Capital Gains and Losses—The “Sale or Exchange” Requirement†

By Boris I. Bittker*

By virtue of Internal Revenue Code (IRC) section 1222, capital gains and losses arise from “the sale or exchange” of capital assets. Because this statutory requirement is clearly satisfied by most routine dispositions of investment assets, such as sales of securities on a securities exchange or over the counter, it is easily overlooked in peripheral situations—for example, termination of the taxpayer’s interest in a capital asset by theft, abandonment, or condemnation—that do not constitute a conventional “sale or exchange.” Moreover, Congress has dispensed with the technical requirement of a “sale or exchange” in many of these peripheral situations, so that its residual importance in a few remaining circumstances can be a trap for the unwary.

Interpreting the phrase “sale or exchange” in these residual situations is made difficult by the absence of any legislative explanation of its function. At first blush, the phrase seems to specify the circumstances in which the taxpayer must compute gain or loss, thus distinguishing realized from unrealized capital gains and losses. This cannot be the function of section 1222, however, because IRC section 1001(a), providing that a gain or loss is to be computed on “the sale or other disposition” of property, applies to both capital and noncapital assets. Thus, section 1001(a) requires increases and decreases in the value of property to be taken into account when the taxpayer engages in a “sale or other disposition” of the property, at which time the adjusted basis of the property is subtracted from the amount realized in order to compute gain or loss.

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In applying section 1001(a), therefore, it is sometimes necessary to decide whether the taxpayer has "sold or otherwise disposed of" the property or has merely licensed or leased it, because these less drastic methods of exploiting the property do not terminate the taxpayer's financial interest in it and hence do not call for a computation of gain or loss. Because section 1001(a) uses the term "sale or other disposition" as a label for the circumstances in which the taxpayer's financial interest in property has been sufficiently terminated to justify taking his or her previously unrealized gain or loss into account, there is no need for this function to be discharged a second time by the "sale or exchange" concept of section 1222.

It has occasionally been suggested that involuntary transactions, which are encompassed by the phrase "sale or other disposition" as used by section 1001, should be denied capital gain status on the grounds that the lower rate was enacted to remove tax obstacles to sales and that this "lock-in effect" is absent from transactions that are forced on the taxpayer, such as condemnations and other involuntary conversions. Despite this theory, which focuses on the "anti-lock-in" function of the capital gain rate to the exclusion of its "anti-bunching" function, the Supreme Court held in Helvering v. Hammel, decided in 1941, that a foreclosure sale was a "sale or exchange" resulting in capital gain or loss treatment.

In the absence of a cogent reason for requiring the taxpayer's interest in capital assets to be terminated in a special way in order to qualify for capital gain or loss treatment—and none has been suggested—it would be appropriate to interpret "sale or exchange" as used in section 1222 as coextensive with "sale or other disposition" as used in section 1001(a). Evidence that the difference in phraseology is accidental can be found in section 1001(c), which uses the phrase "sale or exchange" but is intended to apply to all closed transactions and thus to cover the same ground as section 1001(a).³

1. See Pounds v. United States, 372 F.2d 342, 351 (5th Cir. 1967) (capital gain rate might have encouraged taxpayer to sell or exchange an asset but could have had no bearing on an involuntary transaction).
2. 311 U.S. 504 (1941).
3. A purposeful distinction between "sale or exchange" and "sale or other disposition" is also inconsistent with the fact that § 206 of the Revenue Act of 1921, 42 Stat. 227, which introduced the phrase "sale or exchange," was explained by the Senate Finance Committee as designed to limit the tax burden on "the net gain derived from the sale or other disposi-
In *Helvering v. William Flaccus Oak Leather Co.*, decided in 1941, however, the Supreme Court held that the taxpayer did not engage in a "sale or exchange" within the meaning of section 1222 when its business plant was destroyed by fire and it was compensated for the loss by insurance:

Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" and "exchange" are not to be read any differently. . . . Neither term is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company. Plainly that pair of events was not a sale. Nor can they be regarded as an exchange, for "exchange" . . . implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee's asset.5

Because the events in *William Flaccus Oak Leather Co.* constituted a "sale or other disposition" within the meaning of the statutory predecessor of section 1001(a),6 the case created a rift between that phrase and "sale or exchange" that has continued to this day. As a result, some transactions generate ordinary income or ordinary loss, although a sale of the same property prior to the event would have produced capital gain or loss. This disparity encourages taxpayers with appreciated assets to engage in anticipatory sales in order to realize the profit by a "sale or exchange" rather than wait for a more normal termination of the investment that will fail to satisfy section 1222. The Internal Revenue Service (IRS), in turn, often seeks to frustrate this tactic by asserting that the purported purchaser is merely the taxpayer's agent or that the sale lacks substance.7

The resulting battle of wits would be an everyday occurrence had Congress not intervened in many situations to provide that a particular method of terminating the taxpayer's investment should be treated as a "sale or exchange," even though the "ordinary meaning" principle enunciated in *William Flaccus Oak Leather Co.* would clearly or arguably lead to a different conclusion of capital assets." S. Rep. No. 275, 67th Cong., 1st Sess. 12 (1921), reprinted in 1939-1 (pt. 2) C.B. 181, 189.

4. 313 U.S. 247 (1941).

5. Id. at 249. The result in this case was subsequently changed by I.R.C. § 1231(a) for some assets (for example, capital assets held for more than one year) but not for others (for example, capital assets held for one year or less).


7. For a discussion of anticipatory sales, see notes 72-73 & accompanying text infra.
This Article analyzes Congress' attempt to bring order to the varying interpretations of the "sale or exchange" requirement of section 1222. The Article first examines the status of borderline transactions that have not been the subject of special legislation. The Article next describes the so-called statutory sales in which Congress has expressly determined that the taxpayer's conduct constitutes a "sale or exchange" within the meaning of section 1222.

"Sale or Exchange" versus "Sale or Other Disposition"

Foreclosure, Condemnation, Destruction, and Other Involuntary Events

In Helvering v. Hammel, the Supreme Court held that a foreclosure sale was a "sale or exchange" within the meaning of the statutory predecessor of section 1222, even though it did not result from the taxpayer's voluntary action and hence was not a "sale" for some private law purposes, for example, a property owner's covenant against sale or assignment of his or her interest. It is sometimes suggested that Hammel is applicable only if the mortgagor is released from personal liability on the debt or receives some other consideration from the foreclosure sale, but Hammel itself does not affirmatively support this refinement. A distinction between personal liability and nonrecourse financing would also be inconsistent with Crane v. Commissioner, which holds that the

8. 311 U.S. 504 (1941).
9. Id. at 510. See also Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666 (1941) (per curiam) (tax sale; same result).

If the taxpayer-mortgagor has a right to redeem the property under local law, the foreclosure sale is not complete until the right of redemption is released, expires, or becomes worthless. Rev. Rul. 70-63, 1970-1 C.B. 36. See Commissioner v. Peterman, 118 F.2d 973 (9th Cir. 1941) (failure of financially solvent owner to pay real estate taxes demonstrates worthlessness of right of redemption; also, local law provided indefinite period for redemption); Abelson v. Commissioner, 44 B.T.A. 98 (1941) (nonacquiescence) (same result for twelve-month redemption period); Handler, Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagor, 31 Tax L. Rev. 193 (1976). The existence of a right to redeem also affects the holding period in distinguishing between long term and short term capital losses.

unpaid balance of a nonrecourse mortgage is “realized” by the mortgagor upon disposition of the mortgaged property. Crane involved a sale under threat of foreclosure, but its rationale is that the mortgagor receives a “benefit” on disposing of the property subject to the debt; presumably on this theory, Hammel has been applied even when the mortgagor is not liable on the debt.\textsuperscript{12} In reliance on Hammel, it has been held that property taken by eminent domain is sold or exchanged within the meaning of section 1222, even though for some purposes the event is often described as a “taking” rather than a “sale” and the payment as “damages” rather than consideration.\textsuperscript{13} If, however, the government takes not the property itself but only the right to use it for a limited period, the compensation is a substitute for rent, taxable as ordinary income.\textsuperscript{14} Ancillary payments, such as severance damages and interest to compensate the taxpayer for a delay in awarding or paying damages, similarly constitute ordinary income rather than payment for the property.\textsuperscript{15}

When property is destroyed by fire, however, it has been held that the event does not constitute a “sale or exchange” even if the taxpayer is compensated for the loss by his or her insurance company.\textsuperscript{16} Presumably, this judicial refusal to extend the “forced sale” rationale of Hammel to destruction of property by fire would also encompass losses from tortious or criminal misconduct, such as negligence, theft, and embezzlement, as well as the unexplained disappearance of property as a result of the taxpayer’s failure to keep it under lock and key. If, however, a third party’s misconduct is condoned or forgiven in exchange for a promise to pay for the property, the taxpayer’s agreement may be construed as a constructive sale or exchange within the meaning of section 1222, al-

\textsuperscript{12} See Russo v. Commissioner, 68 T.C. 135, 152-53 (1977) (citing cases); Rev. Rul. 76-111, 1976-1 C.B. 214 (nonrecourse purchase money debt was “satisfied” by transfer of property back to seller; treated as sale or exchange).

