by selling property they have made.

The section 1221(a)(3) exception to capital assets was, however, narrowly written to cover only literary or artistic works and does not cover the full range of the loophole. Building a large ship for one customer is not included, since heavy shipbuilding is presumably not artistic work. While the master is away, the courts, as loyal servants, should continue to construe section 1221(a) to exclude from capital treatment taxable goods constructed or substantially improved by the taxpayer, consistent with the accepted underlying principle.[90] Compensation is ordinary income even if realized in the form of sale of property. *Williams*, which allowed the taxpayer to build a ship (once) and get capital gain, and *Gangi*, allowing the contractor to build and sell their condominiums, need to be understood as unprincipled anomalies. Under this proposed framework, "capital asset" would exclude real and intangible property created or substantially improved by the taxpayer and not just artistic works.

5. Principled Correction: The Shelter Deduction from "Donations" of Services

Treating self-created or improved property as capital gain also creates an unjustified accounting mistake when self-made property is given to charity. In general, the charitable deduction is just an adjustment that matches taxable

87. Associated Press, *Eisenhower to Pay Tax As an "Amateur" Writer,* N.Y. TIMES, June 2, 1948, at 31 (reporting that IRS ruled that General Eisenhower had capital gain from sale of *Crusade in Europe* because he was an amateur).

88. MacMurray v. Comm'r, 21 T.C. 15, 31 (1953).

89. S. REP. NO. 2375, at 43–44 (1950).

90. According to the parable of the faithful servant in *Matthew* 25: 14–30, the truly loyal servants invest their talents, for gain or loss, while the master is away. Faithful servants do not bury their talents awaiting the master's return. The courts need similarly to take responsibility for wise outcomes while Congress is away.

income to the lower amount that the taxpayer has left to spend on their standard of living after making the gift. A deduction of untaxed compensation built into the contribution of certain types of long-term capital gain property, however, means that the taxpayer's money retained for selfish use will be sheltered from tax.[91]

Assume, for example, a taxpayer making \$120*x* a year salary works for 7 months for pay, keeping \$70*x*, and then works for charity for 5 months providing services worth \$50*x* but taking no pay. The taxpayer is not taxed on the \$50*x* of services for charity, under the common sense reason that no pay was received. That exclusion of the \$50*x* is a complete and sufficient tax description of the gift to charity. If the taxpayer also deducts the value of the same excluded \$50*x*, the deduction creates a second adjustment, a sheltering deduction to be used against the first-months' income the taxpayer has kept and used for entirely selfish purposes. The taxpayer has kept \$70*x* in support of their standard of living, but both deducting and excluding the \$50*x* would allow the taxpayer to report only \$20*x* of the \$70*x* the taxpayer has retained for selfish use. The taxpayer would have taken the \$50*x* out of the tax base twice.

Congress can enact a wise subsidy with budgeted government spending, but the deduction of untaxed gain built into donated property does not have the hallmarks of any wisdom. It looks like conceptual error. The value of a deduction, for example, depends on tax brackets, and there is no reason to think that anyone would believe the rich man's \$50*x* is worth a higher rate subsidy than the widow's \$50*x* contribution to charity. If Congress is right about the tax bracket structure, its negation cannot be right. Allowing both an exclusion and deduction has all the hallmarks of error of double deduction.

A normal charitable deduction of cash, by contrast, simply reflects the lesser amount the donor has kept for their own purposes. If the taxpayer had given \$50*x* cash to the charity, starting at \$120*x* income, then a \$50*x* deduction would reflect the \$50*x* less available to the taxpayer, and both tax and real life would show \$70*x* income left over after the gift. Indeed, given that the donor of cash has really lost the \$50*x*, we should not object to the value of the tax savings depending upon the tax bracket. If a rich man or poor loses \$50*x* by theft or tornado, we should adjust taxable income by \$50*x* for the loss before deciding what tax bracket is imposed upon the money retained.

To avoid the possibility of a double adjustment, services performed for charity have never been deductible; the exclusion for unpaid services is a complete remedy. Still, the courts have backhandedly allowed deductions for

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91. This argument was also made in Calvin H. Johnson, *Was It Lost?: Personal Deductions Under Tax Reform*, 59 SMU L. REV. 689, 691 (2006).

services that have "coalesced into property" when the property is contributed, even though the services themselves are not charitable deductions.[92] In 1969, Congress reduced the charitable deduction of contributions of property by the amount of ordinary gain on the property, measured as if the taxpayer sold the property.[93] If the property contributed is an artistic and literary work, reducing the charitable deduction by built-in ordinary gain at the time of contribution ended the tax-shelter charitable deduction for services that had coalesced into contributed property. The 1969 Act, however, left intact deduction of built-in capital gain on property contributed to a public charity, although some further limitations have since been enacted.[94] The efficacy of the 1969 Act reform, beyond the artistic and literary works made ordinary by section 1221(a)(3), depends upon finding that the services were ordinary even if they had coalesced into property. Improving real estate by a material amount should make the real estate property held primarily for sale. Still, for example, where a taxpayer develops a heart-lung machine,[95] or improves a large ship, or builds a condominium, the services built into the machine or the ship may still get the double adjustment, the exclusion-and-deduction tax shelter. This Article's framework rejects the accounting error of allowing a charitable deduction for services embodied in property. In calculating the charitable deduction, no gain created by taxpayer's labor input or deducted expenses would be included in the charitable deduction, without regard to the literary or artistic characteristics of the property. The accounting error is inappropriate for any compensation, even that which has coalesced into property.

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92. *See* Cupler v. Comm'r, 64 T.C. 946, 953–54 (1975) (heart-lung machine invented by taxpayer was property rather than services for purposes of the charitable deduction); Jarre v. Comm'r, 64 T.C. 183, 187–88 (1975) (assumed music manuscripts were property rather than services for purpose of the charitable deduction); Goss v. Comm'r, 59 T.C. 594, 595–96 (1973) (completed essays were deductible as property contributions). *But see* Grant v. Comm'r, 84 T.C. 809, 816–17 (1985), *aff'd per curium*, 800 F.2d 260 (4th Cir. 1986) (finding legal briefs and memorandum were legal services that had not coalesced into property).

93. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1)(B), 83 Stat. 487, 549–58.

94. *See* I.R.C. § 170(e)(1)(B) (limitations including for certain intellectual property, certain tangible property, and taxidermy property).

95. *Cupler*, 64 T.C. at 953–54. The heart-lung machine invented by taxpayer was held to be property, and it is probably not artistic property no matter how beautiful.

6. Principled Correction: Sale of Songs

In 2005, Congress gave capital gain status to sale of a musical composition or copyright by the composer.[96] The exception is reported to be a response to lobbying by the Nashville Songwriters Association.[97] The Nashville Songwriters said that its members' average songwriting income was only $4,700,[98] which would alone be too low to require payment of federal tax.[99] For taxpayers too poor to pay tax anyway, the recharacterizaton as capital gain has no benefit. These country singer-songwriters, however, include some of the richest citizens of America—Taylor Swift is said to be making $44 million a year.[100] Among the arguments proponents made, according to the press, was that a songwriter was more vulnerable to fewer, large payouts and could not arrange to spread out their payments.[101] If Taylor Swift spread out her income over 300 years, however, she would still be in the highest tax bracket. Capital gain characterization cut her tax on this labor income in half, whereas averaging would do nothing for her. Sale of music is also often a steady source of income.

Congress has at various times considered allowing taxpayers with roller-coaster patterns of income to average their income over some number of years, but Congress repealed the last such provision in 1986.[102] General

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96. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 204(a), 120 Stat. 345, 350 (codified at I.R.C. § 1221(b)(3)); *see also* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 412, 120 Stat. 2922, 2963 (making provision permanent).

97. Brody Mullins, *Music to Songwriters' Ears: Lower Taxes: Country Artists' Group Presses Lawmakers to Slash the Levy on Lyricists,* WALL ST. J. (Nov. 29, 2005), https://www.wsj.com/articles/SB113322576138408618.

98. *Id.*

99. *See* INTERNAL REV. SERV., PUB. NO. 17, TAX GUIDE 2016 FOR INDIVIDUALS 5 (2016).

100. *Musicians: Country Stars*, PAYWIZARD, http://www.paywizard.org/main/salary/vip-check/country-star-salaries (last visited July 2, 2017). Singer-song writer Toby Keith is reported to be making $34.5 million a year. *Id.* If the figures are not accurate, assume the text is dealing with a hypothetical country artist.

101. Mullins, *supra* note 97.

102. Congress considered and rejected averaging for salary earned over many years in the same session that it adopted preferential tax cuts on capital gain. H.R. 14198, 66th Cong. § 3 (1920), *reported in* J.S. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938–1861, at 815 (1938). Congress allowed general averaging, without regard to source, from 1964 through 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117 (repealing income averaging);

averaging might or might not be a very good idea,[103] but if averaging is allowed, it needs a better rationale than "I am a country song writer." Committee explanations of the bill stated without embellishment that "[t]he Congress believes it is appropriate" to allow capital gain on the sale of music by the composer,[104] which implies the staff could not think of a good reason for the change. Congress did at least have the grace to deny the sheltering deduction by the contribution of the songs to charity. For the charitable deduction, the deduction is equal to basis, that is, to zero.[105] There is no sound way, in any event, to describe sale of music by the composer on a principled basis as capital gain. It is compensation. Compensation as a matter of principle is taxed by progressive rate brackets to take into account the recipient's standard of living and utility of money. Horizontal equity demands that compensation be treated the same no matter what its source. The Article's framework would repeal the provision.

B. Body Parts

Under current law, sale of blood or other body parts by the person who created them yield ordinary income under a number of competing rationales, not all equally satisfying. The preferred rationale is the one contained within this string: blood and other body parts are like compensation because for both compensation and body parts, the return is not a product of invested capital and so taxing it does not produce a double distortion tax.

Green v. Commissioner[106] held that the sale of blood of a particularly valuable type was a sale of an asset held primarily for sale in the ordinary course of a trade or business[107] because the taxpayer had sufficient selling

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Revenue Act of 1964, Pub. L. No. 88-272, § 232, 78 Stat. 19, 105-12 (1964) (codifying averaging at I.R.C. §§ 1301–1305 (1964)).

103. *Compare*, Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151 (2006) (but retaining averaging for near poverty levels), *and* Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509 (worrying about incentives for too much risk and the complexity and administrability of averaging), *with* William Vickrey, *Averaging of Income for Income-Tax Purposes*. 47 J. POL. ECON. 379 (1939) (advocating general averaging in lieu of capital gains tax).

104. STAFF OF THE JOINT COMM. ON TAX'N, JCS-1-00, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS 277 (2007).

105. I.R.C. § 170(e)(1)(A) (parenthetical material).

106. Green v. Comm'r, 74 T.C. 1229 (1980).

107. I.R.C. § 1221(a)(1).

activity over seven years for it to constitute a trade or business.[108] That rationale is not satisfying. Applying the statute literally, individuals surely have to hold their blood *primarily* for survival, even if they regularly sell some of it. Sales have to be considered subsidiary to the first function of blood. *Green*'s finding of a trade or business also does not settle the case of a taxpayer who has not been regularly selling blood for seven years. In addition, "trade or business" has too nebulous a border to be functional for a tax return instruction, and telling taxpayers how to fill out their tax return is the primary function for any rule of law in tax.

Some authorities treat the sale of blood and other bodily parts as a sale of services, rather than of property, from the first sale because of the effort of separating what is sold from the body.[109] *Green* rejected the argument, while holding that the taxpayer did have ordinary income by reason of high sale volume, saying that the taxpayer's services were not substantial in relation to value. The blood was a valuable tangible product, the Court said, and petitioner did "little more than release the valuable fluid from her body."[110] The rationale proposed in this Article is not that we take into account the labor of extraction but that both work and body parts are ordinary because they are not the product of capital and not subject to double tax distortion.

Green also said that a sale of blood is like a sale of a crop or harvest and not a sale of capital itself:

> The rarity of petitioner's blood made the processing and packaging of her blood plasma a profitable undertaking, just as it is profitable for other entrepreneurs to purchase hen's eggs, bee's honey, cow's milk, or sheep's wool for processing and distribution. . . . Even human hair, if of sufficient length and quality, may be sold for the production of hairpieces. The main thrust of the relationship between petitioner and the lab was the sale of a tangible raw material to be processed and eventually resold by the lab.[111]

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108. *Green*, 74 T.C. at 1235.

109. In Revenue Ruling 162, 1953–2 C.B. 127, the IRS ruled that no charitable deduction was allowed for donation of blood because donation of blood was a service to the charity. Perez v. Comm'r, 144 T.C. 51 (2015), similarly held that payments for human eggs was for services. Lary v. United States, 787 F.2d 1538 (11th Cir. 1986), denied the taxpayer a charitable deduction for blood given to the Red Cross, because the giving constituted services or because the taxpayer had no basis in or long-term holding period for the blood.

110. *Green*, 74 T.C. at 1234.

111. *Id.*

The analogy between petitioner's blood and sale of sheep's wool, hen's eggs, bee's honey, or cow's milk makes the blood like a sale of crops or harvest of the land, that is ordinary.[112] As the High Court of Australia put it, "wool shorn and lambs dropped" belong to the income beneficiary and they are not capital, hence not capital gain.[113] Under the feudal tenures that first defined capital gain, the yet-unknown heir was entitled to the land, but the income beneficiaries were entitled to the harvest of the land, including the products of farm animals. Treating the blood as a crop or harvest means it is not of capital account (brown or black stuff, belonging to the male heir) but of the income interest belonging to living individuals (green stuff) and taxed at ordinary rates.

Professor Jay Soled has called for a statutory amendment to deny capital gains rates to sale of eggs and other body parts because for aging, perishable body parts a reduced rate does not cause earlier sale by enough to justify the tax reduction.[114] The "perishables" argument is a good one, but there are limitations to the rationale. If property might be held until after death, when the step up in basis wipes out gain, then a lower rate for sale during life might increase sales by enough to make the Treasury come out ahead.[115] Would Professor Soled switch his categorization of eggs as ordinary, however, if preservation techniques made it feasible to preserve eggs for the next generation? Is there a different case if the taxpayer intended to preserve the eggs for use after her death? The perishables argument becomes less persuasive as the duration of body parts increases under new technology.

