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Reexamining the Relationship Between Capital Gain and the Assignment of Income

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I. INTRODUCTION

Only gain from the sale or exchange of property qualifies for preferential capital gain treatment under the Internal Revenue Code (IRC).¹ When an interest is sold the question sometimes arises whether the interest is a property interest qualifying for capital gain treatment, or an income interest which is not a capital asset because it is not "property" within the meaning of section 1221 of the Code. The property versus income distinction is also crucial to the assignment of income doctrine, which states that only property, not income, can be transferred by gift for income tax purposes.² If an interest believed to be a property interest is transferred by gift and is later found to be an income interest, the transfer will be disregarded for tax purposes and the transferor taxed on the income. For example, a fee owner of real estate might give his child the right to collect rent from the real estate for a five-year period. Although the child may have an enforceable right to the rent under local law, the assignment of income doctrine precludes recognition of the transfer and therefore the donor will be taxed on the income. If,

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¹I.R.C. §§ 1221, 1222. See also *id.* §§ 1201-1202, 1221-1222.

²Compare *Blair v. Commissioner*, 300 U.S. 5 (1937) (life estate in trust may be assigned by gift), with *Helvering v. Horst*, 311 U.S. 112 (1940) (interest coupons detached from bonds cannot be assigned by gift). Under the grantor trust rules, an income interest of 10 years or more may be assigned through a 10-year trust and the donee will be taxed on the income. I.R.C. §§ 671-677. A mere right to income, however, cannot be assigned for tax purposes. To qualify under the grantor trust rules, the interest assigned to the trust must be a property interest. *Treas. Reg. § 1.671-1(c)*, T.D. 7148, 1971-2 C.B. 251. If the conditions of the grantor trust rules are met, the income from such property will be taxed to the donee-beneficiary during the term of the trust.

For a comprehensive discussion of the assignment of income doctrine, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 *TAX L. REV.* 293 (1962).

however, the fee owner gave away the fee, the transfer of a property interest would be effective for tax purposes, and income accruing after the date of the gift would be taxed to the donee.

The income versus property issue is not new to federal taxation. One issue debated in Congress prior to adoption of the first permanent income tax was whether an income tax on rents was actually a tax on the rental property.³ If so, it was argued, the Constitution required the tax to be apportioned among the states according to population.⁴ Because an income tax could not be so apportioned, the Supreme Court declared the tax unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*⁵ The Court could not resist the notion that a tax on income derived from property is intrinsically the same as a tax on the property itself. This facet of the income versus property issue was laid to rest in 1913 with the adoption of the sixteenth amendment which authorized Congress to tax all income "from whatever source derived, without apportionment among the several states."

This Article will examine the decisional law dealing with the income versus property issue, with particular focus on the relationship between capital gain and gift cases. For example, if a gratuitous assignment of rent is disregarded for tax purposes, does it necessarily follow that a sale of a right to rent should be treated as the sale of an income interest taxable at ordinary rather than capital rates?

It is important to note at the outset that although the verbal formulation of the issue is the same in capital gain and assignment of income cases, that is, whether a property interest or an income interest was transferred,⁶ the purposes for distinguishing property from income in these two categories of cases are quite different. The principal justification for the present scheme of capital gain taxation is that it mitigates the harsh effects of a progressive rate structure on appreciation accrued over a long period of time but realized in a

³26 CONG. REC. 6826-27 (1894).

"No Capitation or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4. It was generally assumed that a property tax of the type commonly used today by counties and municipalities was a direct tax subject to the apportionment clause.

⁵157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).

⁶In some capital gain cases, the courts have focused upon whether a sale or exchange has occurred. Under this analysis, capital gain treatment depends upon whether the transferor sold his entire interest in the property. If he retained an interest, there is no sale and capital gain treatment is denied. Of course, an identical result could be achieved by analysis of what was transferred. A transfer of less than the entire interest in the property is a transfer of an income interest rather than a transfer of property. See text accompanying note 58 *infra*.

single year.⁷ This bunching of income problem could, of course, be dealt with in other ways, such as averaging the gain over the holding period of the asset or requiring recognition of appreciation which has not been realized through a sale or exchange.⁸ The comparative merits of these possibilities are not considered here. Congress has chosen to deal with the bunching problem by taxing capital gains at a lower rate than ordinary income. In deciding whether a given item is a property interest qualifying for capital gain treatment or an income interest which does not qualify, it is appropriate to keep that legislative purpose in mind.

The principal justification for the assignment of income doctrine is to preserve rather than ameliorate the effect of progressive taxation. If a parent with total taxable income of \$100,000 could assign \$25,000 to a child, total taxes would be reduced even though the child is taxed on the amount he received because neither would pay tax at the rate applicable to \$100,000 of taxable income. Before taxes can be reduced through income splitting, the assignment of income doctrine requires that the source of the income, for example, the fee simple interest in real estate generating rent, be assigned. If a taxpayer were permitted to split off and assign a mere income interest, high rates of taxation could be avoided too easily. Requiring a complete transfer of the donor's entire interest lends substantiality to the transaction and justifies its recognition for tax purposes.

An important objective of this Article is to identify common strands running through the cases as an aid in the difficult task of characterizing borderline transactions for capital gain and assignment of income purposes. The vast majority of interests clearly fall into either the income or property category. For example, interest coupons in the hands of a bondholder which represent nothing more

⁷See Emory, *The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues*, 29 TAX L. REV. 3, 94 (1973). Additional justifications sometimes advanced are unconvincing. See *id.* at 94-95.

⁸Whether a tax on unrealized appreciation would be constitutionally permissible has never been decided by the Supreme Court. The landmark case of *Eisner v. Macomber*, 252 U.S. 189 (1920) (holding stock dividends to be outside the scope of income taxable under the sixteenth amendment), generally supports the proposition that unrealized appreciation cannot be taxed. The continued validity of *Eisner v. Macomber* has been questioned. One commentator has suggested that whatever remains of *Eisner v. Macomber* "be consigned to the junk yard of judicial history." J. SNEED, *THE CONFIGURATIONS OF GROSS INCOME* 125 (1967). If a scheme could be devised for overcoming the administrative and judicial problems of taxing unrealized appreciation and Congress chose to adopt it, the Supreme Court would probably uphold it. See Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151 (1964). "Today the Court's tolerance for the tax has reached the point where it would be very surprising if anything which there was a reasonable basis for taxing under the income tax was found to be beyond Congress' constitutional competence." *Id.* at 153.

than the right to collect interest clearly represent income and not property for tax purposes. If they are severed from the bonds and transferred by gift, the donor will be taxed on the interest collected by the donee.⁹ If they are severed from the bonds and sold, the seller will be taxed at ordinary rather than capital rates.¹⁰ It is equally clear that the bond itself is property, even though it carries with it the right to collect future interest.¹¹ If sold, the gain generally qualifies for capital gain treatment.¹² This Article focuses on certain types of interests which are problematical. These include leaseholds; life estates; oil, gas, and mineral interests; franchises; and personal service contracts. In the interest of convenience and clarity, the cases are categorized according to the type of interest involved.

II. LEASEHOLDS

A. *Capital Gain Versus Ordinary Income*

The characterization question most frequently arises when a lessor receives something other than rent in connection with a lease. In *Hort v. Commissioner*,¹³ the seminal decision, the Court denied capital gain treatment to a lessor who received \$140,000 in exchange for cancellation of a lease which had become onerous to the lessee. Conceding that the lease was "property," the Court concluded that "[i]t is immaterial that for some purposes the contract creating the right to such payments may be treated as 'property' or 'capital.'"¹⁴ For the purpose of applying the capital gain provisions, the Court held that the lump sum payment was not a return of capital but a substitute for future rent which would have been taxed as ordinary income.¹⁵

⁹*Commissioner v. Horst*, 311 U.S. 112 (1940).

¹⁰*See Shafer v. United States*, 204 F. Supp. 473 (S.D. Ohio 1962), *aff'd*, 312 F.2d 747 (6th Cir. 1963).

¹¹This conclusion is implicit in *Commissioner v. Horst*, 311 U.S. 112 (1940). The Court characterized interest coupons as representing income *because* the bondholder "separated his right to interest payments from his investment and procured the payment of the interest to his donee . . ." *Id.* at 120.

¹²Of course, amounts representing payment for accrued interest are not received in exchange for property and cannot qualify for capital gain treatment even if received in connection with sale of the bond. *First Ky. Co. v. Gray*, 309 F.2d 845 (6th Cir. 1962). Amounts received for the right to collect principal at maturity and the right to collect interest accruing between the date of sale and maturity will qualify for capital gain if the bond is a capital asset (not held for sale to customers in the ordinary course of business), has been held for more than one year, and was not originally issued at a discount from face value. *See I.R.C. §§ 1221-1222, 1232.*

¹³313 U.S. 28 (1941).

¹⁴*Id.* at 31.

¹⁵*Id.* Similar treatment has been accorded a lump sum payment received in ex-

This substitution analysis looks to the result of applying the capital gain provisions. If the result is deemed incompatible with the congressional intent of taxing an item as ordinary income, the item cannot be property within the meaning of the capital gain provisions regardless of its characterization under local law. The foregoing does not mean, however, that all substitutes for ordinary income fail to qualify for capital gain treatment. The Fifth Circuit has stated:

[Past Supreme Court decisions cannot be interpreted] to mean that any money paid which represents the present value of future income to be earned is always taxed as ordinary gains. As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income.¹⁶

A lump sum substitute for future dividends realized on the sale of stock may qualify for capital gain rates because a sale of stock represents a complete transfer of the taxpayer's entire interest in the property. It is therefore appropriate to regard the lump sum as a return *of* capital, not a return *on* capital. The lump sum in *Hort* was not a return of capital because the taxpayer retained his ownership of the building. If, however, the taxpayer had disposed of his entire interest in the building and leasehold in exchange for a lump sum partly attributable to future rents to be collected under the lease, capital gain treatment would undoubtedly have been allowed. Thus, an amount received in exchange for rights under a lease may or may not qualify for capital treatment depending on whether the transaction terminates the taxpayer's interest in the property.

In some cases the lessor rather than the lessee may wish to terminate the lease and may agree to make a lump sum payment. The receipt of such a payment by the lessee does not usually raise a substitution for income question because the leasehold interest will not normally be a direct source of ordinary income to the lessee. From the perspective of the lessee, the leasehold is beyond the scope of the *Hort* rule and is recognized as property for tax purposes.¹⁷ The leasehold may be a capital asset under section 1221 if not used in a trade or business or a section 1231 asset if used in a trade or business.¹⁸ In either case the transaction normally qualifies

change for a reduction in rent. See *Oliver v. Commissioner*, 364 F.2d 575, 579-80 (8th Cir. 1966) (citing *Hort v. Commissioner*).

¹⁶*United States v. Dresser Indus., Inc.*, 324 F.2d 56, 59 (5th Cir. 1963).

