# Chapter 7: Capital Gains and Losses

## A. Overview

A "capital gain" is gain (within the meaning of §1001(a)) from the "sale or exchange" of a capital asset. A "capital loss" is similarly defined. Capital gains and losses are important for two separate reasons: (1) capital losses are subject to a special loss disallowance rule; and (2) for noncorporate taxpayers, a certain combination of capital gains and losses are taxed (assuming such gains exceeds such losses), at a special, preferential set of rates.

## B. The Technical Definitions

### 1. Definition of a Capital Asset

A "capital asset" is defined in §1221 by exclusion: it encompasses all property other than those assets described in §1221(a)(1)-(8). Note that there is no requirement that to be a capital asset the property must be held for use in a trade or business or for investment. So, for example, a taxpayer's personal residence is a capital asset as is a taxpayer's personal car and personal jewelry. And so are most stocks and bonds.

The exclusions in §1221(a) can be grouped into a few distinct categories: First, there is the inventory exclusion in §1221(a)(1), the inventory receivables exclusion in §1221(a)(4), and the supplies exclusion in §1221(a)(8), all speaking to property used to generate day to day business income. Second, there is the service-favored exclusion in §1221(a)(3) that backstops the requirement of "property" in the introductory language in §1221(a).[1] Third, there are the derivatives exclusions in §§1221(a)(6) and 1221(a)(7). There are a few other exclusions but the only other one we will consider is found in §1221(a)(2) applicable to depreciable property and real estate used by the taxpayer in a trade or business.

#### *a. The Inventory Exception in §1221(a)(1)*

**Bielfeldt v. Commissioner**

**231 F.3d 1037 (7th Cir. 2000)**

POSNER, CIRCUIT JUDGE.

Gary Bielfeldt, a large trader in U.S. Treasury notes and bonds, seeks to overturn a decision by the Tax Court denying him the right to offset immense trading losses that he incurred in the 1980s against all but $3,000 a year in ordinary income. He claims to be not a trader but a dealer and that the losses he incurred in the sale of the Treasury securities were losses connected with his dealer's "stock in trade"; such

[1] The inclusion of patents in §1221(a)(3) was made as part of the TCJA of 2017. Unfortunately, the drafter of that provision failed to notice §1235.

losses, even when they result as his did from the sale of a capital asset, are treated as ordinary rather than capital losses and can therefore be fully offset against ordinary income. 26 U.S.C. §1221(1). In contrast, capital losses, while they can be fully offset against capital gains, can be offset against ordinary income only up to $3,000 a year. 26 U.S.C. § 1211(b). Although the amount is arbitrary, the rationale for limiting such offsets is not; it is to reduce taxpayers' incentives to so structure their capital transactions as to realize losses today and defer gains to the future. If Bielfeldt's characterization of his status is sound, he is entitled to some $85 million in refunds of his federal income tax.

The standard distinction between a dealer and a trader is that the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in. This is not to deny that a trader, whether he is a speculator, a hedger, or an arbitrageur, serves the financial system by tending through his activities to bring prices closer to underlying values, by supplying liquidity, and by satisfying different preferences with regard to risk; he is not a parasite, as the communists believed. But he is not paid for these services. His income from trading depends on changes in the market value of his securities between the time he acquired them and the time he sells them.

Although one thinks of a dealer's inventory or stock in trade as made up of physical assets, it can be made up of securities instead. A stockbroker who owned shares that he sold to his customers at market price plus a commission would be a bona fide dealer. The example of a recognized dealer in securities that is closest to Bielfeldt's self-description because it blurs the distinction between deriving income from providing a service in the purchase or sale of an asset and deriving income from changes in the market value of an asset is a floor specialist on one of the stock exchanges. The specialist maintains an inventory in a specified stock in order to maintain liquidity. If its price soars, indicating that demand is outrunning supply, he sells from his inventory to meet the additional demand, and if the price of the stock plunges, he buys in the open market in order to provide a market for the people who are trying to sell. He is not paid by the stock market for this service, but is compensated by the income he makes from his purchase and sales and by commissions on limit orders (orders contingent on a stock's price hitting a specified level) placed with him by brokers. The Internal Revenue Service treats his gains and losses as ordinary income because the Internal Revenue Code classifies him as a dealer. See 26 U.S.C. §§ 1236(a), (d).

Treasury securities, at least the ones in which Bielfeldt transacted, are not sold on an organized exchange, and so there are no floor specialists-there is no floor. The market for Treasury securities is an over-the-counter market, like the NASDAQ. But the economic function that the specialists on the organized exchanges perform is independent of the form of the market, and dealers who specialize in Treasury

securities (called “primary dealers,” and discussed in the next paragraph) are close analogues of the floor specialists, just as NASD market makers are. There is even a recent law that requires the primary dealers in Treasury securities, with some exceptions, to register with the SEC or the NASD.

Bielfeldt claims that he performs this function too, though he is not a registered or primary dealer. The securities in question are used to finance the national debt. During the period in which he incurred losses, there was no talk of paying off the debt-on the contrary, the debt was growing. To finance growth and redemptions, the Treasury would periodically auction large quantities of bonds and notes, which would be underwritten by a relative handful of primary dealers. Bielfeldt would buy in huge quantities from these dealers and resell in smaller batches, often to the same dealers, a few weeks later. His theory, which worked well for a few years and then turned sour, was that the Treasury auctions were so large that each one would create a temporary glut of Treasury securities, driving price down. He would buy at the depressed price and hold the securities off the market until, the glut having disappeared (because he was hoarding the securities), price rose, and then he would sell. He argues that had it not been for this service that he performed in the marketing of Treasury securities, the price the Treasury got at its auctions would have been depressed, with the result that interest on the national debt would be even higher than it is.

What he is describing is simply the social benefit of speculation. Think back to the Biblical story of Joseph. During the seven fat years, years of glut, Joseph “hoarded” foodstuffs so that there would be an adequate supply in the seven lean years that he correctly predicted would follow. In a money economy, he would have financed the program by buying cheap, which would be easy to do in a period of glut, and selling dear, which would be easy to do in a period of scarcity and would help to ration supplies in that period. He would buy cheap yet pay higher prices than people who were buying for consumption, since he would anticipate a profit from the later sale during the period of scarcity. Similarly, Bielfeldt hoarded Treasury securities during the fat weeks immediately after an auction so that there would be an adequate supply in the lean weeks (the weeks between auctions) that followed. That activity may have been socially beneficial, as he argues, but it is no different from the social benefits of speculation generally. His argument if accepted would turn every speculator into a dealer for purposes of the Internal Revenue Code.

Like a floor specialist, Bielfeldt undertook no obligation to maintain an orderly market in Treasury securities. He did not maintain an inventory of securities; and because he skipped auctions that didn't seem likely to produce the glut that was the basis of his speculative profits, there were months on end in which he could not have provided liquidity by selling from inventory because he had no Treasury securities. In some of the tax years in question he participated in as a few as 6 percent of the auctions, and never did he participate in more than 15 percent. As a result, he was out of the market for as much as 200 days a year. He was a speculator, period. As the Federal Reserve Bank of New York, which kept track of Bielfeldt's trading in Treasury securities and sent updates to the IRS, put it, “his activities are in most cases outright

speculation on interest rate movements." In saying that Bielfeldt was not a specialist, we don't mean to imply that the Internal Revenue Service would be required to recognize as a dealer a trader who structured his operation to resemble that of a floor specialist but was not a floor specialist as defined in 26 U.S.C. § 1236(d)(2). That issue is not before us. Nor is the bearing of a 1997 statute, 26 U.S.C. § 475(f), which allows a securities trader to treat paper gains and losses as ordinary rather than capital income by marking to market the securities he owns at the end of the tax year, that is, by pretending they had been sold then. We note finally that Bielfeldt's alternative argument, that Treasury securities are "notes receivable acquired in the ordinary course of trade or business" and therefore are not capital assets within the meaning of 26 U.S.C. § 1221(a)(4), is frivolous. It implies that no bonds, government or private, are capital assets, since a bond, like a note receivable, is a promise to pay the holder of the instrument.

Affirmed.

*Notes*

1. *Trader vs Dealer*. Judge Posner in *Bielfeldt* says that the case turns on whether the taxpayer is a "trader" or a "dealer," but the relevant statute, §1221(a), does not use either term in its definition of a capital asset. Why does Judge Posner focus on this distinction? He is looking at the inventory exception in §1221(a)(1) and trying to determine if the Treasury bonds and notes bought and sold by the taxpayer fall with that exception to the definition of a capital asset. In holding that the Treasury notes and bonds were capital assets in the hands of Bielfeldt, was he concluding that (1) they were not "inventory" to the taxpayer, (2) they were not "held by the taxpayer primarily for sale to customers," or (3) they were not so held "in the ordinary course of [the taxpayer's] trade or business"? A closer attention to the statutory language by Judge Posner might have made the holding clear.

Instead of emphasizing the statutory language, Judge Posner determines what generated the taxpayer's profits and losses, concluding that he was attempting to profit from market changes in prices over time (i.e., speculating) rather than providing a service to the market for which he was compensated regardless of market value fluctuations. But why is any of this relevant? Does the language of §1221 preclude from capital gain treatment all profits derived from labor income? Consider someone who occasionally purchases dilapidated houses, repairs them on the weekends, and then sells them at a gain. Such sweat equity generates capital gain. Or consider the founding group of a start-up company that enjoys vast gains selling shares after the company goes public. Such gains are taxed as capital gain.

Is Judge Posner attempting to define the word "inventory" as it is used in §1221(a)(1)? If so, what is his definition? It is fair to say that the seller of inventory seeks to profit from something other than changes in market values? What allows Home Depot to make a

profit on its ladders and shovels? What allows Tesla to make a profit (if it makes a profit) on its cars?

The taxpayer conceded in the lower court that he did not hold the Treasury notes and bonds "for sale to customers." But he argued that they nevertheless were "stock in trade" to him. The Tax Court held that the "for sale to customers" limitation in §1221(a)(1) is applicable to all of the clauses in that section including the "stock in trade" provision. Accordingly, the assets were capital asset to him. Bielfeldt v. Commissioner, T.C. Memo 1998-394. The phrase "for sale to customers" was added to the statute in 1934 to ensure that trading securities for one's own account generated capital gain and loss. H.R. Rep. No. 1385. 73d Cong., 2d Sess., 1939-1 C.B. (pt. 2) 627, 632.

2. *A capital asset to whom?* Judge Posner wrote that losses from sales of inventory, "even when they result as his did from the sale of a capital asset, are treated as ordinary rather than capital losses." As a technical matter, this statement is false: an item of inventory within the meaning of §1221(a)(1) is not a capital asset. Judge Posner made a common mistake, thinking that a particular type of asset either is or is not a capital asset. In fact, the same asset can be a capital asset to one taxpayer but not to another depending on the purpose for which the asset is held: if the asset is held for sale to customers in the ordinary course of the taxpayer's business, then it is not a capital asset. One should not ask if a particular asset is a capital asset but rather whether it is a capital asset in the hands of a particular taxpayer.

3. *The §1221(a)(4) argument*. The taxpayer in *Bielfeldt* argued that the Treasury notes and bonds were excluded from the definition of a capital asset by reason of §1221(a)(4) because they constituted "accounts or notes receivable acquired in the ordinary course of the taxpayer's trade or business." But there is more to that provision: it applies only when the accounts receivable are received for services rendered by the taxpayer or from the sale of inventory as described in §1221(a). Since the taxpayer purchased the Treasury notes and bonds for cash, they are not described in §1221(a)(4).

4. *Can a dealer who holds marketable securities as inventory obtain capital gain or loss treatment on securities held for her own account?* Because capital gain often is taxed to noncorporate taxpayers at a favorable rate, such taxpayers seek to classify their gains as capital gain. But because capital losses are subject to a special loss limitation rule (as discussed in *Bielfeldt* and below), taxpayers try to classify their losses as noncapital (i.e., as "ordinary"). As a result, Congress is unwilling to allow securities brokers to classify their gains and losses as personal (i.e., capital) or business (i.e., noncapital) after they discover whether there is a gain or a loss. Under §1236, a broker who holds securities as inventory is permitted to earmark specific securities as held for investment and not as inventory, but the broker must "clearly identify" the choice by the end of the day during which the security was acquired. Such identification generally is made by holding the security in a designated investment account.

**Biedenhard Realty Co. v. United States**

**509 F.2d 171 (5th Cir. 1975)**

GEE, CIRCUIT JUDGE:

Once more we are called on to characterize profit from sales of subdivision lots as ordinary income or capital gain. The facts, pre-eminent in these cases, are detailed in the careful opinion below and we set out only a precis of them.

Taxpayer is a family investment corporation organized by the paterfamilias in 1923 for advantages of scale and unity. Among its holdings are bottling plants, a shopping center, miscellaneous commercial and residential rent properties, several going businesses, a portfolio of stocks and bonds, two farms, and Hardtimes Plantation. This last, he terrain of our case, is a 973-acre farm purchased at a bargain in 1935. Taxpayer has since farmed it continuously but has also, as the nearby city of Monroe expanded toward and over Hardtimes during the years from 1939 through the taxable years in question (1964-66), subdivided and disposed of about half its acreage in residential lots. [T]he United States does not dispute that taxpayer's original purpose in buying Hardtimes was investment, but rather contends that a change in that purpose is evidenced by taxpayer's mode of operation and handling of the property . . . .