\textsuperscript{13} See Commissioner v. Kieselbach, 127 F.2d 359 (3d Cir. 1942), aff’d on other grounds, 317 U.S. 399 (1943); Hawaiian Gas Prods., Ltd. v. Commissioner, 126 F.2d 4 (9th Cir.), cert. denied, 317 U.S. 653 (1942).


\textsuperscript{15} See Commissioner v. Kieselbach, 127 F.2d 359 (3d Cir. 1942), aff’d on other grounds, 317 U.S. 399 (1943).

\textsuperscript{16} See Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941). There appear to be no cases involving the impact of an assignment by the insurer to the insurer of rights to damaged or missing property, which might be viewed as a sale or exchange. See also Rev. Rul. 64-100, 1964-1 (pt. 1) C.B. 130 (involuntary conversion constitutes a sale or exchange for purposes of I.R.C. § 337, relating to corporate liquidations).
though there appear to be no cases or rulings on point.

**Worthless and Abandoned Property**

When property becomes worthless, the taxpayer suffers a loss equal to the property's adjusted basis, but the loss does not arise from a "sale or exchange" within the meaning of section 1222. In the case of worthless securities, however, several special provisions ordinarily require the loss to be treated as though it resulted from a sale or exchange.\(^\text{17}\) When these provisions are not applicable, for example, in the case of bonds issued by an individual and property other than securities, the taxpayer suffers an ordinary loss rather than a capital loss.\(^\text{18}\)

Even if property not only becomes worthless but is abandoned by the taxpayer, the additional step does not constitute a "sale or exchange" within the meaning of section 1222. If, however, mortgaged property is "abandoned" by a voluntary conveyance to the creditor, the transfer is treated by the IRS as a sale or exchange even if the taxpayer is not personally liable on the debt.\(^\text{19}\) This area is murky, however, as is the status of a landowner who "walks away" from encumbered property, intending thereby to abandon it before the lienors can foreclose.\(^\text{20}\)

**Collection of Claims**

In *Fairbanks v. United States*,\(^\text{21}\) the Supreme Court held that the redemption of a corporate bond was not a sale or exchange and that the taxpayer's gain, although attributable to an increase in the

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17. See I.R.C. §§ 165(g), 166(d)(1)(B), 1244. See notes 86-92 & accompanying text infra.

18. It should be remembered, however, that a deduction can be taken only if authorized by I.R.C. § 165; in particular, property devoted to personal use does not give rise to a deduction on becoming worthless.

19. Rev. Rul. 78-164, 1978-1 C.B. 264. Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941), holding otherwise, was decided before *Crane*. The same is true of Jamison v. Commissioner, 8 T.C. 173 (1947), which held that a conveyance of property to a municipality for release of unpaid taxes was not a sale or exchange. *But see* Fox v. Commissioner, 61 T.C. 704, 715 n.7 (1974) (citing *Stokes* and *Jamison* favorably).


value of a capital asset, constituted ordinary income. Explaining its conclusion, the Court stated only that "payment and discharge of a bond is neither sale nor exchange within the commonly accepted meaning of the words." The redemption in *Fairbanks* occurred before maturity, but the opinion obviously also encompassed payments at or after maturity.

When *Fairbanks* was decided, Congress had already enacted the predecessor of IRC section 1232, providing that the amounts paid on the retirement of certain bonds and other obligations "shall be considered" as paid in exchange therefor. This "statutory sale" provision did not apply to the taxable year before the Court, however, and, as will be seen, its limited scope continues to leave a good deal of room for the *Fairbanks* principle. Open-account and noncorporate debts, for example, are not covered by section 1232(a); consequently, the collection of such an obligation produces ordinary income or loss under *Fairbanks* even if the claim is a capital asset. The same principle holds true for compromise settlements of claims and judgments.

Had *Fairbanks* gone the other way, merchants selling on credit would have been invited to claim capital gain treatment on collecting their claims against customers, and employees might have asserted that their claims for unpaid salary were "sold" to the employer for their paychecks. While extravagant assertions like these would no doubt have been quickly blocked by legislation or judge-made restrictions, *Fairbanks* functions as an independent protective device in this area. Nonetheless, it simultaneously has the effect of denying capital gain and loss treatment to taxpayers who purchase claims as investments and hold them until payment

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22. *Id.* at 438. Relying on the reference to "sale or other disposition" in the 1921 legislative reports, S. Rep. No. 275, 67th Cong., 1st Sess. 12 (1921), *reprinted in* 1939-1 (pt.2) C.B. 181, 189, the Board of Tax Appeals had held in 1929 that the statutory phrase "sale or exchange" included redemptions; it overruled this decision three years later on the ground that the statutory language was too clear to permit resort to legislative history as an aid to interpretation. *See* Watson v. Commissioner, 27 B.T.A. 463 (1932) (overruling Werner v. Commissioner, 15 B.T.A. 482 (1929)).

23. 306 U.S. at 437.

24. *See* notes 79-85 & accompanying text infra.

25. *See, e.g.*, Canal-Randolph Corp. v. United States, 568 F.2d 28 (7th Cir. 1977) (lump-sum settlement of right to receive recurrent payments for stockyard services); Graham v. Commissioner, 304 F.2d 707 (2d Cir. 1962) (award by United States-German Mixed Claims Commission held ordinary income; no sale or exchange); Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954) (satisfaction of judgment debt); Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936) (compromise payment to settle mortgage notes).
or settlement by the obligor.26

At first blush, it would seem that a foresighted investor could avoid *Fairbanks* by selling his or her claims to a third party rather than waiting for payment by the obligor. However, because merchants and employees might also seek to avoid *Fairbanks* by selling their claims against customers and employers,27 the courts developed a series of doctrines designed to prevent such transactions from being treated as sales of capital assets28 and these obstacles, especially the theory that a “naked” contract claim is not “property” within the meaning of IRC section 1221,29 may also apply to bona fide investors.

Although a creditor who collects a debt or other claim is not treated as having sold or exchanged it, a debtor paying a claim with appreciated or depreciated property realizes capital gain or loss if the property is a capital asset, because use of the property to satisfy the claim is treated as a sale or exchange thereof.30 It has been held, however, that a sale or exchange is lacking when a shareholder surrenders stock to the issuing corporation on a non-pro rata basis, receiving no benefit except a possible enhancement in the book value of the retained shares.31

**Surrender, Cancellation, and Termination of Contract Rights**

The scope of the term “sale or exchange” is also uncertain as applied to transactions that cancel, terminate, surrender, rescind, or otherwise extinguish the taxpayer’s rights under a contract with

26. *See* Jones v. Commissioner, 306 F.2d 292, 305-06 (5th Cir. 1962) (gain on settlement of claim under construction contract acquired by assignment; held, ordinary income because no sale or exchange).

27. Most such efforts would now founder on I.R.C. § 1221(4), which provides that accounts receivable acquired in the ordinary course of business for services rendered or on the sale of merchandise are not capital assets.


29. If the claim is related to an earlier capital gain or loss transaction, however, it may take on the same character as the earlier transaction by osmosis under Arrowsmith v. Commissioner, 344 U.S. 6 (1952). *See* notes 74-78 & accompanying text *infra*.

30. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940) (payment of pecuniary bequest with appreciated property).

another person. In common parlance, "sale or exchange" connotes a transfer of property to a person who will make use of it, rather than an event that not only terminates the taxpayer's interest but also simultaneously extinguishes the "property" itself. These characteristics of the bond redemption in Fairbanks, discussed above, may well have been what the Court had in mind in holding that the transaction "is neither [a] sale nor exchange within the commonly accepted meaning of the words."32

These "disappearing asset" cases, in which the courts have held or intimated that there was no "sale or exchange," include decisions denying capital gain treatment when a musical booking agent assigned his management contracts to another booking agent as a prelude to their cancellation so that the transferee could enter into new contracts with the performers,33 when a distributor was paid for terminating its exclusive contract with a manufacturer,34 and when a taxpayer was paid to surrender rights under an exclusive contract to purchase coal.35

In Commissioner v. Ferrer,36 however, the Court of Appeals for the Second Circuit described the line between "a sale to a third person that keeps the 'estate' or 'encumbrance' alive, and a release that results in its extinguishment" as a "formalistic distinction," asserting that the tax law should not be concerned with whether the taxpayer's rights are "passed to a stranger or to a person already having a larger 'estate.'"37 This sensible view could have been buttressed by noting that if A's contract rights against B are slated for extinction, they can either be transferred directly to B

32. 306 U.S. at 437. See notes 21-31 & accompanying text supra.
34. Commissioner v. Starr Bros., 204 F.2d 673 (2d Cir. 1953). As to distributors with a substantial capital investment in the distributorship, see notes 103-10 & accompanying text infra.
36. 304 F.2d 125 (2d Cir. 1962).
37. Id. at 131. The court pointed to the enactment of I.R.C. § 1241 (see notes 103-10 & accompanying text infra) as evidence of "congressional disenchantment" with the distinction. The enactment of "statutory sale" provisions, however, also has been treated as evidence that "sale or exchange" should be given its normal meaning with expansions being left to Congress. See Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941). See generally Chirelstein, Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments, 49 Minn. L. Rev. 1 (1964); Eustice, Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case, 20 Tax L. Rev. 1 (1964).
for compensation or be initially "sold" to C, who can then enter into a termination agreement with B. Conversely, if A is to be succeeded by C, A can enter into a termination agreement with B, who can then enter into a new contract with C, or A can transfer rights to C with B's consent, and B and C can then modify the contract, if they so desire, or leave it intact.\textsuperscript{38} In these situations, A may or may not know whether the end result is to be a new contract; in either case, no capital gain policy should turn on A's awareness of either B's or C's plans for the future.

\textit{Ferrer}, a carefully reasoned case gaining additional authority because it came from the court that was the major source of the "disappearing asset" cases, proved to be a turning point in this area; later decisions have played down or wholly disregarded the fact that a contract or other business relationship was "terminated" rather than kept alive in deciding whether it was sold or exchanged.\textsuperscript{39} In a number of other post-\textit{Ferrer} disappearing asset cases, capital gain treatment has been denied on the grounds that the transferor's rights did not constitute "property" within the meaning of section 1221 or represented only an opportunity to earn income from personal services or that the payment was a substitute for future income.\textsuperscript{40} Thus, the "formalistic distinction" be-

\textsuperscript{38} See General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir.), cert. denied, 346 U.S. 866 (1953).

\textsuperscript{39} See Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220 (2d Cir. 1975) (earlier opinion at 476 F.2d 981 (2d Cir. 1973)) (payments received by landlord to release tenant from obligation to restore leased premises to former condition held ordinary income; no mention of disappearing asset theory); United States Freight Co. & Subsidiaries v. United States, 422 F.2d 887 (Ct. Cl. 1970) (forfeiture of down payment by taxpayer contracting to purchase stock creates ordinary, not capital, loss; no sale or exchange); Turzillo v. Commissioner, 346 F.2d 884 (6th Cir. 1965) (proceeds received in settlement of litigation over rights in employment contract and stock options; held, sale or exchange to extent received for options); Anderson v. United States, 468 F. Supp. 1085 (D. Minn. 1979) (amount received for release of taxpayer's right of first refusal qualified as capital gain); Kathman v. Commissioner, 50 T.C. 125 (1968) (food distributor denied capital gain treatment for payments to release salespersons from contract requiring them to purchase through him; reliance on \textit{Ferrer}). But see Rev. Rul. 75-527, 1975-2 C.B. 30 (payment to terminate contract ordinary income because taxpayer's rights "did not pass" to payor; "thus, there was no sale and there could be no gain from a sale").

\textsuperscript{40} See Furrer v. Commissioner, 566 F.2d 1115 (9th Cir. 1977), cert. denied, 437 U.S. 903 (1978) (damages awarded by insurance company to sales manager for breach of agency contract not paid-for "property"); Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972) (payment for cancellation of general insurance agency contract for right to earn income from personal services); Biabee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963) (same as to payment to terminate mortgage servicing contract, to the extent not allocable to goodwill; also uses substitute for future income rationale); Flower v. Commissioner, 61 T.C. 140
between two-party and three-party transactions that was criticized in *Ferrer* is fast becoming a footnote to history.

"Sale or Exchange" versus License or Lease

When property is transferred subject to a reservation of rights in the transferor, the transaction’s tax status may be ambiguous. If it is classified as a sale or exchange, the transferor’s adjusted basis is offset against the amount realized, and the difference can qualify for capital gain or loss treatment if the transferred property is a capital asset or qualifies for the hotchpot established by IRC section 1231. If, on the other hand, the transaction is classified as a license or lease, the transferor must report the amounts received as ordinary income, subject to depreciation or amortization if the property qualifies for such deductions. Similar problems in classifying borderline transactions are encountered in other areas of the tax law, but the distinction between sales and licenses is especially troublesome when taxpayers claim capital gain treatment for amounts received from transfers of patents, copyrights, franchises, and other intangible assets, if the payments are dependent on the transferee’s use of the property and are not limited in amount.

For many years, this area was devoid of legislative boundaries and was bitterly contested in innumerable judicial battles between taxpayers and the IRS. For the last two decades, however, Congress has enacted explicit statutory provisions prescribing the tax status of specified transactions, thus preempting some of the most important issues that were formerly left to judicial resolution. The legislation is particularistic rather than comprehensive, however, and many nooks and crannies remain subject to the case law.

The principal litigated issues can be grouped under three headings: contingent payments, geographical and field-of-use restrictions, and reservations of control, although the facts of many

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(1973), aff’d per order, 505 F.2d 1302 (5th Cir. 1974) (payments to terminate sales representation contract taxed as substitute for future income).

41. For an example of an agreement covering a going business, not merely intangible assets, see Nassau Suffolk Lumber & Supply Corp. v. Commissioner, 53 T.C. 280 (1969) (acq.) (purported sale held a license).

42. See I.R.C. § 1221(3) (denying capital asset status to copyrights, literary and musical compositions, and similar assets held by the creator or certain related persons); id. § 1235 (capital gain treatment of certain patent royalties); id. § 1253 (transfers of franchises, trademarks, and trade names).
cases overlap these categories.43

Contingent Payments

At an early date, the IRS regularly argued that capital gain treatment for payments contingent upon the transferee’s sales or profits from the transferred property was inconsistent with the anti-bunching function of the capital gain provisions, because these payments—royalties, in common usage—were by their nature spread out over a period of years.44 Had this theory carried the day, virtually no transfers of patents, copyrights, franchises and similar assets would have qualified for capital gain treatment because the difficulty of ascribing a value to these intangibles usually impels the parties to employ a royalty arrangement. Largely for this reason, the courts regularly rejected the IRS position.45

In 1958, the IRS bowed to the case law and acknowledged that patent royalties could qualify for capital gain treatment,46 and in a 1960 ruling, it surrendered as to copyrights:

[T]he consideration received by a proprietor of a copyright for a grant transferring the exclusive right to exploit the copyrighted work in a medium of publication throughout the life of the copyright shall be treated as proceeds from a sale of property, regardless of whether the consideration received is measured by a percentage of the receipts from the sale, performance, exhibition or publication of the copyrighted work, or is measured by the number of copies sold, performances given, or exhibitions made of the copyrighted work, or whether such receipts are payable over a period generally coterminous with the grantee’s use of the copyrighted work.47

Although the 1958 and 1960 rulings settle the contested issues for conventional royalty payments received for the use of patents and copyrights, they do not preclude characterizing less common arrangements as licenses rather than sales. In 1969, for example,

43. For a detailed account of this subject, see J. Bischel, Taxation of Patents, Trademarks, Copyrights, and Know-How § 1.3 (1974); Morreale, Patents, Know-How and Trademarks: A Tax Overview, 29 Tax Law. 553 (1976).
44. See, e.g., Dreymann v. Commissioner, 11 T.C. 153, 162-63 (1948) (capital gain not restricted to bunched income) (nonacquiescence as to this issue).
45. See, e.g., Coplan v. Commissioner, 28 T.C. 1189 (1957) (acq.).
47. Rev. Rul. 60-226, 1960-1 C.B. 26, 27. See also Rev. Rul. 75-202, 1975-1 C.B. 170 (contingent payments from sale of copyright by author’s personal holding company not royalties under I.R.C. § 543(a)).
the Tax Court held that a purported sale of a going business for installment payments plus a "license royalty" based on the transferee's sales, to be paid annually for ninety-nine years, perpetuated the transferor's interest in the business requiring the annual payments to be reported as ordinary income.\footnote{48}

The IRS' 1958 and 1960 concessions that the transfer of a payment or copyright on a royalty basis can qualify as a "sale or exchange" for capital gain purposes are less important than might appear at first glance, however, because of two explicit statutory provisions: (1) IRC section 1235, under which most patent royalties received by inventors and certain other persons qualify for capital gain treatment even if the patent is not a capital asset in the taxpayer's hands; and (2) IRC section 1221(3), denying capital gain status to copyrights, literary and musical compositions, and similar assets if held by the person whose personal efforts created the property or by certain other persons. When these statutory provisions are not applicable, however, the 1958 and 1960 rulings continue to state the governing principles.