¹⁷*Commissioner v. Golonsky*, 200 F.2d 72, 73-74 (3rd Cir. 1952).

¹⁸See Rev. Rul. 72-85, 1972-1 C.B. 234.

for capital gain treatment.¹⁹ Capital gain treatment has also been upheld when the lessee received money in exchange for releasing the lessor from a restrictive covenant.²⁰

Lessees have had greater difficulty getting capital gain treatment in connection with subleases. A cancellation payment from the sublessee to the lessee-sublessor is usually taxed as ordinary income under the substitution doctrine of *Hort* because the sublease was a source of ordinary income.²¹

To the contrary is *Miller v. Commissioner*.²² In *Miller* the taxpayer held a lease and paid rent of \$1,650 per month. The property was subleased at a monthly rental of \$1,885. Two years after the sublease was entered into, it was cancelled and the headlease assigned to the sublessee for a single payment of \$32,000. The \$32,000 presumably represented the present value of the difference between \$1,885 monthly rental on the sublease and \$1,650 monthly rental on the headlease which would have been taxed as ordinary income to the taxpayer had he continued to hold the lease and the sublease. In rejecting the Commissioner's argument that the \$32,000 was subject to tax at ordinary rates under the substitution doctrine, the Tax Court distinguished *Hort* on the ground that the taxpayer in *Miller* completely terminated his interest in the property upon receipt of the payment, whereas in *Hort* the taxpayer continued to own the property in fee simple. The court stated:

By assignment [of his leasehold interest] petitioner disposed of his *entire interest* in the property and the fact that the sublessee provided the consideration therefor and entered into an agreement to cancel the sublease does not alter the inescapable conclusion that a sale of income-producing property occurred. . . .

. . . .

. . . Had there been merely a cancellation of the sublease without the assignment, petitioner would have retained his

¹⁹At one time the Commissioner unsuccessfully urged that capital gain treatment should be denied for lack of a sale or exchange. *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir. 1954); *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952). The matter was settled in 1954 with enactment of I.R.C. § 1241 which provides that amounts received by a lessee for cancellation of a lease shall be considered as amounts received in exchange for such lease. Internal Revenue Code of 1954, Pub. L. No. 591, § 1241, 68A Stat. 333.

²⁰*Ray v. Commissioner*, 210 F.2d 390 (5th Cir. 1954), *aff'g* 18 T.C. 438 (1952) (distinguishing the lump sum payment in *Hort* as payment of anticipated rent).

²¹Rev. Rul. 129, 1953-2 C.B. 97.

²²48 T.C. 649 (1967). *See also* *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960).

leasehold interest in the property and realized ordinary income in the form of liquidated rental payments.²³

In a 1972 Revenue Ruling, the Internal Revenue Service (IRS) permitted capital treatment for gain or loss realized by a lessee on the transfer of his entire leasehold interest to a third party.²⁴ Prior to transfer of the leasehold, the lessee had improved and subleased the leased property. The ruling does not suggest that the lessee's gain might be regarded as a substitute for ordinary income on the sublease, presumably because, as in *Miller*, the lessee disposed of his entire interest in the leasehold.

Generally, if one is realizing ordinary income directly from a lease, either as lessor or lessee-sublessor, any disposition of the leasehold interest which is less than a complete disposition of the transferor's entire interest in the leasehold as well as the underlying property will give rise to ordinary income under the substitution doctrine.²⁵ A complete disposition will avoid the doctrine.²⁶ The termination of interest limitation on the substitution doctrine of *Hort* is necessary because the application of *Hort* pervasively to all amounts which represent substitutes for ordinary income would vitiate the capital gain provisions, at least so far as income-producing property is concerned. Thus, it is reasonable to assume that the term "property" as used in the capital gain provisions includes property which is productive of ordinary income, but it does not include a limited income-producing interest carved out of a larger interest owned by the taxpayer.

²³48 T.C. at 653-54 (emphasis added). Cf. *Voloudakis v. Commissioner*, 274 F.2d 209 (9th Cir. 1960) (payments to lessee-sublessor who had a reversionary interest in the lease held ordinary income).

²⁴Rev. Rul. 72-85, 1972-1 C.B. 234.

²⁵Payments received by lessors for damage to leased property are not, of course, substitutes for rent. Ordinarily, such payments qualify for capital gain treatment without regard to the termination of interest rule. See *Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220 (2d Cir. 1975) (compensation by lessee for certain fixtures belonging to lessor should be treated as received in exchange for the fixtures); *Boston Fish Market Corp. v. Commissioner*, 57 T.C. 884 (1972) (cash payment received by lessor in settlement of lessee's obligation to restore leasehold to original condition held taxable as capital gain to the extent it exceeded the cost of the restoration); *Hamilton Main, Inc. v. Commissioner*, 25 T.C. 878 (1956) (compensation for damage to leased building a return of capital and applied to reduce the lessor's basis). Cf. *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944) (compensation for injury to goodwill treated as return of capital).

Compensation for related expenses, however, has been denied capital gain treatment. *Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220 (2d Cir. 1975) (compensation for expense of removing debris abandoned by lessee held ordinary income).

²⁶*Compare* Rev. Rul. 129, 1953-2 C.B. 97, with Rev. Rul. 72-85, 1972-1 C.B. 234.

B. *Assignment of Income Doctrine*

Although the Supreme Court has not ruled on the question of whether leaseholds can be gratuitously assigned for income tax purposes, the IRS and several circuit courts have considered the issue.

The IRS apparently applies the same standard for assignment of income purposes as the courts have applied for capital gain purposes. For the assignment to be effective for income tax purposes, it must be a transfer of the taxpayer's complete interest in the property, not a limited interest carved out of a larger estate. Revenue Ruling 58-337²⁷ involved the transfer of a leasehold interest by the fee owners to a ten-year trust for the benefit of the grantors' children. In ruling that the grantors would continue to be taxed on the rental income the Service stated:

Prior to the creation of the trust in the instant case, the fee owners had carved out of their ownership two separate estates, a leasehold and a reversion. The leasehold was then made the subject of the trust here involved. When a fee owner/lessor assigns a lease without assigning the reversion, only the right to the rent passes to the assignee. Accordingly, the assignment of the lease in trust without an attendant assignment of the reversion constitutes an assignment of income for which the grantor remains taxable, since he may not escape the tax on his income by giving it away or assigning the right to receive it in advance of payment.²⁸

The Service buttressed its argument by noting that the leasehold itself was not transferred absolutely because the trustee was prohibited by the trust instrument from reassigning the leasehold. It is doubtful, however, that the restriction on reassignment was crucial to the holding.

In *Iber v. United States*,²⁹ the taxpayer owned real estate subject to a lease and transferred the lease to a ten-year trust.³⁰ The government argued that "an assignment of a lease by one who continues to hold the reversionary interest in the land *never* constitutes a transfer of income-producing property."³¹ The Court of Appeals for the Seventh Circuit declined to adopt so broad a rule,

²⁷1958-2 C.B. 13.

²⁸*Id.* at 13.

²⁹409 F.2d 1273 (7th Cir. 1969).

³⁰Under the grantor trust rules of I.R.C. §§ 671-677, one may transfer income producing property to a trust for 10 years or more and have the income distributed and taxed to another person during the life of the trust. These rules represent a statutory exception to the assignment of income doctrine.

³¹409 F.2d at 1275.

holding instead that the transfer was ineffective because the assignor retained a reversionary interest in the leasehold.³² Nevertheless, the opinion focuses upon the fact that title to the income-producing property remained with the assignor and that deductions for depreciation and real estate taxes had been claimed by the assignor after he had assigned the lease.³³ The implication is clear that the assignor would have been taxed on the rental income even if he had transferred the entire leasehold retaining a reversion only in the underlying property. Otherwise, the income interest could be separated and assigned while deductions attributable to the production of the income were claimed by the taxpayer.

Contrary to the implication of *Iber* that a leasehold can never be effectively assigned by the fee owner is *Lum v. Commissioner*.³⁴ In *Lum* the owner-lessor assigned by gift all of his rights as landlord, retaining no interest whatever in the leasehold. Although the assignor took deductions for real estate taxes, maintenance expense, and depreciation on the leased property, the Third Circuit Court of Appeals concluded that the assignment constituted a transfer of income-producing property. Rental income was held taxable to the assignee.³⁵

In ruling upon a set of facts similar to those of *Lum*, the Fourth Circuit rejected the taxpayer's contention that more than a right to income was assigned, noting that "[t]he taxpayer does not suggest what these additional rights were and we have been unable to discover them."³⁶ During the term of the lease the taxpayer claimed deductions for taxes, maintenance expense, and depreciation. The court found these deductions indicative of an intent to retain ownership of the reversion and to transfer to the donee only the leasehold, which consisted of little more than a right to rent.³⁷ Although the assignee received a property interest under state law, the court characterized it as a nonassignable income interest for purposes of federal taxation.³⁸

The Seventh and Fourth Circuits hold that the gratuitous assignment of a leasehold by one who owns the underlying property will be ineffective to shift the incidence of tax on the rent. This conclusion is consistent with the treatment of leaseholds under the capital gain provisions in which sale of the leasehold by the owner of

³²*Id.*

³³*Id.* at 1276.

³⁴147 F.2d 356 (3d Cir. 1945).

³⁵*Id.* at 357.

³⁶*United States v. Shafto*, 246 F.2d 338, 342 (4th Cir. 1957).

³⁷*Id.* at 343.

³⁸*Id.*

the underlying property is treated as sale of an income interest giving rise to ordinary income rather than capital gain.

The Third Circuit's treatment of the assignment of a leasehold by one who owns the underlying property as the assignment of a property interest effective for tax purposes is inconsistent with the capital gain cases and with the fundamental principle that income derived from property is taxed to the owner of the property. In an economic sense, only the physical property itself is productive of income. The leasehold is nothing more than a legal arrangement entered into by the owner of the property for exploitation of its economic value. As the Third Circuit recognized, there is merely a technical distinction between assignment of a leasehold and assignment of a right to collect rent.³⁹ That distinction fails to justify recognition, for income tax purposes, of the assignment of a leasehold but not the assignment of a mere right to collect rents.⁴⁰

If the leasehold is assigned along with ownership of the underlying property, rent accruing after the date of assignment is taxable to the assignee as owner of the property. In the case of a transfer to a ten-year trust, rent is taxable to the assignee even though the assignor does not make a complete transfer of his entire interest in either the leasehold or the underlying property. For example, if, as in the *Iber* case, a taxpayer owns real estate subject to an eleven-year lease, the rental income can be assigned by transferring title to the underlying property as well as the leasehold to a properly qualified ten-year trust. The trustee is entitled to deductions for real estate taxes, maintenance expense, and depreciation during the term of the trust, and it is appropriate for the income to be taxed to the trustee or to the trust beneficiaries under the normal rules of trust taxation.