Taxpayer has four employees: A farmer and a camp caretaker are fulltime, but its manager and its bookkeeper are, respectively, principally employed as general manager and comptroller of a soft drink corporation, another family enterprise. The manager testified that taxpayer's affairs occupied about ten percent of his time, chiefly spent in supervising rental collections and building maintenance. Taxpayer has a listed telephone, which rings in the soft-drink concern's offices, but no offices of its own. Though, because of special circumstances, the taxpayer has platted and sold one other tract in lots and platted, though it did not so sell, two others back in the 1920's, it is fair to say it does not have a significant history of acquiring and subdividing other tracts of land. Indeed, the United States does not seriously contend that it is in that business unless its Hardtimes activities put it there.

The subdivision and sale of Hardtimes has proceeded somewhat languidly. From the time of the first lot sale in 1939 through 1966, the last taxable year in question, sales averaged about five per year. Some sales were of multiple lots. 1957 was the high year, with 23 transactions involving 35 1/2 lots. In six of these years, no lots were sold and in eight--including 1962 and 1963--only one. During the three taxable years in question sales were 37, or about one per month on the average.

In all instances taxpayer laid out and paved streets by the lots sold, and sometimes it added curbs and gutters, sewerage and utilities. Selling was by independent commission agents, who handled all aspects of the transaction except fixing of price and transfer of title, done by the taxpayer. The agents bore, from their commissions, such merchandising costs as there were: signs posted on the property and newspaper

advertisements. Taxpayer's profits ranged from 74% to 97%, reflecting in significant part[5] the initial bargain price and the approach of Monroe. During the years in suit, gains from Hardtimes' lots were about 11% of taxpayer's gross income.

Our case originated as taxpayer's action for refund of something over $30,000 in additional taxes determined by the Internal Revenue Service to be due as a result of its classification of the 1964-66 gain on lot sales as ordinary income. The district court, taking testimony and documentary evidence which established as undisputed the facts summarized above, concluded that the lots in question were not 'held primarily for sale' nor were the taxpayer's activities in connection with them a 'trade or business.' Instead, it found the taxpayer to have been engaged in no more than the reasonable improvement for liquidation and liquidation of portions of a large farm property acquired and held for investment, which had greatly appreciated in value as a result of market factors favorable to but not caused by the taxpayer. The Court's analysis proceeded along conventional lines, giving due regard to the seven major factors reiterated in *Winthrop*[2] and recognizing that these furnish only a matrix giving form to the consideration of each individual case as a whole. Other appropriate principles are recognized and applied in the published opinion, a reiteration of which would serve little purpose here. On appeal to us, however, the Government attacks along lines somewhat less conventional, which may be fairly summarized as follows:

Capital gain treatment, we are told, must turn on the purpose for which the property is held at the time of sale, not at some earlier time. Biedenharn Realty Company, the taxpayer, was subdividing, improving and developing this land, a procedure generally recognized as a business. Had Biedenharn bought this land for purposes of subdividing just before so using it, it could not have expected capital gain treatment. Hence, its earlier purposes and uses become irrelevant. Moreover, Biedenharn's activities may not properly be considered liquidation, since in a 'true' liquidation the property is offered without change of form, for whatever price it will bring. Since Biedenharn sought to create additional value by changing the property's form, it chose not to 'liquidate' but to use the property in a new and different manner--and one recognized as a business. Biedenharn's situation should be tested purely by examining the nature of its activities at time of sale, or as if its original purpose in

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[2] "(1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. Smith v. Dunn, 224 F.2d (353) at 356

Despite their frequent use, this court has often declared that these seven pillars of capital gains treatment 'in and of themselves * * * have no independent significance, but only form part of a situation which in the individual case must be considered in its entirety to determine whether or not the property involved was held primarily for sale in the ordinary course of business (source cited)." . . .

buying the land was subdivision and sale of residential lots. Finally, at oral argument stress was laid on the incongruousness, even unfairness, of according markedly different tax treatment to two hypothetical parcels of land, lying side by side and developed and sold in the same or similar manners, on the basis, in part, of past purposes and uses, or even present uses of other adjacent portions in common ownership.

We are not persuaded. The first argument, which asks us in terms to read out of the analysis *Winthrop's* first factor--'the nature and purpose of the acquisition of the property and the duration of the ownership'--would require us to overrule *Winthrop* pro tanto, which we decline to do. Implicit in the capital asset concept are such notions as the factor epitomizes; they belong in the calculus. Further, the argument proves too much: if one focuses exclusively on the instant of sale, of course the lot being sold is at that moment 'held primarily for sale.'[3] And if a recent, constructive purchase for purposes of subdividing is to be imputed in every case of a lot sale, then the concepts of purchase for investment and orderly liquidation, embedded in our case law,[9] are simply purged from it.

The second argument, asserting that any change in form of the asset made by the taxpayer prevents its disposition being a liquidation, flies directly in the face of this Court's holding in Barrios' Estate v. Commissioner of Internal Revenue, 265 F.2d 517, 520 (5th Cir. (1959), cited and quoted with approval in *Winthrop*:

> The idea of selling a large tract of land in lots embraces necessarily the construction of streets for access to them, the provision of drainage and the furnishing of access to such a necessity as water. It is hardly conceivable that taxpayer could have sold a lot without doing these things.

On reason and authority, we reject it.

The final argument, instancing possible differing tax consequences for adjacent tracts developed similarly merely because one was acquired as an investment and long held while the other was not, represents a mild form of the 'chamber of horrors' or 'most unforeseeable consequences' technique--and likewise proves too much. Such possibilities are inherent in the congressional scheme of providing different tax rates for gain realized on disposition of longheld capital assets than for ordinary income. There is nothing especially shocking in this instance of the general plan; a mere day or two's difference in the holding period of a capital asset could have a similar effect. As the Government notes, it is just conceivable that two hypothetical tracts might be side-by-side and be so developed that *Winthrop's* other six factors are equivocal and so that a difference in purpose of purchase and holding period between them might be dispositive of capital gain treatment for one and ordinary income treatment for the other. If so, we need not blanche; if this factor is to be included in the seven other than

[3] [But is it being held for sale “to customers”? – ed]

as a sham there must be instances imaginable in which it will be critical, perhaps dispositive. On this head, the Government's argument finally comes down to a dispute with the Congressional scheme of taxation and with Winthrop. We are powerless to alter the first were we so inclined, and we decline to alter the second.

. . . .

Biedenharn has walked a dangerous path in the case at bar. The trial court concludes that it has done so unscathed. And though, as *Winthrop* notes, where there is no basic disagreement as to the evidentiary facts and the trial court's conclusion of the ultimate facts is the product of legal reasoning, we are not trammeled by the clearly erroneous rule, still the decision of the court which saw and heard the witnesses is always entitled to a certain deference. We conclude, moreover, that the court correctly applied our case law and that its decision is right.

Affirmed.

GEWIN, CIRCUIT JUDGE (dissenting):

With deference to the views expressed in the majority opinion, I respectfully dissent. The relevant facts are sufficiently outlined by Judge Gee. It is my view that the facts, when considered in their totality, United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969), compel the conclusion that the lots in question were 'held primarily for sale' and that the taxpayer's activities in connection with the lots was a 'trade or business.' Accordingly, the profits from the land sales should be regarded as ordinary income, rather than capital gain.

*Note*

1. *The issue in* Biedenhard Realty. There was no dispute that the taxpayer in *Biedenhard Realty* held the real estate with a profit-seeking motive. But that does not resolve the case: if the real estate is treated as falling with the inventory exception as defined in §1221(a)(2), then the gain (or loss) it generates cannot be treated as capital gain (or loss). The law is clear that it is the taxpayer’s intention at the time of disposition that controls: assets held for investment initially can be converted into inventory and, conversely, inventory can be converted into investment property. How should a court determine a taxpayer’s intention? *Biedenhard Realty*, a frequently cited case on this issue, adopts the seven-factor test articulated in *Winthrop*. Of these factors, the most import are the number and frequency of sales as well as the extent of the seller’s activity in seeking buyers. That being said, it is hard to explain why sales activity by the taxpayer or the taxpayer’s employees points against capital asset characterization while the same activity by independent contractors does not. While these cases invariably are determined by their particular facts and circumstances, improvement to the land (such as adding streets, curbs and drainage) along with rezoning into individual lots almost always is fatal.

*Note*

1. *Preserving capital gain despite developing investment real estate*. Suppose T owns unimproved real estate with an adjusted basis of $1,000,000 and a fair market value of $10,000,000, all of which would qualify as capital gain if the property were sold. T is convinced that if $3,000,000 is invested in improving the property by adding streets, curbs and sewers and then having the property zoned for individual site development, it could be sold off in lots for a total of $15,000,000. But if T invests $3,000,00 to generate an additional $2,000,000 in profit, the accumulated appreciation of $9,000,000 will be converted into ordinary income.

To avoid this result, T can form a corporation with $3,000,000 of cash. The corporation can then purchase the real estate from T at a cost of $10,000,000, paying the entire amount in the form of notes so that T can report the gain on the installment method. The corporation then improves the real estate and sells the lots, using the sale proceeds from the lots to satisfy the notes held by T. In this way T's gain remains capital, and T's corporation captures the development gain of $2,000,000 because the corporation's adjusted basis in the land equals the sum of its cost to the corporation (i.e., $10,000,000) plus the amount invested by the corporation to improve the land (i.e., $3,000,000). By using the notes, this technique avoids accelerating income to T. Of course, the development gain of $2,000,000 is not capital gain, but there is no reason why it should be.

*b. Substitutes for Ordinary Income*

**Commissioner v. Gillette Motor Transport, Inc.**

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

MR. JUSTICE HARLAN delivered the opinion of the Court.
The question in this case is whether a sum received by respondent from the United States as compensation for the temporary taking by the Government of its business facilities during World War II represented ordinary income or a capital gain. The issue involves the construction and application of § 117(j) of the Internal Revenue Code of 1939.

In 1944, respondent was a common carrier of commodities by motor vehicle. On August 4, 1944, respondent's drivers struck, and it completely ceased to operate. Shortly thereafter, because of the need for respondent's facilities in the transportation of war materiel, the President ordered the Director of the Office of Defense Transportation to "take possession and assume control of" them. The Director assumed possession and control as of August 12, and appointed a Federal Manager, who ordered respondent to resume normal operations. The Federal Manager also announced his intention to leave title to the properties in respondent and to interfere as little as possible in the management of them. Subject to certain orders given by the Federal Manager from time to time, respondent resumed normal

operations and continued so to function until the termination of all possession and control by the Government on June 16, 1945.

Pursuant to an Act of Congress creating a Motor Carrier Claims Commission, 62 Stat. 1222, respondent presented its claim for just compensation. The Government contended that there had been no "taking" of respondent's property, but only a regulation of it. The Commission, however, determined that, by assuming actual possession and control or respondent's facilities, the United States had deprived respondent of the valuable right to determine freely what use was to be made of them. In ascertaining the fair market value of that right, the Commission found that one use to which respondent's facilities could have been put was to rent them out, and that therefore their rental value represented a fair measure of respondent's pecuniary loss. The Commission noted that, in other cases of temporary takings, it has typically been held that the market value of what is taken is the sum which would be arrived at by a willing lessor and a willing lessee. Accordingly, it awarded, and the respondent received in 1952, the sum of $122,926.21, representing the fair rental value of its facilities from August 12, 1944, until June 16, 1945, plus $34,917.78, representing interest on the former sum, or a total of $157,843.99.

The Commission of Internal Revenue asserted that the total compensation award represented ordinary income to respondent in 1952. Respondent contended that it constituted an amount received upon an "involuntary conversion" of property used in its trade or business, and was therefore taxable as long-term capital gain pursuant to §117(j).

. . . .

Respondent stresses that the Motor Carrier Claims Commission, rejecting the Government's contention that only a regulation, rather than a taking, of its facilities had occurred, found that respondent had been deprived of *property,* and awarded compensation therefor. That is indeed true. But the fact that something taken by the Government is property compensable under the Fifth Amendment does not answer the entirely different question whether that thing comes within the capital gains provisions of the Internal Revenue Code. Rather, it is necessary to determine the precise nature of the property taken. Here, the Commission determined that what respondent had been deprived of, and what the Government was obligated to pay for, was the right to determine freely what use to make of its transportation facilities. The measure of compensation adopted reflected the nature of that property right. Given these facts, we turn to the statute.

. . . .

While a capital asset is defined in § 117(a)(1) as "property held by the taxpayer," it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one

year. *Burnet v. Harmel,* 287 U. S. 103, 287 U. S. 106. Thus, the Court has held that an unexpired lease, *Hort v. Commissioner,* 313 U.S. 28, and oil payment rights, *Commissioner v. P. G. Lake, Inc.,* 356 U. S. 260, are not capital assets, even though they are concededly "property" interests in the ordinary sense.