**Geographical and Field-of-Use Restrictions**

Taxpayers owning patents, copyrights, and other intangibles often confine their licenses to specified geographical areas, for example, the United States or the United States and Canada, or fields of use, such as book publication or motion picture production. The IRS' original position was that geographical and functional divisions were hallmarks of a license, producing ordinary income, rather than a sale, producing capital gains, even if the assignee was vested with exclusive rights within the specified domain.\footnote{49}

Like its contingent payment theory, however, the IRS' indivisibility theory of patents and copyrights was rejected by the courts, which held that the transfer of exclusive rights to a patent, copyright, or trademark could be a sale for tax purposes even if restricted to a geographical area or prescribed field of use.\footnote{50} In 1954,
the IRS accommodated itself to these judicial defeats by abandoning its indivisibility theory as to copyrights, acknowledging that copyrights and trademarks can be divided "into separately saleable fractions," and ruling that the transfer of the exclusive right to exploit a copyrighted work in a particular medium, such as motion pictures, can qualify as a sale. The 1954 ruling was restricted to transfers for a fixed amount, but it was modified in 1960 to include conventional royalty agreements, contingent on the number of copies sold or the assignee's receipts.

Reservations of Control

Geographical and field-of-use restrictions are often accompanied by provisions requiring the assignee to adhere to quality and other standards prescribed by the assignor, designed both to ensure the continued flow of income from the assigned rights and to prevent debasement of the assignor's name, symbols, and process. In the litigated cases, the courts had difficulty finding "a legitimate place to draw the line between the reservation of sufficient rights and restrictions to protect [the taxpayer's] continuing financial interest and the reservation of rights to continuing participation in the business on such a scale that it cannot properly be said that there was a sale." In five appellate cases involving Dairy Queen franchises, for example, the courts reached results that were described in a similar case as "essentially irreconcilable." Moreover,

52. Id. For the current status of geographical and field-of-use restrictions, see L.R.C. § 1253.
54. United States v. Wernentin, 354 F.2d 757, 766 (8th Cir. 1965) (transfer of Dairy Queen franchise resembled lease more than sale, as indicated by agreement and conduct of parties; lessor's active, continuing interest in development and guidance of lessee's business held incompatible with capital gain treatment of payments; extensive review of cases).
55. Conde Nast Publications, Inc. v. United States, 38 A.F.T.R.2d 5796 (S.D.N.Y. 1976) (payments received by assignor from assignee of dress pattern business qualified only in part as capital gains), rev'd in part and remanded, 575 F.2d 400 (2d Cir. 1978) (on facts, taxpayer did not have any significant continuing interest or participation in assignee's business but only the right to protect value of retained rights). See also Resorts Int'l, Inc. v. Commissioner, 511 F.2d 107 (6th Cir. 1975) (capital gain treatment denied to payments
because both the conduct of the parties and their formal contract rights must be taken into account in determining whether the arrangement is a "sale," the outcome of particular cases is of limited predictive value. But this area is now largely preempted by the statutory rules of IRC section 1235, relating to patents, and IRC section 1253, relating to franchises, trademarks, and trade names.

Bootstrap Sales—Price and Payment Contingent on Future Profits

Capital assets are ordinarily sold for a fixed price, and if credit is extended by the seller, the buyer is usually personally liable for the unpaid balance. In commercial contexts, however, property is sometimes sold for a price determined in part by the buyer's future profits or the productivity of the transferred assets, to a buyer who assumes no personal liability for the unpaid balance or who has no assets other than the transferred property. Carried to its logical extreme, a bootstrap purchase may entail a price wholly dependent upon future profits to a buyer who makes no down payment, assumes no personal liability for the scheduled payments, and either supplies no managerial skill or is to be compensated before computation of the profits from which the payments are to be made. When the seller reports the profits on a transaction of this type as capital gain, the IRS is understandably restive; because there is no bunching of income, the seller remains fully subject to downside risks, and the arrangement resembles a joint venture between two parties to exploit the transferred property and share the profits.

In the fountainhead of learning on this subject, however, the Supreme Court held that a once-popular bootstrap sale to a tax-exempt organization generated capital gain for the sellers. In Commissioner v. Brown\(^{56}\)—usually known as the Clay Brown case, in honor of the lead plaintiff in the Tax Court—the transaction en-

under agreement giving assignee neither exclusive nor perpetual rights, forbidding sublicenses and authorizing assignor to fix prices charged by assignee); Leisure Dynamics, Inc. v. Commissioner, 494 F.2d 1340 (8th Cir. 1974) (agreement gave assignor significant control over assignee's marketing activities); Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967) (reserved right to manufacture for own use "so insubstantial as to be of little tangible value"; held, sale); PPG Indus., Inc. v. Commissioner, 55 T.C. 928, 1010-18 (1970) (transfers of patented and unpatented technology under agreements with varying terms; extensive discussion); Cubic Corp. v. United States, 28 A.F.T.R.2d 6105 (S.D. Cal. 1971), cert. denied, 419 U.S. 900 (1974) (patent rights and know-how).

tailed the sale of a closely held corporation to a tax-exempt organization for $1,300,000 (which was found by the Tax Court to be "within a reasonable range" in light of the corporation's earnings and net worth), of which $5,000 was payable from the company's assets and the balance was to be paid within ten years solely from earnings.\textsuperscript{57} As prearranged, the exempt buyer liquidated the corporation and leased its assets to a newly organized corporation, owned by the seller's attorneys, for 80\% of the operating profits, computed before depreciation and taxes. The exempt organization was required to pay 90\% of the amount received by it to the selling shareholders to apply to the sales price.\textsuperscript{58}

The function of this labyrinthine arrangement was to protect the amounts received by the exempt buyer from being taxed to it as unrelated business income under the pre-1970 version of IRC section 511.\textsuperscript{59} With this crucial objective accomplished, the business profits realized by the lessee operating company were offset in large part, if not in their entirety, by its deductions for depreciation and the rent paid to the exempt lessor; the rents were received tax free by the lessor; and the selling shareholders, who received the lion's share of the business profits, offset the basis of their stock against the payments and reported the balance as long term capital gain. Because the business profits were virtually untouched by taxation while traveling through the lessee and lessor, the selling shareholders were paid off faster (and paid their taxes sooner) than would have been possible under a similar arrangement with a taxable buyer.

The down payment in \textit{Brown} was not only nominal but came from the transferred company's assets; the purchase price was evidenced by a nonrecourse promissory note; and the business was to be managed by the principal selling shareholder (the famous Clay Brown) at a specified salary.\textsuperscript{60} Thus, the transaction was as close to a perfect bootstrap for the buyer as could be devised. For practical purposes—and aside from taxes—the arrangement resembled an


\textsuperscript{58} 380 U.S. at 567.

\textsuperscript{59} Before it was amended by the Tax Reform Act of 1969, I.R.C. \S 511 did not tax rents received under leases of the type employed in \textit{Clay Brown}. See 68A Stat. 1969 (1954).

\textsuperscript{60} 380 U.S. at 567-68.
announcement by the selling shareholders that they would draw $1,300,000 out of the business and then donate the husk to the exempt organization as a charitable contribution. Attacking the selling shareholders' claim that their profit was capital gain rather than ordinary income, the IRS first asserted that the transaction was a sham and that it did not qualify as a sale for capital gain purposes because of the economic interest and control retained by the shareholders. After losing in the Tax Court and the court of appeals, however, the IRS ceased to allege that the transaction was a sham and instead argued the narrower point that the transaction did not constitute a sale within the meaning of section 1222(3). As summarized by the Supreme Court:

[The government's] argument is that since the [tax-exempt buyer] invested nothing, assumed no independent liability for the purchase price and promised only to pay over a percentage of the earnings of the company, the entire risk of the transaction remained on the sellers. Apparently, to qualify as a sale, a transfer of property for money or the promise of money must be to a financially responsible buyer who undertakes to pay the purchase price other than from the earnings or the assets themselves or there must be a substantial down payment which shifts at least part of the risk to the buyer and furnishes some cushion against loss to the seller.