Under this string of the conceptual framework, human body parts sold by the human who grew them are always ordinary because they are not the product of capital and not subject to double tax distortion. When a taxpayer sells blood or other body parts, the taxpayer cannot establish an investment or capital in the body that produced the parts. The costs of maintaining health are

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112. *See, e.g.*, *supra* note 17 and accompanying text.

113. *Hassell v Perpetual Ex'rs Trs & Agency Co* (1952) 86 CLR 513, 522 (Austl.).

114. Jay A. Soled, *The Sale of Donors' Eggs: A Case Study of Why Congress Must Modify the Capital Asset Definition*, 32 U.C. DAVIS L. REV. 919, 948–49 (1999); *id.* at 952–53 (arguing that Congress should limit capital gains to cases in which lower rates will increase earlier realizations). Professor Soled believes that making sales of eggs ordinary requires a statutory amendment because, when services are sufficiently embodied in "property," they become property. *Id.* at 923–32, 962. This framework rejects the embodied-in-property rationale for compensation as unprincipled and rejects the same argument for body parts, even without statutory amendment.

115. *See* discussion *infra* Part V.B.

inherently personal and not investments because a taxpayer will try to maintain life and health even if no body parts are sold.[116] If the body parts are not the product of invested capital, there is no double tax distortion tax, as there is with a tax on the products of capital.

The analogy between body parts and "wool shorn and lambs dropped" also creates an alternative or supplementary argument that the gains are ordinary. Crops and calves, lambs and chicks are the product of capital, but are green stuff, income, and not themselves brown stuff or capital. Within this string, however, it is the absence of double tax that makes the gains ordinary and that is sufficient to deny capital gain.

The conclusion that the sale of body parts is ordinary applies both to replaceable and one-time-only body parts. It was once thought that all the human eggs a woman would produce were present at birth, whereas blood, human hair, and sperm are renewed. The nonrenewable origin of human eggs is subject to doubt now.[117] The issue does not trigger a distinction, however, so long as we do not recognize or tax human capital and do not treat the ova as the result of the appreciation of human capital. It might well be that much compensation is a one-time event. Even Einstein had only one General Theory of Relativity in him, and Alexander Graham Bell only one telephone. Still, body parts, like compensation, are not subject to double tax, even if the part is only a one-time thing.

III. NEGATIVE TAX

The ordinary understanding of capital gain is that it lowers rates but does not provide a result better than no tax on the transaction. As a matter of

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116. *Green*, 74 T.C. at 1236 (saying that the costs of maintaining health are "primarily a personal concern" and not akin to investment in manufacturing machinery); Lary v. United States, 787 F.2d 1538 (11th Cir. 1986) (denying the taxpayer a charitable deduction for blood given to the Red Cross because the taxpayer had shown neither basis nor long-term holding period for the blood).

United States v. Garber, 607 F.2d 92, 99–100 (5th Cir. 1979) (en banc), *rev'g*, 589 F.2d 843 (5th Cir. 1979), held that the government had not established the "willfulness" required in a criminal case because of the argument, raised by the taxpayer's advocate, that payment for blood might be a recovery of personal capital or income. The original decision had held simply that the receipts were economic gain, taxable as ordinary income under the general reach of § 61. 589 F.2d at 847–48. The reversal en banc did not reach the legal issue of whether blood was tax exempt as a matter of law but only determined that the seller of the blood had not shown criminal willfulness in excluding it.

117. *Do Ovaries Continue to Produce Eggs During Adulthood?*, SCIENCE DAILY (July 26, 2012), www.sciencedaily.com/releases/2012/07/120726180259.htm.

principle, Congress needs to allow subsidies that are better than no tax, if at all, only under strict budget control that ensures that the cost of the subsidy does not exceed its benefit to the general public. The cost of subsidy should be transparent in a democracy and not hidden in the tax accounting.

A negative tax is a treatment of a positive value transaction that causes the transaction to be more valuable after tax than before tax. A negative tax includes making a loss before tax into a profit after tax. Recognizing an economic loss in tax also does make a transaction better after tax than before, but that is something different. Among other things, no one voluntarily has an economic loss, even after reduction of its impact by tax deduction.

Because a negative tax is a better result than no tax, it is a serious enough breach of ordinary tax accounting that it should never be implied by the courts without the very clearest of marching orders.

The function of tax accounting is to provide a description of the taxpayer's available resources without subsidy or penalty. Code section 446(b) does not permit a method of accounting that does not "clearly reflect income" in the opinion of the Secretary of the Treasury (or delegate). A tax accounting that produces negative tax can never reflect income from the transaction. Results better than no tax cannot be justified by a nirvana of no tax impediment; negative taxes are government interventions that stretch, warp, and distort the allocation of investment. If negative tax is available, investments will be made that would never be made in the absence of tax and should not be made if we care about the real economic value of an investment derived from its real pretax demand. The courts should, accordingly, abhor an interpretation of capital gain that would yield a negative tax or subsidy by which the tax treatment increases the value of a transaction. So should Congress.

Negative is a very low bar. In a world in which some investments overall bear 40% ordinary tax, a lower rate of tax is a distorting subsidy. Tax should be a level playing field for the competition among investment projects so that choices are made on the pretax merits of a project based on real demand. Still, the no-tax line—when the tax treatment is more generous than tax free—is an intuitively defensible line for identifying cases in which the distortions are especially abusive.

A. *Expensed Investments*

1. *Principle Illustrated: Expensed Items*

Items that have been expensed need to remain ordinary items when sold. It is a building block of tax economics that an immediate deduction for an investment combined with full ordinary taxation of the return yields a tax

that will not reduce the pretax return. With constant tax rates for the time of both input and output, an immediate deduction is equivalent in value to exemption of the return.[118] With a lower tax rate, such as the capital gains rate, on the return from an expensed investment, the impact is a negative tax—a result better than no tax. The combination of immediate deduction of expensing an investment and capital gain for the yield or the output of the transaction means that the tax improves the yield from the transaction, which is inconsistent with a tax system that is trying to reduce the yield to transfer value to fund government payments for common defense and general welfare.

Assume, to illustrate, a cost of \$100*x* that produces \$90*x* revenue. In the absence of tax, the \$100*x* cost would not be undertaken because the demand for the product, revealed by the \$10*x* loss, is not great enough to justify the cost. Absent a showing that the goods are "merit goods," properly subsidized even if the market demand does not justify them, the judgment of the market—this transaction is worth only \$90*x* for its \$100*x* cost—needs to prevail. Inferior investments should not prevail over better ones. The \$100*x* cost needs to go elsewhere where it will produce more than a \$100*x* benefit.

Deduction of the \$100*x* and capital gain for \$90*x*, however, will motivate an investment into this inferior investment. If the \$100*x* is deducted in a 40% tax bracket, then after tax, considering the \$40*x* value of the deduction, the \$100*x* cost becomes a \$60*x* cost. If the \$90*x* pretax return is

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118. The seminal piece is E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948). Algebraically, an income tax reduces \$100 salary or other income to take home pay of *\$100*(1-T)* which may be invested at *R* to grow for *n* to reach

$$(1)\ \$100 * (1\text{-}T) * (1\text{+}R)^n$$

where *T* is tax rate, *R* is annual return rate, and *n* is number of years of the investment. If the return is tax exempt (as, for example, Roth IRAs are tax exempt), then *(1)* represents the final return. If the \$100 is deducted or exempt from that then the full \$100 may be invested, yielding a pretax amount at *n* of *\$100*(1-T)*(1+R)n*. If the full return is subject to tax, as in distributions from a regular IRA (and the taxpayer has no basis, since the \$100 cost has already been deducted), then the return after tax is

$$(2)\ \$100 * (1\text{+}R)^n * (1\text{-}T)$$

Expressions *(1)* and *(2)* are equal because of the commutative law of multiplication, which states that the order of multiplied terms does not matter. Therefore, with a constant *T*, *R*, and *n*, tax exemption for the profit or tax deduction for the input are equivalent.

taxed at 20% as a capital gain, the return drops only to $72*x*. The $60*x* input and $72*x* return represents a 20% after-tax profit as a percentage of after-tax cost.[119] Tax, which is negative, has turned a 10% loss as a matter of real pretax economics into a 20% post-tax profit. For a taxable investor in a 40% bracket, a 20% post profit is obtained only with a 33.3% real pretax return.[120] The negative tax will turn taxpayers away from a quite wonderful investment that makes a bit less than 33.3% pretax return and channel the money into this inferior investment. That kind of accounting will draw great crowds of investors beating a path into wasteful investments that lose money pretax based on their real costs and demand for their output.[121]

"Recapture" alone will not prevent the negative tax. The entire asset needs to become an ordinary asset just to get up from negative to zero tax impact. A "recapture" remedy would treat gain as ordinary up to the original ordinary deduction but not beyond.[122] Even with recapture, the expensing combined with capital gain for unrecaptured amounts yields a negative tax. Assume, for example, a pretax profit of 10% from $100 input and $110 output in the absence of tax. Expensing would again reduce the cost to $60 for someone within the 40% tax bracket. Taxing the first $100 recaptured amount at 40% and the $10 gain after recapture by a 20% capital gain tax would reduce the $110 by $40+$2, for an after-tax return of $68. The ratio of 68 to 60 represents a 13.3% profit,[123] for an increase over the pretax 10% profit by one-third. Superior investments, giving just short of 22.2%, but subject to 40% tax, would lose out to this inferior investment given its access to negative tax.[124] "Recapture" is not sufficient because it allows negative tax. The asset needs to be considered ordinary in full just to get up to zero tax.

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119. $60 * (1+20%) = $72.

120. To match at 20% post-tax profit, a taxpayer in a 40% bracket and normal ordinary tax would have to have *20%/(1-t)*, or $33^{1}/_{3}$% annual profit.

121. With the mismatch in accounting, an investment that lost up to $25 in real pretax terms would break even, after tax. The breakeven point is illustrated by *$100 * (1-T) = $75 * (1-cg)*, where *T*, for ordinary tax rate, is 40% and *cg*, for capital gain rate, is 20%: *$100*(1-40%) = $75*(1-20%) = $60*.

122. *See* I.R.C. § 1245; *cf.* I.R.C. § 1250. Section 1231 is the statutory path allowing gain in excess of recapture to be treated as long-term capital gain (if § 1231 gains exceed § 1231 losses). Under current depreciation conventions, real property almost never generates recapture; the unrecaptured amount may be taxed at a higher capital gains rate (25%) than the usual, but one that is still lower than ordinary rates. I.R.C. § 1(h).

123. $60 * (1+13.3%) = $67.98.

124. 22.2% * (1-40%) = 13.32%.

2. *Principle Illustrated: Recovery of Expensed Items*

The courts have doctrine to deny capital gain treatment for expensed items on the ground that the accounting does not "clearly reflect income."[125] In *Merchants National Bank v. Commissioner*, the Court appropriately held that bad debts written off by a bank generated ordinary income when sold.[126] The notes were property held for over a year and disposed of in a sale or exchange. Still, the sale was held to be ordinary by reason of the prior deduction. A mismatched combination of ordinary deduction and capital gain for recovery of the same item would have generated a negative tax windfall. The economic distortion arising from the ordinary deduction combined with capital gain is serious enough abuse that the courts have laudably used available doctrine to meet the abuse.

3. *Principled Correction: Goodwill*

Under the principle that negative tax is to be abhorred, self-developed goodwill would be an ordinary asset under this framework. Congress should treat sale of goodwill as sale of an ordinary asset.[127] Under the authority of section 446(b), applicable when the taxpayer's accounting method does not clearly reflect income, courts should also treat goodwill as an ordinary asset to prevent the creation of negative tax.

Business goodwill is the value of a business that cannot be transferred apart from the business as a whole and is not attributable to any other accounting-identified asset.[128] Under the regulations defining capital expenditures, expenses incurred to develop goodwill are immediately expensed and are not capital expenditures, even if economically the expenditures are investments producing significant future revenue.[129] Self-developed goodwill is the product of business expenses, arising from operating income without a tax-recognized investment. Self-developed goodwill is never capital because the expenditures in developing goodwill are deducted immediately from the ordinary income account.

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125. 22.2% * (1-40%) = 13.32%.

126. 199 F.2d 657, 659 (5th Cir. 1952).

127. Calvin H. Johnson, *Sale of Goodwill and Other Intangibles as Ordinary Income,* 118 TAX NOTES 321 (Jan. 14, 2008).

128. *See* Reg. § 1.1060–1. Going concern, to the extent it is something separate from goodwill, would meet the same fate as that proposed here for goodwill.

129. Reg. § 1.263(a)–4(b)(3) (allowing expensing for acquisitions of interests not "intrinsically capable of being sold, . . . separate and apart from a trade or business").

It would be a first-best solution to capitalize the costs of self-developed goodwill and other intangibles, up to the level of the investment value of those costs, because that would maintain a tax on the return from the investment in the intangible.[130] A fallback position is that given the expensing of the costs of developing goodwill, all the gain from self-developed business goodwill (and not just the gain up to the expensed amounts) is ordinary. Full ordinary tax on goodwill would not mean that the return from goodwill is reduced by tax, but only that the tax would not be negative, *increasing* the pretax return.

That the sale of goodwill produces ordinary income is also supported by string number five, "Treasury Must Profit," under which depreciable and amortizable property is ordinary.[131] Section 197 of the Code allows taxpayers to amortize purchased goodwill and other intangibles over 15 years. Capital gain for sold goodwill steps up the amortizable basis for goodwill at too cheap a price. Whether the goodwill is self-developed or purchased, proceeds allocated to goodwill need to be ordinary.

4. *Principled Correction: Accelerated Depreciation*

The problem of negative tax arises not just from capital gain on expensed investments but also from capital gain on equipment for which accelerated depreciation has been taken. Accelerated depreciation generates a deduction for amounts not lost as a matter of economics and yields reduction of pretax economic income to a fraction of what the statutory tax rate would imply. Bonus depreciation, for example, allows half the investment to be expensed immediately and also allows a schedule of accelerated ACRS depreciation on the other half of the investment.[132] Under one set of reasonable assumptions, bonus depreciation cuts a statutory tax rate of 35% down to a real economic tax rate—that is, the reduction of the internal rate of return—of only eight percent.[133] When, even better, capital gain is allowed on gain from a sale of accelerated-depreciation property, a negative tax can arise, even without full expensing.