In the present case, respondent's right to use its transportation facilities was held to be a valuable property right compensable under the requirements of the Fifth Amendment. However, that right was not a capital asset within the meaning of §§ 117(a)(1) and 117(j). To be sure, respondent's facilities were themselves property embraceable as capital assets under § 117(j). Had the Government taken a fee in those facilities, or damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion of capital assets. But here, the Government took only the right to determine the use to which those facilities were to be put.

That right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves. Respondent suggests no method by which a cost basis could be assigned to the right; yet it is necessary, in determining the amount of gain realized . . . to deduct the basis of the property sold, exchanged, or involuntarily converted from the amount received. Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital gains provisions. In short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent. That is precisely the situation here, and the fact that the transaction was involuntary on respondent's part does not change the nature of the case.

. . . .

We conclude that the amount paid to respondent as the fair rental value of its facilities from August 12, 1944, to June 16, 1945, represented ordinary income to it. *A fortiori,* the interest on that sum is ordinary income.

*Reversed.*

*Note*

1. *Substitutes for ordinary income*. Horizontal equity tells us that if one type of income is a substitute for a second type of income, then the two should be taxed the same, a rule that generally applies to court judgments and settlements. For example, a recovery for lost wages generally is taxed the same as the wages they replace[4] and a recovery for lost profits generally is taxed as the profits they replace. But the rationale can be problematic.

For example, suppose a taxpayer purchases an investment duplex for $500,000 that generates $40,000 per year in taxable income after all costs associated with the property

[4] But see §104(a)(2), discussed in Chapter 3 *supra*.

have been paid (and ignore depreciation). If market values change and the property doubles in value (to $1,000,000), then presumably the rental value will also increase (say, to $80,000 per year after expenses). If the property is sold, the taxpayer will have a $500,000 capital gain. But if the taxpayer continues to hold and rent the property, the entire annual net rent of $80,000 will be taxed as ordinary income even though half of it presumably represents the increase in value of the underlying capital asset. That is, the $500,000 gain from sale is nothing but the present value of the increased rental income and is in this sense a substitute for the rent. And yet this substitute for the ordinary rental income is taxed as capital gain.

Was *Gillette Motor Transport* about substitutes for ordinary income or about the statutory "sale or exchange" requirement? Should it matter?

**Hort v. Commissioner**

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

MR. JUSTICE MURPHY delivered the opinion of the Court.

We must determine whether the amount petitioner received as consideration for cancellation of a lease of realty in New York City was ordinary gross income . . . and whether, in any event, petitioner sustained a loss through cancellation of the lease . . . .

Petitioner acquired the property, a lot and ten-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. He did not deduct this figure, however, because he reported other losses in excess of gross income.

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, made certain other adjustments not material here, and assessed a deficiency. . . .

Petitioner apparently contends that the amount received for cancellation of the lease was capital, rather than ordinary income . . . . . Further, he argues that, even if that amount must be reported as ordinary gross income, he sustained a loss which [§165] authorizes him to deduct. We cannot agree.

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section [61(a)] . . . expressly defines gross income to include "gains, profits, and income derived from . . . rent, . . . or gains or profits and income from any source whatever." Plainly this definition reached the rent paid prior to cancellation, just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. That the amount petitioner received resulted from negotiations ending in cancellation of the lease, rather than from a suit to enforce it, cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. . . . [I]t is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments, rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. Presumably the bond in *Helvering v. Horst,* 311 U. S. 112, and the lease in *Helvering v. Bruun,* 309 U. S. 461, were also "property," but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property," the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments . . . [it] must be regarded as ordinary income, and it is immaterial that, for some purposes, the contract creating the right to such payments may be treated as "property" or "capital."

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately, and to label each a capital asset. But that would not have converted into capital the amount petitioner received from the Trust Co., since § 22(b)(3) of the 1932 Act would have required him to include in gross income the rent derived from the property, and that section does not distinguish rental payments and a payment which is clearly a substitute for rental payments.

We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease, without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but, to that extent, he was relieved of the duty to pay income tax. . . .

The judgment of the Circuit Court of Appeals is affirmed.

*Notes*

1. *Computation of gain or loss*. When the taxpayer received the building subject to the lease through the estate of his father, he took a fair market value basis in the property. Assume that the value of the building and its fair rental value did not change between the time the lease was signed in 1927 and the time the taxpayer's father died in 1928. Does the lease add a significant value to the property? If not, is it fair to say that the taxpayer's basis in the lease should be $0?

2. *What if there had been a premium lease?* How would the analysis change if the taxpayer inherited the property in 1930 rather than in 1928? Because of the depression, presumably the value of the property – both its fair market value and its rental value – would have declined significantly. As a result, the rental payments provided in the lease renewal would now be considerably above current fair rental value so that the value of the taxpayer's inheritance – and so the taxpayer's basis in the inherited property – would equal not only the depressed value of the real estate itself but also the right to receive above-market rent for 12 years. A lease that calls for rental payments in excess of current fair market value is called a "premium lease." For example, suppose the land unencumbered by the lease is worth only $250,000 but when encumbered by the premium lease it is worth $390,000. Should the taxpayer's basis in the real estate equal $390,000 or should it be only $250,000 with an additional $140,000 allocated to the taxpayer's ownership interest in the above-market income stream?

3. *Character of the gain.* Should the taxpayer's income of $140,000 be capital? By citing to *Horst*, the Supreme Court seems to be saying that what was sold was not property but rather just the income from property (note that *Horst* had nothing to do with computation of gain nor with character of gain). This case has come to stand for the proposition that the sale of a *carved out* interest in property cannot qualify for capital gain treatment. Professor Chirelsten has argued that capital gain should arise from relative changes in market values rather than from the passage of time.[5] From that perspective, did the $140,000 reflect the time value of money or from change in market values?

4. *Payment to a tenant.* What if the value of the property had increased and then the landlord had paid the tenant to quit the property? Under the carve-out approach, this should yield capital gain to the tenant because the tenant is selling its entire interest in the property. Further, it we look through the financial asset to the underlying real estate, then the gain would be described in §1231 if the taxpayer used the rented property in its trade or business. That is precisely the conclusion of Rev. Rul. 72-85, 1972-1 C.B. 234.

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[5] Marvin Chirelstein, *Fruit-Tree and the Ordinary Income Tax Base*, first published in 1 Bridgeport Law Rev. 1 (1980), now available at https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=5562&context=fss_papers .

### c. *Sale of a Business*

**Williams v. McGowan**

**152 F.2d. 570 (2d Cir. 1945)**

Before L. HAND, SWAN, and FRANK, Circuit Judges.
L. HAND, Circuit Judge.
. . . .
Williams, the taxpayer, and one, Reynolds, had for many years been engaged in the hardware business in the City of Corning, New York. On the 20th of January, 1926, they formed a partnership, of which Williams was entitled to two-thirds of the profits, and Reynolds, one-third. . . . The business was carried on through the firm's fiscal year, ending January 31, 1940, . . . and thereafter until Reynolds' death on July 18th of that year. Williams settled with Reynolds' executrix on September 6th in an agreement by which he promised to pay her $12,187.90, and to assume all liabilities of the business; and he did pay her $2,187.98 in cash at once, and $10,000 on the 10th of the following October. On September 17th of the same year, Williams sold the business as a whole to the Corning Building Company for $63,926.28 — its agreed value as of February 1, 1940 — "plus an amount to be computed by multiplying the gross sales of the business from the first day of February, 1940 to the 28th day of September, 1940," by an agreed fraction. This value was made up of cash of about $8100, receivables of about $7000, fixtures of about $800, and a merchandise inventory of about $49,000, less some $1000 for bills payable. To this was added about $6,000 credited to Williams for profits under the language just quoted, making a total of nearly $70,000. Upon this sale Williams suffered a loss upon his original two-thirds of the business, but he made a small gain upon the one-third which he had bought from Reynolds' executrix; and in his income tax return he entered both as items of "ordinary income," and not as transactions in "capital assets." This the Commissioner disallowed and recomputed the tax accordingly; Williams paid the deficiency and sued to recover it in this action. The only question is whether the business was [a] "capital asset[]" . . . .

It has been held that a partner's interest in a going firm is for tax purposes to be regarded as a "capital asset." . . .When Williams bought out Reynolds' interest, he became the sole owner of the business, the firm had ended upon any theory, and the situation for tax purposes was no other than if Reynolds had never been a partner at all, except that to the extent of one-third of the "amount realized" on Williams' sale to the Corning Company, his "basis" was different. The judge thought that, because upon that sale both parties fixed the price at the liquidation value of the business while Reynolds was alive, "plus" its estimated earnings thereafter, it was as though Williams had sold his interest in the firm during its existence. But the method by which the parties agreed upon the price was irrelevant to the computation of Williams' income. The Treasury, if that served its interest, need not heed any fiction which the parties found it convenient to adopt; nor need Williams do the same in his dealings with the Treasury. We have to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the

definition [of a capital asset], or whether the whole business is to be treated as if it were a single piece of property.

[I]n this instance the section itself furnishes the answer. It starts in the broadest way by declaring that all "property" is "capital assets," and then makes three exceptions. The first is "stock in trade * * * or other property of a kind which would properly be included in the inventory"; next comes "property held * * * primarily for sale to customers"; and finally, property "used in the trade or business of a character which is subject to * * * allowance for depreciation." In the face of this language, although it may be true that a "stock in trade," taken by itself, should be treated as a "universitas facti," by no possibility can a whole business be so treated; and the same is true as to any property within the other exceptions. Congress plainly did mean to comminute the elements of a business; plainly it did not regard the whole as "capital assets."
. . . .
Judgment reversed.

FRANK, Circuit Judge (dissenting in part).

. . . I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company, actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern. Here is what they said in their agreement:

> The party of the first part agrees to sell and the party of the second part agrees to buy, all of the right, title and interest of the said party of the first part in and to the hardware business now being conducted by the said party of the first part, including cash on hand and on deposit in the First National Bank & Trust Company of Corning in the A. F. Williams Hardware Store account, in accounts receivable, bills receivable, notes receivable, merchandise and fixtures, including two G. M. trucks, good will and all other assets of every kind and description used in and about said business. * * * Said party of the first part agrees not to engage in the hardware business within a radius of twenty-five miles from the City of Corning, New York, for a period of ten years from the 1st day of October 1940.

To carve up this transaction into distinct sales — of cash, receivables, fixtures, trucks, merchandise, and good will — is to do violence to the realities. I do not think Congress intended any such artificial result. In the Senate Committee Report, it was said:

> It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss. The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for

depreciation, and real property held for more than six months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section.

These remarks show that what Congress contemplated was not the sale of a going business but of its dismembered parts. Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspects of the matter should guide our guess as to what Congress meant. I believe Congress had those aspects in mind and was not thinking of the nice distinctions between Roman and Anglo-American legal theories about legal entities.

*Notes*

1. *One asset or many?* Was the court correct in its holding that the sale of a business should be fragmented into a sale of the individual assets? It is clear that the gain and loss arising in Williams v. McGowan was not generated in the ordinary course of the taxpayer's trade or business. Should more be required to avoid capital gain or loss? The statute is far from clear that the sale of "a business" should be taxed as the sale of individual assets. Does the court's fragmentation approach best comport with the congressional definition of a capital asset in §1221?

2. *The technical analysis in* Williams v. McGowan. Suppose, for example, that a business holds inventory for sale in the ordinary course of its trade or business but then sells of all of assets in a bulk sale to a single purchaser and then goes out of business. Has the purpose for holding the inventory changed from "held for sale to customers in the ordinary course of its trade or business" into something else? The law generally is clear that it is the taxpayer's purpose at the time of sale that is relevant and not a prior purpose. For example, property acquired primarily for sale can be converted into property held for investment,[6] and property held for investment can be converted into property for sale.[7]

This suggests that the bulk sale of inventory should generate capital gain and loss because the inventory no longer is held for sale to customers in the ordinary course of the taxpayer's trade or business. And yet in this context the court have been surprisingly reluctant to recognize the implications of a taxpayer's change of purpose. For example, in

[6] E.g., Maddux Constr. Co. v. Commissioner, 54 T.C. 1278 (1970).

[7] E.g., Bush v. Commissioner, 610 F.2d 426 (6th Cir. 1979).

Grace Bros., Inc. v. Commissioner, 10 T.C. 158, 163 (1948), aff'd, 173 F.2d 170 (9th Cir. 1959), the court wrote: "We adhere to the view that an intent to discontinue business or to liquidate does not convert stock in trade into a capital asset."

Where does *Biedenhard Realty Co.* fall in this spectrum?

3. *The importance of Williams v. McGowan*. Consider the owners of a corporation who are approached by a potential buyer of the corporation's assets. This sale can be accomplished in two distinct ways: (1) the corporation can sell its assets, and then the corporation can liquidate, distributing the sale proceeds to the owners; or (2) the owners can sell their shares to the buyer, and the corporation can then liquidate, distributing its assets to the buyer. Assuming the buyer is itself a corporation, these two transactions will be taxed very differently to both the owners and to the sellers, to the owners under the fragmentation approach accepted in Williams v. McGowan and under special provisions applicable to corporate liquidating distributions.[8]

### *d. Service-Flavored Property*

**Commissioner v. Ferrer**

**304 F.2d. 125 (2d Cir. 1962)**

Before FRIENDLY, SMITH and MARSHALL, Circuit Judges.