To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term "sale," is contrary to the policy of the capital gains provision of the Internal Revenue Code, and has no support in the cases. We reject it.62

Despite its emphasis on the term "sale" as used by section 1222(3), the IRS implicitly acknowledged that the transaction was a "sale or other disposition" of the stock within the meaning of IRC section 1001(a), because it computed the shareholders' income by subtracting the adjusted basis of their shares from the payments received by them. The offset was not allowed inadvertently;

62. 380 U.S. at 570.
indeed, on audit, the IRS increased the basis of the shares by certain legal expenses and thus determined that the gain was less than the amount reported by the stockholders, although the tax as asserted was of course higher because the ordinary income rates were applied by the IRS.63

In holding that the shareholders in Clay Brown could report their profit as long term capital gain, the Supreme Court stressed the factual finding by the Tax Court that the sales price was "within a reasonable range" in light of the company's earnings and net worth; pointed out that the shares had in fact appreciated in value over a period of years, as contemplated by the capital gain provisions; held that the term "sale" was used by section 1222(3) in its common and ordinary meaning; and concluded that the transaction in the case was a "sale" in which the shareholders realized gain "upon the enhanced value of a capital asset."64 The Court also observed that requiring "a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale"65 and that if such a rule was to be imposed, Congress was the proper governmental agency to do so.66

The Court might have added that judicial adoption of the government's risk shifting theory would have required case by case evaluations of the adequacy of the down payment, the buyer's financial responsibility, and the managerial services supplied by the buyer in future transactions resembling, but not replicating, the Clay Brown transaction. Moreover, if the price paid for the transferred property does not exceed its fair market value, the capital gains reported by the sellers are the same as they would have reported on a conventional sale of the property to a financially responsible buyer, a fact suggesting that the Clay Brown sellers may have been, after all, only sheep in wolves' clothing.67

When responding to Clay Brown in 1969, Congress avoided the enforcement problems adumbrated above by taxing rents of

64. 380 U.S. at 572-73.
65. Id. at 575.
66. Id.
the Clay Brown type to the exempt organization as unrelated business income, rather than adding a risk shifting requirement to the capital gain rules. Although the 1969 statutory change eliminated the appeal of Clay Brown transactions to tax-exempt organizations, it did not undercut the Court's decision, and Clay Brown transactions are still feasible with buyers who have operating loss carryovers that can be applied against the business profits or who are subject for other reasons to low tax rates. If the purchase price is excessive, however, it has been held that Clay Brown applies only to the reasonable portion and that the excess must be reported as ordinary income. Moreover, Clay Brown does not explicitly reject the government’s "sham" argument, which can probably be revived for use in such special circumstances as a sale of stock to children of the sellers or to a family trust.

Transactions resembling Clay Brown, in that the sales price depends on the productivity of the transferred property, include transfers of patents and franchises for an amount dependent on the transferee's use of the property or receipts from subassignees and transfers of income producing property for a private annuity in amounts calculated to income. These analogues to Clay Brown use different techniques but similarly cause the transferred property to pay for itself.

68. See I.R.C. § 514.

69. See Rev. Rul. 66-153, 1966-1 C.B. 187 (IRS will continue to litigate if amount payable for stock exceeds its fair market value). See also I.R.C. § 483 (requires unstated interest in deferred payments to be reported as ordinary income rather than capital gain if the contract does not provide for interest at the rate prescribed by the IRS) (not applicable to the taxable years in Clay Brown); University Hill Foundation v. Commissioner, 446 F.2d 701 (9th Cir. 1971) (loss of tax-exempt status where charitable organization became a "used-business dealer").

70. See Berenson v. Commissioner, 507 F.2d 262 (2d Cir. 1974) (remanding case to divide purchase price between amount attributable to accumulated value of transferred property when sold and amount attributable to buyer's "extra purchasing power" by virtue of tax-exempt status). For the proceedings on remand, see 612 F.2d 695 (2d Cir. 1979). See also Kraut v. Commissioner, 527 F.2d 1014 (2d Cir. 1975) (Tax Court's allocation upheld); Raymond Allen, [1975] T.C.M. (P-H) ¶ 75,039 (extensive review, with citations; purchase price within reasonable range, as required by Clay Brown).

71. See, e.g., Boone v. United States, 470 F.2d 232 (10th Cir. 1972) (sale of closely held insurance company for $10,500,000, with down payment of $1,000,000 and balance to be paid solely from premiums collected by buyer on transferred policies; held, seller entitled to report profit as capital gain on establishing that price was not "outlandish").
Anticipatory Sales

On the eve of a property transaction that will produce ordinary income, taxpayers sometimes attempt to convert the anticipated ordinary income into long term capital gain by selling the property to a third person, who then steps into the taxpayer's shoes and consummates the transaction as originally contemplated. These transactions ordinarily fail to achieve their objectives, under the "substitute for ordinary income" doctrine. Because of the breadth of this doctrine, the courts usually can avoid questioning the bona fides of the purported sale, although that could often be an alternative ground of decision, particularly if the intervening third party is related to or financed by the taxpayer.

Transaction Related to Prior Sale or Exchange

In two categories of transactions, both important although of uncertain scope, the courts relate current receipts to an earlier sale or exchange, so that capital gain or loss treatment results even though the current transaction, if viewed in isolation, does not satisfy the "sale or exchange" requirement of section 1222.

Open Transaction Cases

The first category consists of so-called open transaction cases, in which the taxpayer sells or exchanges property under a contract calling for a series of variable or contingent payments, usually related to the gross receipts, profits, or production generated by the transferred property. If the contract rights cannot be valued with reasonable accuracy, the seller's gain or loss cannot be computed in the year of the sale; but when the payments are received, they enjoy the same status that they would have occupied if received in the earlier year. Thus, if the property was a capital asset, the difference between its adjusted basis and the amount ultimately received under the contract qualifies as capital gain or loss.

73. See Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942).
74. In bootstrap sales involving a price contingent on future profits or productivity, see notes 56-71 & accompanying text supra, the courts assume that contingent contracts can be valued with sufficient accuracy to decide whether the purchase price is excessive but still accord the payments open transaction status, thus allowing them to qualify for capital gain treatment.
On the other hand, if the contract rights can be valued in the year of the sale, the transaction is "closed" by computing the taxpayer's gain or loss as of that date, capital gain or loss is computed at that time, and if the later collections exceed or fall short of the value assigned to the contract, the difference usually constitutes ordinary income or loss because the contract has not been sold or exchanged, even though there was a sale or exchange of the original property.\(^7\)

**Relation Back to Earlier Transaction**

In the second category of cases, a sale or exchange in an earlier year determines how a later transaction is to be characterized; in effect, the courts dispense with the requirement of a technical sale or exchange in the later year in order to relate its events to the earlier capital gain or loss transaction. The leading case in this area is *Arrowsmith v. Commissioner*,\(^6\) in which the Supreme Court held that taxpayers who reported capital gain on the liquidation of a closely held corporation were required to treat their subsequent payment of unpaid corporate obligations as a capital loss despite the absence of a sale or exchange at that time, because payment of the obligations by the corporation before liquidation would have reduced the taxpayers' capital gain on the liquidation.\(^7\) In the same vein, payments that can be viewed as retroactive adjustments to the sales price of a capital asset are related back to the original transaction so as to qualify for capital gain or loss treatment, even though, viewed in isolation, they do not entail a sale or exchange of a capital asset.

**Statutory Modifications of Sale or Exchange Requirements**

**Retirement of Bonds and Other Obligations**

Section 1232(a)(1) provides that amounts received on the retirement of certain bonds and other evidences of indebtedness "shall be considered" as having been received in exchange for the

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\(^6\) 344 U.S. 6 (1952).