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130. *Cf.* Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (Aug. 10, 2009).

131. *See* Part V.

132. I.R.C. §§ 168(e), (k).

133. Calvin H. Johnson, *Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation,* 100 TAX NOTES 713 (Aug. 4, 2003). The exact impact of bonus depreciation depends on assumptions about discount rate and the pattern of pretax cash flows, which would cause variance in the eight percent effective tax rate. *Id.*

Capital gain does not come up very often on sales of used equipment. Under current law, capital gain on sale of equipment is converted into ordinary gain by the recapture rules of section 1245 to the extent of prior depreciation. Used equipment does not generally increase in value over time above its original cost, so that capital gain on sale is relatively rare. Capital gain is, however, possible,[134] and with enough capital gain, the combination of depreciation and capital gain on sale will yield a negative overall impact. Calculations of the exact remedy to reach exactly zero tax is, however, not simple. The remedy to prevent negative tax, but yield zero rate of effective tax, depends critically on length of holding and rate of return, and it is not a pretty or elegant remedy.[135] Nor is a zero rate tax a sufficient goal when competing investments are subject to tax. Taxing all of the little capital gain that shows up on used equipment as ordinary income would be far simpler. Because the capital gain on used equipment is rare, making the gain ordinary in full would not have much revenue impact.

For reasons stated in the string discussed below in Part V, no depreciable property should ever qualify for capital gain rates even above recapture. The capital gain rate allows a step up in basis for the buyer at too low a price because the value of the added depreciation from the higher basis reduces the Treasury's revenue by more than the Treasury collects on sale. Current law converts what would otherwise be capital gain to ordinary income when a seller sells depreciable property to narrowly defined related parties.[136] The gain on all depreciable property should, however, be ordinary because of the damage to the Treasury from the too cheap increase in basis from the taxable sale. That remedy, applied across the board to all depreciable property, would avoid the hard, and sloppy, remedy of taking away just the right amount of capital gain to allow bonus or accelerated depreciation to yield an effective tax rate at no lower than zero.

5. *Principled Correction: Sale of Bargain Expenses*

A current sale that increases future deductible expenses is generally treated as capital gain, but it should not be.[137] Assume for example, a taxpayer

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134. I.R.C. § 1231(a)(1).

135. *See* Johnson, *supra* note 133.

136. I.R.C. § 1239.

137. BITTKER & LOKKEN, *supra* note 10, at ¶ 47.9.5 (2017) (discussion entitled, "Receipts affecting future deductible expenses," which questions the capital gain treatment matched with loss of future expenses); Calvin H. Johnson, *Sale of Long-Term Electricity Supply Contract Is Ordinary Gain*, 152 TAX NOTES 887 (Aug.

has a long-term business lease and demand in the area has gone up so that the fixed rental costs on the lease have become a bargain. The taxpayer sells the lease to another tenant for a price that reflects the discounted value of the bargain. Under the sale, the buyer will make the rental payments required, at the bargain rate. The courts have treated the sale of the lease as capital gain.[138] Similarly, sales of valuable water rights[139] or state tax credits[140] increase future deductible expenses, and yet each has been treated by courts as a capital gain transaction.[141]

A sale that increases future expenses is like a borrowing transaction in which the taxpayer pays capital gain tax on borrowed proceeds and then deducts the repayment of the loan from ordinary income. The combination of capital gain for amounts received now and ordinary deductions for the increased expenses attributable to the sale creates an inappropriate negative tax. The borrowing becomes not a cost, but a profit center after tax.

Assume, for instance, the tenant with the long-term lease for business premises at a fixed rent discovers that rents have gone up for comparable premises in the area such that for one future year, the rent on comparable premises would be $100*x* higher. The tenant sells the lease right to occupy the premises to a lease buyer, who pays the selling tenant $90*x* for the right to pay the bargain rent. The $*90x* sale price is the present value of the $100*x* bargain reflected in the sold lease, at a discount rate negotiated by the parties.

8, 2016) (questioning the availability of capital gain as to sale of electricity supply contracts).

138. Comm'r v. McCue Bros. & Drummond, Inc., 210 F.2d 752, 753–54 (2d Cir. 1954) (payment by landlord for tenant to vacate rent-controlled business premises); Comm'r v. Golonsky, 200 F.2d 72, 74 (3d Cir. 1952) (tenant's receipts for vacating before end of the lease).

139. Gladden v. Comm'r, 112 T.C. 209, 221–23 (1999) (sale of water rights forcing taxpayer to buy water at higher open market price was capital gain), *rev'd*, 262 F.3d 851, 853–55 (9th Cir. 2001) (holding that additional purchase price could be apportioned as cost basis).

140. Tempel v. Comm'r, 136 T.C. 341, 352–55 (2011) (sale of Colorado tax credit for donated conservation easement was capital gain, but short-term capital gain and with no basis allocated to sold credit); McNeil v. Comm'r, T.C. Memo 2011-109, 2011 WL 1990545, at *4 (following *Tempel* and holding taxpayer's sale of state tax credits resulted in short-term capital gains); C.C.A. 2011-47-024 (Sept. 15, 2011) (concluding that the sale of various Massachusetts state tax credits results in capital gains).

141. *Tempel*, 136 T.C. at 352–55; *Gladden*, 112 T.C. at 221–23. *But see* Comm'r v. Pittston Co., 252 F.2d 344, 348 (2d Cir. 1958) (amounts received for cancellation of advantageous exclusive right to purchase coal was ordinary income, but on the grounds that cancellation was not a sale or exchange, not that contract was an ordinary asset).

Undoubtedly, the taxpayer will sell many periods' rent by assigning the entire lease, but focusing on one rent for one period makes the point simply. Assume the seller needs comparable premises and will pay \$100*x* extra deductible rent by giving up the lease. As to the lease seller, the transaction has the cash flow of a loan and is not an investment—that is, money is received now in exchange for higher cash paid latter. The taxpayer is willing to pay interest on the loan, in the amount of \$10*x*, which as determined by an arm's length sale is the right amount for the risks for the period between the receipt of \$90*x* cash and the "repayment" that occurs when the seller spends \$100*x* extra in rent. Had the interest payment been labeled as such, a 40% tax would reduce the cost of interest from \$10*x* down to \$6*x,* which is the right result for a \$10x cost.

Tax at capital gains rates will reduce the after-tax cost of the borrowing into the negative range and indeed turn a borrowing transaction into a profit. The \$90 cash, taxable at 20% capital gains rates, would be reduced to \$72. The expected after-tax costs of the rent is reduced by the 40% rate deduction from \$100 to \$60. Now the after-tax result is receipt of \$72 and repayment of \$60. Thus, a loan bearing real economic interest of \$10 is turned into an after-tax profit of \$12. Tax has increased the value of the transaction to the lease seller by \$22 from a pretax cost of \$10, to an after-tax profit of \$12. The value added by such tax accounting does not reflect income.

Section 446(b) of the Code gives the Treasury Secretary, or the IRS as delegate, the authority to prohibit a tax accounting that does not "clearly reflect income." Section 446(b) is an embodiment of the principle that the function of accounting is to account accurately, that is, to describe the world it is recording. Accounting is not just debits and credits scratched on the back of a napkin, impervious to the world. Section 446(b) authority is exercised pursuant to court supervision under an abuse of discretion standard. Even if there were no section 446(b), the courts would nonetheless have independent authority, in addition to the Service, to make accounting responsible as a description. The courts as well as the Service should and sometimes will abhor negative tax.

In replacing the business premises, the seller of the tenant position cannot be expected to match the sold lease exactly. The taxpayer might upgrade or downgrade the business premises after assignment of the lease. The selling tenant might be scattering its old functions among many offices or consolidating many offices into one. If the tenant's new arrangements are complicated enough, it would be impossible to trace through the bramble bush of new arrangements replacing the sold lease to determine whether the tenant-seller paid the \$100 higher rent. The tenant selling the lease might also be going out of business. The future is alas impossible to predict at the time when the lease assignment occurs and the capital or ordinary character of the sale must be ascertained.

Even if the tenant chooses to downgrade business premises or abandon the business, however, the lease needs to be considered an ordinary asset in full. The buyer of the lease is paying the present value of the bargain price of future expenses, and the seller's position is symmetrical to selling the bargain deductible expenses available with the sold lease. The buyer's price reached by arm's length bargaining seems sufficient to treat the sale as an ordinary asset in full by connection with future ordinary expenses, without inquiry as to what the seller in fact does to replace the sold expenses. The rule proposed for this conceptual framework is that a sale of a contract for deductible expenses produces ordinary gain, not capital gain.

It would be common that the selling tenant has no non-deducted capital investment in the lease. If the tenant made no investment in acquiring the lease, the gain is considered under current law to be ordinary because the gain is not the product of capital.[142] That result is consistent with another string of this conceptual framework, that capital gain is a relief from double distortion tax on capital. By contrast, if the tenant purchased the lease or improved the premises in ways the buyer can use, the alternative no-basis, string II, would not apply. Still, even there the sale of the business lease needs to be ordinary to prevent the mismatch of immediately recognized capital gain and delayed ordinary deductions.

So far, the courts have not seen that sales of deductible expense contracts turn costs into profit centers. Without seeing the telling argument, the courts have allowed the sale of deductible expense contracts to be capital gain. In *Gladden v. Commissioner*, for instance, the taxpayer sold water rights that forced it later to buy water at a higher, open-market price, yet the Tax Court treated the sale as capital gain.[143] Two courts have also treated receipts by tenants from their landlord to terminate the lease as capital gain.[144] In none

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142. Turner v. Comm'r, 47 T.C. 355, 362–63 (1967) (payment received by restaurant to surrender occupancy of leased premises was ordinary income because right to use is not a capital asset and taxpayer had no investment in the underlying premises).

143. 112 T.C. at 221–23.

144. *See* Comm'r v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954); Comm'r v. Golonsky, 200 F.2d 72 (3d Cir. 1952). Tenant capital in the lease was not discussed in those cases, so the courts did not resolve whether they agreed with the holding in *Turner*, 47 T.C. at 355, that a sale of lease is not a capital asset if the tenant has no capital in the lease.

In *Commissioner v. Pittston Co.*, 252 F.2d at 348, the court treated amounts received for cancellation of an advantageous exclusive right to purchase coal as ordinary income, but on the grounds that the cancellation was not a sale or exchange because the asset disappeared as a result of the transaction. Sections 1241 and 1234A

of the cases was it argued that the capital gain created a negative tax by reason of immediate capital gain mismatched with greater, later ordinary expense deductions. In none of the cases was there a section 446(b) opinion rendered by the IRS that the mismatch failed to clearly reflect income.

The taxpayer in *Tempel v. Commissioner* sold state tax credits, with the result that the taxpayer would in the future have to pay higher (deductible) state taxes because the credits would no longer be available. The court refused to treat the receipt from the sale as a substitute for ordinary income because the tax credit that the taxpayer had sold was not income: "A reduction in a tax liability is not an accession to wealth. Consequently, a taxpayer who has more section 164 deductions [because of loss of tax credit] has not received any income."[145] It is certainly true that what the purchaser bought (and the taxpayer sold) was a reduction in expense, not an income item. This is, however, a distinction without a difference because both a reduced expense and higher income have the same positive enhancement of wealth. Both increase taxable amounts in the same way. The problem of negative tax, adding value to a transaction, is serious enough in any event that the court would not have let it go had it understood what it was doing. The *Tempel* court, while refusing to treat the asset as an ordinary asset, gave the taxpayer no favors, however, because it treated the tax credit as a short-term asset, not held for the requisite year, without any basis, so that the sale, if it stood alone, would be subject to ordinary tax rates.[146]

6. *Capital Gains and Ordinary Losses*

Negative taxes, adding value to an investment also arise from asymmetrical treatment of volatile investments. If a loss is deducted immediately from ordinary income and the gain is subject to capital gain, a transaction that has an expected negative in the absence of tax can become a positive value after tax. For instance, assume a transaction with $100 cost that has a 50% chance of becoming worth $190 and a 50% chance of becoming worthless. In the absence of tax, the transaction would not be undertaken because it has an expected value of $95, all from the half chance of $190,

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now treat the termination of a contract as a sale or exchange if it is a capital asset. The proposal here would not treat gain from sale of contract to pay deductible expenses as a capital asset.

145. *Tempel*, 136 T.C. at 350; *accord McNeil*, 2011 WL 1990545, at *4.

146. A short-term capital gain can be offset by capital losses, whether short or long term, but not by net operating losses. An ordinary asset gain can be offset by net operating losses but, except for $3,000 for individuals, not by capital losses. I.R.C. §§ 1222, 1211.

which is too low to justify its $100 cost. If, however, the $90 gain on the up leg is taxed at a 20% capital gain tax gain and the $100 loss on the down leg is an immediate ordinary loss saving $40 tax, the expected revenue *increases* in value to $106, enough to justify the $100 cost.[147] Indeed, if the property can he held until death on the gain leg, so that the capital gain disappears, mere timing can generate an even larger negative tax. The immediate ordinary deduction of the loss, combined with the forgiveness upon death of the gain, increases the expected value by tax from $95 pretax to $115 after tax,[148] even more than enough to justify its $100 cost. As explained better, or in more detail elsewhere, the courts and Congress need to enforce a symmetry of timing and character of gains and losses.[149] The best available remedy is section 1211, which matches the losses to capital gain both as to rate and timing.

IV. LOOK-THROUGH PROPERTIES

Some assets, including receivables, judgments, contracts, and interests in partnerships and S corporations are look-through assets that derive their capital gain or ordinary character by looking through the asset to the underlying rights. Look-through rights are ordinary if they transfer rights to ordinary income on the underlying asset.

A. *Rights to Ordinary Income*

1. *Accrued Ordinary Income*

A cash-method taxpayer is not taxed on income that has been earned but not yet actually or constructively received. Under this Article's conceptual framework, sale of earned or accrued income would be ordinary income even if the right to the income were sold before the taxable income is received. The cash method may delay the time for taxing ordinary income, but it does not transform ordinary income into capital gain.