Although there are no cases directly on point, a lessee should be able to assign a leasehold interest by gift if he assigns his entire interest in the leasehold and has no interest in the underlying property. In the *Miller* case the taxpayer-lessee who was obligated to pay rent of \$1,650 per month subleased the property for \$1,885 per month. The leasehold itself was a valuable income-producing interest which was sold for \$32,000. The Tax Court characterized the transaction as a sale of property qualifying for capital gain treatment. By

³⁹The court characterized the distinction as "technical but real," "real" in the sense that if rent were assigned, "the landlord retained his interest and made a gift of the rent," whereas if the leasehold were assigned, "he transferred his interest as landlord." *Lum v. Commissioner*, 147 F.2d at 357. The court's analysis lacks substance.

⁴⁰The courts are unanimous in holding the gratuitous assignment of a right to rent ineffective for tax purposes. *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954); *Ward v. Commissioner*, 58 F.2d 757 (9th Cir. 1932); *Bing v. Bowers*, 22 F.2d 450 (S.D.N.Y. 1927).

analogy, a gratuitous transfer of the leasehold would qualify as a transfer of income-producing property effective for tax purposes.

III. LIFE ESTATES

A. *Assignment of Income Doctrine*

In *Blair v. Commissioner*,⁴¹ the owner of a life estate in a testamentary trust gave to his daughter an income interest amounting to \$9,000 per year for the duration of the life estate. The income versus property issue was particularly acute. If, in accordance with economic reality, the life estate were treated as a nonassignable income interest for tax purposes, the taxpayer could never assign the income even if he were to make a complete gift of his entire life estate because he would be powerless to assign the underlying property. On the other hand, if the life estate were unqualifiedly recognized as income-producing property, nothing would prevent the taxpayer from assigning any portion of it he chose. He could assign or keep the income on a year-by-year basis.

The Supreme Court observed that the taxpayer did not attempt to "limit the assignment so as to make it anything less than a complete transfer of the specified interest" assigned.⁴² Because there was a complete transfer of a vertical slice of the life estate, the Court held the assignment effective for income tax purposes.⁴³

In *Harrison v. Schaffner*,⁴⁴ the life beneficiary of a trust assigned to her children income from the trust for a one-year period. Unlike *Blair*, *Harrison* did not involve a complete transfer of a specified interest. In holding the transfer ineffective for tax purposes, the *Harrison* Court stated:

We think that the gift by a beneficiary of a trust of some part of the income derived from the trust property for the period of a day, a month or a year involves no such substantial disposition of the trust property as to camouflage the reality that he is enjoying the benefit of the income from the trust of which he continues to be the beneficiary. . . . Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest in it, we have not allowed the form to obscure the reality.⁴⁵

⁴¹300 U.S. 5 (1937).

⁴²*Id.* at 13.

⁴³*Id.* at 14.

⁴⁴312 U.S. 579 (1941).

⁴⁵*Id.* at 582-83.

Blair clarified that the complete transfer of a life estate would be recognized as a transfer of income-producing property for tax purposes. *Harrison* obscured the issue by holding that an interest in a life estate limited to one year, which is a thin horizontal slice of the life estate, would not be recognized because the taxpayer did not make a "substantial disposition of the trust property."⁴⁶ What would qualify as a substantial disposition was not addressed by the Court.

In 1955 the IRS ruled that a gratuitous, irrevocable assignment of a life estate for a period of not less than ten years would be recognized for tax purposes and the income would be taxable to the assignee.⁴⁷ The ruling was a pragmatic one in view of the fact that a life estate, transferable in its entirety under *Blair*, could be effectively transferred by gift for a ten-year period under sections 671-677 of the IRC. The economic effect of transferring a life estate to a ten-year trust with income payable to a donee-beneficiary would be identical with a direct transfer to the donee of a ten-year interest in the life estate. Thus, the IRS position is reasonable in view of the statutory provisions.

B. Capital Gain Versus Ordinary Income

In *McAllister v. Commissioner*,⁴⁸ the taxpayer transferred her entire life interest in a trust to the remainderman for \$55,000. Relying on *Hort*, the Commissioner argued that the \$55,000 was received as consideration for a right to income which would have been taxed at ordinary rates if distributed as earned, and that the \$55,000 should therefore be taxed at ordinary rates under the substitution for income doctrine. The Court of Appeals for the Second Circuit relied upon the decision in *Blair* that the gratuitous transfer of an income interest in a trust was the assignment of a property right with subsequent income, taxable to the donee,⁴⁹ and held the transaction to be a disposition of property taxable at capital gain rates.⁵⁰ The court had some difficulty in distinguishing the *Hort* case:

Here the line of demarcation between the *Blair* and *Hort* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all

⁴⁶*Id.* at 582.

⁴⁷Rev. Rul. 55-38, 1955-1 C.B. 389.

⁴⁸157 F.2d 235 (2d Cir. 1946).

⁴⁹*Id.* at 236.

⁵⁰*Id.*

would agree that there is some distinction between selling a life estate in property and anticipating income for a few years in advance. . . . The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate at least is.⁵¹

Although *McAllister* and *Hort* both involved a gain on a sale, the *McAllister* court distinguished *Hort* and relied upon *Blair* which involved a gift. Was it simply that *McAllister* and *Blair* each involved disposition of a substantial and durable property interest, whereas *Hort* did not? Although the court's language supports this conclusion, it provides no explanation as to why the fifteen-year leasehold in *Hort* with nine years remaining and annual rent of \$25,000 was not a substantial and durable property interest.

The court probably characterized the life estate in *McAllister* as a property interest because the taxpayer had assigned his entire interest in the property, whereas in *Hort* the taxpayer-lessor merely terminated a lease and continued to hold the property as a fee owner. *McAllister* and *Hort* can be reconciled only if termination of interest rather than durability is regarded as the appropriate test for determining the property versus income issue. Admittedly there is no direct support for the termination of interest analysis in the *McAllister* case. Nevertheless, termination of the transferor's interest was the only sound reason for the Supreme Court's holding in *Blair* that property rather than income was transferred. *McAllister* relied upon *Blair* and thus presumably upon a termination of interest theory.

Most life estates are acquired either by gift or bequest. The basis determined under sections 1014 or 1023 in the case of a bequest, or section 1015 in the case of a gift, cannot be amortized.⁵² At the time of the *McAllister* decision, however, the basis could be used to reduce gain on a sale, thus providing a great incentive for sale. Congress subsequently modified the effect of *McAllister* with section 1001(e) which provides that upon sale of a life estate any basis determined under sections 1014, 1023, or 1015 shall be disregarded.⁵³ Thereafter, the IRS announced that it will follow the holding of

⁵¹*Id.* at 235, 237 (emphasis added).

⁵²I.R.C. § 273.

⁵³In 1976 when § 1023 was adopted, Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 182-77, § 1001(e) was not amended to apply to bases determined under § 1023. However, § 1001(e) was so amended in 1978. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2928.

McAllister with respect to a sale by a life beneficiary of his entire interest.⁵⁴

IV. OIL, GAS, AND MINERAL INTERESTS

A. *Capital Gain Versus Ordinary Income*

Under the rule of *Hort*, one who owns real estate may not sell a leasehold and retain the underlying property for purposes of the capital gain provisions. The proceeds of such a "sale" are taxed as rental income. If one owns real estate upon which a natural deposit exists, however, he is regarded as holding two separate assets: the real estate and the deposit. The deposit may be sold in place for a fixed consideration and the gain taxed at capital rates.⁵⁵ The seller, having sold the depletable asset, will not be entitled to deductions allowed for depletion.⁵⁶ No substitution for income issue will arise by virtue of the seller's retention of the underlying real estate.

On the other hand, if the owner engages in the business of exploiting the deposit he will qualify for the depletion allowance, but resulting income will be taxed at ordinary rates because no sale or exchange is involved.⁵⁷ He may also engage in exploitation indirectly by entering into a lease or contract whereby others will carry on exploitation activities. In the latter case, it may be unclear whether the owner has sold the natural deposit in place with gain taxed at capital rates,⁵⁸ or has arranged for exploitation of the deposit with income subject to depletion and taxed at ordinary rates.

The touchstone which emerges from several oil and gas cases decided by the Supreme Court is whether the owner has retained an economic interest in the deposit.⁵⁹ If an economic interest has been retained, no sale has occurred and income is taxed at ordinary rates subject to depletion. If no economic interest has been retained—the deposit has been sold in place, payments received by the seller may qualify for capital gain treatment, but the seller will not be entitled to any depletion allowance. Most of the Supreme Court decisions involved taxpayers who had assigned exploitation rights to a natural

⁵⁴Rev. Rul. 72-243, 1972-1 C.B. 233.

⁵⁵*Whitehead v. United States*, 555 F.2d 1290 (5th Cir. 1970). See Treas. Reg. § 1.221-1.

⁵⁶See Treas. Reg. § 1.611-1(b).

⁵⁷See *id.*

⁵⁸See, e.g., *Cox v. United States*, 497 F.2d 348 (4th Cir. 1974); *United States v. White*, 401 F.2d 610 (10th Cir. 1968); *Commissioner v. Remer*, 260 F.2d 337 (8th Cir. 1958).

⁵⁹E.g., *Commissioner v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933). See 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 24.21 (1977).

deposit in exchange for some form of periodic payment. Typically, the taxpayer-assignor attempted to treat the transaction as an exploitation arrangement producing ordinary income, with attendant depletion allowances, rather than as a sale.⁶⁰ The Commissioner urged that the taxpayer had sold his economic interest in the oil or gas deposit and thus had nothing to deplete.⁶¹

Although most of the cases in which the economic interest test was developed involved the availability of deductions for depletion rather than the availability of capital gain treatment, the determinative question for both purposes is the same: whether a sale occurred. Thus, the economic interest test applies to the determination of whether a transaction involves a sale of a natural deposit or an exploitation contract.⁶² Several Supreme Court decisions provide a foundation for the economic interest test. These decisions merit careful evaluation.

Although the Court in these cases focused on whether a sale had occurred, the economic interest test which it applied is identical in substance to the test applied in *Hort* for the purpose of determining whether a property interest or an income interest had been sold. Here, just as under *Hort*, a retained interest will negate capital gain treatment. The only difference is a superficial one in that here a retained interest breaches the sale or exchange requirement, whereas under *Hort* it breaches the property requirement.⁶³

In considering the cases, it is important to keep in mind the distinction between two forms of payment commonly used in oil, gas, and mineral transactions. One who owns a natural deposit in place is said to hold the "working interest" because he has the power of exploitation. He may transfer the working interest to another in exchange for a royalty which entitles him to a specified percentage of production without limitations on the total amount which may be

⁶⁰*But see* text accompanying note 69 *infra* for a discussion of *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), which applied the economic interest test for a purpose other than determining the availability of depletion deductions.