FRIENDLY, Circuit Judge.

This controversy concerns the tax status of certain payments received by José Ferrer with respect to the motion picture "Moulin Rouge" portraying the career of Henri de Toulouse-Lautrec. The difficulties Mr. Ferrer must have had in fitting himself into the shape of the artist can hardly have been greater than ours in determining whether the transaction here at issue fits the rubric "gain from the sale or exchange of a capital asset held for more than 6 months," as the Tax Court held, 35 T.C. 617 (1961), or constitutes ordinary income, as the Commissioner contends. We have concluded that neither party is entirely right, that some aspects of the transaction fall on one side of the line and some on the other, and that the Tax Court must separate the two.

In 1950 Pierre LaMure published a novel, "Moulin Rouge," based on the life of Toulouse-Lautrec. He then wrote a play, "Monsieur Toulouse," based on the novel. On November 1, 1951, LaMure as "Author" and Ferrer, a famous actor but not a professional producer, as "Manager" entered into a contract, called a Dramatic Production Contract, for the stage production of the play by Ferrer.

[8] Compare a regular liquidation of a corporation under §§331, 334(a) and 336 with subsidiary liquidations under §§332, 334(b), and 337. See also §§336(e) and 338,

The contract was largely on a printed form recommended by the Dramatists Guild of the Authors League of America, Inc. However great the business merits of the document, which are extolled in Burton, Business Practices in the Copyright Field, in C. C. H., 7 Copyright Problems Analyzed (1952) 87, 109, for a court, faced with the task of defining the nature of the rights created, it exemplifies what a contract ought not to be. Its first six pages include eleven articles, some introduced by explanatory material whose contractual status is, to say the least, uncertain. Here the last of these pages was preceded by three single-spaced typewritten pages of "Additional Clauses," one with a still further insert. Finally come 15 pages of closely printed "Supplemental Provisions," introduced by explanatory material of the sort noted. We shall thread our way through this maze as best we can.

By the contract the Author "leased" to the Manager "the sole and exclusive right" to produce and present "Monsieur Toulouse" on the speaking stage in the United States and Canada, and gave certain rights for its production elsewhere. Production had to occur on or before June 1, 1952, unless the Manager paid an additional advance of $1500 not later than that date, in which event the deadline was extended to December 1, 1952. Five hundred dollars were paid as an initial advance against Author's royalties; the Manager was required to make further advances of like amount on December 1, 1951, and January 1, 1952. Royalties were to be paid the Author on all box-office receipts, on a sliding scale percentage basis.

. . . .

Shortly after signature of the Dramatic Production Contract, John Huston called Ferrer to ask whether he would be interested in playing Toulouse-Lautrec in a picture based upon "Moulin Rouge." On getting an affirmative indication, Huston said he would go ahead and acquire the motion picture rights. Ferrer replied, in somewhat of an exaggeration, "When you get ready to acquire them talk to me because I own them."

Both Huston and Ferrer then had discussions with LaMure. Ferrer expressed a willingness "to abandon the theatrical production in favor of the film production, provided that, if the film production were successful, I would be recompensed for my abandoning the stage production." On the strength of this, LaMure signed a preliminary agreement with Huston's corporation. In further negotiations, Huston's attorney insisted on "either an annulment or conveyance" of the Dramatic Production Contract. LaMure's lawyer prepared a letter of agreement, dated February 7, 1952, whereby Ferrer would cancel and terminate the Contract. Ferrer signed the letter but instructed his attorney not to deliver it until the closing of a contract between himself and the company that was to produce the picture; the letter was not delivered until May 14, 1952.

Meanwhile, on May 7, 1952, Ferrer entered into a contract with Huston's company, Moulin Productions, Inc. ("Moulin"), hereafter the Motion Picture Contract. This was followed by an agreement and assignment dated May 12, 1952, whereby LaMure sold

Huston all motion picture rights to his novel, including the right to exploit the picture by radio and television. Under this agreement LaMure was to receive a fixed sum of $25,000, plus 5% and 4% of the Western and Eastern Hemisphere motion picture profits, respectively, and 50% of the net profits from exploitation by live television.

The Motion Picture Contract said that Romulus Films Limited, of London, proposed to produce the picture "Moulin Rouge," that Moulin would be vested with the Western Hemisphere distribution rights, and that Moulin on behalf of Romulus was interested in engaging Ferrer's service to play the role of Toulouse-Lautrec. Under clause 4(a), Ferrer was to receive $50,000 to cover 12 weeks of acting, payments to be made weekly as Ferrer rendered his services. Ferrer's performance was to begin between June 1 and July 1, 1952. By clause 4(b), Ferrer was to receive $10,416.66 per week for each additional week, but this, together with an additional $50,000 of salary provided by clause 4(c), was "deferred and postponed" and was payable only out of net receipts. Finally, clauses 4(d) and (e) provided "percentage compensation" equal to stipulated percentages of the net profits from distribution of the picture in the Western and Eastern Hemispheres respectively — 17% of the Western Hemisphere net profits until Ferrer had received $25,000 and thereafter 12¾% (such payments to "be made out of sixty-five (65%) percent of the net profits," whatever that may mean), and 3¾% of the Eastern Hemisphere net profits. If Ferrer's services were interrupted by disability or if production of the picture had to be suspended for causes beyond Moulin's control, but the picture was thereafter completed and Ferrer's "acts, poses and appearances therein" were recognizable to the public, he was to receive a proportion of the compensation provided in clauses 4(c), (d) and (e) corresponding to the ratio of his period of acting to 12 weeks. The same was true if Ferrer failed to "conduct himself with due regard to public conventions and morals" etc. and Moulin cancelled on that account. The absence of any similar provision with respect to termination for Ferrer's wilful refusal or neglect to perform services indicates that all his rights, except that for compensation already due under clause 4(a), would be forfeited in that event. Over objections by the Commissioner, Ferrer offered testimony by Huston's attorney, who was also president of Moulin, that in the negotiation "it was said that the ultimate percentage payment to be made to Ferrer would be his compensation for giving up his interest in the dramatization guild," and a letter from the same attorney, dated March 3, 1953, confirming that in the negotiations with Ferrer's attorney "for the sale of the dramatic rights held by you to the property entitled `MONSIEUR TOULOUSE' and the novel `MOULIN ROUGE,' is was understood that the consideration for such sale price was the payments due, or to become due, to you under Clause 4(d) and Clause 4 (e)," and also that LeMure "refused to sell the motion picture rights for the production of the motion picture known as `MOULIN ROUGE' unless you sold the aforesaid dramatic rights." Ferrer's agent testified, again over objection, that the largest salary Ferrer had previously received for a moving picture appearance was $75,000.

Moulin's books showed $109,027.74 as a salary payment to Ferrer in August, 1953, and $178,751.46 at various later dates in 1953 as the payment of "Participating Interests" under clause 4(d).1 Ferrer's 1953 return reported the former as ordinary

income, and the latter, less expenses of $26,812.72,2 as a long-term capital gain. The Commissioner determined a deficiency on the basis that the difference, $151,938.74, constituted ordinary income; from the Tax Court's annulment of that determination he has taken this appeal.

Section 117(a) of the 1939 Code, now § 1221 of the 1954 Code, tells us, not very illuminatingly, that "`capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include" four (now five) types of property therein defined. However, it has long been settled that a taxpayer does not bring himself within the capital gains provision merely by fulfilling the simple syllogism that a contract normally constitutes "property," that he held a contract, and that his contract does not fall within a specified exclusion. This is easy enough; what is difficult, perhaps impossible, is to frame a positive definition of universal validity. Attempts to do this in terms of the degree of clothing adorning the contract cannot explain all the cases, however helpful they may be in deciding some, perhaps even this one; it would be hard to think of a contract more "naked" than a debenture, yet no one doubts that is a "capital asset" if held by an investor. Efforts to frame a universal negative, e.g., that a transaction can never qualify if the taxpayer has merely collapsed anticipation of future income, are equally fruitless; a lessor's sale of his interest in a 999 year net lease and an investor's sale of a perpetual bond sufficiently illustrate why . . . .

Perhaps we can get more help from analyzing the fact situations in cases in adjacent areas . . . .

One common characteristic of the group 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." We are painfully aware of the deficiencies of any such attempt to define the wavering line even in this limited area, but it is the best we can do. We add, with greater confidence, that more recent cases have moved away from the distinction . . . between a sale to a third person that keeps the "estate" or "encumbrance" alive, and a release that results in its extinguishment. Indeed, although reasoning from another section of a statute so full of anomalies is rather treacherous business, we take § 1241 of the 1954 Code as indicating Congressional disenchantment with this formalistic distinction. In the instant case we can see no sensible business basis for drawing a line between a release of Ferrer's rights to LaMure for a consideration paid by Moulin, and a sale of them, with LaMure's consent, to Moulin or to a stranger who would then release them. Moulin's attorney, as we have seen, did not care a fig whether there was "an annulment or conveyance" of the Dramatic Production Contract. Tax law is concerned with the substance, here the voluntary passing of "property" rights allegedly constituting "capital assets," not with whether they are passed to a stranger

or to a person already having a larger "estate." So we turn to an analysis of what rights Ferrer conveyed

. . . .

When Huston displayed an interest in the motion picture rights in November, 1951, Ferrer was possessed of a bundle of rights, three of which are relevant here. First was his "lease" of the play. Second was his power, incident to that lease, to prevent any disposition of the motion picture rights until June 1, 1952, or, on making an additional $1500 advance, to December 1, 1952, and for a period thereafter if he produced the play, and to prevent disposition of the radio and television rights even longer. Third was his 40% share of the proceeds of the motion picture and other rights if he produced the play. All these, in our view, Ferrer "sold or exchanged," although the parties set no separate price upon them. To be sure, Moulin had no interest in producing the play. But Ferrer did, unless a satisfactory substitute was provided. Hence Moulin had to buy him out of that right, as well as to eliminate his power temporarily to prevent a sale of the motion picture, radio and television rights and to liquidate his option to obtain a share of their proceeds.

(1) Surrender of the "lease" of the play sounds like the transactions held to qualify for capital gain treatment. Ferrer . . . had an "equitable interest" in the copyright of the play.

The Commissioner did not suggest in the Tax Court, and does not here, that this interest or, indeed, any with which we are concerned in this case, fell within § 117(a) (1) (C) of the 1939 Code, now § 1221(3), excluding from the term "capital asset" "a copyright; a literary, musical, or artistic composition; or similar property; held by —

> "(i) a taxpayer, whose personal efforts created such property * * *."

He was right in not doing this. In one sense the lease of the play was "created" simply by the agreed advance of $1500. If it be said that this is too narrow an approach and that we must consider what Ferrer would have had to do in order to make the lease productive, the result remains the same. Although the Dramatic Production Contract demanded Ferrer's personal efforts in the play's production, much else in the way of capital and risk-taking was also required. Yet the legislative history, see S.Rep. No. 2375, 81st Cong., 2d Sess., printed in 2 U.S.Code Cong.Serv. p. 3053 (1950), shows that § 117(a) (1) (C), initially added by the Revenue Act of 1950, 64 Stat. 906, 933, was intended to deal with personal efforts and creation in a rather narrow sense. Ferrer's role as producer, paying large sums to the theatre, the actors, other personnel, and the author, is not analogous to that of the writer or even the "creator" of a radio program mentioned by the Committee. Moreover, the dramatic producer does not normally "sell" the production to a single purchaser, as an author or radio program "creator" usually does — he offers it directly to public custom.

We see no basis for holding that amounts paid Ferrer for surrender of his lease of the play are excluded from capital gain treatment because receipts from the play would have been ordinary income. The latter is equally true if a lessee of real property sells or surrenders a lease from which he is receiving business income or subrentals. Likewise we find nothing in the statute that forbids capital gain treatment because the payment to Ferrer might be spread over a number of years rather than coming in a lump sum; although prevention of the unfairness arising from applying ordinary income rates to a "bunching" of income may be one of the motivations of the "capital gain" provisions, the statute says nothing about this. Compare Burnet v. Logan, 283 U. S. 404 (1931). Finally, with respect to the lease of the play, there was no such equivalence between amounts paid for its surrender and income that would have been realized by its retention . . . .

(2) Ferrer's negative power, as an incident to the lease, to prevent any disposition of the motion picture, radio and television rights until after production of the play, was also one which, under the cases previously cited, would be protected in equity unless he had contracted to the contrary, and would thus constitute an "equitable interest" in this portion of the copyright. . . . Ferrer's power to enjoin disposition of the motion picture rights prior to production of the play and would remit him to arbitration — a consequence serious from the standpoint of definition of a capital asset, especially in view of the emphasis we placed in Pittston, 252 F.2d at 348, on the unavailability of injunctive relief there. In the absence of authority, we should not read the clause so broadly; we would construe it as relating to disputes as to the manner of disposition of the rights after the Negotiator had become entitled to dispose of them, not as closing the door on the only effective method for protecting the Manager's important interest against premature disposition. As a practical matter, this feature of the Dramatic Production Contract "clouded" LaMure's title, despite the Contract's contrary assertion. Huston would not conclude with LaMure and LaMure would not conclude with Huston unless Ferrer released his rights; Huston's attorney testified that a contract like Ferrer's "imposes an encumbrance on the motion picture rights." Ferrer's dissipation of the cloud arising from the negative covenant seems analogous to the tenant's relinquishment of a right to prevent his landlord from leasing to another tenant in the same business, held to be the sale or exchange of a capital asset in Ray. What we have said in (1) with respect to possible grounds for disqualification as a capital asset is a fortiori applicable here.