Expressly, under section 1221(a)(4) of the Code, receivables from the sale of services or of inventory are excepted from capital asset qualification.

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147. When 20% capital gain tax applies to the $90 gain and 40% immediate tax savings are available to the $100 loss, the expected value after tax is 50%*[190-20%* (80)] + 50% * $40 = $106.

148. The expected value of the transaction with sale deferred until death, hence no tax on the gain, combined with immediate tax savings of $40 on the loss leg is 50% * $190 + 50% * 40 or $115.

149. Calvin H. Johnson, *End Tax Subsidy from Abandonments and Swaps,* 152 TAX NOTES 1171 (2016).

A receivable is a fixed right to be paid, which an accrual method taxpayer would include in income.[150] Bittker and Lokken conclude that the results of section 1221(a)(4) would be reached without the statute even if the statutory exception did not exist.[151] If the law were otherwise, it would be too easy to avoid ordinary income from services or inventory by selling the right to be paid for services or inventory after the right becomes enforceable but before payment is made.

Section 1221(a)(4), however, is narrower than the underlying principle that proceeds from the sale of a right to ordinary income remain ordinary. Section 1221(a)(4) covers only rights to receipt from sale of services or inventory, but court doctrine covers other sources of income. In *Commissioner v. Phillips*,[152] for example, an endowment life insurance contract allowed the holder to pull out the cash surrender value during life, which would have been ordinary gain.[153] The taxpayer sold the contract instead, 12 days before maturity. The court found the income on the policy had already accrued and that the sale was ordinary gain because it was in anticipation of ordinary income.[154] Under this string of the conceptual framework, the right to payment has no character of its own; it is a look-through property with an ordinary character when it is a right to ordinary income, even beyond the borders of sale of inventory or services.

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150. Reg. § 1.451–1(a).

151. BITTKER & LOKKEN, *supra* note 10, at ¶ 47.5 (2017) (citing O'Neill v. Comm'r, T.C. Memo 1964-3, 1964 WL 549 (proceeds were ordinary where lawyer sold claim for compensation for finding distributor for client's products)).

152. 275 F.2d 33 (4th Cir. 1960); *accord* First Nat'l Bank v. Comm'r, 309 F.2d 587, 588–91 (8th Cir. 1962) (sale of entire retirement policy 16 days before first pension payment was due to be made resulted in ordinary income); Jones v. Comm'r, 39 T.C. 404, 408–10 (1962) (same result on transfer of insurance policy to bank 35 days before maturity); Rev. Rul. 2009–13, 2009–21 I.R.B. 1029 (sale of term insurance policy without cash surrender value was capital gain, but sale of policy with cash surrender value arising from investment build was ordinary to extent of cash surrender value); *see also* Cohen v. Comm'r, 39 T.C. 1055, 1060 (1963) (holding that ordinary income resulted from purported sale of life insurance policies because the buyer was acting merely as selling policy holder's agent).

Revenue Ruling 2009–13 allowed the sale of a term insurance policy to be a capital asset because there were no accrued earnings on the insurance. Some commentators would treat the gain attributable to improvement in actuarial value as appropriately tax exempt if received after death, while arguing that income earned on the policy should be taxed as it accrues. *See* Calvin H. Johnson, Andrew Pike & Eric Lustig, *Tax on Insurance Buildup*, 122 TAX NOTES 665 (Feb. 2, 2009).

153. I.R.C. § 72(e).

154. 275 F.2d at 35–37.

The principle that accrued income remains ordinary has been applied, for instance, to sale of lottery winnings. Lottery winnings are treated as ordinary income and not as capital gain return on one's investment in the lottery ticket.[155] Gambling is considered, perhaps just by convention, as not productive investment worthy of capital gain.[156] Just as winning the lottery is an ordinary income event, so too the sale of the rights to lottery winnings is ordinary. In *Lattera v. Commissioner*, the taxpayers took state lottery winnings as an annuity payable over twenty-six years, but after taking the annuity for nine years, they sold the remaining installments.[157] The Third Circuit held that the taxpayer had already earned the rights to all the payments by winning the lottery and sale of the rights was thus ordinary.[158] The best rationale for the result is that the cash method of accounting allows the taxpayer to defer tax until payments are received, but the timing advantage of the cash method does not alter the ordinary character of the payments.[159]

The framework would also adopt the general judicial result that when accrued income is sold as part of the sale of the underlying capital asset, the sale price attributable to the earned income is separated out from the capital gain and treated as ordinary income.[160]

2. *Future Unearned Income*

Sale of a right to ordinary income also remains ordinary even if the taxpayer has not yet earned or accrued the right. There is dicta in *Lattera,* rejected here, that suggests that, although the seller of lottery payments had

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155. Comm'r v. Groetzinger, 480 U.S. 23, 32 n.11 (1987) (noting that a state lottery is a form of "public gambling").

156. A sufficient rationale for ordinary character is that lower rates would not produce more Treasury revenue. See discussion *infra* Part V. A higher tax rate on lottery winnings would not decrease the number of taxpayers who win or take their winnings, and a lower rate would not increase the lottery winners who take their winnings. *Groetzinger*, 480 U.S. at 23, however, might well just have considered gambling not to be a productive investment of the kind meriting lower rates.

157. 437 F.3d 399, 401 (3d Cir. 2006).

158. *Id.* at 409–10.

159. Matthew S. Levine, Comment, *Lottery Winnings as Capital Gains*, 114 YALE L.J. 195, 200–02 (2004).

160. Watson v. Comm'r, 345 U.S. 544, 550–53 (1953) (finding unharvested crops to be ordinary) (reversed when Congress enacted I.R.C. § 1231(b)(4)); Storz v. Comm'r, 583 F.2d 972, 976–77 (8th Cir. 1978) (accrued compensation from a partially fulfilled contract carved out from a sale that overall qualified for nonrecognition).

ordinary income because the taxpayer had earned the payments by winning, the taxpayer would have had capital gain if the item had not accrued by the time of the sale and the taxpayer had had something left to do to earn the income.[161] The *Lattera* dicta is contradicted by greater weight of authority.

Some courts, for example, reject any distinction between already earned and yet-to-be earned income by holding that money from the sale of a contract to make future income is in lieu of compensation and is ordinary.[162] Those results should not change when the taxpayer takes a payment to let others provide the services instead of ultimately providing the services himself. Sale of accrued or of yet-to-be-earned compensation is still ordinary.

Outside of compensation, it is also clear that prepayments in lieu of unearned rents are ordinary. In *Hort v. Commissioner*, for example, the bank tenant bought its way out of a lease, when the Great Depression made holding the lease no longer profitable.[163] The tenant was not in arrears in rent when the lease was settled and settlement affected only rent for future periods, not yet earned by the landlord. The settlement that the landlord received was prepaid rent under the Court's holding and not a recovery of capital.[164] Receipts in lieu of rent are ordinary even if the rent is not yet due.

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161. Lattera v. Comm'r, 437 F.3d 399, 408 (3d Cir. 2006) (saying if the sale is a lump-sum payment for a future right to *earned* income, ordinary-income treatment applies, but if it is a lump-sum payment for a future right to *earn* income, capital gain treatment applies); *accord* Thomas G. Sinclair, Note, *Limiting the Substitute-for-Ordinary-Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights*, 56 S.C. L. Rev. 387, 423 (2004).

162. *See, e.g.*, Vaaler v. United States, 454 F.2d 1120, 1123 (8th Cir. 1972) (termination payments to general insurance agent measured by fraction of increase in premiums since start of the contract); Md. Coal & Coke Co. v. McGinnes, 350 F.2d 293, 294 (3d Cir. 1965); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929, 934 (5th Cir. 1963) (specially finding no distinction between mortgage fees already earned and mortgage fees to be earned); Gen. Artists Corp. v. Comm'r, 205 F.2d 360, 361 (2d Cir. 1953); Michot v. Comm'r, T.C. Memo 1982-128, 1982 WL 10423; Flower v. Comm'r, 61 T.C. 140, 150–51 (1973), *aff'd mem.*, 505 F.2d 1302 (5th Cir. 1974); Brown v. Comm'r, T.C. Memo 1969-257 (1969), 1969 WL 1239; Turner v. Comm'r, 38 T.C. 304, 308 (1962) (sale of future commissions was sale of "naked rights to future income"); McFall v. Comm'r, 34 B.T.A. 108, 111 (1936) (saying that receipts from termination of employment contract were ordinary, and that taxpayer had given up "only a potential right to be paid contemporaneously with performance"). *But see* Comm'r v. Killian, 314 F.2d 852 (5th Cir. 1963); Nelson Weaver Realty Co. v. Comm'r, 307 F.2d 897, 903–04 (5th Cir. 1962) (distinguishing between already earned and yet to be earned income).

163. 313 U.S. 28 (1941).

164. *Id.* at 31.

The Code also defines "receivables" broadly in other contexts to include, without distinction, both rights to payment as to goods and services that have been provided and also with respect to goods and services yet "to be rendered."[165] Thus, in general, a sale of a partnership interest produces capital gain in default,[166] but section 751 of the Code carves out each partner's share of inventory and "receivables" and characterizes that portion of the sale price as ordinary income. The rights made ordinary as "receivables" include not just a partner's interest in receivables from goods and services that have been delivered but also rights from goods "to be delivered" and services "to be rendered."[167]

Even if the buyer faces common collection contingencies or risks that the payments will not be made, sale of rights to ordinary income need to remain ordinary. The tax standard for accrual requires that "all the events have occurred [to] fix the [liability] . . . and the amount thereof can be determined with reasonable accuracy."[168] If there are contingencies or risks of nonpayment, the ordinary income is not yet accrued income, taxable to an accrual method taxpayer. Still, by selling, the taxpayer has received cash equal to the expected value the payments will produce, as negotiated between the buyer and the seller dealing adversely as to price at arm's length. As to the seller, who is to be taxed, all the contingencies have disappeared to be replaced by cash in hand. Cash in hand has no contingencies to it. Such cash in hand needs to be ordinary, even though the sale of the risky rights and not the collection from the customer generated the cash. Unearned, risky rights to compensation remain compensation if sold, notwithstanding the contingencies, because there is no other explanation for the receipt except compensation.

More generally stated, profit from rents, interest, and from the delivery of goods and services is supposed to be subject to the income tax, and progressive rate structure, whether the delivery of the goods and services comes before the payment, simultaneously with the payment, or only after the payment. Under the traditional meaning, discussed in Part I, there is nothing about the rights that would make them analogous to capital that needs to be preserved for the heir.

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165. § 751(c)(2).

166. I.R.C. § 741. Distributions, which are generally treated as capital gain under I.R.C. §§ 731 and 736 (the latter of which governs retiring and deceased partners), are also subject to I.R.C. § 751, which recharacterizes some gain as ordinary because of partnership inventory and receivables.

167. I.R.C. § 751(c)(1)–(2).

168. Reg. § 1.451–1(a).

3. *Stopping Point?*

It cannot, however, be that all sales are ordinary because the sale is in lieu of ordinary income. Market value is nothing but the discounted present value of expected future cash flows. Property has value and gain only because it will produce future income. Treating gain as always ordinary because of future income would leave "capital gain" applicable to nothing.

Distinguishing between a look through to the rights to ordinary income and true capital assets is made easier by another string of the framework, discussed in Part V. Depreciable property is not appropriately capital gain because the step up in depreciable basis in the hands of the buyer hurts Treasury more than the low-rate capital gain tax on the seller helps Treasury. A critical argument for the capital gain preference is that Treasury will come out ahead with a lower, fire-sale price imposed on sales, but that is impossible when the buyer gets a tax reduction worth more than the Treasury's tax on sale. Depreciable property is not what we think of as capital assets under the Treasury-must-profit norm. Sales of property including ordinary income extending in perpetuity would, accordingly, appropriately be treated as a sale of a capital asset, but sales of rights with a defined or ascertainable tax life would be see-through assets taxed as ordinary gain. The argument has a different source than the argument that receivables, broadly defined to include unearned income, are ordinary, but it covers what might otherwise be a difficult issue.

B. *Judgments*

The usual standard for treatment of money received under a judgment, settlement, or sale of a lawsuit is the "in lieu of" test: in lieu of what was the payment received?[169] The function of the in-lieu-of test for judgments and settlements is to place plaintiffs in the same tax position as if they had received their economic benefit without the disruption that violated the taxpayers' legal right to receive the benefit and, moreover, without any lawsuit. Thus, lawsuits for past wages yield ordinary compensation income, whether by judgment or settlement, even though the employee had to sue to get the wages.[170] Suits for

169. *See, e.g.*, Freda v Comm'r, 656 F.3d 570, 574–77 (7th Cir. 2011) (affirming lower court finding that settlement was in lieu of lost profits and not return of capital); Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944) (saying the test is "in lieu of what were the damages awarded?" (citations omitted)).

170. *See, e.g.*, Comm'r v. Schleier, 515 U.S. 323 (1995) (lost wages received through age-discrimination suit were ordinary).

physical injury are tax exempt[171] on the best rationale that the taxpayer would have no income from an uninjured body in the normal course without the violation of rights that the tort injury caused. Judgments are see-through rights whose character is determined by what they are a right to and by what they replace. Sale of the right to a judgment or a settlement is also appropriately determined by looking through to the underlying rights in the litigation.