\(^7\) Id. at 8-9.
bonds, with the result that capital gain or loss is realized if the obligation is a capital asset in the hands of the taxpayer.\textsuperscript{78} By giving the retirement the status of a "statutory sale," section 1232(a)(1) dispenses with the need for a technical sale or exchange, thus avoiding an anomalous disparity between a bond that is sold by the holder just before retirement and one that is held until retirement. Retirements that are outside the scope of section 1232(a)(1), however, are subject to the holding in \textit{Fairbanks v. United States},\textsuperscript{79} that the redemption of a bond is not a "sale or exchange" thereof.\textsuperscript{80}

Section 1232(a)(1) embraces bonds, debentures, notes, certificates, and other evidences of indebtedness that (a) are capital assets in the hands of the taxpayer and (b) were issued by a corporation or a government or political subdivision thereof. It has been held that the term "evidences of indebtedness" is not limited to instruments evidencing an unconditional obligation to pay a sum certain in money at a fixed or determinable date but also includes amounts payable from a designated source or fund.\textsuperscript{81} Because the \textit{Fairbanks} rule applies when section 1232(a)(1) is inapplicable, the following self-contained limits on section 1232(a)(1) should be noted: (1) Section 1232(a)(1) applies only to evidences of indebtedness issued by corporations and governmental bodies, not to those issued by individuals and partnerships; (2) Even in the case of corporate and governmental debtors, section 1232(a)(1) applies only to "evidences of indebtedness," not to open-account loans and similar claims. Moreover, if the obligations were issued before January 1, 1955, section 1232(a)(1) applies only if they were issued with interest coupons or in registered form, or were in registered

\begin{itemize}
\item \textsuperscript{78} I.R.C. § 1232(a)(1).
\item \textsuperscript{79} 306 U.S. 436 (1939).
\item \textsuperscript{80} Id. at 437. See notes 21-27 & accompanying text \textit{supra}.
\item \textsuperscript{81} See Jamison v. United States, 297 F. Supp. 221 (N.D. Cal. 1968), aff'd per curiam, 445 F.2d 1397 (9th Cir. 1971) (amounts received by assignees of real estate developer from utility company, based on revenue received by utility from customers); Wilson v. Commissioner, 51 T.C. 723 (1969) (acc.) (same, with extensive discussion). See also Trees, Reg. § 1.1232-1(c)(1), T.D. 7311, 1974-1 C.B. 234 (interpreting "evidence of indebtedness" to include face amount certificates issued by investment companies, as defined by the Investment Company Act of 1940, § 3, 15 U.S.C. § 80a-3 (1976)); Greenvine Corp. v. Commissioner, 40 T.C. 926 (1963) (acc.) (payments on revolving fund credits in cooperative marketing association produced capital gain, either as redemption of stock under I.R.C. § 302(a) or as retirement of evidences of indebtedness under I.R.C. § 1232(a)(1)). \textit{Greenvine} was preempted in 1966 by the enactment of I.R.C. §§ 1381-1388 which deal with the tax treatment of cooperatives.
\end{itemize}
form on March 1, 1954;\(^8\) Section 1232(a)(1) applies only to amounts received on the "retirement" of a bond or other evidence of indebtedness. In *McClain v. Commissioner*,\(^8\) the Supreme Court held that the term "retirement" is broader than "redemption," including payments by a financially embarrassed obligor to retire its bonds for less than their face amount, as well as payments to redeem obligations in accordance with their terms.\(^8\) The difference in *McClain* between the adjusted basis of the bonds and the amount received in settlement therefor gave rise to a capital loss rather than to a deduction from ordinary income under the statutory predecessor of section 166,\(^8\) relating to bad debts. If the creditor is paid in a transaction that does not constitute a "retirement," however, he or she may realize ordinary income or loss, although a sale of the claim would have produced capital gain or loss.

The general rule of section 1232(a)(1) is qualified by sections 1232(b) and 1232(c) if the taxpayer realizes gain on an instrument that was issued at a discount or that was purchased after the detachment of interest coupons. These provisions separate the interest component of the taxpayer's gain from the "true" capital gain component and treat it as ordinary income, and they are applicable to gain realized on a sale or exchange, as well to gain realized on retirement.

**Worthless Securities**

When property becomes worthless, the taxpayer's loss is usually an ordinary loss, even if the property is a capital asset, because the property has not been "sold or exchanged" within the meaning of section 1222. For this reason, a taxpayer who holds deteriorating property until it becomes totally worthless may be better off than if he or she sells the property for a nominal consideration. The taxpayer in *McClain v. Commissioner*,\(^8\) for example, received $125

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82. *See* Wilson v. Commissioner, 51 T.C. 663, 669 (1978) (acq.) (pre-1955 water refund contracts not "in registered form"; extensive discussion); Rivers v. Commissioner, 49 T.C. 663 (1968) (acq.) (requirements of I.R.C. § 1232(a) not met as to pre-1955 notes). The phrases "with interest coupons" and "in registered form" also appear in I.R.C. § 165(g) (relating to worthless securities). *See* notes 86-90 & accompanying text infra.

83. 311 U.S. 527 (1941).

84. *Id.* at 530.


86. 311 U.S. 527 (1941).
from an insolvent debtor for debentures costing $24,750, resulting in a capital loss of $24,625, although under the law in force for the taxable year before the court he would have incurred an ordinary loss of $24,750 if they had become totally worthless.\textsuperscript{87} Section 165(g)(1) eliminates disparities of this type for an important category of capital assets by providing that if a "security" becomes worthless during the taxable year, the resulting loss shall be treated as a loss from the sale or exchange of the security on the last day of the taxable year.\textsuperscript{88} The term "security" is broadly defined by IRC section 165(g)(2) to mean corporate stock; the right to subscribe for or receive corporate stock; and bonds, debentures, notes, certificates, or other evidences of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Several limits on the scope of section 165(g)(1) should be noted. First, section 165(g)(1) applies only to securities issued by corporations or political bodies. A loan to an individual or to a partnership will give rise to a bad debt deduction from ordinary income when it becomes worthless, although a sale before it became worthless would have produced a capital loss.\textsuperscript{89} This disparity is eliminated for taxpayers other than corporations if the worthless obligation is a "nonbusiness debt," because IRC section 166(d) then imposes short term capital loss treatment; but even in this situation there is a residual disparity, because a sale of the claim would have produced either a long term or a short term capital loss, depending on the holding period.

Second, even if the borrower is a corporation or a political body, section 165(g)(1) does not apply to loans if there is no evidence of indebtedness or if the evidence of indebtedness is not coupon bearing or in registered form. When section 165(g)(1) is inapplicable, the taxpayer's deduction on worthlessness is governed by section 166(a) (relating to bad debts), subject to the restriction

\textsuperscript{87} ID. at 528. This disparity was eliminated in 1938, when the statutory predecessor of I.R.C. § 165(g)(1) was enacted. See Revenue Act of 1938, ch. 289, § 23(g)(2), 52 Stat. 461.

\textsuperscript{88} Backstopping I.R.C. § 165(g)(1), I.R.C. § 166(e) provides that the general rule of § 166, permitting a deduction for bad debts, does not apply to debts evidenced by "securities" as defined by § 165(g)(2)(C).

\textsuperscript{89} For unsuccessful efforts to charge off the uncollectible portion of a partially worthless debt when the claim is sold, see Ardela, Inc., [1969] T.C.M. (P-H) § 69,083 (taxpayer entitled only to capital loss attributable to sale, not to ordinary bad debt deduction). But see Levine v. Commissioner, 31 T.C. 1121 (1959) (acq.) (partial charge-off valid if independent of subsequent disposition of claim).
of section 166(d) described in the preceding paragraph.

Third, when section 165(g)(1) applies, the worthless security is treated as though it had been sold on the last day of the taxable year, presumably because it is difficult enough to determine the year of worthlessness without endeavoring to pinpoint the day, which may give the taxpayer a long term capital loss even if a sale a few days earlier would have resulted in a short term capital loss.

Fourth, by virtue of section 165(g)(3), the general rule of section 165(g)(1) is ordinarily inapplicable if the taxpayer is a domestic corporation and the worthless securities were issued by an "affiliated" corporation. A corporation is "affiliated" with the taxpayer for this purpose if (a) stock possessing at least eighty percent of the voting power of all classes of stock plus eighty percent of each class of nonvoting stock is owned directly by the taxpayer and (b) more than ninety percent of its gross receipts for all taxable years came from sources other than royalties, dividends, gains from the sale or exchange of stock and securities, or similar sources. The restriction of section 165(g)(3) serves to approximate the treatment that would have been accorded to the loss if it had been incurred directly by the taxpayer. For example, if a subsidiary is used to conduct manufacturing operations and the parent's investment in the subsidiary's stock and securities becomes worthless, the loss can be deducted by the parent from ordinary income, paralleling the deductions that the parent would have incurred had it conducted the same operations without the intervention of the subsidiary. If the subsidiary had been engaged in investment activities, however, the gross receipts restriction would not be satisfied, with the result that it would not be an affiliated corporation; hence, the parent's loss would be subject to the general rule of section 165(g)(1) (capital loss), rather than to the special rule of section 165(g)(3) (noncapital treatment). Here again, the result usually parallels the result achieved by directly conducting the activities through the parent. Section 165(g)(3) applies, however, only if the securities of the affiliated corporation become worthless, not if they are sold.