⁶¹*See Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1945); *Palmer v. Bender*, 287 U.S. 551 (1933). Both cases are discussed in the text accompanying notes 64-68 *infra*.

⁶²*Vest v. Commissioner*, 481 F.2d 238 (5th Cir. 1973). "[I]t has also been recognized on several occasions that regardless of the original purpose of the economic interest test, it is substantially the same as the test employed to determine whether income is taxable as capital gain or ordinary income." *Id.* at 242. *But see Barker v. Commissioner*, 250 F.2d 195 (2d Cir. 1957).

⁶³This parity of treatment is entirely appropriate. In applying the capital gain provisions, uniform standards should be applied irrespective of the subject matter of the transaction. If a retained interest disqualifies a transaction involving a leasehold or a life estate, it should also disqualify a transaction involving a natural deposit or a franchise.

received. As an alternative, he may receive only a "production payment" entitling him to a specified percentage of production up to a specific dollar amount. In short, the production payment is like a royalty except that it provides for a maximum amount payable. The distinction between a royalty and a production payment has been a significant factor in applying the economic interest test.

1. *Cases Involving Royalties or Other Unlimited Payments.*—*Palmer v. Bender*,⁶⁴ the first Supreme Court decision applying the economic interest test, concerned taxpayers who had acquired, through a lease, complete control of an oil deposit. Although referred to as lessees, the taxpayers clearly owned the deposit in place and were free to sell it outright for a lump sum or to exploit it themselves. Instead, the taxpayers assigned the exploitation rights to an oil company in exchange for (1) an immediate cash payment, (2) a deferred payment of \$1,000,000 to be paid out of one-half of the first oil produced, and (3) a royalty of one-eighth of all oil produced. The Commissioner urged that inasmuch as taxpayers transferred all of their rights in the deposit, the transaction was a sale rather than a sublease under applicable state law and that the taxpayers were not entitled to depletion deductions. Noting that whether the transaction was a sale or a sublease under state law is immaterial for federal tax purposes, the Supreme Court held that the taxpayers "retained, by their stipulations for royalties, an economic interest in the oil in place identical with that of a lessor."⁶⁵ Through the royalty agreement, the taxpayers shared in the oil produced and in the risk of the oil being destroyed. Since the taxpayers retained an economic interest, they were entitled to an equitable portion of the depletion allowance.⁶⁶ It was thus established that a retained royalty based on output or production is a retained economic interest.

In *Kirby Petroleum Co. v. Commissioner*,⁶⁷ the owner in fee of the real estate leased it for the production of oil, gas, and other minerals. The lessee agreed to pay the taxpayer a lump sum bonus, a royalty based on production, and twenty percent of the net profits realized from exploitation under the lease. The Commissioner allowed depletion deductions based on royalty payments and the bonus, which was regarded as an advance royalty, but denied depletion based on income derived from the profit sharing arrangement. In overruling the Commissioner, the Court stated:

⁶⁴287 U.S. 551 (1932).

⁶⁵*Id.* at 558.

⁶⁶When more than one party has an economic interest in a depletable asset, the depletion allowance must be equitably apportioned. I.R.C. § 611(b).

⁶⁷326 U.S. 599 (1946).

If the additional payments in these leases had been a portion of the gross receipts from the sale of oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to a share of net profit.⁶⁸

*Burton-Sutton Oil Co. v. Commissioner*⁶⁹ involved a similar transaction wherein the taxpayer, an oil company engaged in exploitation activities, had obtained an oil lease by assignment, and agreed to pay the lessee-assignor fifty percent of the net profit realized from production. The taxpayer deducted these payments on the theory that the lessee-assignor retained an economic interest in the deposit and that the payments were similar to rent on a sublease. The Commissioner denied the deduction, claiming that the lessee-assignor had sold its entire interest and the payments were nondeductible acquisition costs.

The government attempted to distinguish *Kirby* wherein the taxpayer had retained a right to royalties based on production as well as a right to share in net profits. The Court responded:

We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possessor of a right to share in net profits the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.⁷⁰

The Court observed that one could divest himself of his economic interest as by a sale for cash, but that no such divestment occurs where one retains an interest in net profits. Because the lessee-assignor had retained an economic interest through the profit sharing arrangement, the taxpayer had not purchased the lease and was entitled to deduct profit sharing payments. *Burton-Sutton* clarifies that the owner of a deposit who assigns the working interest in exchange for a right to share in net profits has retained an economic interest.⁷¹

In *Commissioner v. Southwest Exploration Co.*,⁷² the taxpayer

⁶⁸*Id.* at 604.

⁶⁹328 U.S. 25 (1946).

⁷⁰*Id.* at 32.

⁷¹*Id.* at 36. *Cf.* *Commissioner v. Elbe Oil Land Dev. Co.*, 303 U.S. 372 (1938) (holding that a profit sharing arrangement did not constitute a retained economic interest in the transferor was limited to its facts).

⁷²350 U.S. 308 (1956).

owned real estate which was upland from oil deposits off the coast of California but held no interest in the oil deposits themselves. Under state law the offshore oil could be recovered only by slant drilling from the uplands. The taxpayer entered into an agreement with Southwest Exploration whereby Southwest would recover the offshore oil through drilling operations conducted on taxpayer's property. The taxpayer received a percentage of the net profits and took a deduction for depletion.

In determining whether the taxpayer was entitled to depletion, the Court noted that to qualify for the deduction one must have acquired an interest in the oil in place. Although the taxpayer had no direct ownership interest in the offshore oil, use of the uplands was essential to exploitation and the Court thus held that the taxpayer had an economic interest in the oil in place.⁷³ The economic interest consisted of control over exploitation which could have been sold to Southwest for a stated sum of money. Instead, the taxpayer retained an economic interest by permitting use of the uplands for a share of the profits. Income derived therefrom was ordinary income subject to depletion.

Under these Supreme Court decisions, the owner of a natural deposit who has arranged for exploitation in a manner which makes his return dependent upon royalties, net profits, or other measures of production has retained an economic interest in the deposit.⁷⁴ Although the decisions did not deal directly with the capital gain versus ordinary income issue, it is apparent that one who has retained an economic interest has not terminated his interest in the deposit; thus, the rule of *Hort* denies capital gain treatment. Although the lower courts have accepted this proposition,⁷⁵ they have had difficulty applying the economic interest test.

According to the Eighth Circuit's decision in *Commissioner v. Remer*,⁷⁶ making payment of the purchase price a function of produc-

⁷³*Id.* at 316.

⁷⁴For one to retain an economic interest in connection with an exploitation transaction, it is necessary that he hold such an interest before the transaction. One who owns the deposit in place, that is, holds the exploitation rights and is entitled to all income therefrom, clearly holds an economic interest. Since our concern is with how such a taxpayer's exploitation transaction will be characterized, the issue of whether more limited interests may also qualify as economic interests will not be discussed. Compare *Southwest Exploration Co.* (fee owner of land adjoining that on which deposit existed who, by virtue of such proximity to the deposit, controlled production had an economic interest in the deposit), with *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965) (mine operator's contract right to mine coal for sale to mine owner at a certain price did not give operator an economic interest in the coal in place). See generally 4 J. MERTENS, *supra* note 59, § 24:21, at 83-87.

⁷⁵See note 62 *supra*.

⁷⁶260 F.2d 337 (8th Cir. 1958).

tion will not in itself cause an economic interest to be retained by the transferor. In *Remer* the taxpayer transferred mineral leases in exchange for lump sum payments plus ten cents per ton of mineral extracted by the transferee. In upholding capital gain treatment the court stated:

The written assignments were in the language of an absolute sale under warranty of title and contained no provision retaining any interest in the property so sold. The provision in the assignments for the payment of ten cents per ton on such concentrates as might be shipped imposed no obligation on the transferee to ship any ore, and the transferor retained no interest in the ore in place. The consideration to be paid was definite and absolute and the provision with reference to paying ten cents per ton for the ore shipped was simply a method of measuring the added consideration to be paid. The transferor had the bare right to payments measured by production. This did not, we think, result in the transferor retaining an economic interest in the property sold.⁷⁷

In *Rabiner v. Bacon*,⁷⁸ the Eighth Circuit declined to apply the rule of *Remer* to a fee owner of gravel land who was to receive a fixed price per ton of gravel removed. The court stated:

[T]axpayer's income here was derived solely from the extraction of the mineral and was geared to the production of the mineral. We think it can be safely said that taxpayer retained an economic interest in the subject minerals whether any were mined or not. He had an economic interest in the minerals mined by reason of income he received from the exploitation of his lands and the extraction of the minerals.⁷⁹

Because the taxpayer had an economic interest in the gravel in place, capital gain treatment was denied. The *Remer* case was distinguished as involving the assignment of a mineral lease by a lessee rather than the granting of a mineral lease by a fee holder.⁸⁰ This distinction is without merit because a fee holder may make an effective sale of the mineral deposit in place for tax purposes, provided only that he has not retained an economic interest in the deposit.⁸¹

The Tenth Circuit reached a result contrary to *Remer* in *United*

⁷⁷*Id.* at 339. See also *Lineham v. Commissioner*, 297 F.2d 276 (1st Cir. 1961).

⁷⁸373 F.2d 537 (8th Cir. 1967).

⁷⁹*Id.* at 539.

⁸⁰*Id.*

⁸¹See notes 55-58 *supra* and accompanying text.

States v. White,⁸² a case involving very similar facts. In *White*, the taxpayer transferred uranium land by an outright mineral deed, retaining no reversionary interest. In exchange, he received a lump sum payment of \$175,000 plus ten percent of the gross value of all minerals mined. The taxpayer retained no control over exploitation; the transferee could recover the minerals or not, as he wished. In the first consideration of the case,⁸³ the Tenth Circuit held that the taxpayer "retained no investment or interest, economic or otherwise, in the minerals in place"⁸⁴ and was entitled to capital gain treatment on the lump sum. The court specifically declined to determine the character of the percentage payments.⁸⁵

Six years later, the court considered the same transaction for characterization of the percentage payments.⁸⁶ Noting that a single disposition of the mineral rights necessitated a single characterization of the consideration received, the court overruled its earlier decision and concluded that the taxpayer had retained an economic interest and that all amounts realized were properly characterized as ordinary income.⁸⁷

The court in *White* noted that the *Remer* decision was based upon an agreement to pay a fixed amount per unit, whereas the taxpayer in *White* was to receive a percentage of the value of the recovered ore. As the court implied, the distinction is specious⁸⁸ because in both cases the taxpayer's return is dependent upon production. The added variable of the recovered ore's value should be immaterial.⁸⁹

2. *Cases Involving Production Payments or Other Limited Payments.*—The Supreme Court has had some difficulty applying the economic interest test to production payments. A production payment entitles the holder to a specified sum of money payable

⁸²401 F.2d 610 (10th Cir. 1968).

⁸³United States v. White, 311 F.2d 399 (10th Cir. 1962), *overruled*, 401 F.2d 610 (10th Cir. 1968).