This Article's framework would reverse *Long v. Commissioner*,[172] in which the Eleventh Circuit held that a judgment was a capital asset even assuming, *arguendo*, that the underlying right, if satisfied, would have yielded ordinary gain. Long, the taxpayer, was a developer of high-rise condominiums who sued for specific performance of a contract to buy land well suited for condominium development. Having won a judgment, the taxpayer sold the judgment to another developer, and the other developer completed the purchase of the land under the terms of the contract and built high-rise condos. The other developer did all the construction and finished sales of all the units. The Tax Court below had held that the selling taxpayer intended to hold the land for development and for sale to customers in the ordinary course of a trade or business. The evidence supporting the Tax Court's finding was that Long was a professional developer who had hired an architect, applied for zoning ruling, printed brochures and advertised for sale of units, and had taken deposits on 20% of the units.[173] That activity was sufficient evidence to support the Tax Court's finding. The Eleventh Circuit reversed, finding that the judgment itself was property wholly apart from the underlying land, and that Long was not in the business of selling *judgments* to customers. Long, the Eleventh Circuit concluded, had capital gain on sale of the judgment.[174]

The Eleventh Circuit might have been second-guessing the Tax Court's determination that the underlying contract was related to inventory held for sale to customers and manipulating the legal rule to reverse the factual finding below. The developer who bought the judgment from Long did all of the building and 80% of the selling of the units. There plausibly had been considerable market appreciation in the underlying Fort Lauderdale beachfront land since the contract had originated, independent of any value Long had added. Appreciation beyond the taxpayer's control is what is meant by capital gain. Long's activities might not have quite been a material addition to the value, in the opinion of the Eleventh Circuit. Still, the appellate court should have taken the Tax Court's finding of fact that the land was ordinary

171. I.R.C. § 104(a)(2).
172. 772 F.3d 670 (11th Cir. 2014) (per curiam).
173. Long v. Comm'r, T.C. Memo 2013-233, 2013 WL 5708408.
174. 772 F.3d at 676–77.

unless the finding was "clearly erroneous."[175] Given the Tax Court's finding that the land was held for sale in Long's hands, selling the judgment for specific performance should not have avoided the ordinary character. The case seems indistinguishable from a judgment for lost wages, which is ordinary, or a sale of the judgment for lost wages before the judgment is collected. This Article's conceptual framework rejects the *Long* holding that sale of a judgment can be a capital asset when execution of the judgment would be ordinary. A judgment is a look-through asset that determines its character by looking through to the underlying rights.

C. Contracts

Similarly, had Long sold the contract to buy the land before judgment, Long's gain on the contract should be determined by the character of the land in his hands. If we assume, as the Tax Court found, that Long had undertaken enough improvement and merchandizing activity even before acquisition for the land to be ordinary, then the alternative hypothetical that Long sold a contract rather than the judgment for specific performance or the land itself should make no difference to the result. If a taxpayer sells a contract to get paid salary, rather than receiving the salary from the employer, the contract is still compensation and ordinary income.[176]

As discussed above, the Service has ruled that a sale of a long-term supply contract by the supplier generated capital gain,[177] but it should not have. The electricity was the inventory of the supplier. The taxpayer could have sold its electricity on a spot market or by long-term contract, for a low price or a high price and still it was selling inventory. Selling by contract or selling a contract should not change sales of inventory into capital gain. The supplier was selling the crop, the grasses, and apples, and that sort of thing, but keeping the underlying productive land. The contract was also a carve-out, selling a 20 to 30-year chronological subdivision of the output from the power plant, while keeping the remainder, the heir's interest. A contract has no different character than its contents. In the compensation area, sale of a right to make compensation is ordinary income whether the services have been performed or will be performed.[178] Contracts that deliver ordinary income if satisfied

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175. FED. R. CIV. P. 52(a)(6).

176. See discussion *supra* Part II.A.1–2.

177. T.A.M. 2000-49-009 (Aug. 9, 2000); P.L.R. 2002-15-037 (Jan. 14, 2002). For discussion of these, see *supra* notes 46–47 and accompanying text.

178. See discussion *supra* Part II.A.2.

remain ordinary assets if sold before they are satisfied.[179] That principle needs to be applied to all contracts to make future ordinary income. The Service erred in treating the right to deliver inventory, the electricity in a supply contract, as if were a capital gain.

D. Related-Party Transfers

1. Gratuitous Transfers

The framework proposed in this Article would provide that a gratuitous transfer of an ordinary asset to a family member or other recipient would not transform the character of the asset to a capital asset in the hands of the new owner. A transfer by gift or death or to a controlled corporation or to a partnership would not turn an ordinary asset into a capital asset under this conceptual framework. The recipient of the transfer would have an ordinary asset because the asset was ordinary to the transferor.

Under current law, section 1221(a)(3)(B) provides that the ordinary asset character for artistic works and copyrights applies to a taxpayer with a carryover of basis from the person whose efforts created such property. Section 1221(a)(3)(B) was enacted to cover a "loophole,"[180] but the language only covers the loophole as to artistic or literary works. The principle is broader. Under current law, for example, farmers are advised to give their crops to their not-yet-farmer children for sale because the farmer would have property held for sale to customers in the ordinary course of a trade or business, but a child not yet in the business would not.[181] The framework rejects the advice: an ordinary asset should remain ordinary in the hands of the gratuitous transferee even beyond the artistic and literary assets specified by section 1221(a)(3)(B). There is no principled distinction between artistic works and other assets for ordinary character. Crops and produce are green stuff, income, not capital reserved for the heir, even if first transferred to a kid.

The framework would apply the look-through rule to gifts upon death. Thus, children of famous painters who inherit the paintings would have ordinary income, not capital gain, on sale of the paintings. Paintings sold are the salary of the painter, already earned by the painting before death. The deferral in timing of tax does not properly change salary into capital. The

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179. Sections 1241 and 1234A make terminations of certain contracts a sale or exchange, but the sale or exchange issue matters only once we assume a capital asset.

180. S. REP. NO. 81-2375, at 43–44 (1950).

181. Philip E. Harris, *When Is Grain a Capital Asset?*, 30 S.D. L. REV. 275, 278 (1985).

paintings are akin to income in respect of a decedent, earned by the painter (even though not all the events have occurred to receive the income), but realized as ordinary income by the heir. There is no other explanation for the profit from the painting except as compensation. Compensation needs to remain ordinary even in the hands of the heirs who ultimately get the compensation.

When heirs of a celebrity sell rights to use the name, voice, or likeness of the deceased celebrity for commercial purposes, the courts have found their gain is ordinary, under a number of different rationales. In *Miller v. Commissioner*, the Second Circuit held that the heirs' receipts were not capital gain, relying in part on the argument that the heirs were not given a property right by state law.[182] To qualify for capital asset treatment under section 1221, the taxpayer must be selling "property." The rationale is increasingly undercut by changes in state law giving the heir property rights in the celebrity's name, image, or privacy.[183] The celebrity's name, voice, or likeness are not "capital," and "property" under section 1221 is best understood as a synonym for "capital." Still, federal tax law should probably not rest on state law definitions of "property." State legislators, like state voters would generally like to see a reduction of tax, and they will accommodate tax savings with such things as giving heirs property rights in the celebrity of the decedent. The heir in any event does not have a capital interest, eligible for capital gain, just because of state law definitions of property. Eligibility as capital to qualify as a capital gain is a federal issue.

A number of courts have held that heirs are not selling the celebrity's name and image but only licensing it.[184] Licenses produce rent, green stuff, rather sales of the underlying land or castle, the brown stuff. That rationale may cover the ground, except that perhaps a perpetual license allowing use of some aspect of the celebrity in perpetuity might cross over into a sale and not be a rental. Even if so, this conceptual framework would treat the proceeds of the sale of the celebrity's name, voice, or image as akin to compensation, earned by the celebrity before death, but realized only after death. The sale or exchange issue would not matter. Sale of a person's name for commercial

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182. Miller v. Comm'r, 299 F.2d 706, 710–11 (2d Cir. 1962).

183. *See, e.g.*, CAL. CIV. CODE § 3344.1(b) (Westlaw 2017) (making rights in name, voice, signature, or likeness of living or dead person, "property rights, freely transferable."). *See* Peter L. Felcher & Edward K, Rubin, *Privacy, Publicity, and the Portrayal of Real People by the Media*, 88 Yale L.J. 1577, 1618–22 (1977) (arguing for heir's property right).

184. Runyon v. United States, 281 F.2d 590, 592 (5th Cir. 1960) (son's assignment of rights to father's name, image, and license to a filmmaker was not a sale of the rights).

purposes is too much akin to compensation or sale of body parts to be treated differently. Compensation received after death remains ordinary in the hands of the successor.

2. *Related Entities*

Ordinary treatment would apply to ordinary assets transferred from shareholders to their corporation and from partners to their partnership.[185] Transfers from direct ownership to ownership as a shareholder or partner are not considered to change the nature of the ownership sufficient to generate tax or loss of basis. The receiving corporation or partnership pays no tax on the receipt and gets to use the transferor's basis in computing its own gain.[186] That carryover should imply that the event was not substantial enough to transform ordinary into capital gain. Giving or selling to a related entity, which then makes the sale, should never be an end-run around ordinary character.

An asset, however, could be a capital asset in the hands of a partner, but ordinary for the partnership. If an art collector, who would get capital gain for sale of the art, contributes paintings to a partnership that runs a gallery for sale of paintings, the contributed paintings become inventory by contribution to the partnership. Similarly, if a partner contributes raw land that would produce capital gain if sold, and the partnership develops the land, the land is ordinary on the partnership level, and passes through to partners as ordinary gain. For the related entity, the facts have changed.

E. *Corporate Stock*

Corporate stock in a corporation subject to corporate tax is generally a capital asset under current law, even if the efforts of the shareholder caused the gain on the stock.[187] Capital gain for corporate stock has a separate

185. Section 724 provides a limited codification of the proposed rule for inventory and accounts receivable contributed to a partnership. *See also* I.R.C. § 735 (similar rule for distributions).

186. I.R.C. §§ 351, 721, 362, 723. Transfer of ordinary assets to a corporation to try to achieve capital asset status is usually terrible tax planning because the corporation gets no reduction in tax rate on capital gain, even if the asset is treated as a capital asset in the corporation's hands, and because transfer of appreciated assets creates a double tax, at both corporation and shareholder level, on the gain built into the appreciated property. Section 351 is included in the proposal mostly by symmetry with section 721, governing partnerships.

187. *See, e.g*, Rev. Rul. 59–325, 1959–2 C.B. 185 (acquiescing in giving Jack Benny and Groucho Marx capital gain on sale of stock or partnership interest

rationale, which is to ameliorate the double tax when shareholder tax is added to corporate tax on the same earnings. Since 1993, for instance, dividends from C corporations have been eligible for capital gains rates to ameliorate corporate double tax.[188]

Shareholder capital gain is not a perfect form of corporate integration. The "double tax" argument presumes that the corporation has paid a first corporate-level tax on the earnings distributed as a dividend, whereas in fact corporate taxable income understates economic profit and does not cover all the free income that a corporation is able to distribute to shareholders as its profits.[189] A drop in tax for shareholders is highly inappropriate, moreover, if, as is plausible, the corporate tax is shifted off of shareholders over to all investors, including investors who do not hold corporate stock, or over to officers, customers, or employees. Shareholders should not get reduced tax for a corporate tax they do not bear. Still, capital gain rates for shareholder gain is our form of corporate integration, and the conceptual framework, based on principles extracted from current law, maintains the rule that C corporate stock is a capital asset even if the source of the shareholder gain is ordinary income to the corporation.

F. Pass-Throughs

Partnerships and S corporations, by contrast, pay no entity-level tax but pass their reported income to their owners who pay the tax with their

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holding assets that amounted just to the comedians' services). Section 341, collapsible corporations, was enacted in 1950 in part in response to show business shareholders putting their compensation rights into their corporations, and selling the stock before the compensation was collected. The collapsible corporation provisions, where triggered, turned stock gain into ordinary gain. Section 341(f), however, provided for exemption from the shareholder-level recharacterization if the gain would be recognized on the corporation level, confirming the norm respected here that corporate level tax justifies shareholder capital gain. Alan L. Feld, *Collapse Section 341*, 78 TAX NOTES 1187 (Mar. 2, 1998) persuasively argued that section 341 was no longer necessary given corporate level recognition of gain on distributed assets. Congress apparently agreed, as the provision was repealed in 2003. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, § 302(e)(4)(A), 117 Stat. 752, 763 (2003).

188. I.R.C. § 1(h)(11) (giving capital gains rates to qualified dividends) was added by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Pub. L. 108-27, § 302(a), 117 Stat. at 760–61.

189. Calvin H. Johnson, *Corporate Distributions from Earnings and Beyond*, 127 TAX NOTES 813 (May 17, 2010) (arguing for corporate tax on distributions to the extent the corporation had not previously paid corporate tax).

personal tax return.[190] The double-corporate-tax argument does not apply to them so that sale of their ownership interests should not be capital gain to reduce the impact of two tiers of tax.

A partnership interest is a look-though interest where that which was ordinary gain on the partner level is passed through to the partners as ordinary. Sale of the partnership interest, rather than the asset, should never be an opportunity to change the ordinary character of the gain.

This framework would treat the gain from sale or taxable redemption of a partnership interest as producing ordinary gain to the selling partner, except as the gain is attributable to readily marketable capital assets held by the partnership. Partnership interests need to be ordinary, unless specifically attributable to partnership-level capital gain, first, to prevent negative tax. The excess value over previously taxed income and specific partnership assets is an intangible, usually called goodwill. Goodwill is the price a buyer pays for the sale of a going concern that is not explained by the value of any specific accounting assets. Goodwill arises from operation of the business incurring ordinary business expenses. As noted above, goodwill and other intangibles arising from expensed items need to be treated as ordinary assets in full. Mere recapture of prior expenses, making gain ordinary to the extent of prior deductions, is not sufficient.[191] Self-created intangible assets of all kinds, in addition to goodwill, would be ordinary assets because they have been expensed and have no basis. Selling the partnership interest instead of the intangible should not change the ordinary character of the gain. Treating a partnership interest as ordinary, in default, would reverse the default position under current law, which treats the sale of a partnership interest as capital gain, except to the extent that it is attributable to partnership ordinary assets, specifically inventory and receivables, broadly defined.[192]

The framework would, however, allow capital gain on the sale of a partnership interest to the extent the gain can be traced to readily marketable assets that would be long-term capital gain if sold on the date the partnership interest is sold. Except for a readily marketable asset, the framework would not let possible capital gain character of partnership assets pass through to the partners. Unrealized appreciation is not generally part of the tax system because the system is skeptical about value or about liquidity with which to pay tax. If unrealized appreciation officially does not exist, because it is not recognized by tax, then appraisals should not be used to carve out some capital gain from the default rule of ordinary income for gain on sale of a partnership

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190. This discussion will use "partner" as the owner, and "partnership" as the pass-through entity, but it applies to S corporations as well.