(3) We take a different view with respect to the capital assets status of Ferrer's right to receive 40% of the proceeds of the motion picture and other rights if he produced "Monsieur Toulouse."

We assume, without deciding, that there is no reason in principle why if the holder of a copyright grants an interest in the portion of a copyright relating to motion picture and other rights contingent on the production of a play, or, to put the matter in another way, gives the producer an option to acquire such an interest by producing the play, the option would not constitute a "capital asset" unless the producer is disqualified by § 117(a) (1) (A), now § 1221(1). Although the copyright might not be

such an asset in the owner's hands because of that section or § 117(a) (1) (C) (i), now § 1221(3) (A), the latter disqualification would not apply to the producer for reasons already discussed, and the former would not unless the producer was a professional. However, it is equally possible for the copyright owner to reserve the entire "property" both legal and equitable in himself and agree with the producer that a percentage of certain avails shall be paid as further income from the lease of the play — just as the lessor of real estate might agree to pay a lessee a percentage of what the lessor obtained from other tenants attracted to the building by the lessee's operations. In both instances such payments would be ordinary income. If the parties choose to cast their transaction in the latter mold, the Commissioner may take them at their word.

Here the parties were at some pains to do exactly that. LaMure was to "retain for his sole benefit, complete title, both legal and equitable, in and to all rights whatsoever" other than the right to produce the play. Ferrer was to "have no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive the Manager's share of the proceeds"; even as to that, he was to have "no recourse, in law or in equity" against a purchaser, a lessee, or the Negotiator, but only a right to arbitration against the Author. We cannot regard all this as mere formalism. The Contract is full of provisions designed to emphasize the Negotiator's freedom to act — provisions apparently stemming from a fear that, without them, the value of the motion picture rights might disintegrate in controversy. . . .Although the Appellate Division's opinion contains some remarks as to the equitable interest of a licensee in a copyright, these were not essential to the holding, namely, that "the clear language" of the agreement entitled the producer to the moneys there in question. Moreover, examination of the papers on appeal shows that the contract between the producer and the author in that case was an earlier form not containing the extensive negation of equitable property interests present here.

It follows that if Ferrer had produced the play and LaMure had sold the motion picture, radio and television rights for a percentage of the profits, Ferrer's 40% of that percentage would have been ordinary income and not the sale or exchange of a capital asset. The decision[] in *Hort* point[s] to what would seem the inevitable corollary that if, on the same facts, Ferrer had then sold his rights to a percentage of the profits for a lump sum, that, too, would have been ordinary income. The situation cannot be better from Ferrer's standpoint because he had merely a contingent right to, or an option to obtain, the 40% interest. . . .

The situation is thus one in which two of the rights that Ferrer sold or exchanged were "capital assets" and one was not. Although it would be easy to say that the contingent contract right to a percentage of the avails of the motion picture, radio and television rights was dominant and all else incidental, that would be viewing the situation with the inestimable advantage of hindsight. In 1952 no one could tell whether the play might be a huge success and the picture a dismal failure, whether the exact opposite would be true, whether both would succeed or both would fail. We cannot simply dismiss out of hand the notion that a dramatic production, presenting an actor famous

on the speaking stage and appealing to a sophisticated audience, might have had substantial profit possibilities, perhaps quite as good as a film with respect to a figure, not altogether attractive and not nearly so broadly known then as the success of the picture has made him now, which presumably would require wide public acceptance before returning production costs. At the very least, when Ferrer gave up his lease of the play, he was abandoning his bet on two horses in favor of a bet on only one.

In such instances, where part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded. If it be said that to remand for this purpose is asking the Tax Court to separate the inseparable, we answer that no one expects scientific exactness; that however roughly hewn the decision may be, the result is certain to be fairer than either extreme; and that similar tasks must be performed by the Tax Court in other areas,.

. . . .

We therefore reverse and remand to the Tax Court to determine what portion of the percentage compensation of the Motion Picture Contract constituted compensation for Ferrer's surrendering his lease of the play and his incidental power to prevent disposition of the motion picture and other rights pending its production, as to which the determination of deficiency should be annulled, and what part for the surrender of his opportunity to receive 40% of the proceeds of the motion picture and other rights as to which it should be sustained. The expenses allowed as basis must likewise be allocated. Doubtless further evidence will have to be taken unless the parties can reach some practical adjustment.

It is so ordered.

*Notes*

1. *Contract rights*. The court in *Ferrer* took pains to distinguish the right of an owner of property to profit from exploitation of that property from the right of a laborer to profit from her labor. Does the court’s distinction persuade you? Recall the essential difficulty in applying the “substitute for ordinary income” doctrine typified by *Gillette Motor Transport*: the value of any piece of property arises from its ability to produce income, income that invariably is taxed as ordinary income rather than as capital gain. For example, a parcel of real estate generally takes its value from the amount of rental income the parcel can generate. Yet gain from the sale of the parcel is capital while the rent is ordinary income.

2. *Property arising from the performance of services*. The definition of a capital asset in §1221 requires the sale or exchange of “property,” and property in this context has long been understood to exclude services. But labor sometimes can be embodied in a legally-recognized form of property such as a patent by the inventor, a copyright by the artist, and an account receivable owned by a laborer received in exchange for her labor.

Congress in §1221 has excluded all of these assets from characterization as a capital asset. See §1221(a)(3)-(4).[9] Some of the exclusions from the definition of a capital asset seem idiosyncratic. See §§1221(a)(3)(B) (letter is not a capital asset in the hands of the person to whom the letter was sent) and 1221(a)(5)(A) (publications of the United States in the hands of a taxpayer who received the publication directly from the United States).

Some taxpayers have extremely valuable blood. How should the sale of such blood be taxed? In Rev. Rul. 53-162, 1953-2 C.B. 127, the Service ruled that contributing blood plasma to a charitable hospital should be treated as the provision of services so that no deduction is allowed. And in United States v. Garber, 589 F.2d 843 (5th Cir. 1979), the same argument was made by the government when a taxpayer claimed that sale proceeds received from selling her blood either were (a) excludible under § 104(a)(2) as compensation for person injury or (b) amounts realized from the sale of property.

### 2. Definition of a "Sale or Exchange"

A capital gain or loss can arise only from the "sale or exchange" of a capital asset. §1222; see also §1211. A "sale or exchange" is narrower than a "disposition" as used in §1001(a) so that some dispositions are not sales or exchanges. The Supreme Court long ago held that the holder of a debt instrument that is repaid by the borrower has not "sold or exchanged" the debt instrument.[10] Similarly, the Court held that a shareholder whose shares are cancelled as part of a complete liquidation of the corporation has not "sold or exchanged" the shares. Thus, a "sale or exchange" requires that what the taxpayer gives up must continue in existence in the hands of the transferee.[11] Note that Congress can and has reversed the Court's "sale or exchange" decisions, with §1271(a)(1) now providing that retirement of a debt instrument is treated as an exchange and §331(a) now providing that amounts received by shareholders on a complete corporate liquidation are treated as received in an exchange for their cancelled shares. However, some "dispositions" continue to be excluded from the definition of a sale or exchange including abandonments[12] and casualties.[13] The difference between a "sale" and an "exchange" is what is received by the taxpayer: cash is received in a sale while property is received in an exchange.

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[9] Congress, though, sometimes does not seem to know what it has written, though, because the 2017 Act added §1235(a) providing that most dispositions of a patent by any holder (including the inventor) "shall be considered the sale or exchange of a capital asset."
[10] Fairbanks v. United States. 306 U.S. 436 (1939).
[11] Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962); see Helvering v. Hammell, 311 U.S. 504 (1941) (transfer pursuant to foreclosure is sale or exchange).
[12] E.g., Echols v. Commissioner, 935 F 2d 703 (5th Cir. 1991). Note, however, that the abandonment of encumbered property always will be treated as sale or exchange because release of the encumbrance is treated as an amount realized.
[13] Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

*Question*

Q-1. If Congress had not reversed the decision that retirement of equity and debt instruments did not generate capital gain (or loss) for want of a sale or exchange, how could a taxpayer desiring capital gain treatment obtain it?

### 3. Definition of a Capital Gain and a Capital Loss

*Capital gains and losses are relevant only to the extent they are otherwise includible or deductible.* See, e.g., §§1222(1), 1222(2). Capital gains, like all accessions to wealth, are includible unless excluded by some statutory provision; capital losses are deductible only to the extent some provision (usually §165) authorizes a deduction. Sales and exchanges of capital assets generating gains or losses that are not taken into account in computing gross income (for gains) or taxable income (for losses) technically are not capital gains and losses. Rather they are nonevents for the tax system and play no role in the computation of tax liability.

*Note*

1. *Lottery tickets*. Should the winner of a state lottery report ordinary income or capital gain? If the winner simply accepts the winning payment in exchange for the ticket, then the income should be ordinary for want of a sale or exchange. But what if the winner sells the ticket for an amount very close to the amount of the winnings? Courts routinely conclude that the income should be taxed as ordinary rather than as capital gain,[14] although the arguments they make border on the ridiculous. For example, in Womack v. Commissioner, 510 F.2d 1295 (11th Cir. 2007), the court held that gain from the sale of a lottery ticket was ordinary because it was a substitute for ordinary income. And in Lattera v. Commissioner, 437 F.2d 399 (3rd Cir. 2006), the court said that the income was ordinary because "[a] capital asset has the potential to earn income in the future based on the owner's actions in using it. Lottery winners, by contrast, are 'entitled to the income merely by virtue of owning the property.'"[15] Could not the same comment be made about a share of stock? One wonders why these courts are unwilling to be more direct in their conclusion, namely that they believe Congress would not want the capital gain preference to apply to lottery tickets.

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[14] E.g., Womack v. Commissioner, 510 F.2d 1295 (11th Cir. 2007); Lattera v. Commissioner, 437 F.2d 399 (3rd Cir. 2006); United States v. Maginnis, 356 F.3d 1179, 1181 (9th Cir.2004); Davis v. Commissioner, 119 T.C. 1 (2002).

[15] *Quoting* Thomas G. Sinclair, Note, Limiting the Substitute-for-Ordinary-Income-Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights, 56 S.C. L. Rev. 387, 400 (2004).

*Question*

Q-2. The Irish Sweepstakes, discontinued in 1987, was composed of a lottery and a horserace. People purchased tickets, and approximately 15 winning tickets were drawn by lottery, with each winning ticket holder associated with a particular horse in the race. If the winning ticket holder's horse came in first, second, or third place, the ticket paid off, giving the holder a substantial sum. How should the taxpayer be taxed if she sold the winning ticket prior to the start of the horse race?

## C. Limitations on the Deductibility of Capital Losses

Capital losses (like all other losses) are nondeductible unless some provision affirmatively provides a deduction. For assets held in connection with a trade or business or for other profit-seeking activity, that provision is §165. However, an additional limitation is placed on the deductibility of capital losses otherwise allowable under §165.

For corporate taxpayers, capital losses in a taxable year otherwise deductible are allowable only to the extent of capital gains in that year. §1211(a). For individuals, otherwise deductible capital losses are allowable to the extent of capital gains plus the lesser of (1) $3,000 and (2) taxable income. §1211(b).

Capital losses in excess of the limitations in §1211 can be carried over to other taxable years. For corporate taxpayers, excess capital losses can be carried back up to three years and then forward up to five years. §1212(a). For noncorporate taxpayers, excess capital losses cannot be carried back but can be carried forward indefinitely. §1212(b). Whether carried forward or back, such losses retain their character as capital and so are limited by the rules of §1211 in the carryover year.

*Note*

1. *Why is there a limit on the use of otherwise-allowable capital losses?* Capital gains generally arise from the appreciation of investment property, and recognition of such gain generally is within the taxpayer's control because it will not be recognized until disposition of the investment by the taxpayer. The same is true for capital losses, so if there were no limitation on recognition of capital losses, astute taxpayers would retain their appreciated investment assets and sell their loss investment assets (called "harvesting" the losses). That is, even though the realization doctrine seemingly is a two-way street, because the decision to trigger recognition through a disposition generally is within the taxpayer's control, in practice the realization doctrine postpones gains but not

losses. The limitations in §1211 are a crude attempt to restore some semblance of equality to the recognition of gains and losses.

But these limitations often can fail dramatically. Consider someone who tried her hand at day-trading prior to the market crash in 2007. Prior to the crash, the trader might have generated significant gains, all of which were taxable. Once the crash struck, that trader might have suffered significant losses. Assuming the trader has run out of funds (or the courage to re-enter a fickle market), she may never generate a capital gain in the future, in which case her losses will not be deductible except to the extent of $3,000 per year. For a taxpayer who lost several hundred thousand dollars, an extraordinary life expectancy would be needed. A similar issue arises under §163(d), the investment interest limitation.