⁸⁴311 F.2d at 402.

⁸⁵*Id.* at 403.

⁸⁶401 F.2d 610 (10th Cir. 1968).

⁸⁷*Id.* at 614. At least one court has suggested that a retained interest of insignificant value ought not to characterize the entire transaction. *Wood v. United States*, 377 F.2d 300 (5th Cir. 1967).

⁸⁸*Id.* at 612. See *Cox v. United States*, 497 F.2d 348 (4th Cir. 1974) (lessee who assigned oil and gas leases for a lump sum payment plus a percentage of production had ordinary income); *Commissioner v. Pickard*, 401 F.2d 615 (10th Cir. 1969); *Wood v. United States*, 377 F.2d 300 (5th Cir. 1967). "Under the economic interest test, the critical consideration is whether payment is dependent upon extraction, not the method by which that payment is calculated." *Id.* at 306.

⁸⁹401 F.2d at 612.

from production. Unlike a royalty, it contemplates a limited rather than an unlimited return. Should such a limited return be considered dependent on production and therefore an economic interest? At first blush, it would clearly seem so. If one transfers the working interest in an oil deposit to another in exchange for \$395,000 to be paid at the rate of twenty-five percent of the oil produced, his return is dependent on production because no return will be realized unless oil is produced. In *Thomas v. Perkins*,⁹⁰ the Supreme Court held under similar circumstances that the transferor did not sell the oil in place for \$395,000 payable from production, but instead arranged for exploitation while retaining ownership. Thus, the transferor was taxed at ordinary rates on the twenty-five percent portion of the income from production used to satisfy the \$395,000 obligation.⁹¹

It could be argued, however, that a retained production payment should not be regarded as an economic interest. The economic interest test appropriately looks to the risk of ownership to determine whether an interest has been sold.⁹² If the transferor continues to bear the risk of ownership, he has not sold his interest. If the transferor is entitled to a specified sum regardless of production, he has shifted the risk of ownership to the transferee. Risk is a double-faceted concept, involving the possibility of gain as well as loss. The transferor in *Perkins* relinquished the possibility of gain beyond \$395,000, but the fact that he continued to bear the risk of loss was apparently deemed sufficient to negate a sale.

Three years later, in *Anderson v. Commissioner*,⁹³ the Court sharply curtailed the rule of *Perkins*. In *Anderson*, oil properties, including fee interests, were transferred in exchange for a specified sum of money payable from oil or gas to be produced and from proceeds realized upon a resale of the fee interests in any of the properties conveyed. Payments due under the agreement were secured by liens on the oil and gas produced and on the fee interests. The Court distinguished *Perkins* on the basis that it involved only a reservation by the transferor of an interest in production, whereas in *Anderson* there was reserved an interest in the fee and in production. "In the interests of a workable rule," the Court observed, "*Thomas v. Perkins* must not be extended beyond the situation in

⁹⁰301 U.S. 655 (1937).

⁹¹*Id.* at 661.

⁹²See *Palmer v. Bender*, 287 U.S. 551, 558 (1933). In *Palmer*, the taxpayers possessed an economic interest through a royalty contract, which allowed them to share in the income from the oil produced as well as the loss resulting from the destruction of oil in place. See *id.* at 558.

⁹³310 U.S. 404 (1940).

which . . . the reserved payments are to be derived solely from the production of oil and gas."⁹⁴

After *Perkins* and *Anderson*, a retained production payment payable *solely* from production will be treated the same as a retained royalty and will constitute an economic interest negating a sale; if the production payment is secured by anything other than production it will not be regarded as an economic interest. This technical distinction, which is without practical significance in many instances, probably resulted from the Court's recognition in *Anderson* that *Perkins* was wrongly decided and a reluctance to overrule *Perkins* so soon after it had been decided. Nonetheless, these early Supreme Court decisions mean that establishing a total maximum price, as and when recovered, will not qualify the transaction for capital gain treatment.⁹⁵ On the other hand, a fixed price which is to be paid from production if the deposit is exploited but which is due in any event qualifies for capital gain. It does not result in a retained economic interest because the purchase price is not dependent upon production.⁹⁶

As a practical matter, collecting the price depends on production unless there is personal liability on the obligation. Personal liability, however, has not been regarded as crucial. In *Strutzel v. Commissioner*,⁹⁷ for example, the taxpayer owned mining rights which gave him power to extract and sell certain mineral deposits. In effect, the taxpayer owned in place any such deposits discovered on the property. He transferred his entire interest for \$500,000, payable in fixed installments over a ten-year period. If the transferee exploited the deposits, the taxpayer-transferor was entitled to a five percent production payment which would reduce the fixed installments and the \$500,000 purchase price. In the event of default, the mining rights would revert to the taxpayer without further obligation on the part of the transferee.

In upholding capital gain treatment the Tax Court observed that "[p]roduction royalties, if paid, would only serve to accelerate payment of the total purchase price."⁹⁸ The court therefore concluded that the provision for a reverter in the event of default did not constitute a retained economic interest.⁹⁹ Although the installment payments were not technically dependent on production because they were due in any event, as a practical matter they were dependent. If the claims proved worthless, the transferee could simply

⁹⁴*Id.* at 413.

⁹⁵*United States v. Witte*, 306 F.2d 81 (5th Cir. 1962).

⁹⁶*Strutzel v. Commissioner*, 60 T.C. 969 (1973).

⁹⁷60 T.C. 969 (1973).

⁹⁸*Id.* at 974.

⁹⁹*Id.* at 976.

default and allow the claims to revert to the transferor. Note that capital gain treatment would not have been available if the contract had called for a five percent production payment not to exceed \$500,000. This premium on drafting is an unfortunate side effect of the Supreme Court's distinction of *Perkins* in *Anderson*. The Court should have overruled *Perkins* by holding that establishing a maximum price strips the assignor of the principal benefit of ownership, the possibility of speculative gain, without which there is no retention of a meaningful economic interest.¹⁰⁰

3. *Sale of Retained Interest*.—A question closely related to that of characterizing the original exploitation transaction may arise if the entire retained interest is transferred at a later date. If the taxpayer disposes of his retained interest and thereafter has no economic interest in the deposit, transfer of the carved-out interest originally retained ordinarily qualifies for a capital gain treatment.¹⁰¹ This is true even though the carved-out interest would have been productive of the ordinary income to the transferor if he had continued to hold it. Thus, a twelve percent royalty, which yields an average of \$15,000 annually taxable at ordinary rates, could be sold for a lump sum payment taxable at capital gain rates. The result is sensible. Because the initial transfer would have qualified for capital gain treatment if it had terminated the taxpayer's interest, the second transfer, which did terminate it, should qualify.

Consistent with this analysis is the Supreme Court's holding in *Commissioner v. Lake*¹⁰² that transfer of a carved-out interest does not qualify for capital gain treatment if the transferor's interest in the deposit is not terminated.¹⁰³ In *Lake*, a corporate taxpayer which held oil and gas leases for exploitation transferred to its president an oil payment right¹⁰⁴ in the amount of \$600,000, payable from the working interest, in exchange for cancellation of a debt. After payment of the \$600,000, the taxpayer would be restored to its original

¹⁰⁰By the same reasoning a bootstrap sale of a business could qualify for capital gain treatment without violating the principles of the oil, gas, and mineral cases. See *Commissioner v. Brown*, 380 U.S. 563 (1965) (sale of stock in a wholly-owned corporation in exchange for a specified sum to be paid out of post-sale profits held subject to capital gains tax). Three justices dissented, stating that "the sellers here retained an economic interest in the business fully as great as that retained by the seller of the oil interests in *Thomas v. Perkins*." *Id.* at 586 (Goldberg, Black, J.J., & Warren, C.J., dissenting).

¹⁰¹Rev. Rul. 73-428, 1973-2 C.B. 303.

¹⁰²356 U.S. 260 (1958).

¹⁰³*Id.* at 268.

¹⁰⁴As described by the Court, an oil payment is "the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as and when produced." *Id.* at 261 n.1.

position with respect to the working interest. In short, the taxpayer assigned \$600,000 of the future income it expected to realize from the leases.

In holding that ordinary income resulted from the debt cancellation, the Court relied upon its earlier decision in *Helvering v. Horst*¹⁰⁵ that a taxpayer who detached interest coupons from negotiable bonds and made a gift of them to his son was taxable on the interest even though it was paid to his son.¹⁰⁶ The coupons were characterized as income interests which could not be assigned by gift.¹⁰⁷ Similarly, the *Lake* Court characterized the oil payment right as an income interest which could not be sold at capital rates, stating: "Only a fraction of the oil . . . rights were transferred, the balance being retained."¹⁰⁸ Although much of the opinion in *Lake* concerned the type of interest that was transferred, the clear implication was that there could be no capital gain treatment because the source of the income was retained. Under either rationale a complete termination of interest would qualify the transaction as a transfer of property for capital gain purposes.

B. Assignment of Income Doctrine

Although the cases are sparse, the assignment of income doctrine has been applied in a manner consistent with the capital gain decisions. In *Flewellen v. Commissioner*,¹⁰⁹ a taxpayer who owned a royalty interest in an oil well made a gift of a production payment of \$3,000 to be paid from the royalties. The Commissioner included the \$3,000 in taxpayer's income, although it had been paid directly to the donee. The Tax Court observed that had the production payment been sold, the proceeds would have been taxed as ordinary income under the *Lake* case.¹¹⁰ Inasmuch as the *Lake* decision rested on assignment of income principles stated in *Horst*,¹¹¹ the Tax Court viewed them as controlling and upheld the Commissioner.¹¹² By assigning a production payment, the taxpayer attempted to strip off an income interest from a larger royalty interest which he owned.

Had the taxpayer in *Flewellen* assigned a vertical slice of his royalty interest, for example, \$3,000 per year for the duration of the royalty contract, the assignment would have been recognized for tax

¹⁰⁵311 U.S. 112 (1940).

¹⁰⁶*Id.* at 117.

¹⁰⁷*Id.* at 117-18.

¹⁰⁸356 U.S. at 265.

¹⁰⁹32 T.C. 317 (1959).

¹¹⁰*Id.* at 322-23.

¹¹¹See text accompanying note 108 *supra*.

¹¹²32 T.C. at 323.

purposes.¹¹³ In *United States v. Spalding*,¹¹⁴ the holder of a royalty interest in a gas well assigned by gift a percentage of all amounts payable to him in the future under the royalty agreement. Relying on *Blair*,¹¹⁵ the Court held the transfer effective for tax purposes.

V. FRANCHISES

A. *Capital Gain Versus Ordinary Income*

Many similarities exist between the tax issues raised by the disposition of franchises and those pertinent to gas, oil, and mineral cases. If the transferor of a franchise makes an outright sale retaining no interest in or control over the franchise, it will constitute a sale or exchange of property and will normally qualify for capital gain treatment.¹¹⁶ An incomplete disposition may be regarded as a licensing transaction producing ordinary income.