191. *See supra* Part III.A.1.

192. I.R.C. §§ 741, 751.

interest. This Article would adopt a compromise: Fair market value of capital assets with a readily ascertained market value by reason of trading on an established market would be carved out of the amount realized on sale of the partnership interest and treated as capital gain if the sale of the assets would produce capital gain to the partnership. Otherwise, the gain would not be recognized to determine character, just as it is not recognized by the partnership to determine taxable income.

Treating unrealized gain as invisible for assets not traded on an established market might mean that tax planners would sometimes find it better for tax reasons to sell partnership assets rather than partnership interests, because they can establish the value of an asset that is a capital asset, by selling it. The tax system needs the arm's length bargain between adverse parties to establish value when market price is not available. Thus, forcing taxpayers to a sale of assets seems like a necessary improvement to the administrability of the tax system.

G. Trust Income Interests

In the arrangements that defined capital gain at the time of the adoption of the first British income tax, income interests of a trust could not get access to capital gain. Capital gain was capital allocated to the capital or heir's interest and not to the living *income* beneficiaries. The inaccessibility of capital gain to any living person adequately explains the exemption of capital gains from the British income tax. Congress imitated the British system in 1921 with the first tax preference for capital gain and pulled in the core of the traditional meaning in the statutory language.

Within the original meaning, capital gain for income interests is an oxymoron, on the order of "round squares" or "silent noise." The framework follows that original meaning enough that income allocated to income interests would necessarily be ordinary income. The framework follows *Bogert's Law of Trusts and Trustees*, a leading trust treatise, which warns that if capital gain is given to income interests, then the law might be changed and require that the income beneficiaries take the capital gain as ordinary income.[193] The framework takes up the suggestion.

Distributions on trust income interests would be ordinary even if the distribution represents gain that is capital gain to the trust. In some sense, the treatment of trusts would be the symmetrical opposite of treatment of corporations. Corporate distributions or shareholder sales would be capital

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193. GEORGE GLEASON BOGERT ET AL. THE LAW OF TRUSTS AND TRUSTEES § 858 (2017) (saying that if capital gains held in trust go to income beneficiaries, it may be argued that the distributions are ordinary not capital gain for tax purposes).

gain, even if they arise from ordinary earnings of the entity. Trust income interests would be ordinary even if they arise from capital gain of the trust. Neither the trust nor the corporation would pass through the entity-level character.

V. TREASURY MUST BE EXPECTED TO PROFIT

An original and recurring argument critical to the adoption of the lower capital gain rate is that the Treasury will profit from the lower tax rates on sales. A cut in the tax rate on gain will lower the Treasury's revenue from any sale, but if the rate cut induces voluntary realizations of the gain by enough, the Treasury losses from lower tax rates will be more than made up by the extra volume of sales. In passing the first lower tax rate for capital gain in 1921, the Ways and Means Committee said that the lower rate "would materially increase the [Treasury] revenue . . . because it would stimulate profit-taking . . ."[194] The only testimony relevant to the capital gain preference in the legislative hearings in 1921, was by a Frederick Kellogg of the New York Bar, who argued that capital gain tax on capital gain was "injurious" and "unfair" to the government because it deprived the government of revenue and that capital gain tax was a "full stop to business and not . . . a revenue producer."[195] The argument that Treasury will profit with a lower tax on capital gain is recurring over the long history of the income tax.[196] If Treasury

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194. H.R. REP. NO. 67-350, at 11 (1921). The House Report also attributed the gain in limitations on the tax benefit from capital losses to the same rate it would apply to capital gain, and argued that "[u]nder present conditions there are likely to be more losses than gains." *Id.* The Senate dropped the limitation on the rate applicable to losses and did not repeat the argument that revenue would increase. S. REP. NO. 67-275, at 13 (1921).

195. *Internal-Revenue Hearings on the Proposed Revenue Act of 1921 Before the S. Comm. on Fin.*, 67th Cong. 534, 534–337 (1921) (statement of Frederick R. Kellogg, N.Y. Attorney).

196. 144 CONG. REC. 14,992–93 (1998) (statement of Sen. Wayne Allard); 133 CONG. REC. 29,515–16 (1987) (statement of Rep. Connie Mack, quoting Mark A. Bloomfield, President of the Am. Council for Capital Formation); Martin Feldstein, Joel Slemrod & Shlomo Yitzhaki, *The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains,* 94 Q.J. ECON. 777 (1980); Stephen J. Entin, *The Effect of the Capital Gains Tax Rate on Economic Activity and Total Tax Revenue,* IRET.ORG (Oct. 9, 2009), http://iret.org/pub/CapitalGains-1.pdf (arguing that the government will get more revenue taxing capital gains at 15% rather than 24%); Paul Evans, *The Relationship Between Realized Capital Gains and Their Marginal Rate of Taxation, 1976-2004*, IRET.ORG (Oct. 9, 2009), http://iret.org/pub/CapitalGains-2.pdf (estimating that the optimal rate of capital gain taxation for

comes out ahead and taxpayers like the lower rates, that is a win-win proposition, an undeniable argument for lowering capital gains rates. If Treasury will make more revenue from a fire sale on tax rates, the argument goes, only the Grinch would object. The argument is plausibly critical to the adoption and reaffirmation of the lower capital gain rates, that is, without the argument the lower rate would never have been adopted or reaffirmed.[197]

In identifiable situations, by contrast, a lower rate cannot be expected to mean that Treasury will profit from lower rates. The property then was not what Congress was thinking of when it gave the rate preference for capital gain. The argument that Treasury can be expected to profit from a lower rate excludes from capital-gain-rate qualification depreciable property, perishables, and assets that expire upon the death of the current holder.

A. *Depreciable Property*[198]

Under current law, preferential capital treatment on gain from the sale of depreciable property steps up depreciable basis for the buyer at too cheap a price. Treasury loses on every taxable sale of depreciable property to a taxpayer because the extra depreciation deductions the buyer gets by reason of the sale are worth more than the tax the Treasury collects from the seller. Every sale of depreciable property is a loss of revenue. An increase in the quantity of sales increases the loss.

Treasury's loss arises because of a rate inconsistency: capital gain to the seller is taxed at 20%, but depreciation deductions arising from the new basis to the buyer are worth 40% per dollar. Depreciation deductions are delayed, allowed over the tax life of the asset, but the timing difference does not overcome the mismatch in character for any current depreciation schedule under Treasury discount rates.

Section 1239, under current law, converts the sale of otherwise capital property into ordinary if the property will be depreciable in the hands of certain related-party buyers. Section 1239 prevents a step up in depreciable basis at too cheap a price, but only for related party sales. The revenue loss to the

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revenue collection to be 10%); Allen Sinai, *Cap Gains Taxation: Less Means More*, WALL ST. J. (Sept. 21, 2010), https://www.wsj.com/articles/SB10001424052748703556604575501892210065882 (arguing a 15% capital gain rate would raise more money than a 20% rate).

197. *See, e.g.*, Shaviro, *supra* note 9, at 397 (saying that the capital preference would be an easy question if one could stipulate that it would raise revenue long term because a revenue-raising rate is nearly always desirable).

198. This section is a truncated version of the argument in Calvin H. Johnson, *Nyet, Nein, Non, No to Capital Gain on Depreciable Property*, 152 TAX NOTES 1455 (Sept. 5, 2016).

Treasury, however, is the same whether the buyer is a related party or not. When the buyer and seller are not related, the parties must split the bounty of Treasury's loss in the negotiations over price between them, but unrelatedness of the buyer and seller do not decrease the Treasury loss. Treasury cannot be expected to profit from a sale of any property that will be depreciable in the buyer's hands, so that the critical Treasury-will-profit argument for capital gain is missing.

A view of both buyer and seller of depreciable property would show that capital gain and resulting depreciation yield a negative tax. Taking depreciable property out from under capital gains rates might have been categorized under the string principle that negative taxes should be abhorred by Congress and courts, except that the negative tax string otherwise identified advantages available to one taxpayer, and here the negative tax is shared by buyer and seller. Looking to the seller alone, capital gain on sale creates a positive tax. Still when buyer and seller together cause the Treasury to lose revenue, the parties can be expected to share the bounty of the Treasury loss by bargaining for some fractional division of Treasury's loss. From the Treasury point of view, the sale of the depreciable property is still a revenue loss, a negative tax, no matter how the bounty is shared.

To show the Treasury loss, assume that nonresidential real estate appreciates by $1,000 over original purchase price. Further assume that the appreciation above original cost is all capital gain, without either recapture or 25% tax on unrecaptured real estate depreciation,[199] so the Treasury collects 20% capital gains tax or $200 on the appreciation when the property is sold. The buyer, however, has a higher basis than the seller, by the same $1,000, which the buyer can then depreciate. For nonresidential real estate, straight-line depreciation is taken over 39 years,[200] so the extra depreciation deductions are $^1/_{39}$ of $1,000, or $25.64 each year. If we assume an ordinary tax rate of 40%, the value of the tax savings from depreciation is $10.26 per year for 39 years. Graphically, the cash flow chart from Treasury's viewpoint on the $1000 of capital gain is as follows:

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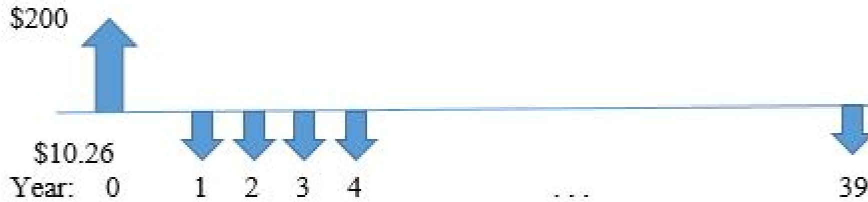
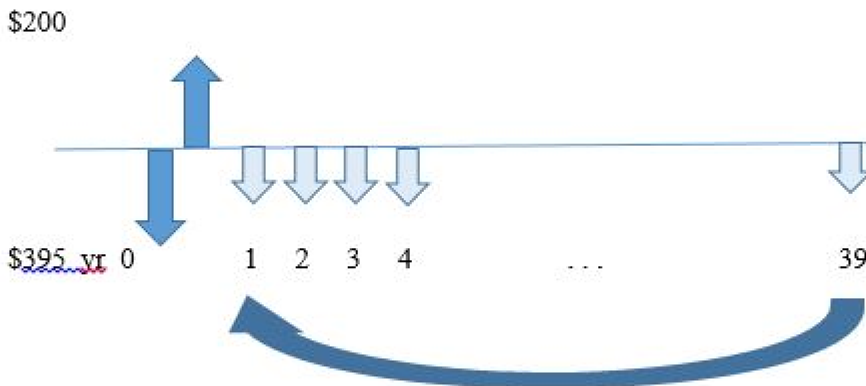
199. *See* I.R.C. § 1245; *see also* I.R.C. § 1(h)(1)(E).
200. *See* I.R.C. § 168(c).

Chart 1: Treasury revenue gain and loss from $1000 gain on nonresidential real estate



What the $10.26 depreciation deductions per year are worth depends upon the Treasury's discount rate. Treasury's nominal interest rate on 30-year bonds is now 2.69%.[201] Treasury collects some tax on borrowing because federal interest is taxable. Inflation reduces the burden of interest to any borrower. After tax of say 20% and inflation at 1.4%,[202] the Treasury interest burden is 0.75% per year. Under the standard formula for the present value of equal cash flows, a 39-year annuity of $10.26 per year for 39 years, generated by the $1000 capital gain, has a present value cost to Treasury at its 0.75% interest of $394.66:[203]

Chart 2: Treasury present value from $1000 gain on nonresidential real estate



201. *See Daily Treasury Yield Curve Rates*, TREASURY.GOV, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield (choose "Daily Treasury Yield Curve Rates" from "Select Type of Interest Rate Data" field and "2016" for "Select Time Period" field; then find the rates under the "30 Yr." column for Mar. 2, 2016).

202. *See* U.S. Labor Dep't, *supra* note 58.

203. $394.66 = $10.29 * [1- (1+0.69%)-39/ 0.69%]. This is the standard formula for present value of an annuity. *See* Shauna Carther, *Calculating the Present and Future Value of Annuities*, INVESTOPEDIA (Oct. 31, 2016, 3:59 PM), http://www.investopedia.com/articles/03/101503.asp.

Treasury makes \$200, but loses present value of \$346, under its current discount rates for a net \$146 loss on a sale of nonresidential property with \$1,000 gain. If there are many such sales, Treasury will lose some multiple of the \$146.

With Treasury's rock-bottom, zero-risk interest rates, Treasury will lose even with considerably slower depreciation. Under current discount rates, after inflation and tax, Treasury will lose if the extra basis is depreciated by straight-line method over any period of less than 211 years. That is a recovery period longer than for any known property.

The drama of Treasury losses on sale of depreciable property is partially a result of the historically low interest rates that Treasury is now facing after tax and after inflation. Still, the difference between Treasury tax collection at 20% capital gain rates and deduction at 40% ordinary rates means that the loss position will hold for higher discount rates. There is a rule of thumb, the rule of 160, that will tell when an annuity of 40% tax has a present value of half its future value, that is, a level equal to the 20% capital tax. The rule of thumb is $n*i = 160$, where i is the discount rate and n is the years of the annuity. The rule of thumb is a reasonable approximation over a range of interest rates, appropriate for risk-free Treasury borrowing.[204] If the Treasury's after-tax, after-inflation borrowing rate rises to 2%, then Treasury loses on the sale of depreciable property with a tax life of less than 80 years. Interest at 3% after tax collections and inflation means Treasury loses from the combination of gain and straight-line depreciation of less than 52 years. There is no asset, however, with a tax life of more than 80 or 52 years. No known depreciation schedule can be expected to give the Treasury a gain.

For residential real estate and for equipment, the Treasury loss position is even worse. Residential real estate produces depreciation that amounts to an annuity over 27.5 years.[205] For residential real estate, the \$1,000 gain produces depreciation deductions worth \$1,000/27.5*40% or \$14.55 a year for 27.5 years. The present value of the \$14.55 annuity is \$360.13, at Treasury's low current 0.75% borrowing rate. Again, there is a negative tax, and Treasury loses via depreciation arising from the sale almost twice the capital gain tax it collects on sale. Under the rule of 160 approximation, Treasury will lose from the step up in basis after a capital gain sale, as long as its borrowing rate after tax collected and inflation is below $5^2/_3$%.