## D. Taxation of "Net Capital Gain" for Noncorporate Taxpayers

Under §1(h), a taxpayer pays taxes at the ordinary rates on all income other than "net capital gain" plus a reduced rate of tax on net capital gain. Actually, the computation is more complicated because Congress determined that different types of assets should be subject to different net capital gain preferential rates. For high-bracket individuals, net capital gain attributable to most depreciation recovery on real estate is taxed at 25%, net capital gain from collectibles is taxed at 28%, and net capital gain from other assets (generally considered to be financial assets such as stocks and bonds, as well as real estate held for investment) is taxed at 20%. For low-bracket taxpayers, there are a different set of rates. Note: corporate taxpayers enjoy no preferential taxation on net capital gain.

The definition of net capital gain can be found in §1222. It is computed in three steps. In step 1, the taxpayer determines her long-term capital gains and losses as well as her short-term capital gains and losses. As discussed above, only gains that enter into the computation of gross income are used and only losses that are used in the computation of taxable income are used. The dividing line between long-term and short-term is one year: capital assets held for one year or less generate short-term gains and losses. In step 2, the taxpayer must net all long-term capital gains and losses to arrive at her net long-term gain or her net long-term loss. Similarly, she must net all her short-term capital gains and losses to arrive at her net short-term gain or net short-term loss. And in step 3, the taxpayer determines her net capital gain by subtracting from her net long-term gain, if any, her net short-term loss, if any. The following chart sets forth the step 3 computation.

**Computation of Net Capital Gain**

| | **Net Short Gain** | **Net Short Loss** |
|---|---|---|
| **Net Long Gain** | Net Long Gain | Net Long Gain-Net Short Loss |
| **Net Long Loss** | Zero | Zero |

*Problem*

P-1. For each set of transactions, determine the taxpayers net long-term gain or loss, her net short-term gain or loss, and her net capital gain.

a. A long-term gain of $500, a long-term loss of $100, a short-term gain of $500, and a short-term loss of $150.

b. A long-term gain of $100, a long-term loss of $500, a short-term gain of $500, and a short-term loss of $150.

c. A long-term gain of $800, a long-term loss of $200, a short-term gain of $350, and a short-term loss of $500.

*Notes*

1. *Holding period*. A capital gain or loss will be treated as long-term if the taxpayer's holding period with respect to the asset is greater than one year. Holding period usually begins when the taxpayer acquires the asset. However, in some circumstances the taxpayer may be allowed to include in her holding period either (a) the holding period of a prior owner of the asset or (b) her holding period in some other asset. We call this "tacking" of a holding period.

Under §1223(2), if a taxpayer acquires an asset in a transaction in which the taxpayer's basis in the asset is determined in whole or in part by reference to the adjusted basis of the transferor, then the taxpayer may add (i.e., tack) the transferor's holding period to her holding period. This rule applies to, for example, gifts as well as transfers of property to corporations and partnership assuming certain statutory requirements are met.[16]

Under §1223(1), a taxpayer adds (i.e., tacks) to her holding period in an asset (the "replacement asset") her holding period in a different asset (the "relinquished asset") if her basis in the replacement asset was determined in whole or in part by reference to her basis in the relinquished asset provided that the relinquished asset was, in the hands of the taxpayer, a capital asset or an asset described in §1231. This rule applies, for example, to a taxpayer who engages in a like-kind exchange under §1031, with or without boot.

Under §1223(9), a taxpayer who acquires property through the estate of a decedent and takes a basis under §1014(b) is treated as holding the property for more than one year.

Recall the *Garber* case in which the taxpayer sold her blood plasma. In that case, the taxpayer was criminally prosecuted for failing to report her income from such sales, and

[16] See §§351, 362 (transfers to corporations), 721, 723 (transfers to partnerships).

the court treated the income (with one judge dissenting) as service income. If the court had treated the blood plasma as a capital asset, how would its holding period be determined?

2. *Net capital gain rates*. Net capital gain is taxed using a set of rates provided in §1(h). For low income taxpayers, the rate can be either 0% or 15% under §1(h)(1)(B)-(C). For other taxpayers, there are three rates applicable to net capital gain based on the type of assets generating the gain. For collectibles such as artwork, rare coins and stamps, the rate is 28%, §§1(h)(1)(F), 1(h)(4). For "unrecaptured section 1250 gain," the rate is 25%, §§1(h)(1)(E), 1(h)(6). And for everything else, the rate is 20%, §1(h)(1)(D). For a taxpayer having multiple capital gain and loss transactions generated by assets of various types, determining which rate applies to the eventual "net capital gain" requires disaggregating the various capital gain and loss transactions.

4. *Justifications for the capital gain preference*.[17] The rate preference for net capital gain of noncorporate taxpayers has been a feature of the income tax for many years although the precise method of computing that preference has changed over the years. Congress has never identified what it believes is the justification for the capital gain rate preference although courts have opined on the matter when interpreting various provisions of the capital gain provisions. Most of the arguments that have been put forth can be dismissed easily. Of course, whether a court understands the basis for the rate preference or not, it is obligated to follow the statute as best it can.

One argument for the capital gain preference is the bunching problem. Under this theory, because assets appreciate over time but the gain is taxed all at once upon disposition, the effect of the realization doctrine is to push the taxpayer into a higher bracket when a capital asset is sold because of the accumulated gain. The problem with this argument is three-fold. First, capital assets need be held for only a day and a year to generate long-term capital gain, hardly a period sufficient to cause a serious bunching problem. Second, the vast majority of capital gain is reported by taxpayers who are in the highest bracket each year and by pension trusts that are tax-exempt. Neither of these groups faces any bunching problem. Third, the solution to a bunching problem is income averaging whereby the taxpayer's tax liability is computed by averaging the tax that would be payable if the capital gain had been reported across multiple years.

A second argument for the capital gain preference is that it encourages investment in risky assets, an investment that otherwise would not be made. While that may be true, it is difficult to explain why such an investment should be encouraged. In the absence of a capital gain preference, a risky investment will be made only if the potential gain adjusted for risk justifies the cost. If that is not true – that is, if the risk-adjusted return does not justify the cost of the investment – why should the investment be made?

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[17] See Walter J. Blum, *A Handy Summary of the Capital Gains Arguments,* 35 Taxes: The Tax Magazine 247 (1957).

A third argument in favor of the capital gain preference is that it responds to the lock-in effect of the realization doctrine. Assets that have appreciated will continue to be held rather than sold even if the owner believes there is a better use of her funds because sale of the asset will generate an immediate tax. Indeed, if the asset is held until death, the tax deferred by the realization doctrine escapes taxation forever because of the step-up in basis rule provided by §1014(a). To encourage the redeployment of capital, the capital gain preference reduces the lock-in by reducing the tax on dispositional gain.

This is a second-best solution, and a partial solution at that. Ideally, it is the realization doctrine that should be eliminated, and that would take with it any lock-in caused by the doctrine. If the realization doctrine cannot be eliminated for practical reasons, then reducing the impact of the lock-in effect by reducing the dispositional tax liability ameliorates the lock-in. But it is less than obvious why a single rate reduction – or, if a single rate reduction is appropriate, what single rate reduction – is the right solution.

## E. Additional Implications of Capital Gains

### 1. Depreciation Recapture Under Sections 1245 and 1250

When an asset is sold at a gain, the amount realized necessarily exceeds the taxpayer's adjusted basis in the asset. Ordinarily, a taxpayer who acquires an asset buys it, producing a cost basis to the taxpayer under §1012. Thus, basis and fair market value begin equal. If the fair market value exceeds the adjusted basis when the asset is sold, either the fair market value went up or the adjusted basis went down (or some combination of each).

For example, suppose T purchases a printing press for $100,000 and holds it for 4 four years. During those years, assume the taxpayer is entitled to claim depreciation of $30,000. Thus, the taxpayer's adjusted basis will be $70,000 after 4 years. If the taxpayer then sells the printing press for $120,000, there will be a taxable gain of $50,000. Of that gain, $30,000 is attributable to the reduction in the taxpayer's basis caused by the depreciation and the remaining $20,000 is attributable to a true increase in the value of the asset.

Should all of the gain qualify as preferential capital gain? The first $30,000 of gain is not attributable to an increase in the value of the property but is merely a tax pay-back of the depreciation deductions, deductions which had offset ordinary income.

The primary role of §§1245 and 1250 is to recharacterize as ordinary income gain attributable to a decrease in adjusted basis rather than to an increase in asset value. However, these sections can have even greater effect, sometimes forcing the recognition of ordinary income when, but for these sections, all gain would be deferred by reason of some specific deferral provisions. Any gain recognized or recharacterized under §§1245 or 1250 is referred to as "recapture" because such gain is depreciation recaptured.

Section 1245 applies to all depreciable assets other than real estate. See §1245(a)(3). Under §1245(a)(a)(1), gain from the disposition of §1245 property is taxable as ordinary income to the extent the gain does not exceed the depreciation previously taken. Thus, all depreciation is recaptured when §1245 property is disposed if the amount realized equals or exceeds the initial cost of the property.

To the extent §§1245 says it applies to a particular transaction, it does so without regard to any other provision. §1245(d). Accordingly, *whenever an asset is sold and not all the gain realized is recognized at ordinary rates, §§1245 and 1250 must be considered*. Some transactions are not covered by §1245(a)(1) because of specific exceptions contained in §§1245. See §1245(b). In particular, §1245 does not apply to gifts and or to devises, and it usually applies to nonrecognition transactions *only to the extent that boot is received and gain would be recognized even in the absence of depreciation recapture.*

Section 1250 applies to depreciable real estate (buildings and other structures). Like §1245, §1250 overrules all other statutory provisions. §1250(h). It contains its own exceptions and limitations. §1250(d). In general, §1250 only recaptures so much of the claimed depreciation as exceeds straight-line depreciation (called "accelerated depreciation"). *See* §1250(b)(1). Since real estate usually can be depreciated only using the straight-line method, see §168(b)(3), this means that there will not be any recapture under §1250. However, Congress has provided for some accelerated depreciation of real estate to encourage rebuilding in designated areas (such as in the city of New York following the 9/11 attacks), and section 1250 will apply to disposition of property qualifying for such accelerated depreciation. Tenant improvements now qualify for bonus depreciation under §168(k), and so the bonus portion of the bonus depreciation can be recaptured under §1250.

Straight-line depreciation from depreciable real estate is *not* recharacterized as ordinary income under §1250. Such gain is called "unrecaptured §1250 gain," and while it is treated as capital gain (this is important for recognition of capital losses), if it gives rise to "net capital gain" to a noncorporate taxpayer, it will be taxed at a 25% rate (rather than the normal rate of 20%).

*Problems*

P-2. T purchases investment real estate for $600,000. While holding the real estate, T properly claims $250,000 of depreciation using straight-line depreciation. T then sells the real estate for $750,000. How much gain does T recognize, and how is that gain taxed?

P-3. Reconsider the facts of the problem immediately above, but assume that straight-line depreciation would have been only $225,000 and taxpayer was entitled to claim $25,000 on an accelerated basis. How much gain does T recognize, and how is that gain taxed?

P-4. How do your answers to problems 2 and 3 above change if the property is equipment rather than real estate?

### 2. Limitations on the Charitable Deduction

The deduction provided by §170(a) for property contributed to a charity equals the fair market value of the property contributed. Reg. §1.170A-1(c)(1). However, that deduction is reduced under §170(e)(1).

Under §170(e)(1)(A), the charitable deduction under §170(a) is reduced to the extent that gain from sale of the contributed property would be other than long-term capital gain (i.e., to the extent it would be short-term capital gain or ordinary income). Thus, for example, there will be a reduction for any recapture amount under §1245.

Under §170(e)(1)(B), there is also a reduction to the extent a sale of the contributed property would produce long-term capital gain if (a) the property is tangible personal property *and* (b) the use of the property by the charitable organization is "unrelated to the purpose or function constituting the basis for its [charitable] exemption." Note that this limitation never applies to contributions of real estate or of intangible property such as stocks and bonds.

*Problems*

P-5. T, the owner of a large printing company, contributes a used printing press to the local high school to be used by the school in training some of its students. At the time of the contribution, the printing press has a fair market value of $65,000. The printing press was purchased new by T for $100,000. T's adjusted basis in the printing press is $0. Is the contribution by T deductible and, assuming it is deductible, how much is the deduction?

P-6. Q contributes publicly-traded stock to a charitable organization. The value of the stock at the time of contribution is $20,000. Q purchased the stock a few months prior to the contribution at a cost of $18,000. (a) Assuming this contribution is deductible by Q, what is the amount of the deduction? (b) How would your answer change if the stock had been purchased by Q for $25,000? (c) How would your answer to part (a) change if the stock had been held by Q for more than a year prior to the contribution?

P-7. R contributes a painting to a charitable hospital when the painting is worth $65,000? The painting was purchased by R several years prior to the contribution for $50,000. Assuming the contribution is deductible by R, what is the amount of the contribution? How would your answer change if the contribution were made to a charitable art museum?