*Gowdey v. Commissioner*¹¹⁷ illustrates the problems which frequently arise. The taxpayer in *Gowdey* held a Dairy Queen franchise for the state of Virginia which gave him the exclusive right to use patented machines, to use the name "Dairy Queen," and to prepare and sell the product Dairy Queen. Franchise rights for specified territories within Virginia were assigned to various individuals in exchange for an immediate lump-sum payment plus periodic payments of thirty-five cents per gallon of Dairy Queen mix used. The issue was whether the taxpayer had entered into a subfranchise or licensing arrangement resulting in ordinary income or whether he had sold a portion of his statewide franchise.

The Court allowed capital gain treatment for the initial payment, but not for the periodic payments, noting that the assigned franchise privileges could be exercised in perpetuity.¹¹⁸ Under this analysis, the taxpayer had transferred to each assignee a portion of his entire interest, a vertical slice of the statewide franchise consisting of all substantial rights for a specified territory. The court had some difficulty with the requirement that the taxpayer approve any subsequent transfer of the franchise, but held that the restriction was insufficient to negate a sale.¹¹⁹

¹¹³See text accompanying notes 41-46 *supra* for a discussion of vertical and horizontal interests in life estates.

¹¹⁴97 F.2d 701 (9th Cir. 1938).

¹¹⁵See text accompanying note 41 *supra* for a discussion of *Blair v. Commissioner*, 300 U.S. 5 (1937).

¹¹⁶*Brook v. Commissioner*, 360 F.2d 1011 (2d Cir. 1966); Rev. Rul. 73-428, 1973-2 C.B. 303. The franchise must also qualify as a capital asset under I.R.C. § 1221(1).

¹¹⁷307 F.2d 816 (4th Cir. 1962).

¹¹⁸*Id.* at 820.

¹¹⁹*Id.* at 819.

It is difficult to see why any distinction should be drawn between the initial payment and the subsequent payments. The fallacy of this bifurcated approach has been recognized in the mineral cases.¹²⁰ A single transaction either does, or does not, constitute a sale of the franchise. On facts similar to those of *Gowdey*, the Tenth Circuit held that all payments qualified for capital gain treatment.¹²¹

A Fifth Circuit case, *Moberg v. Commissioner*,¹²² also involved transfers of Dairy Queen subfranchises. The consideration for each subfranchise consisted in part of \$4,000, of which \$2,000 was payable at closing with the balance to be paid at the rate of fifteen cents per gallon of mix used but not less than \$1,000 per year. This part of the consideration would clearly have qualified for capital gain treatment. In addition, the franchiser was entitled to fourteen cents per gallon of mix used for as long as the franchise existed. The Tax Court had held all gain except that resulting from the sale of tangible assets to be taxable as ordinary income, not because of the royalty arrangement but because of the many restrictions and controls reserved by the taxpayer.¹²³ In the Tax Court's view, these restrictions and controls gave the taxpayer a continuing interest in how the franchised businesses were conducted, thereby making the transactions licensing arrangements rather than sales.¹²⁴ The Fifth Circuit reversed, noting that "these restrictions were consistent with a sale of the franchise to use the machine and trademark in an exclusive territory. The traditional test of ownership is the power to exclude others and that test was met here."¹²⁵

The court of appeals held that the transaction constituted a sale but declined to characterize the royalties.¹²⁶ On remand, the Tax Court held that the franchises constituted capital assets in the hands of the taxpayer but that the royalty payments "did not represent a part of the sales price" and were therefore ordinary income.¹²⁷

In a related case,¹²⁸ the Ninth Circuit agreed with the Fifth Circuit as to one form of the Dairy Queen subfranchise. Regarding a second form which imposed substantially greater restrictions on the franchisees, the Ninth Circuit found no sale and held all payments to be taxable as ordinary income. The distinguishing feature was that

¹²⁰See notes 82-87 *supra* and accompanying text; *Consolidated Foods Corp. v. United States*, 569 F.2d 436 (7th Cir. 1978).

¹²¹*Dairy Queen v. Commissioner*, 250 F.2d 5031 (10th Cir. 1957).

¹²²305 F.2d 800 (5th Cir. 1962).

¹²³*Moberg v. Commissioner*, 35 T.C. 773 (1961).

¹²⁴*Id.* at 784.

¹²⁵305 F.2d at 806.

¹²⁶*Id.* at 784.

¹²⁷*Moberg v. Commissioner*, 32 T.C.M. (P-H) ¶ 63,288, at 1680-63 (1963).

¹²⁸*Moberg v. Commissioner*, 310 F.2d 782 (5th Cir. 1962).

those franchises which resulted in capital gain reserved to the franchiser controls which were designed primarily to assure that the agreed purchase price would be paid. Those franchises which resulted in ordinary income reserved to the franchiser more extensive power, including the power to make policy determinations about how the franchised operation should be conducted.

It is entirely appropriate to allow a franchiser to retain powers intended to protect the value and reputation of a trademarked product without disqualifying the franchise for capital treatment. In that respect, franchises are different from mineral rights and call for different rules of taxation. No apparent justification exists, however, for the difference in the treatment of royalty rights. If, as Supreme Court decisions have made clear, retention of a right to royalties based on production is incompatible with a transfer of all the risks and benefits of ownership and thus precludes a sale when transfer of a mineral interest is concerned,¹²⁹ the same result should obtain where a royalty right is retained in connection with granting a franchise.

This view draws some support from section 1253, adopted by Congress in 1969 in an attempt to clarify taxation of franchise transfers.¹³⁰ Under this provision, a transfer of a franchise will not be treated as the sale of a capital asset if the transferor retains any significant power, right, or continuing interest in the subject matter of the franchise. The statute specifies that a continuing interest includes a right to payments contingent on productivity if such payments constitute a substantial element under the transfer agreement, thereby contemplating an analysis identical to that developed by the courts in the oil, gas, and mineral cases. Those cases, however, have denied capital gain treatment without regard to whether retained royalty rights were substantial or insubstantial.¹³¹ The question which arises is whether a sound basis exists for denying capital gain treatment to oil, gas, or mineral transactions when royalty rights are retained but denying it to franchise transactions only when substantial royalty rights are retained.

Some justification for this distinction is found in section 1253(c), which provides that contingent payments are taxable at ordinary rates even if the transaction qualifies as the sale of a capital asset. In other words, if the transferor of a franchise is to receive payments contingent on productivity which do not constitute a

¹²⁹See notes 64-89 *supra* and accompanying text.

¹³⁰Tax Reform Act of 1969, Pub. L. No. 91-172, § 516(c)(1), 83 Stat. 487.

¹³¹At least one court has suggested that a retained interest of insignificant value ought not characterize the entire transaction. *Wood v. United States*, 377 F.2d 300 (5th Cir. 1967).

substantial element under the transfer agreement, the transfer may be treated as a sale, but the contingent payments are nevertheless taxed at ordinary rates. Thus, section 1253 adopts a bifurcated approach which may result in part capital gain and part ordinary income treatment. Although the statute provides a more lenient standard than the oil, gas, and mineral cases in determining whether a sale of property has occurred, the tax effect of finding a sale under the statute is less significant. The bifurcated approach reduces the pressure on the sale versus license issue. Even if a sale has occurred, royalty income is taxed at ordinary rates. A similar statutory rule would be as desirable in the oil, gas, and mineral area as it is in the franchise area. It would prevent the characterization of an entire transaction by a retained royalty which may be an insubstantial part of the total consideration received.

B. *The Assignment of Income Doctrine*

No case has been found concerning the tax consequences of assigning a portion of a franchise by gift. Presumably, a vertical slice of a franchise could be effectively transferred. Thus, if one holds the right to make and sell Dairy Queen products in a five-state area, an unconditional assignment of the franchise pertaining to one of the states should be recognized for tax purposes.

If the donor retained some control over use of the franchise by the donee or assigned the franchise for a limited period of time, the issue would be whether the interest assigned was a mere right to income. If the interest transferred would have qualified for capital gain treatment had a transfer in exchange for a lump sum payment of cash occurred, the interest should be regarded as a gift of income-producing property with income subsequently produced taxed to the donee. On the other hand, if the donor retained control over operation of the franchised business, income may well be attributable to the continuing supervision of the donor and appropriately taxed to the donor.

VI. CONTRACTS

A. *Capital Gain Versus Ordinary Income*

1. *Service Contracts.*—Courts have consistently denied capital gain treatment to income arising out of pure employment contracts.¹³² As the Tax Court recently stated: "It is a well settled principle of law 'that consideration received for the transfer of a contract right

¹³²See, e.g., *Holt v. Commissioner*, 303 F.2d 687 (9th Cir. 1962); *Flower v. Commissioner*, 61 T.C. 140 (1973); *Heyn v. Commissioner*, 39 T.C. 719 (1963); *McFall v. Commissioner*, 34 B.T.A. 108 (1936).

to receive income for the performance of personal services is taxable as ordinary income.'"¹³³ The principle applies equally to payments for cancellation of an employment contract not yet performed.¹³⁴

In many instances, transactions will include not only cancellation or transfer of a service contract but also transfer of an interest in a number of other assets, tangible or intangible, some of which would yield capital gain if sold separately. Transactions of this kind have produced litigation and confusion.

In *Jones v. Corbyn*,¹³⁵ the taxpayer had an agency contract with an insurance company under which he had the exclusive right to solicit customers in the state of Oklahoma. When difficulties developed, the insurance company paid the taxpayer \$45,000 in exchange for termination of the agency contract, all books, records, and files pertaining to the business, and rented office space from which the business had been conducted. The Commissioner argued that the agency contract was simply a right to perform services which would have generated ordinary income. The Tenth Circuit disagreed, concluding that the contract was a form of intangible property within the meaning of the capital gain provisions.¹³⁶

In a subsequent case, *Elliott v. United States*,¹³⁷ the Tenth Circuit declined to follow its decision in *Jones v. Corbyn*, observing that the decision had been criticized by several courts and at least one commentator.¹³⁸ *Elliott* arose out of the merger of two insurance companies. The taxpayer had made an agreement with the surviving company to terminate his general agency contract with the merging company in exchange for nearly \$50,000 plus a percentage of business produced under the contract prior to its termination. According to the termination agreement, the lump sum payment was for personal money invested in the business by the taxpayer. Nevertheless, the court held the \$50,000 taxable as ordinary income, stating that personal money was expended by him to pay current operating expenses which he intended to recoup through com-

¹³³*Goldman v. Commissioner*, 44 T.C.M. (P-H) ¶ 75,138, at 628-75 (quoting *Flower v. Commissioner*, 61 T.C. 140, 148 (1973), *aff'd*, 50 F.2d 1302 (1974)) (lump sum received in exchange for release of all claims arising under partially performed employment contract held ordinary income).