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204. The exact rule from which the rule of thumb of 160 is derived is from the standard annuity formula, under which *\$20 = \$40 * [1-(1+i)-n]/i*, such that *1/(1/2*i -1) = (1+i)n and n = ln (1+i)/ ln [1/(1/2*i -1)]. See id.*

205. *See* I.R.C. § 168(c).

For intangibles acquired by the taxpayer, including goodwill and the output of research and development, the Treasury losses from a capital gain sale are even worse. Intangibles acquired by a buyer are entitled to amortization over 15 years.[206] A $1,000 gain will give the buyer depreciation deductions worth $1,000/15*40% or $26.67 for 15 years. At current 0.75% after tax and inflation borrowing rates, the extra depreciation hurts the Treasury by a present value of $377, again well in excess of the $200 capital gain tax the Treasury collects on sale. As long as Treasury's borrowing cost is under $10^{1}/_{4}$% after inflation and taxes collected, Treasury will lose from the sale of an intangible.[207]

Intangibles subject to the 15-year life if purchased are also expensed as created, which leads to very strong negative tax that enhances terminal value to 133% of what would be in an "ideal" nontax world.[208] The loss from the buyer's depreciation is a compound wound on top of the distortion arising from the seller's mismatch of ordinary deduction for input and capital gain for the gain.

For equipment, the loss is worse. Bonus depreciation allows a deduction of half the cost of the equipment upon purchase and then a schedule for the other half over five years that starts at twice the value of straight-line depreciation.[209] The present value of the 40% tax depreciation deductions are

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206. *See* I.R.C. § 197.

207. The rule of 160 becomes a rule of 153 with interest rates in the 10.25% range.

208. *See* I.R.C. § 174 (expensing of research and experimental expenditures); *see also* Reg. § 1.263(a)–4(b)(3) (business goodwill is not a separate and distinct asset because it cannot be sold apart from sale of the business as a whole).

Independent of any tax benefit to the buyer, a sale of an intangible, including goodwill and research and development, needs to generate ordinary income to keep the (internal return reducing) effective tax rate on the seller above the negative range. The investment in goodwill and research and development is expensed immediately. Expensing combined with full ordinary taxation of the cash flows yields a zero effective tax rate, and no reduction of the pretax return. When expensing is combined with lower tax capital gain of the output, there is a strong negative tax, leading to terminal value 33% of the tax-free world. *See* Johnson, *supra* note 127. The focus here, however, is to ignore the seller's prior expensing.

209. The logic of bonus depreciation is half of basis deducted immediately, and the other half deducted under 200% double-declining depreciation schedule. I.R.C. § 168(b)(1). The half-year convention treats equipment put in place in the second half of the year as if the property were purchased at the midpoint of the tax year, yielding a more accelerated depreciation deduction. I.R.C. § 168(d)(1). Revenue Procedure 87–57, 1987–2 C.B. 687, summarizes the accelerated depreciation

$397, which is very close to twice the capital gain Treasury collects at sale. Treasury collects $200 on the sale from capital gain but refunds tax deductions with a present value of $397 because of the step up in depreciable basis from the sale. Because the tax savings from bonus depreciation are not annuitized, there is no parallel to the rule of thumb of 160 to identify when depreciation and capital gain are equal, but the present value calculations are not difficult. At three percent Treasury discount rate, after inflation and tax collected, the depreciation deductions are worth $389. There is also no interest rate at which Treasury will break even or better on the gain, realized by individuals, because bonus depreciation refunds 60%*40%, or 24%, of basis immediately in year zero, and capital gains collects only 20%.

For equipment subject to section 179 expensing, Treasury's loss is worse. Prior depreciation is recaptured for sale of previously expensed equipment, but if there is $1000 gain above recapture, the Treasury will make $200 from capital gain and immediate lose $400 from the tax deduction of the gain amount.

Prior to 2003, the maximum tax rate on capital gain was only 15%. The analysis under those conditions is the same in structure but resulted in a larger loss to the Treasury. Treasury collected only $150 from a $1,000 capital gain and refunded, via greater depreciation deduction, amounts with a present value approaching $400. Increases in ordinary tax rates will *increase* the negative tax on the sales transactions, and decreases in ordinary tax rates will decrease the value of the depreciation deductions.

The problem is not generally an issue for sales between corporations. Treasury loss is dependent upon the mismatch between preferential capital gain rates for the gain and then ordinary deductions for the added depreciation. Corporations, however, pay at the same tax rate on capital gains as they benefit from for depreciation deductions, so there is no rate mismatch.[210]

For nondepreciable property, sale of which produces capital gain or loss, the sale creates fair market basis for the buyer, but any extra basis will only be used by the buyer down the road in a sale of the property. The extra

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deductions. Combining bonus depreciation and accelerated depreciation of the other half, the resulting depreciation deductions, per $1000 of extra basis, are as follows:

Year	0	1	2	3	4	5
Deduction	$600	$160	$96	$57.60	$57.60	$28.80

Bonus depreciation reduces statutory tax rates of 35% down to an effective tax rate of eight percent, under one set of reasonable assumptions. *See* Johnson, *supra* note 133, at 713.

210. *Compare* I.R.C. § 11, *with* I.R.C. § 1(h).

basis will reduce capital gain or increase capital loss, and Treasury does not lose from immediate capital gain followed by less capital gain later because it will not reduce Treasury revenue.

There are contingencies to the Treasury's expected loss from the higher deprecation, even beyond such things as Congress repealing the income tax, or a big comet hitting Earth. The sale might be to a low tax-bracket holder. Indeed, there is no advantage to the sale if the buyer uses depreciation to save tax at less than 20%, the capital gain rate—that is, there is no benefit if the depreciation deductions are used, roughly speaking, against taxable income of less than $77,000. The next holder might get a step up in basis anyway without any capital gain tax because of section 1014.[211] Still, with reasonable assumptions about an ordinary future, Treasury cannot be expected to profit from capital gain on sales of depreciable property because the depreciation deductions for the buyer can be expected to be worth more than the tax collected at capital gain rates from the seller.

B. Perishables

Cutting the tax rate on sale of perishables[212] cannot be expected to increase Treasury revenue if the perishables have to be sold soon enough anyway that the Treasury cannot come out ahead through cutting tax rates to get an earlier sale.

Assume a special variety of strawberries that lasts just more than one year—enough to establish a long-term holding period—and then must be sold within another week before they rot. Assume lower capital gain rates would in fact induce a taxpayer to sell the strawberries at the beginning of the last week instead of near the end. If the sale of the strawberries at the end of the last week would produce ordinary income, taxable at 40%, then Treasury would lose by giving a lower 20% capital gain rate to get a sale at the beginning of the week. Treasury now borrows short term, at rates that are negative considering inflation and tax on interest. Borrowing is, for now, a profit center, not a cost. Because Treasury delaying the taxable event for a week is not a cost, Treasury cannot come out ahead with the lower tax to avoid delay. Even in more ordinary times when Treasury pays positive interest, the rate reduction, by half, hurts Treasury more than the earlier receipt helps. The taxpayer might also die during the week and the heir get a step up that makes

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211. See discussion *infra* section VI.C, "The Dominating Role of Death," as to the role of step up in basis at death.

212. *See* Soled, *supra* note 114, at 952–54 (arguing for amendment of the statute to take away capital asset status for sale of human eggs because the eggs are perishable).

the ordinary tax go away. A comet might strike the strawberry patch in the last week. Still the doubts about future collection of tax and the discount for the time value of money would be very minor reductions in the expected value of Treasury's ordinary income tax. Treasury should wait until the end of the week because unlocking the strawberry sales cannot be expected to leave it ahead. Since Treasury cannot be expected to be better off giving a lower tax rate to entice an earlier sale, it follows that the strawberries were not what Congress was thinking of when they gave a preferential rate for capital assets.

Perishables are also not capital assets under the "color coding" in the traditional understanding of what a capital asset is. As previously discussed in Part I, in the feudal systems and eighteenth century strict-settlement trusts from which the concept of capital gain arose, perishables could not be preserved for the male heir and were not required to be. The practical consideration was that perishables could not be preserved because they would not last that long. As a matter of law, moreover, perishables were chattels, and all chattels were free of the entailments to preserve the estate for one heir. The castle and manor—real property—were entailed to go to a single male heir, but even at the death of the holder, chattels passed by will or in absence of will, by succession rules that scattered the estate.[213] Perishables are green stuff for the benefit of the living.

C. Property That Expires on Death

Taxable capital gain will disappear if a mortal owner holds onto the asset until death. The successor after the current holder's death takes the property with a tax basis as if the property were freshly purchased at the death of the predecessor.[214] Any gain built into the property by accrual before death then disappears from the tax base. A rate reduction that would convince the current holder to give up the immunity on death by selling before death will give the Treasury some tax, at the reduced rate, instead of zero tax. If sales induced by a lower rate are a mixture of a seller giving up the step up at death, and earlier sales that lose Treasury money, it is possible, depending upon the mix, that Treasury would come out better overall.

If the step up in basis at death did not exist, however, it is not reasonable to expect the Treasury to come out ahead by reducing the rates imposed upon sales. If the gain will be taxed eventually, Treasury can expect to do much better by waiting for the later sale and taxing it at ordinary rates.

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213. A.W.B. SIMPSON, A HISTORY OF THE LAND LAW 248–251 (2d ed. 1986).
214. *See* I.R.C. § 1014.

Treasury's cost of borrowing even long term is now less than one percent,[215] and at those low rates Treasury can wait patiently for full tax at a very minimal cost to itself. Capital gains rates are currently approximately half of ordinary rates - 20% as against 40% for maximum rates. Treasury would be better off waiting for its 40%, under current rates, unless the lower rate causes the sale and tax to be 94 years earlier than what it would otherwise be.[216] For all practical purposes, if property is ever going to be sold, Treasury should wait and collect its ordinary tax at the sale.

Any revenue gain projected for Treasury when rate cuts are proposed is driven primarily by convincing taxpayers to give up amnesty that they have available to them by the step up in basis at death.[217] There is a short-term blip or dip in realizations because tax reductions and rate hikes for capital gain are announced or known in the tax year before they take effect. Taxpayers can put off a sale for some months if they know that the tax rate applied to the sale is going to drop if they delay the sale. They can also sell early if the property has a big built-in gain, and the rate for capital gain has been announced as going up. The short-term effects would go away if the change in rates took effect in the year in which they are generally known about. The blips or dips in anticipation of a rate change also have a very modest one-time effect given Treasury's very modest borrowing cost. The one-time reaction in anticipation of a pending tax change will show up in the comparative statistics before and after the tax change, but the difference will not be permanent, nor a good indication of what will be the long-term or permanent change. Once the one-year deferral or anticipation is filtered out, Treasury's gains come from taxpayers giving up their tax immunity available on death.

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215. *See Daily Treasury Real Long-Term Rates*, TREASURY.GOV, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=reallongtermrate (choose "Daily Treasury Real Long-Term Rates" from "Select Type of Interest Rate Data" field and "2016" for "Select Time Period" field; then find the rates for Mar. 23, 2016).

216. $20\% = 40\% / (1+0.74\%)^n$. Therefore, $n = \ln 2 / \ln 1.0074$, or 94 years.

217. *See* JANE C. GRAVELLE, CONG. RESEARCH SERV., LIMITS TO CAPITAL GAINS FEEDBACK EFFECTS 11 (1991) (stating that a fraction of accruals that are realized is primarily a result of forgiveness at death); *see also* Gerald E. Auten & Joseph J. Cordes, *Policy Watch: Cutting Capital Gains Taxes*, 5 J. ECON. PERSP. 181, 184 (1991) (arguing that, for realizations to be significantly higher in the long run, additional realizations would have to come primarily from gains otherwise not taxed at death).

1. Principle Illustrated: No Corporate Preference

The predominance of basis step up, which makes it possible that Treasury might profit from lower capital gains rates, justifies current law denying lower capital gain rates to corporations. Since 1986, corporations must pay tax on the built-in gain on property distributed to shareholders. Prior to 1986, under what is called the *General Utilities*[218] doctrine, a corporation would not generally pay tax on the gain in distributed property, and shareholders would get a fair market value basis for property.[219] The *General Utilities* doctrine was akin to a step up in basis at death applicable to corporations, except that it applied also to non-terminating distributions. A corporation could thus avoid paying any corporate level tax on capital gain by distributing the property to its shareholders instead. With the change in 1986, capital gain for the corporation will, eventually, be taxed,[220] and the issue is a matter of immediate gain or eventual ordinary tax on the inevitable income, and that assumption puts the justification for capital gain preference on a wholly different footing.[221] With low borrowing rates, Treasury has patience. It can wait for ordinary income. Congress's decision not to extend the capital gain preference to corporations in 1993, when it cut the tax rate on capital gain for individuals, is consistent with corporation's inaccessibility to tax forgiveness on death. Without the forgiveness of tax at death, Treasury cannot expect to profit from a lower tax on capital gain.

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218. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

219. The instigating case for repeal of *General Utilities* is in AM. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C: PROPOSALS ON CORPORATION ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 117 (1982). *See* Bernard Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the* General Utilities *Doctrine*, 22 SAN DIEGO L. REV. 81 (1985).

220. *See* I.R.C. §§ 311(b), 336.

221. It is sometimes argued that a corporation can avoid tax on foreign earnings forever if the earnings are reinvested overseas perpetually. A dollar of earnings, however, has an expected present value of $1 because the multi-national enterprise will reinvest the dollar in the best available investment, until repatriation of the dollar. So too, the 35% fraction of the $1 of earnings has a 35% cost for the same reason the $1 of foreign earnings is worth $1. Tax due upon repatriation is a cost realized at the same time the earnings are repatriated. If accounting is willing to recognize the foreign earnings dollar as worth a dollar notwithstanding the delay in its repatriation, it should recognize the offsetting 35% tax fraction at the same time. *See* Calvin H. Johnson, *Transition to Territoriality without Plunder: A $725 Billion Tax,* 154 TAX NOTES 1135 (Feb. 27, 2017).