Finally, section 165(g)(1) is also limited by IRC section 1244, which allows losses on so-called small business stock to be deducted from ordinary income, up to $50,000 per taxpayer ($100,000

90. See I.R.C. § 165(g)(3); Treas. Reg. § 1.165-5(d)(2) (1956).
91. See note 90 & accompanying text supra.
for husband and wife filing a joint return) for each taxable year. Losses on stock in a company operating under the Small Business Investment Act of 1958 are also deductible from ordinary income, by virtue of IRC section 1242.

Cancellation of Leases and Distributorships

As explained earlier, when a contract is terminated or cancelled in exchange for a payment by one contracting party to the other, it is at least arguable that the recipient of the payment has not engaged in a “sale or exchange” of any rights under the rescinded contract, because the rights do not survive the transaction. This “disappearing asset” theory was employed by the Court of Appeals for the Second Circuit in Commissioner v. Starr Brothers, decided in 1953, to deny capital gain treatment to a payment received by a distributor from a manufacturer for agreeing to terminate an exclusive agency contract, even though the contract was concededly a capital asset.

Section 1241, enacted in 1958, gets the taxpayer over the “sale or exchange” hurdle in this situation if the payment is received by a lessee for the cancellation of a lease or a distributor of goods for the cancellation of a distributor's agreement, provided he or she has a substantial capital investment in the distributorship. The Treasury Regulations define “cancellation” to include a “partial cancellation” if the change relates to a severable economic unit, such as a portion of the leased premises, a distinct geographical area or product, or a part of the agreement’s unexpired term. Payments for modifications in a contract that do not amount to a “cancellation,” however, are outside the scope of section 1241. The regulations also provide that the term “distributor of goods” excludes purveyors of personal services, such as insurance agents and securities brokers, and that the phrase “substantial capital investment in the distributorship” refers to such physical assets as inventories of tangible goods, machinery and equipment, and storage facilities, and is not satisfied by the equipment required to main-

93. See notes 32-40 & accompanying text supra.
94. 204 F.2d 673 (2d Cir. 1953).
95. Id. at 674.
96. I.R.C. § 1241.
tain an office for clerical purposes.  
Section 1241 is now of minor importance, because the “disappearing asset” theory that it supersedes has been significantly curtailed by the courts, and payments to lessees for the cancellation of leases have been held by the courts to qualify for capital gain or loss treatment independently of section 1241. Moreover, being addressed only to the “sale or exchange” prerequisite to capital gain or loss treatment, section 1241 does not prevent the IRS from relying on the “substitute for ordinary income” doctrine for denying capital gain treatment when appropriate. Finally, because section 1241 is explicitly limited to payments received by lessees and distributors, it has no bearing on contract termination payments received by lessors and manufacturers from their lessees and distributors, which are likely to be treated as substitutes for ordinary income.

Franchises, Trademarks, and Trade Names

When a taxpayer receives periodic payments contingent on the productivity or use of transferred property, the IRS has traditionally argued that the payments do not constitute capital gains because they do not entail a bunching of income into a single year. If the transferor not only arranges for payment in installments over a period of years but also retains supervisory authority over the transferee’s business practices in the interim, resistance by the IRS to capital gain treatment is ordinarily even stiffer, on the theory that the continuing relationship is typical of a license or joint venture and correspondingly antithetical to the statutory requisite of a “sale or exchange” of the property. Because both of the characteristics raising the hackles of the IRS are common in business arrangements for the transfer of franchises, trademarks, and trade names, this area became an important battleground for a struggle

98. Id. §§ 1.1241-1(c).
99. See Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962) (discussed at notes 36-40 & accompanying text supra).
101. See Kathman v. Commissioner, 50 T.C. 125 (1968) (food distributor denied capital gain treatment of payments to release salesperson from exclusive purchase arrangement, relying on Ferrer).
between taxpayers, bearing the "sale" banner aloft, and the IRS, which contended that the typical agreement was a "license" producing ordinary income.

After a series of inconclusive skirmishes in the courts, Congress intervened in 1969 by enacting IRC section 1253, which deals separately with retained powers and contingent payments. As to retained powers, section 1253(a) provides that "[a] transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest [as defined] with respect to the subject matter" of the transferred property. As for contingent payments, section 1253(c) provides that "[a]mounts received . . . on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name . . . shall be treated as . . . received from the sale or other disposition of" a noncapital asset if "contingent on the productivity, use, or disposition of" the transferred property. These two basic rules are discussed separately below, along with the status of transfers that are outside the scope of section 1253 and the treatment of the transferee.

Section 1253(b)(1) defines the term "franchise" to include agreements giving one of the parties the right to "distribute, sell, or provide goods, services, or facilities within a specified area." Transfers of franchises to engage in professional sports are excluded by section 1253(e), but franchises to operate sports facilities for the public are within the statutory coverage. The term "trademark" has the meaning assigned to it by the Trademark Act of 1946, which defines "trademark" to include "any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others." The Senate


104. See notes 114-20 & accompanying text infra.

105. See notes 121-22 & accompanying text infra.

106. See note 123 & accompanying text infra.


Finance Committee's Report on section 1253 states that the term "trade name" includes a "trade brand."\(^{109}\)

Although neither section 1253 nor the legislative committee reports mention the issue, the proposed regulations provide that section 1253 includes the transfer of franchises, trademarks, and trade names incident to the transfer of a going business.\(^{110}\)

The payments subjected by section 1253 to ordinary income treatment are analogized to royalties by the Senate Finance Committee,\(^ {111}\) but they are not formally designated as such by section 1253 itself; and the proposed regulations provide that their status as royalty income under provisions "specifically relating to royalties" shall be determined under those sections.\(^ {112}\)

**Retained Powers**

If the transferor of a franchise, trademark, or trade name retains "any significant power, right, or continuing interest," the transaction does not qualify for capital gain or loss treatment under section 1253(a), even if some or all of the payments are fixed in amount, rather than contingent, and are paid in a lump sum. Although enacted to deny capital gain treatment, sections 1253(a) and 1253(c) are evenhanded in the sense that they permit the transferor to deduct losses from ordinary income,\(^ {113}\) but this privilege can seldom be exercised because franchises, trademarks, and trade names rarely have a cost basis in the transferor’s hands.

Recommending the enactment of section 1253(a), the Senate Finance Committee made the following comments on its underlying theory:

Some transferors retain significant powers, rights, or continuing interests with respect to the subject matter of the franchise, trademark, or trade name. The committee believes that if the transferor exercises continuing, active, operational control of a franchise, trademark, or trade name, by retaining significant powers, rights or continuing interests, that exercise of control is inconsistent with a sale or exchange of property.

In addition, some transferors participate so substantially in

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the day-to-day management of the transferee's business activities and operations that the transferor in effect has an operational interest in the transferee's business operations. For example, a transferor may participate in the business by conducting activities such as sales promotion (including advertising), sales and management training, employee training programs, holding of national meetings for transferees, providing the transferees with blue prints or formulae, and other forms of continuing assistance. The committee believes that any general control of the transferee's activities and operations by the transferor constitutes the retention of a significant power, right, or continuing interest.\textsuperscript{114}

In keeping with this rationale, section 1253(b)(2) defines "significant power, right, or continuing interest" very broadly to include—without being limited to—six categories of rights with respect to the transferred interest: (1) a right to disapprove assignments of the interest; (2) a right to terminate the transfer at will; (3) a right to prescribe quality standards for the products, services, and promotional equipment and facilities; (4) a right to require the transferee to sell or advertise only the transferor's service and products; (5) a right to require the transferee to purchase substantially all supplies and equipment from the transferor; and (6) a right to payments contingent on productivity, use, or disposition of the subject matter of the transferred interest if they are a substantial element of the transfer agreement.\textsuperscript{115} In addition to these specific instances of a forbidden "significant power, right, or continuing interest," attention must also be given to the reference in the Senate Finance Committee's Report to participation by the transferor in the transferee's business operations by sales promotion, management training, "and other forms of continuing assistance."\textsuperscript{116}

\textbf{Contingent Payments}

Even if the transferor of a franchise, trademark, or trade name escapes the ordinary income rule of section 1253(a) by relinquishing all significant powers, rights, and interests, section 1253(c) provides that amounts contingent on "productivity, use, or disposition" of the transferred interest are to be treated as received from

\textsuperscript{114} Id. at 208.
the sale or other disposition of a noncapital asset. When recom-
mending this treatment for contingent payments, the Senate Fi-
nance Committee observed that “the receipt of contingent pay-
ments could be viewed [by the courts] as constituting a continuing
economic interest in the subject matter as well as being analogous
to the receipt of royalty or rental income.” The Committee did
not attempt to reconcile this approach with the treatment of pat-
ent royalties under IRC section 1235, which grants capital gain
treatment even if the licensor is a professional inventor.