¹³⁴*McFall v. Commissioner*, 34 B.T.A. 108 (1936) (lump sum received by employee for cancellation of five-year employment contract with three years remaining held ordinary income).

¹³⁵186 F.2d 450 (10th Cir. 1950).

¹³⁶*Id.* at 452.

¹³⁷431 F.2d 1149 (10th Cir. 1970). *See also Vaaler v. United States*, 454 F.2d 1120 (8th Cir. 1972).

¹³⁸431 F.2d at 1154.

missions that would have been ordinary income.¹³⁹ Because the lump sum was received in exchange for relinquishing the right to earn ordinary income, application of the substitution doctrine was deemed appropriate.

A similar problem arose in the Fifth Circuit case of *Nelson Weaver Realty Co. v. Commissioner*.¹⁴⁰ A mortgage banking company had entered into a contract with a life insurance company for placing and servicing the insurance company's mortgage loans. Under the arrangement, the taxpayer agreed to make mortgage loans which it deemed to be sound and sell them to the insurance company as the permanent lender. For an agreed fee, the mortgage company collected periodic payments of principal and interest, arranged for payment of insurance and property taxes, and performed other routine services. This contract was assigned to another mortgage banker for \$121,841. The assignee acquired all rights under the contract, including the right to service approximately 1,830 mortgages, and all business records pertaining to the contract. Although the Commissioner argued that the lump sum was a substitute for fees to be earned in the future which should be taxed as ordinary income, the court found no correlation between future income which would have been derived from servicing the loans and the purchase price. This lack of correlation and the fact that the taxpayer had transferred to the buyer business records which had been compiled over the years in connection with mortgage loans, including a customers list, persuaded the court to conclude that a longstanding relationship with a satisfied clientele, the equivalent of goodwill, had been sold. Accordingly, capital gain treatment was upheld.¹⁴¹

In *Weaver Realty*, the Fifth Circuit characterized the transaction as a whole. Because the consideration was not entirely a substitute for ordinary income, the court did not apply the substitution for income doctrine. This approach was promptly abandoned in *Bisbee-Baldwin Corp. v. Tomlinson*.¹⁴² On facts similar to those involved in *Weaver Realty*, the court held that the proceeds were ordinary income to the extent attributable to servicing mortgage loans and capital gain to the extent attributable to goodwill or other valuable interests qualifying as capital assets.¹⁴³

¹³⁹*Id.* at 1153.

¹⁴⁰307 F.2d 897 (5th Cir. 1962).

¹⁴¹*Id.* at 901.

¹⁴²320 F.2d 929 (5th Cir. 1963).

¹⁴³*Id.* at 934-36. See also *United States v. Wollsey*, 326 F.2d 287 (5th Cir. 1963) (gain realized on sale of a business involving the management of mutual insurance companies taxed partly as ordinary income, partly as capital gain); *United States v. Edison*, 310 F.2d 111 (5th Cir. 1962) (gain realized on sale of an insurance business carried on under a general agency contract taxed at ordinary rates).

Finally, in *Flower v. Commissioner*,¹⁴⁴ the Fifth Circuit affirmed a Tax Court decision holding amounts received in exchange for termination of a selling contract to be ordinary income.¹⁴⁵ The taxpayer had received a lump sum payment for termination of a contract under which he was to promote and sell the products of a drug manufacturer. The taxpayer urged that he had disposed of assets other than the terminated contract, including goodwill, and that the sale price should be allocated among such assets with any gain attributable to capital assets taxed at capital rates. The court rejected this argument on the theory that any goodwill generated through the taxpayer's efforts attached to the manufacturer's products, not the taxpayer's business, and thus could not have been transferred by the taxpayer.¹⁴⁶ In addition, the court observed that the taxpayer did not transfer a franchise, he simply released a contract right to earn ordinary income, and that as a general principle consideration received for the transfer of a contract right to receive income for the performance of future services is taxable as ordinary income.¹⁴⁷

As the foregoing cases demonstrate, the courts have employed property and agency laws in characterizing transactions which involve the disposition of service contracts plus other valuable rights. For example, in *Flower* the court emphasized that the taxpayer was the agent of another so that as a matter of law any goodwill or business records developed by the taxpayer did not belong to him but to his principal.¹⁴⁸ Thus, the taxpayer lacked a property interest to which a portion of the consideration could be allocated. In *Bisbee-Baldwin*, however, the taxpayer was accorded partial capital gain treatment because he had developed goodwill and business records under a contract as a nonagent.¹⁴⁹

The distinction based on agency and property law is artificial and unpersuasive. The Supreme Court has frequently admonished that the answer to capital gain problems is not to be discovered in concepts of property law or other local law which may vary from state to state.¹⁵⁰ As a matter of substance, the taxpayers in all these

¹⁴⁴505 F.2d 1302 (5th Cir. 1974), *aff'g mem.* 61 T.C. 140 (1973).

¹⁴⁵61 T.C. 140, 149 (1973), *aff'd mem.*, 505 F.2d 1302 (1974).

¹⁴⁶*Id.* at 150.

¹⁴⁷*Id.* at 151. *See, e.g.*, *Furrer v. Commissioner*, 45 T.C.M. (P-H) ¶ 76,331 (1976), 115 (9th Cir. 1977) (capital gain denied on facts similar to those in *Flower*).

¹⁴⁸61 T.C. at 150.

¹⁴⁹320 F.2d at 934.

¹⁵⁰"It is the will of Congress which controls, and the expression of its will in legislation . . . is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. . . . State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent on state law." *Burnet v. Harmel*, 287 U.S. 103, 110 (1932) (citations omitted).

cases were doing business under a contract and were able to negotiate for a payment in exchange for relinquishing their contractual rights. Regardless of who owned the business records and goodwill, the taxpayer in each case was entitled to their use and benefit so long as the contract endured and was being compensated for the surrender of that valuable right. The fact that ordinary income would have been realized had the taxpayer continued to conduct business should not be controlling. One who sells inventory in the ordinary course of his business also earns ordinary income. That does not preclude capital gain treatment when the business is liquidated and the inventory sold in bulk. Similarly, the liquidation of valuable contractual rights should not preclude capital gain treatment merely because the rights would have produced ordinary income if retained.

For the same reasons, the pure employment contract cases¹⁵¹ have not been decided on a principled basis. The absence of business records, goodwill, or some other property aside from the contract itself should not result in automatic denial of capital gain treatment. That amounts received in exchange for service contracts are substitutes for ordinary income should not be conclusive. The sale of inventory or the sale of stock for a price determined by expected dividends could also be described as a substitute for income.

It seems the assignment of income cases which flatly preclude the gratuitous assignment of earned income¹⁵² have had an unfortunate impact here. Preserving the integrity of progressive taxation provides an adequate basis for an absolute prohibition on the assignment of income to be earned in the future by the assignor. That rationale does not extend to the capital gain area where one is giving up not only the right to receive income but also the right to earn future income. Following a gratuitous assignment of income, the assignor renders services but the assignee collects the income. Obviously, the assignor should be taxed. Similarly, if one sells his right to income from future services under an employment contract for a lump sum and thereafter renders the services with the assignee collecting the income, the assignor should be taxed at ordinary rates on the lump sum because it is a mere substitute for periodic payments. The employment contract continues to exist and the assignor continues to render services. But if more is involved—if all rights, including the right to render services under an employment

¹⁵¹See text accompanying notes 132-34 *supra*.

¹⁵²*E.g.*, *Lucas v. Earl*, 281 U.S. 111 (1930). In what has become a famous metaphor, Justice Holmes declared he could think of no reason "by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115. The flat rule taxing all earned income to whoever earned it has endured. See *United States v. Basye*, 410 U.S. 441 (1973).

contract, are liquidated for a lump sum — a right to earn a flow of income in the future is exchanged for its present value, a transaction no different from any sale of income-producing property. In the final analysis, all income-producing property is equal to the present value of the future income it is expected to produce.¹⁵³ Thus, all sales of income-producing property involve the substitution of a lump sum for a flow of future income. Unless the substitution doctrine is limited to transactions not involving a termination of interest, it virtually swallows the capital gain provisions.

Furthermore, the substitution doctrine was developed to deal with transactions not involving a complete termination of interest because such transactions are outside the intended scope of the capital gain provisions. They do not involve the realization in a single year of the entire income the taxpayer will ever realize from the property. If a complete bunching of income occurs, as in the termination of an employment contract, the transaction is within the principal purpose of the capital gain provisions: to ameliorate the effect of progressive taxation on bunched income. Application of the substitution doctrine is incompatible with the purpose it was intended to serve. Finally, the Tax Court is incorrect in suggesting that *Lake* dictates ordinary income treatment whenever a lump sum payment is realized in lieu of periodic payments taxable at ordinary rates.¹⁵⁴ Capital gain treatment was denied in *Lake*, as in *Hort*, because income-producing property was not entirely disposed of. Under such circumstances the transferred interest was properly regarded as an income interest subject to the substitution doctrine. If a taxpayer with a ten-year employment contract sold the right to income for five years, the transaction would not be a termination of the employee's rights and duties under the contract but a mere collapsing of income and the *Lake* rationale should apply. However, the *Lake* rationale clearly should not control the cancellation of an employment contract which involves a complete termination of all economic interests in the contract. Under such circumstances, even-handed treatment of wage earners and property owners demands capital gain treatment for the termination payment except to the extent that it constitutes payment for past services.

¹⁵³As graphically stated by the court in *United States v. Dresser Indus.*, 324 F.2d 56 (5th Cir. 1963), "[t]he value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income." *Id.* at 59.

¹⁵⁴In *Flower v. Commissioner*, 61 T.C. 140 (1973), the Tax Court found "strong support" in *Lake* for the following proposition: "[T]he consideration petitioner received for termination of his contract was a substitute for ordinary income he would have received had the contracts not been terminated, and nothing else. Thus, we conclude, the entire amounts received are taxable as ordinary income . . ." *Id.* at 149.

2. *Contracts Other than Service Contracts.*—Contracts in which the rendition of services played a subsidiary role have fared only slightly better under the capital gain provisions. Many of the decisions turned on whether the contract right was regarded as “naked,” or as a “substantial property right.” Under this approach, contract rights qualify as a capital asset only if they create a direct interest in something conventionally regarded as property, such as a leasehold in real estate, or a life estate in a trust corpus consisting of securities.¹⁵⁵ Contracts which do not create such interests are said to be “naked” and therefore not property for purposes of the capital gain provisions.