2. *Principled Correction: Assets That Expire Upon Death*

The predominance of basis step up as an explanation for Treasury expected profit also implies that assets that expire with or before death are not what Congress thought of as capital assets, because such assets will not benefit from a step up. In *Commissioner v. McAllister*,[222] the taxpayer sold the income interest of a trust, which expired upon the death of the current holder. The court allowed McAllister capital gain on the sale, but this Article's framework would reverse that result. McAllister had no access to the step up in basis at death, and so the Treasury could not expect to profit by cutting the tax to get him to sell early.

McAllister was also wrongly decided because an income interest is green stuff, not brown or black stuff that has to be preserved for the heir.[223] Interests such as McAllister's are not a capital assets within the tradition from which capital gain arose, which is embedded in our ordinary language.

VI. WITHOUT CAPITAL GAIN PREFERENCE?

This conceptual framework assumed the continuing existence of the rate preference for capital gain but suggested that the rate preference be constrained within the scope of its legitimating rationales. This section is a supplement explaining that if we replace the income tax with a consumption tax, move to a mark-to-market system, or repeal step up in basis at death, the capital gain preference has no place.

A. *Consumption Tax*

A consumption tax imposes no tax on the profits from invested capital. There are two main formats for a consumption tax to achieve the effect of no tax on profits. The cash flow consumption tax allows an immediate deduction for investments but taxes withdrawals from investment at full ordinary tax rates.[224] The alternative format is to allow no deductions for investments but to exclude all profits from investment, including both periodic income from

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222. 157 F.2d 235 (2d Cir. 1946), *acq.*, Rev. Rul. 72–243,1972–1 C.B. 233; *see also supra* notes 51–53 and accompanying text.

223. *See* Part I.

224. The seminal article that brought the cash flow consumption tax into current policy debates is William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). *See supra* note 118 for an algebraic explanation of why immediate deduction of investment is equivalent to no tax on its profit.

capital and gain from a sale or exchange.[225] A capital gain preferential rate has no role in either a cash flow consumption tax or an exemption of investment profits. In the cash flow consumption tax, the full proceeds would need to be ordinary to prevent a negative tax or subsidy. In the yield-exemption form of the consumption tax, the appropriate tax on gain is zero, which is lower than the capital gain preference allows.

B. Mark-to-Market Systems

Neither preferential capital gain rates nor capital loss restrictions make any sense within a mark-to-market system. Under a mark-to-market system, the increase in value of property for a year is taxed at year-end, without the need for a sale or other realization event, and the loss in the value of the property for the year is deducted immediately, also without the need for a realization event. Under a mark-to-market system, there is no justification for giving a preferential rate incentive for a sale, because the taxpayer must recognize gain involuntarily without a sale. There is also no worry about an asymmetrical timing of early realization of losses because the related gains are recognized immediately without the owner having control of the timing of the losses. Losses measured by a drop in the market value would thus be allowed as they accrue without the capital loss limitation, now found in section 1211.

Under current law, section 475 of the Code provides that any security that is inventory in the hands of a dealer, who is merchandizing the security to customers, is marked to market. The annual gain or loss is ordinary, as is appropriate.[226] There have been serious proposals for mark-to-market taxation of all derivatives.[227] A mark-to-market system for publicly traded stock was

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225. U.S. TREASURY DEP'T., BLUEPRINTS FOR BASIC TAX REFORM (1977) is the classic work setting out the two formats.

226. I.R.C. § 475(d)(3).

227. Proponents making the case for a mark-to-market system include, e.g., Alvin C. Warren, Jr., Commentary, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993); Yoram Keinan, *Mark-to-Market for Derivatives*, 128 TAX NOTES 1269 (Sept. 20, 2010). Serious legislative proposals for mark to market of derivatives from both the Republican and Democratic side include Joint Comm. on Tax'n, Description of the Modernization of Derivatives Tax Act of 2016 (May 18, 2016), http://www.finance.senate.gov/imo/media/doc/JCT%20Technical%20Explanation%20of%20MODA_114-5061.pdf (attachment to letter from Thomas A. Barthold to Sen. Ron Wyden); *Overview of Ways and Means Tax Reform Discussion Draft: Financial Products*, http://waysandmeans.house.gov/UploadedFiles/Overview_of_WM_Discussion_Draft_Financial_Products.pdf (last visited July 2, 2017) (describing Rep. Dave Camp's proposal for comprehensive tax reform).

be easy administratively because market prices are reliable and easily available online. Cash is readily available from publicly traded stock when the market is open. Under mark-to-market systems, gain or loss would be reported annually, and both gains and losses would need to be ordinary.

Current law, as embodied in section 1256, needs a principled intervention, to bring the tax rate on a set of specified financial instruments up to ordinary rates. Section 1256 now requires mark-to-market for a miscellaneous group of financial instruments including specifically defined "regulated futures contracts," "dealer securities futures contracts," "foreign currency contracts," and "nonequity options."[228] Section 1256 gives the gains or losses a mixed rate of capital and ordinary rates. The tax on section 1256 gains is calculated as 60% long-term capital gain and 40% ordinary gain, even on the assets that would be ordinary dealer property. At maximum tax rates for ordinary and capital gain, section 1256 yields an aggregate rate of just under 28%.[229] Since realizing gain is involuntary, there is no need to give an incentive to convince taxpayers to sell their gain property, and no reason to tax the gains at anything less than the ordinary tax bracket rates.

C. The Dominating Role of Death: Why Did She Swallow the Fly?

As discussed in the previous Part V, under current, admittedly low Treasury borrowing rates, if the gain will be realized within the next 94 years, Treasury should wait for it rather than giving a lower rate to see the gain earlier. Once the amnesty on death is considered, however, then Treasury can come out ahead by reducing the tax rate on capital gain to convince taxpayers to give up their amnesty. If taxpayers have access to zero tax on capital gain at death, then the comparison is not between capital tax now or inevitable ordinary tax on income sometime within the next 94 years, but between some immediate capital gain tax and zero tax.

If zero tax after death is available, then the logic of efficiency pushes inexorably tier by tier toward a zero tax on capital gain realized at any time. For terminally ill taxpayers, for instance, who can see access to the zero tax well within their planning horizon, a tax on capital gain will collect little or no revenue because the taxpayers will hold until death forgives the capital gain tax. The elasticities are such that any tax will suppress all sales, and if not all sales, still enough that Treasury would profit by cutting the rates in half and more. And if terminally ill taxpayers have zero tax, then elderly or ill taxpayers, in the next mortality tier back will have high elasticity and will need

228. I.R.C. § 1256(b)(1).

229. The formula used to calculate the 28% aggregate rate is *60%*20% + 40%*40%.*

a tax cut to get to a sale. If terminally ill (less than one year to live) get a zero tax, then someone with one year to live also needs zero tax, and then so will taxpayers with two years, then 5, then 10, and so on until all sales get zero tax. Some middle-range taxpayers do not have the option of holding property until the amnesty at death, under current rules, because they need to live off their investments in retirement and for rainy-day spending, but if you look at the tiers of extension of the zero rate, then the zero rate will get to the middle-aged investors eventually and then to everyone.

Borrowing against capital gain is not a realization event, and taxpayers can sometimes borrow with respect to appreciated assets instead of selling those assets. Still, creditors need a cushion of collateral, and they charge interest to absorb risk and transaction costs so that there are practical limitations on how much an owner can borrow against the built-in gain. As we go up in the wealth spectrum, however, less investment property with large capital gains is needed for consumption during life and more of the gains can be held until disappearance at death. The cushions that allow tax-free borrowing with respect to property with built-in gain are more forgiving for taxpayers with great wealth. Given that there is an exemption for capital gain on death, efficiency for those with great wealth would be promoted tier by tier, eventually by giving an exemption to all sales during life. Step by step, the Treasury needs to give up tax because it needs to give up tax on the tier nearer to death. Step by step, a zero tax is an inevitable result. In general, it is very hard to convince taxpayers to give up a zero rate amnesty. The tax on sales during life, to meet the requirements of efficiency, must approach the zero rate available on death. Thus, every tax reduction will increase sales before death. Any tax that the Treasury collects on capital gain is better for Treasury than the zero tax amnesty that would otherwise be the ordinary course.

Reducing tax on capital gain in logic by tiers of remaining life expectancy resembles the "old lady who swallowed a fly." She swallowed a spider to catch the fly that wiggled and jiggled and tickled inside her. She swallowed a bird to catch the spider, and eventually swallowed a horse to catch a cow. Once you have swallowed a fly, it makes a certain amount of sense to swallow the spider and on through a horse. When she swallowed the horse, the song tells us, "she's dead, of course." But "I don't know why she swallowed a fly."[230]

Why did she swallow the fly? It would be reasonable to repeal the step up in basis at death. The step up in basis at death cannot be a part of any tax accounting system that reflects income because it creates a fake cost that the

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230. *There Was an Old Lady Who Swallowed a Fly*, WIKIPEDIA, https://en.wikipedia.org/wiki/There_Was_an_Old_Lady_Who_Swallowed_a_Fly (last updated June 25, 2017).

heir can subtract from usable cash proceeds to compute taxable income. Rich heirs who have inherited appreciated property are very attractive sources of tax because their expected utility from every extra dollar is so small. The step up in basis at death is another legacy, like capital gain, of the time when the castle and manor belonged to the male heir, whatever the assets' worth. It has been many years since capital assets have been entailed for the unknown male and accessible to no living person. A wastrel heir can pull down the founder's hard-earned enterprise, for consumption of bonbons and foofaraws without either the founder or heir paying any tax.

We can tolerate some conventions and estimates for the founder's basis given the critical need to reach the wealth that is now unreachable because of the step up in basis. In a pinch, zero basis for inherited property is an accurate result. The property was a windfall to the heir; if the heir does not know the predecessor's basis, then it is difficult to see how the basis was a cost or a burden. Ending the step up in basis would have the simplifying advantage of allowing us to repeal the complicated capital gain preference as well.

CONCLUSION

Current law defining capital gain is complicated, fuzzy, and incoherent. Current court cases or statutory law commonly gives capital gain rates to items that should not generate capital gain under the principles that explain the historical origin or the rationales used to justify the lower rates. Compensation is not supposed to be capital gain, for instance, but it sometimes qualifies. Judgements and contracts for ordinary income should remain ordinary gain on sale, but sometimes they qualify as capital gain. "Property" qualifying as capital gain has been defined too broadly so that the capital gains rates appropriate only for capital interest usurp the government's rights to the income interest. This Article's conceptual framework has attempted to rationalize the complicated knot that is capital gain by pulling at separate principles or strings.

The first string, "Color Coding," argued that capital gain was adopted by Congress from the British property system, under which capital was property that had to be preserved for the yet unknown male heir. Thus, no living individual had access to capital gain. Income beneficiaries lived off "the annual produce, the grass, the apples, and things of that sort." To this day, capital gain is brown or black stuff, akin to the castle and manor that had to be preserved for the heir. Ordinary assets, to this day, are green stuff akin to the income beneficiary's interest. Thus, rents and interests that expire on death are not appropriately capital assets because of the tradition that Congress adopted.

The second string, "Arising from Capital," argued that capital gain is the product of capital and not from taxpayer's labor. Capital gain is a relief

from a double tax on both orchard and fruit, and compensation income does not merit the relief. So too, income from sale of blood and other body parts are not subject to double tax and not appropriately capital gain.

The third string, "No Negative Tax," says that capital gain is in principle a reduction in positive tax on gain and is never a subsidy that is better than no tax. Negative taxes never clearly reflect income under section 446(b). Thus, the product of inputs that have been expensed when incurred should be treated as ordinary in full to prevent the tax from going negative. Goodwill and research and development are ordinary assets under this principle. Proceeds from the sale of a contact to pay ordinary expenses need to be ordinary to prevent the character mismatch of capital gain for the positive gain, followed by an ordinary deduction for the resulting extra expenses.

The fourth string, "Look-Through Properties," says that as a matter of principle some properties derive their character by looking through to the underlying income. Thus, receivables, judgments, contracts, settlements, and other rights to receive ordinary income remain ordinary if sold before the income comes in. Sale of a nondepreciable perpetual interest is a sale of rights to future income, but is it is not a look-through claim and is a capital asset when sold. A transfer by donation at death or in life, or by contribution to or out of an entity would not change an ordinary asset into a capital asset. Stock of a taxable C corporation is not a look-through asset, because shareholder capital gain is our form of corporate integration, whatever its limitations. Ownership interests of partnerships and S corporations would be look-through assets. A trust income interest would never have an allocation of something qualifying as capital gain to the income beneficiary.

The fifth string, "Treasury Must Profit," argues that capital gain was adopted and readopted because Treasury revenue was expected to increase through a higher volume of sales induced by the lower "fire-sale" rate. Capital gain is inappropriate in principle where the Treasury cannot be expected to increase revenue. Thus, short-term perishables are not capital assets. Moreover, sales of depreciable property step up depreciable basis at too cheap a price, and should not be capital gain even when the property is sold to an unrelated party. Rights that will expire upon death of the holder should not be capital assets.

The final section, "Beyond the Rationales for Capital Gain," argues that there is no room for either capital gain preference or limitations on capital losses under a consumption tax system that replaces the income tax or under a mark-to-market system that taxes gains annually without a sale. Moreover, if step up in basis at death were repealed, capital gain would be inappropriate because Treasury could not be expected to profit from a lower rate to induce sales.

The lessons of the five strings are that capital gain that follows their principles would be defined considerably more narrowly than current law allows. Capital assets appropriately include C corporation stock because that is our form of corporate integration, for better or worse. Capital assets also appropriately include nondepreciable land that the taxpayer has not developed and look-through assets in which the underlying rights are capital assets, including judgments, contracts, options and swaps into capital assets. Capital gain of a partnership or S corporation appropriately passes through to the owners. On the other hand, depreciable property, trust income interests, intangible property created by expensed investments, and the residual value of a partnership interest are not appropriately capital assets. Rights to receive ordinary income, including receivables broadly defined, judgments, and settlements, would be ordinary.