Section 1253 does not define the phrase “contingent on the
productivity, use, or disposition” of the transferred franchise,
trademark, or trade name, but the Senate Finance Committee ex-
plains the statutory language as follows:

Contingent payments would include continuing payments (other
than installment payments of a principal sum agreed upon in the
transfer agreement) measured by a percentage of the selling price
of products marketed or based on the units manufactured or sold,
or any other similar method based upon production, sale or use,
or disposition of the franchise, trademark, or trade name
transferred.

As this extract from the Senate Finance Committee’s Report
indicates, section 1253(c) disqualifies only contingent payments;
fixed amounts, whether paid in a lump sum or installments, can
qualify for capital gain treatment even if received in addition to
contingent payments subject to section 1253(c). But this possibility
is diluted by section 1253(b)(2)(F), providing that a right to con-
tingent payments is a “significant power, right, or continuing inter-
est” for purposes of section 1253(a) if the payments “constitute a
substantial element under the transfer agreement.” Unless the
contingent payments are modest by comparison with the fixed pay-
ments, this seems to mean that section 1253(a), rather than the
narrower rule of section 1253(c), will apply; this in turn disqualifies all payments for capital gain or loss treatment, whether contingent
or not.

Transfers Outside the Scope of Section 1253

Section 1253 denies capital gain or loss treatment on the

117. For a discussion of losses, see text accompanying note 114 supra.
transfer of franchises, trademarks, and trade names if the transferor retains significant powers or receives contingent payments, but it does not explicitly deal with other transfers of such interests. To qualify for capital gain or loss treatment, therefore, transfers that are outside the scope of section 1253 must satisfy the general capital gain rules requiring a “sale or exchange” of a “capital asset.”

The “sale or exchange” requirement will ordinarily be satisfied by any transfer that escapes the clutches of section 1253, since to escape, the transferor must relinquish all significant rights, powers, and continuing interests and eschew contingent payments. But the fact that a transfer is outside the scope of section 1253 does not provide any assurance that the transferred franchise, trademark, or trade name is a “capital asset” in the transferor’s hands. This point was made by the Senate Finance Committee’s Report on section 1253:

The nature of some franchise, trademark, or trade name transactions support a determination that the property transferred by transferors is property held primarily for sale in the ordinary course of business. For example, if property is held for only a short time before it is sold—which may not be unusual in some franchise operations—there is an indication that the property is held primarily for sale in the ordinary course of business (i.e., that it was acquired with an intention to sell it). It also may not be unusual for a franchisor to transfer as many as 15 or 20 or more subfranchises in the course of a given year, and although a number of sales of property in a given year does not necessarily place the seller in a business, a number of sales does suggest an intention to hold the property primarily for sale. In addition, it is not unusual for some franchisors to divide their territories into a number of smaller franchises for marketing purposes and to sell them to individual franchisees. As is the case in determining the status of a dealer in real estate [under IRC section 1237], the subdivision of property and its sale in a market which differs quantitatively from that in which it was purchased indicates an operation and sales activity consistent with holding the property primarily for sale in the ordinary course of business.\(^{120}\)

Although section 1253 does not explicitly so provide, it applies

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120. S. Rep. No. 91-552, supra note 109, at 209. For a case holding that franchises were held primarily for sale to customers in the ordinary course of the taxpayer’s business, see Devine v. Commissioner, 558 F.2d 807 (5th Cir. 1977).
on a mandatory basis only to transfers after December 31, 1969, but because the term “transfer” is defined by section 1253(b)(3) to include the “renewal” of a franchise, trademark, or trade name, payments under pre-1970 agreements become subject to section 1253 if the agreement is renewed after December 31, 1969.

**Tax Treatment of the Transferee**

Section 1253(d) provides rules for the transferee of a franchise, trademark, or trade name that are roughly parallel to the rules governing the transferor. First, amounts paid or incurred that are contingent on the productivity, use, or disposition of the transferred interest can be deducted by the transferee under IRC section 162, relating to trade or business expenses. Second, if the transfer is subject to section 1253(a), noncontingent payments discharging a principal sum agreed upon in the transfer agreement are, in general, deductible over an appropriate period of years. This result is accomplished by three rules: (1) A single payment made in discharge of the principal sum is deductible ratably over a ten-year period or the life of the agreement, whichever is shorter; (2) payments that are part of a series of approximately equal payments over either the life of the agreement or a period of more than ten years are deductible when made; and (3) other payments are deductible in the years specified by the regulations, consistent with the preceding principles.

**Miscellaneous “Statutory Sales”**

The IRC contains many other “statutory sale” provisions, requiring certain transactions to be treated as sales or exchanges whether or not they are encompassed by the normal meaning of that term. The most important of these statutory sale provisions are summarized below.

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122. I.R.C. § 1253(d)(1).

123. Id. § 1253(d)(2).

124. See notes 1-77 & accompanying text supra.
Involuntary Conversions

In *William Flaccus Oak Leather Co.*, the Supreme Court held that destruction of the taxpayer's business plant by fire and subsequent recovery of the insurance proceeds did not constitute a "sale or exchange" within the meaning of the statutory predecessor of section 1222. By virtue of the last sentence of IRC section 1231(a), however, if a taxpayer's losses on the involuntary conversion by casualty or theft of property used in a trade or business and capital assets held for more than one year do not exceed his or her gains on such transactions, both the losses and the gains go from this "preliminary hotchpot" to the section 1231 regular "hotchpot" (along with certain other gains and losses), and if the regular hotchpot gains exceed the hotchpot losses, both are treated as gains and losses from the sale or exchange of capital assets.

Short Sales

When a short sale is closed out by the delivery of stock or other property in satisfaction of the seller's obligations, it is debatable whether the transferred property has been sold or exchanged. Section 1233(a) gets the taxpayer over this obstacle by providing that gain or loss on the transaction shall be attributed to the sale or exchange of a capital asset if the transferred property constitutes a capital asset in the taxpayer's hands, and IRC sections 1233(b) and 1233(d) promulgate three special rules to deal with tax-avoidance transactions employing short sales.

Lapse of Options to Buy or Sell Property

If the holder of an option to purchase property fails to exercise it, its expiration does not constitute a sale or exchange in common parlance, but IRC section 1234(a) provides that it shall nevertheless be so treated if the property subject to the option is, or would be, a capital asset in the taxpayer's hands. Similarly, gain realized by the grantor of a lapsed option is treated as gain from the sale or exchange of a capital asset despite the absence of an actual sale or exchange.

125. See notes 1-5 & accompanying text *supra*.
126. I.R.C. § 1233(a).
Transfer of All Substantial Rights to a Patent

Section 1235 provides that a transfer of all substantial rights to a patent (or an undivided interest therein) by an inventor or other "holder" shall be treated as a sale or exchange of a capital asset, regardless of whether the payments are payable periodically or are contingent on the productivity, use, or disposition of the transferred property. In addition to protecting the taxpayer against an IRS claim that a transfer contingent on the productivity, use, or disposition of the patent is not a "sale or exchange," section 1235 serves a more dramatic function—permitting royalties to be reported as capital gain even if the inventor is a professional who holds patents for sale to customers in the ordinary course of business.

Special rules are also provided for the following transactions: the cutting of timber and the disposition of coal or domestic iron ore; corporate distributions, redemptions, partial and complete liquidations, and other transactions; partnership distributions; lump-sum distributions by qualified employee retirement plans; and transfers of appreciated property to foreign corporations, trusts, and partnerships.

Conclusion

Most routine dispositions of investment assets easily satisfy the statutory "sale or exchange" requirement of section 1222 and thus are eligible for capital gain or loss treatment in the computation of taxes. In important peripheral situations, however, the transaction involved does not constitute a conventional sale or exchange. The result has been that in interpreting the sale or exchange requirement, courts have classified certain transactions as generating ordinary income or ordinary loss, although a sale of the same property prior to the event would have produced capital gain or loss. In some of these situations, Congress has intervened to

127. Id. § 1235.
128. Id. § 631.
129. See, e.g., id. § 301(c)(3) (distributions in excess of basis); id. § 302(a) (redemptions of stock); id. § 303 (same); id. § 331(a) (partial and complete liquidations); id. § 357(c)(1) (certain liabilities in excess of basis).
130. Id. § 731.
131. Id. §§ 402(a)(2), 403(a)(2).
132. See id. §§ 1057, 1491.
provide by statute that an event should or should not be treated as a "sale or exchange." Because attention is usually focused on the more fundamental statutory requirement that the property must qualify as a "capital asset," the accompanying requirement of a sale or exchange, or of a "statutory sale," is often overlooked, resulting in a trap for the unwary.