The Second Circuit applied this analysis in *Commissioner v. Pittston Co.*,¹⁵⁶ characterizing as ordinary income a lump sum received by the taxpayer for release of its right to purchase all coal produced by a certain plant at eight percent below the market price.¹⁵⁷ The court stated that “[t]he courts have not been entirely consistent in their treatment of lump sum payments received by a taxpayer for the termination of jural relations”¹⁵⁸ Indeed, the Tax Court in *Pittston* had upheld capital gain treatment,¹⁵⁹ and Judge Moore, dissenting from the Second Circuit’s decision, concluded that the “contract rights can only be rendered ‘naked’ by stripping from them and discarding the raiments which the parties found to be essential.”¹⁶⁰

One of the most carefully reasoned opinions in this area is *Commissioner v. Ferrer*.¹⁶¹ The taxpayer had acquired the exclusive right to produce a stage play based upon a copyrighted novel, the power to prevent the sale of film rights in the novel for a specified period of time, and, if he in fact produced a play, the right to share in any proceeds subsequently generated through film rights. In exchange for cancellation of these contract rights, the taxpayer received a right to seventeen percent of the net profits realized from production of a movie. The Commissioner contended that the entire royalty was taxable at ordinary rates. The Second Circuit Court of Appeals reviewed the cases involving the tax treatment of amounts received

¹⁵⁵See *Dorman v. United States*, 296 F.2d 27 (9th Cir. 1961); *Metropolitan Bldg. Co. v. C.I.R.*, 285 F.2d 592 (9th Cir. 1960); *C.I.R. v. Golonsky*, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

¹⁵⁶252 F.2d 344 (2d Cir. 1958).

¹⁵⁷*Id.* at 348.

¹⁵⁸*Id.* at 347.

¹⁵⁹*Pittston Co. v. Commissioner*, 26 T.C. 967, 969 (1956).

¹⁶⁰252 F.2d at 349 (Moore, J., dissenting). See *Commissioner v. Goff*, 212 F.2d 875 (3d Cir. 1954) (surrender of contract rights to the entire product of four machines a capital gain transaction).

¹⁶¹304 F.2d 125 (2d Cir. 1962).

in exchange for contract rights and described the "naked" versus "substantial" analysis:

One common characteristic of the group [of transactions] held to come within the capital gain provision is that the taxpayer had either what might be called an "estate" in . . . or an "encumbrance" on . . . or an option to acquire an interest in . . . property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another . . . or by rendering services . . . or by virtue of ownership of a larger "estate."¹⁶²

Accepting this analysis, the court categorized the various interests held by the taxpayer as either capital gain or ordinary income by examining the character of the transaction.¹⁶³ The court noted that the play production right "sounds like the transactions held to qualify for capital gain treatment."¹⁶⁴ The court theorized that the interest resembled a lease or an equitable interest, which is more than a contract right to earn income by rendering services.¹⁶⁵ In addition, the court observed that the production right is intimately related to the copyright of the play, which is a capital asset.¹⁶⁶ The court thus rejected the Commissioner's substitution for income argument, stating that payment in exchange for relinquishment of the right to produce a play could qualify for capital gain even though exercise of the right would have generated ordinary income.¹⁶⁷

Similarly, the court decided that the taxpayer's right to prevent the sale of motion picture rights for a specified period of time constituted an equitable interest in the author's copyright over motion picture rights.¹⁶⁸ The court held that relinquishment of that interest should be taxed at capital gain rates,¹⁶⁹ producing the same result as

¹⁶²*Id.* at 130-31 (citations omitted).

¹⁶³The court rejected the wholly unsatisfactory approach it had taken earlier in *Commissioner v. Starr Bros., Inc.*, 204 F.2d 673 (2d Cir. 1953), and *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953). In these cases, the court had focused upon whether the interests relinquished had survived the transaction, thereby meeting the sale or exchange requirement, or had been extinguished. This approach would seldom result in capital gain treatment upon cancellation of a contract because the interests are normally extinguished. As the *Ferrer* court recognized, the parties to the transaction generally will "not care a fig whether there was an 'annulment or conveyance.'" 304 F.2d at 131.

¹⁶⁴304 F.2d at 131.

¹⁶⁵*Id.* at 132.

¹⁶⁶For a more recent application of the same analysis, see *Crisp*, 42 T.C.M. (P-H) ¶ 73,006 (1973).

¹⁶⁷304 F.2d at 132.

¹⁶⁸*Id.* at 133.

¹⁶⁹*Id.*

the transfer of the entire copyright, rather than a limited interest relating to the copyright. When considering the right to share in profits derived from the sale of movie rights, the court reached the opposite result. The contract provided that the taxpayer was to have "no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive"¹⁷⁰ a share of the proceeds. Because the author expressly retained all property rights relating to producing a motion picture, the taxpayer had nothing more than a right to a share of future income which would have been taxed at ordinary rates. Relying on *Hort* and the substitution for income arguments, the court held that the amounts received in exchange for release of the percentage rights constituted ordinary income.¹⁷¹

In deciding the tax treatment of gains from the sale of covenants not to compete, the courts have relied upon property law concepts. In the words of the Second Circuit:

It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will.¹⁷²

Thus, the capital gain treatment depends on the relationship of the covenant to some other item, usually goodwill, conventionally recognized as a property interest. It is difficult to conceive how a covenant not to compete given by the seller of a business can be anything but ancillary to the sale of business assets.¹⁷³ Nonetheless, many cases have denied capital gain treatment on the theory that the covenant was severable from the sale of other assets.¹⁷⁴ If the covenantor is a shareholder in the corporation which sold business assets, capital gain treatment has generally been denied on the grounds that the covenantor sold no assets to which the covenant could be ancillary.¹⁷⁵ This result, grounded on the corporate law concept of the corporation as a separate entity, ignores the economic

¹⁷⁰*Id.* at 134.

¹⁷¹*Id.*

¹⁷²*Ullman v. Commissioner*, 264 F.2d 305, 307-08 (2d Cir. 1959).

¹⁷³*See* 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.33, at 297 (1977).

¹⁷⁴*See, e.g., Barran v. Commissioner*, 334 F.2d 58 (5th Cir. 1964).

¹⁷⁵*Montesi v. Commissioner*, 340 F.2d 97 (6th Cir. 1965); *Hamlin Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954).

unity of the corporation's business and the shareholder's business which made the shareholder covenant necessary. Stripped of its technicalities, most would agree the result is unfortunate.¹⁷⁶

The answer to capital gain issues should not be sought in the law of corporations any more than in the law of property or agency. The convoluted reasoning of the lower courts has led to conflicting and inappropriate results and has increased tremendously the complexity of the characterization process. Proper analysis would follow the simpler lines of *Hort* and *Lake*. If there were a complete disposition of whatever valuable rights the taxpayer owned, the transaction would fall within the intended scope of the capital gain provisions.¹⁷⁷ If the disposition were incomplete, there would be no sale of property rights, merely an arrangement for their exploitation.

Under the termination of interest test, the result of many of the cases considered above would be altered. For example, the taxpayer in *Pittston Co.* liquidated its entire contract right for a specified sum of money and would qualify for capital gain treatment under the termination of interest test. To deny capital gain treatment for such a transaction when the liquidation of other forms of valuable interests qualify, is arbitrary and unfair. In *Ferrer* the taxpayer held three contract rights, one relating to production of a stage play and two relating to production of a motion picture. Only the first was liquidated and only it should have qualified for capital treatment. The taxpayer, in effect, exploited the other contract rights by relinquishing them in exchange for a share of profits realized from production of a movie. On the other hand, covenants not to compete would generally qualify for capital treatment since they normally involve a complete relinquishment of the right to compete during the term of the covenant—the covenantor's consideration is not usually dependent upon the covenantee's profits.

B. *Assignment of Income Doctrine*

Rights and duties under a personal service contract cannot be assigned by gift. One can assign the right to collect payments for the rendition of services, but the assignment is ineffective for tax purposes. The assignor will be responsible for the taxes on any income earned by his services even though the income is collected by

¹⁷⁶See 3B J. MERTENS, *supra* note 173, at 300.

¹⁷⁷Of course, limitations unrelated to those discussed here may preclude capital gain treatment. See, e.g., *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955) (transactions which are an integral part of a trade or business do not qualify for capital gain treatment).

the assignee.¹⁷⁸ This practice is consistent with ordinary income treatment for any lump sum received in lieu of periodic payments for past or future services.¹⁷⁹

Contracts which do not involve the retention of services by the transferor should be freely assignable by gift for income tax purposes, subject to the usual termination of interest rule. Even a contract right productive of ordinary income in the hands of the donor should be assignable. Such treatment is consistent with the *Blair* ruling concerning an assignment of a life estate¹⁸⁰ and should not depend on whether the contract right is deemed "naked" or "substantial." The "naked" versus "substantial" test is irrelevant to the purpose of the assignment of income doctrine which prevents frustration of progressive taxation by splitting income among taxpayers. No splitting of income occurs when one transfers his entire interest. The donee may be in a lower tax bracket than the donor, but no sound reason exists for precluding assignment of an entire contract right to a low-bracket donee while permitting assignment of other income-producing property to such a donee. Nevertheless, the courts are likely to apply the analysis of *Pittston*, *Ferrer*, and the covenant-not-to-compete cases. If the courts adopt this approach, assignability would depend on the "naked contract" versus "substantial property interest" test.¹⁸¹

VII. CONCLUSION

Equity and simplicity should be goals of any area of the law. Although not mutually exclusive, the two concepts often clash. If capital gains were taxed at the same rates as ordinary income, simplicity would be achieved but inequities created because gains accumulated over a period of years would be taxed in a single year according to a progressive rate structure. Thus, equity may require a certain degree of complexity.

The Supreme Court's decisions provide a coherent theory in which transfers of income-producing interests are recognized for capital gain and assignment of income purposes if the transfer terminates the taxpayer's interest in the transferred property. This theory is not only easy to understand and apply, but also is consistent with the underlying purposes of capital gain treatment and the assignment of income doctrine. If one has not terminated his interest in property, all income to be realized from the property is not assessed in a single year, and capital gain treatment is appropriately

¹⁷⁸*Lucas v. Earl*, 281 U.S. 111 (1930).

¹⁷⁹See text accompanying note 152 *supra*.

¹⁸⁰See text accompanying note 41 *supra*.

¹⁸¹The author has found no cases involving gifts of this interest.

withheld. Similarly, transfer by gift of less than one's entire interest in property results in a splitting of income between donor and donee. The transfer should be disregarded to preserve the integrity of the progressive rate structure. The termination of interest rule produces equitable results if applied uniformly without regard to the nature of the property in question.

Lower court decisions are another matter. In dealing with certain types of property interests, such as franchises and contractual rights, which the Supreme Court has not considered specifically, the lower courts have applied ambiguous and specious standards in construing the capital gain provisions. They have made the relatively simple process of characterizing a transaction for capital gain or assignment of income purposes, complicated, speculative and, to a large degree, unpredictable. Furthermore, the selection of different standards for different types of interests ignores equitable concerns. Arbitrary distinctions have led to arbitrary and inequitable results. Simplicity and equity need not be sacrificed if the lower courts adopt the guiding principles of *Hort*, *Blair*, *Lake*, and other Supreme Court decisions.