### 3. Qualified Dividends

Congress has provided that most corporate dividends (called "qualified" dividends) are taxed at the same rate as net capital gain (currently 20%). §1(h)(11). Note that such

dividends are not capital gains but merely are taxed at the net capital gain rate. In particular, a taxpayer's qualifying dividend income has no effect on the computation of the limitation on capital losses under §1211.

### 4. Property Described in Section 1231

In general, §1231 apples to the sale and exchange of assets described in §1221(a)(2), i.e., to depreciable property and real estate used by the taxpayer in a trade or business. See §1231(a)(3)(A)(i). However, such property does not become §1231 property until it is held for more than one year: until that time, it is neither a capital asset nor a §1231 asset. At the end of each taxable year, all gains and losses from dispositions during the year of §1231 are netted together to produce a single net §1231 gain or loss. If it is a gain, it is treated as long-term capital gain that can contribute for individual taxpayers to the computation of net capital gain. If it is a loss, it is treated as an ordinary loss. Thus, §1231 property gets the benefit of capital gain without the detriment on the loss side. Note: §1231 includes gains from the involuntary conversion of long-term capital assets; e.g., a taxpayer's car is wrecked, and insurance proceeds exceed the taxpayer's basis in the car.

*Notes*

1. *Ordering.* While §1231 offers a scheme of taxation that is even better than the usual capital gain rules, taxpayers can use a bit of self-help to improve the benefit of §1231 even further. Suppose a taxpayer owns two assets described in §1231, one that has a built-in gain and one that has a built-in loss. If the two assets are sold in the same year, the gain and loss will offset, leaving only the net gain (or net loss) to benefit from §1231. But if the assets are sold in separate years, the entire gain and the entire loss will benefit from §1231.

Which should asset should be sold first, the gain asset or the loss asset? To benefit from the realization doctrine as much as possible while still selling both assets, the loss asset should be sold in one taxable year and the gain asset should be sold in the subsequent taxable year. If the assets are sold in this order, not only is the required netting of gain and loss avoided but the taxpayer benefits from one year's deferral on the gain.

However, following this approach goes too far. Congress has provided that if a taxpayer claims a net §1231 loss in a year, any net §1231 gain recognized in the succeeding five years will be treated as ordinary income rather than as capital gain to the extent of the prior net §1231 loss. §1231(c). Accordingly, if a taxpayer is going to sell §1231 gain assets in one year and §1231 losses in different year, it makes sense to the sell the gain assets first.

*Problem*

P-5. T sells a §1231 asset at a gain of $20,000 and another at a loss of $12,000. How are these gains and losses taxed?

P-6. Using the facts of problem 5, how are the gains and losses taxed if the assets are sold in different years, with the gain asset sold first?

P-7. Using the facts of problem 5, how are the gains and losses taxed if the assets are sold in different years, with the loss asset sold first?

### 5. Bad Debts

If a taxpayer lends money with an intention to seek repayment (so that the transfer cannot be characterized as a gift) but then is unable to collect some or all of the principle, how should the taxpayer's loss be treated? Under §166(a), a deduction is permitted to a lender for a worthless or partially worthless debt. However, if the debt is a "nonbusiness" debt, then the deduction is treated as a short term capital loss. §166(d)(1). For the definition of a "nonbusiness bad debt," see §166(d)(2).

## F. Correlations with Prior Transactions

**Arrowsmith v. Commissioner**

**344 U.S. 6 (1952)**

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts as shown by findings of the Tax Court. In 1937, two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937-1940 returns there is no dispute. But, in 1944, a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. Treatment of the loss as a capital one would have allowed deduction of a much smaller amount. The Commissioner viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss, just as the taxpayers had treated the original dividends as capital gains. . . .

I.R.C. [§1222] treats losses from sales or exchanges of capital assets as "capital losses," and I.R.C. [§331] requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of "capital losses" contained in these

sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that, had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

It is contended, however, that this payment, which would have been a capital transaction in 1940, was transformed into an ordinary business transaction in 1944 because of the well established principle that each taxable year is a separate unit for tax accounting purposes. But this principle is not breached by considering all the 1937-1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

. . . .

*Affirmed.*

MR. JUSTICE JACKSON, whom MR. JUSTICE FRANKFURTER joins, dissenting.

This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto this problem under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution, which would have reduced the liquidating dividends proportionately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation's own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us, and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

This Court simplifies the choice to one of reading the English language, and declares that the losses here come "squarely within" the definition of capital losses contained within two sections of the Internal Revenue Code. What seems so clear to this Court was not seen at all by the Tax Court, in this case or in earlier consideration of the same issue, nor was it grasped by the Court of Appeals for the Third Circuit.

I find little aid in the choice of alternatives from arguments based on equities. One enables the taxpayer to deduct the amount of the judgment against his ordinary

income which might be taxed as high as 87%, while, if the liability had been assessed against the corporation prior to liquidation, it would have reduced his capital gain which was taxable at only 25% (now 26%). The consequence may readily be characterized as a windfall (regarding a windfall as anything that is left to a taxpayer after the collector has finished with him).

On the other hand, adoption of the contrary alternative may penalize the taxpayer because of two factors: (1) since capital losses are deductible only against capital gains plus $1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond $5,000, and, (2) had the liability been discharged by the corporation, a portion of it would probably, in effect, have been paid by the Government, since the corporation could have taken it as a deduction, while here, the total liability comes out of the pockets of the stockholders.

Solicitude for the revenues is a plausible but treacherous basis upon which to decide a particular tax case. A victory may have implications which in future cases will cost the Treasury more than a defeat. This might be such a case, for anything I know. Suppose that, subsequent to liquidation, it is found that a corporation has undisclosed claims, instead of liabilities, and that, under applicable state law, they may be prosecuted for the benefit of the stockholders. The logic of the Court's decision here, if adhered to, would result in a lesser return to the Government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss if the shoe were on the other foot?

Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. . . . [T]he Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own.

*Questions*

Q-8. Suppose a taxpayer owned corporate notes that became worthless, and the taxpayer claimed an ordinary deduction for its basis in the notes under §166(a). Sometime thereafter, the debtor becomes viable and the notes regain some of their value, allowing the taxpayer to sell the notes for $100,000. It is clear that the taxpayer has income of $100,000 on the sale. But what is its character? See Merchants National Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952).

Q-9. Suppose corporate officers are sued for misappropriating corporate assets, and a former shareholder receives a settlement of $100. How should this settlement payment be taxed? Arguably, had there been no misappropriation, the taxpayer could have sold her shares for more, so that the payment should be taxable as a capital gain (assuming the stock was a capital asset). On the other hand, perhaps the additional value would have been distributed as (ordinary income but low taxed) dividends?

## G. Implicit Interest and the OID Rules

Consider a bond paying no interest during its four-year existence (i.e., a zero-coupon bond) and redeemable for $1,000 at maturity. If interest rates are 10% when the bond is issued, the issue price should be about $680 because the right to receive $1,000 discounted four years at 10% per year is about $680. Still assuming a constant 10% discount rate, the bond should increase in value from its issue price of $680 to its redemption price of $1,000 according to the following schedule (all values rounded):

| | Value | Change in Value |
|---|---|---|
| Date of Issue | $ 680 | --- |
| 1 Year Later | 750 | $ 70 |
| 2 Years Later | 825 | 75 |
| 3 Years Later | 910 | 85 |
| Redemption | $1000 | 90 |
| Total | | $320 |

### 1. Original Issue Discount

Anyone who holds a bond with original issue discount (OID) must include as interest income the OID from the bond for the period held. §1272(a)(1). For this provision, OID is defined as the excess, if any, of the redemption price over the issue price. §1273(a)(1). For example, in the zero-coupon bond above, the OID is $320. Note that OID is determined only once per bond and is defined by reference to what the first purchaser paid. Of course, each taxpayer who includes OID in income can adjust the bond's adjusted basis upwards dollar for dollar. The bond issuer treats as interest paid on the bond the OID amount using the same schedule as the bond holders use for reporting their interest income.

If the first purchaser in the example above pays $680 on the first day of its taxable year and holds the bond the entire year, the first purchaser must include $70 of OID for that year. If the first purchaser continues to hold the bond throughout the second year, she must include $75 of OID for the second year. Similarly, if the first purchaser sells the bond to T at the beginning of the second year, T must include the $75 OID during the bond's second year of existence (the first year that T holds the bond). If the sale from first purchaser to T takes place during the second year, they will divide the $75 OID between them.

Note that OID is includible as it accrues, not ratably. Thus, there is less OID in the early years and more in the later years. See §1272(a)(3) (technically it is deemed to accrue ratably during each 6-month accrual interval).

### 2. Acquisition Premium

It may be the case that a subsequent purchaser pays more for the bond than the sum of the issue price plus accrued OID to date. For example, T might pay $780 for the bond after one year. In this case we say that the unanticipated $30 is an "acquisition premium." More generally, an acquisition premium is the excess, if any, of the amount paid for a bond over the sum of its issue price plus accrued OID. §1272(a)(7). A subsequent holder who pays an acquisition premium is entitled to reduce the includible OID by the acquisition premium, where the acquisition premium accrues at the same rate as the OID.

Suppose T purchases the zero-coupon bond for $780 after one year. There is a $30 acquisition premium to T. If T holds the bond the entire year, T will include $75 of OID less a fraction of that OID. That fraction equals the acquisition premium divided by the OID accruing after the purchase giving rise to the acquisition premium. Here, that fraction equals 30/250.[18] Thus, when T holds the bond during its second year, T includes $75 less $75 times (30/250), or $66.00. If T holds the bond for the next year as well, T will include OID of $85 less $85 times (30/250), or $74.80. Finally, if T also holds the bond for its final year, T will include OID of $90 less $90 times (30/250), or $79.20. Of course, T increases her adjusted basis in the bond by the OID includible, so that after one year T's adjusted basis will be $780 plus $66, or $744. If T holds the bond for three full years, T's basis will equal $780 plus $66 plus $74.80 plus $79.20, or $1,000.00.

Suppose U buys the bond from T at the end of the second year for $855. U also has a $30 acquisition premium, and if U holds the bond until redemption, U will include $85 less $85 times (30/175), or $70.43 for the third year and $90 less $90 times (30/175), or $74.57 for the fourth year.

Reconsider the first example above, but focus on the initial purchaser who sells the bond to T for $780. She paid $680 for the bond and included OID of $70, so that her adjusted basis in the bond is $750. When the bond is sold to T, there is a gain of $30 under §1001(a). Further, assuming the bond is not held as inventory, that gain should qualify as capital gain. This is appropriate because the increase in value of the bond above the accrued OID reflects a change in market values rather the time value of money.

Note that the tax treatment of acquisition premium does not affect how the bond *issuer* accrues interest deemed paid on the bond.

### 3. Market Discount

If an acquisition premium is one side of the coin, the other side is market discount. Market discount is the excess, if any, of the issue price plus accrued OID over the purchase price. In contradistinction to acquisition premium, market discount does not affect the amount

[18] In this fraction, $30 is the acquisition premium (i.e., purchase price of $780 over scheduled value of $750) while $250 is the unaccrued OID as of the date of T's purchase (i.e., $75 + $85 + $90).

of OID a bondholder reports. Rather, a taxpayer who purchases a bond with market discount will have some of the dispositional gain characterized as ordinary income. More specifically, so much of the gain as does not exceed the *accrued market discount* will be taxed as ordinary income, §1276(a)(1), where market discount is assumed to accrue ratably, §1276(b)(1). Thus, the implicit interest represented by market discount is deferred until disposition of the bond. Note that market discount, like acquisition premium, is determined anew for each holder of the bond.

Suppose T purchases the zero-coupon bond after year 1 for $735. There is $15 of market discount because T's purchase price of $735 is $15 below the issue price ($680) + accrued OID ($70). If T holds the bond for one year, T will include OID of $75 and increase his basis to $810. If T then sells the bond for $850, there will be a gain of $40. Of that $40 gain, $5 will be taxed as ordinary income because there was $15 of market discount when Y acquired the bond, market discount that would accrue over the three remaining years of the bond, or $5 per year.

Reconsider this example but assume that T holds the bond until redemption. T will include a total of $250 of OID and will increase his adjusted basis in the bond to $985. Thus, there is a gain of $15 on the redemption, gain that can qualify as capital under §1271(a)(1). However, all of that gain will be recharacterized as ordinary income under §1276(a)(1) because there was $15 of market discount and all of it has accrued at redemption.

The existence of market discount does not affect the issuer's tax treatment of the bond in any way.

*Problems*

P-8. Using the OID instrument described in the text having an issue price of $680 and a redemption price of $1,000, consider the following: P purchases the instrument for $680 from the issuer. P holds the instrument for 2 years and then sells the instrument for $840 to X. X holds the instrument for one year and then sells it to Y for $915. Y holds the instrument for one year when it is redeemed by the issuer for $1,000. What are the tax consequences of these transactions to P, X, and Y?

P-9. Using the OID instrument described in the text having an issue price of $680 and a redemption price of $1,000, consider the following: P purchases the instrument for $680 from the issuer. After one year, P sells the instrument to J for $720. J holds the instrument for 2 years and then sells the instrument to K for $900. K holds the instrument for one year until it is redeemed by the issuer for $1,000. What are the tax consequences of these transactions to P, J, and K?

#### 4. Coupon Stripping

Consider a 4-year bond with issue price and redemption price of $1000 carrying 12% coupons. The following chart sets forth the value of the corpus and of the coupons as of the beginning of each year.

| | Start | Year 1 | Year 2 | Year 3 |
|---|---|---|---|---|
| Coupon 1 | $ 107.14 | $ 120.00 | ---- | ---- |
| Coupon 2 | 95.66 | 107.14 | $ 120.00 | ---- |
| Coupon 3 | 85.41 | 95.66 | 107.14 | $ 120.00 |
| "Bond" | 711.78 | 797.19 | 892.86 | 1000.00 |
| Total | $1000.00 | $1120.00 | $1120.00 | $1120.00 |

If the holder of the bond separates any of the coupons prior to maturity and then sells one or more of the coupons or the corpus, the holder is treated as if he sold the remaining parts of the bond to himself on that date for fair market value. By this fiction we explicitly allocate a basis to each of the retained coupons and corpus (if retained) equal to fair market value. Then, each of these retained items is treated as a separate zero-coupon bond subject to the OID rules. Further, the sold items also are treated as separate zero-coupon bonds subject to the OID rules. See §1286(a)-(b).

Suppose the holder of the bond sells coupon 3 immediately for its fair market value of $85.41. The buyer takes a cost basis of $85.41 in coupon 3 and will treat the difference between that price and the redemption amount of $120.00 as OID. Thus, the purchaser will include OID of $10.25 in the first year, OID of $11.48 in the second year, and OID of $12.86 in the third year. The seller follows a similar pattern with respect to coupons 1 and 2 as well as with respect to the corpus. Thus, he will include OID of $109.75 in the first year, OID of $108.53 in the second year, and OID of $107.14 in the third year.

There is one statutory difficulty in §1286. Subsection (b) sets forth the taxation of the bond stripper, and by its terms it applies whenever a coupon or the corpus is "dispose[d] of" prior to maturity. Subsection (a) applies to the transferee, and it purports to apply whenever a coupon or the corpus is "purchase[d]." It is clear that these sections must operate in tandem, *but not all dispositions are purchases*. A gift, for example, is a disposition but not a purchase. In such circumstances, the two possibilities are to narrow the application of §1286(b) or broaden the application of §1286(a).

*Problem*

P-10. Suppose F purchases at issuance the three-year bond having 12% coupons (as described in the text) for $1,000. One year later, F sells the “corpus” to S for $817.19. How much interest income do F and S include from the bond each year? Are there any other tax consequences to F or to S from these transactions?

## F. Character of Option Transactions

### 1. Section 1234

Gain or loss from the exercise or lapse of an option takes its character from the underlying property. Because the holder of an option can trigger the same gain (or loss) either by (a) selling the option (or allowing it to lapse) or (b) by exercising the option and then selling the underlying property, this section ensures that the character of these two equivalent transactions are the same. Note that if the taxpayer allowed the option to lapse, the resulting loss would be ordinary (in the absence of §1234) for want of a "sale or exchange."

### 2. Section 1234A

This section extends the rule of §1234 to certain "terminations" of an option contract when the underlying asset is a capital asset. One such termination is the acquisition of an equivalent option on the other side: that is, the *seller* of a call option effectively could terminate the option by *buying* a call option with the same duration and strike price. Section 1234A has come to play an important role in failed merger and acquisition transactions because such transactions often include a "break up" or similar fee. In the absence of this provision, a would-be acquirer that receives a fee upon cancellation of a stock acquisition would treat the fee as ordinary income for want of a sale or exchange. Now, it is capital gain.

## Answers to Problems

**P-1. For each set of transactions, determine the taxpayers net long-term gain or loss, her net short-term gain or loss, and her net capital gain.**

**a. A long-term gain of $500, a long-term loss of $100, a short-term gain of $500, and a short-term loss of $150.**

There is a net long-term gain of $400, there is a net short-term gain of $350, and the net capital gain equals $400 (net short-term gain is ignored).

**b. A long-term gain of $100, a long-term loss of $500, a short-term gain of $500, and a short-term loss of $150.**

There is a net long-term loss of $400, a net short-term gain of $350, and net capital gain of $0 (if there is a net long-term loss, net capital gain is zero).

**c. A long-term gain of $800, a long-term loss of $200, a short-term gain of $350, and a short-term loss of $500.**

There is a net long-term gain of $600, a net short-term loss of $150, and a net capital gain of $450 (subtract net short-term loss from net long-term gain).

**P-2. T purchases investment real estate for $600,000. While holding the real estate, T properly claims $250,000 of depreciation using straight-line depreciation. T then sells the real estate for $750,000. How much gain does T recognize, and how is that gain taxed?**

There is gain of $400,000 (amount realized of $750,000 less adjusted basis of $350,000). Of that gain, $250,000 is unrecaptured §1250 income (potentially taxed as 25%) and the remainder of $150,000 is long-term capital gain (potentially taxed at 20%).

**P-3. Reconsider the facts of the problem immediately above, but assume that straight-line depreciation would have been only $225,000 and taxpayer was entitled to claim $25,000 on an accelerated basis. How much gain does T recognize, and how is that gain taxed?**

The gain again is $400,000. Of that amount, $25,000 is ordinary income under §1250 (recaptured of accelerated portion of depreciation), $225,000 is unrecaptured §1250 income, and $150,000 is long-term capital gain.

**P-4. How do your answers to problems 2 and 3 above change if the property is equipment rather than real estate?**

There again is gain of $400,000 but now all $250,000 of the depreciation is recaptured as ordinary income by reason of §1245. This is true on the facts of problem 2 as well as on the facts of problem 3.

**P-5. T, the owner of a large printing company, contributes a used printing press to the local high school to be used by the school in training some of its students. At the time of the contribution, the printing press has a fair market value of $65,000. The printing press was purchased new by T for $100,000. T's adjusted basis in the printing press is $0. Is the contribution by T deductible and, assuming it is deductible, how much is the deduction?**

The transfer of the printing press is almost certainly deductible. The government might argue that the printing company is hoping that the students will become proficient on the equipment that the printing company uses, and in that way the students will graduate already trained for employment by the printing company. But because neither the students nor the school have made any promise to provide trained labor to the printing company, this potential benefit seems too remote to be considered.

The deduction starts at the $65,000 fair market value of the printing press. However, under §170(e)(1)(A), that amount is reduced by so much of the gain as would not be long-term capital gain if the printing press were sold for its fair market value rather than contributed. That hypothetical gain would be $65,000, and all of the gain would be ordinary as depreciation recapture under §1245. Accordingly, the deduction is reduced from $65,000 to $0.

**P-6. Q contributes publicly-traded stock to a charitable organization. The value of the stock at the time of contribution is $20,000. Q purchased the stock a few months prior to the contribution at a cost of $18,000. (a) Assuming this contribution is deductible by Q, what is the amount of the deduction? (b) How would your answer change if the stock had been purchased by Q for $25,000? (c) How would your answer to part (a) change if the stock had been held by Q for more than a year prior to the contribution?**

(a) $20,000 less $2,000 (that is, $18,000) because the gain of $2,000 would be short-term, captured by §170(e)(1)(A).

(b) $20,000 (fair market value). Built-in loss is irrelevant.

(c) There would be no reduction under §170(e)(1)(A) because all of the gain would be long-term, and there would be no reduction under §170(e)(1)(B) because stock is an intangible. Accordingly, the deduction would equal $20,000.

**P-7. R contributes a painting to a charitable hospital when the painting is worth $65,000? The painting was purchased by R several years prior to the contribution for $50,000. Assuming the contribution is deductible by R, what is the amount of the**

**contribution? How would your answer change if the contribution were made to a charitable art museum?**
Gain from the painting would be long-term capital gain, so the reduction in §170(e)(1)(A) would not apply. But because the painting will not be used by the hospital in furtherance of its charitable function, the reduction of §170(e)(1)(B) would apply, reducing the deduction from $65,000 down to $50,000. If the painting is placed in the hospital's waiting room, perhaps the taxpayer can argue that the painting will be used in furtherance of the hospital's charitable function because it helps calm anxious patients and their families.

If the contribution is made to an art museum, it seems clear that the reduction of §170(e)(1)(B) will not apply because the painting will be used by the charity in furtherance of its charitable function. However, if the charity immediately sells the painting, this argument will be much more difficult to make, especially if the donor had been advised prior to the contribution of the charity's intention to sell.

**P-8. Using the OID instrument described in the text having an issue price of $680 and a redemption price of $1,000, consider the following: P purchases the instrument for $680 from the issuer. P holds the instrument for 2 years and then sells the instrument for $840 to X. X holds the instrument for one year and then sells it to Y for $915. Y holds the instrument for one year when it is redeemed by the issuer for $1,000. What are the tax consequences of these transactions to P, X, and Y?**

P must include the OID for the period that P holds the instrument, and that is $70 for year 1 and $75 for year 2, all reported as ordinary interest income. P increases P's adjusted basis to $680 + $70 + $75, or $825. The sale from P to X for $840 generates a gain to P of $15, and that gain will be long-term capital gain to P unless the instrument is inventory in P's hands.

X takes a cost basis of $840, and that includes an acquisition premium of $15. During the year that X holds the instrument, the OID equals $85. X includes that amount as interest income less a reduction for a portion of the acquisition premium. That reduction equals $85 times (15/(85 + 90)), or $7.29. Thus, X includes $85 - $7.29, or $77.71, as interest income, and X increases her adjusted basis to $840 + $77.71, or $917.71. When X sells the asset to Y for $915, X recognizes a loss of $2.71, a capital loss unless the instrument is inventory on X's hands.

Y takes a cost basis of $915, and that includes an acquisition premium of $5. The OID in the year that Y holds the instrument is $90, and Y includes that amount less a reduction for Y's acquisition premium. That reduction equals $90 times (5/90), or $5. Accordingly, Y includes interest income of $90 - $5, or $85, and increases adjusted basis to $915 + $85, or $1,000. On the redemption, Y does not realize any gain or loss.

**P-9. Using the OID instrument described in the text having an issue price of $680 and a redemption price of $1,000, consider the following: P purchases the instrument for $680**

**from the issuer. After one year, P sells the instrument to J for $720. J holds the instrument for 2 years and then sells the instrument to K for $900. K holds the instrument for one year until it is redeemed by the issuer for $1,000. What are the tax consequences of these transactions to P, J, and K?**

P must include the OID for the period that P holds the instrument, and that is $70 for year 1, all ordinary income. P increases her adjusted basis in the instrument from $680 to $750, so when P sells the instrument for $720, P recognizes a loss of $30, a capital loss unless the instrument is inventory in P's hands.

J takes a cost basis of $720, and that generates a market discount to J of $30. J must include the OID for the period when J holds the instrument, and that is $75 for year 2 and $85 for year 3, for a total of $160. This is ordinary income to J, and J increases her adjusted basis in the instrument from $720 to $880. When J sells the instrument for $900, J recognizes a gain of $20. That gain will be ordinary to the extent of J's *accrued* market discount. When J acquired the instrument, there were three years remaining to the instrument. Because J held the instrument for two of those three years, J's *accrued* market discount equals two-thirds of J's market discount, and that equals two-third of $30, or $20. Accordingly, all of J's gain is ordinary income. Had there been any additional gain, it would have been capital to J unless the instrument was inventory in J's hands.

When K purchases the instrument for $900, K takes a cost basis of $900. This generates $10 of market discount to K. K must include the $90 of OID for the year that K held the instrument, so that K has $90 of ordinary income and increases adjusted basis from $900 to $990. When the instrument is redeemed, K recognizes a gain of $10. Because K's market discount equals $10 and it all accrues in the one year that K held the instrument, all of K's gain is ordinary income.

**P-10. Suppose F purchases at issuance the three-year bond having 12% coupons (as described in the text) for $1,000. One year later, F sells the "corpus" to S for $817.19. How much interest income do F and S include from the bond each year? Are there any other tax consequences to F or to S from these transactions?**

In the first year, F includes $120 of interest income. On the sale of the "corpus" to S, F includes $20 of capital gain (assuming F does not hold the bond as inventory). In the second year, F includes the implicit interest on coupon 2 ($120.00 - $107.14, or $12.86) and on coupon 3 ($107.14 - $95.66, or $11.48) while S includes implicit interest on the "corpus" of $892.86 – $797.19, or $95.67 less a portion of S's $20 acquisition premium. That portion equals $20.00 times ($95.67/$202.81), or $9.43, for net inclusion of $95.67 - $9.43, or $86.24.

In the third year, F includes the implicit interest on coupon 3 ($120.00 - $107.14, or $12.86), and S includes the implicit interest on the "corpus" ($1,000 - $892.86, or $107.14)

less a portion of S's acquisition premium. That portion equals $20.00 times ($107.14/$202.81), or $10.57, for net inclusion of $107.14 - $10.57, or $96.57.