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CAPITAL GAINS AND LOSSES OF INDIVIDUALS AND RELATED MATTERS UNDER THE TAX REFORM ACT OF 1969*

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I know that you believe you
understand what you think I said,
but I am not sure you realize
that what you heard is not
what I meant.

Anonymous

The federal taxing statute, known officially as the *Internal Revenue Code*, imposes perhaps the most complex income tax structure conceivable. While the words of the Code seem virtually unintelligible, one necessarily feels the grave import of understanding, if even for a fleeting moment, the message of Congress. The search for understanding is underscored, yet facilitated, by tons of paper and printer's ink appearing as legislative committee reports explaining new provisions; administrative pronouncements, issued as regulations and rulings by the Treasury, interpreting the statute; and prolific and often voluminous court decisions. To keep up is like running in place, and yet, for the general practioner this is impossible. He must leave it to others to pore over the mass of material in order to interpret the law and determine its meaning. While this is not a copping-out attitude and is understandable, it may be short-sighted. For one reason, the most effective dollar "earned" is a dollar saved in tax. This is so because the tax-saved dollar is not taxable and is therefore a 100 percent dollar.

* Portions of this article are based on a speech delivered by Professor Andrews at the Twelfth Annual Arizona State University Tax Institute in Phoenix, Arizona on December 11, 1970. Other topics are based upon sections of volume II, *Cases and Other Materials on the Federal Income Taxation of Individuals* (1970) by J. Freeland and R. Stephens, which is currently being used as teaching material for the federal income tax courses at the University of Arizona College of Law, the University of Florida College of Law and other law schools.

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One frequently hears a lawyer remark that if he has a tax problem he will turn it over to a tax specialist. This is sensible, and we who qualify for that questionable caption are happy to roll up our sleeves, put on a green eye shade like Tiny Tim, and go to work. If a lawyer is to refer a tax matter to a specialist, however, he first must be able to recognize the tax problem itself. This may be like saying the most difficult part of a recipe for hummingbird pie is catching the hummingbird.†

One of the purposes of this basic article is to refresh and acquaint the non-tax lawyer with important recent developments. We realize that he simply cannot take the time to go to the source materials, and therefore we feel that the material offered here may serve as a middle ground of enlightenment. As the title suggests, this article concerns the Tax Reform Act of 1969, and we limit our discussion to capital gain and loss provisions and related matters as they concern individuals. Our objective then is to illuminate these provisions, since we consider them to be some of the more important and difficult parts of the Tax Reform Act. We leave it to others to lay bare other segments of the statute.

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† See Ferguson, *Income and Deductions in Respect of Decedents and Related Problems*, 25 TAX L. REV. 1, 6 (1969).

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THE ALTERNATIVE TAX: SECTION 1201(b)[1]

BACKGROUND

From an early date, the federal taxing statute has accorded preferential treatment to the excess of net long-term capital gain over net short-term capital loss[2] by taxing such gains at rates lower than those applicable to ordinary income. In the case of individual taxpayers, the friendly rate is effected by one of two familiar methods: the section 1202 deduction method or the alternative (tax rate) method. While the Tax Reform Act of 1969[3] did not disturb the familiar methods of taxing capital gains, nor the preferential treatment, in some instances it makes the tax rate less friendly.

Section 1202 has not been changed by the T.R.A. Section 1202, applicable only to non-corporate taxpayers, requires the taxpayer to deduct from gross income[4] one-half the excess of net long-term capital gain over net short-term capital loss.[5] Using the rates in section 1, the tax on taxable income is then computed.[6] The effect is simply to cut the section 1 rate in half with respect to the entire excess of net long-term capital gain over net short-term capital loss. Obviously, the full rate of tax applied to half the gain is the same amount of tax as if the statute applied half the section 1 rate to the entire amount of such gain. Thus, the 1202 deduction is simply a means whereby Congress has cut the rate of tax with respect to the excess net long-term capital gain to half the rate applicable to the same amount of ordinary taxable income.

Since the maximum section 1 tax rate is 70 percent, it is apparent that under the section 1202 deduction method, the effective rate of tax as to

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[1] All citations of section numbers are to the *Internal Revenue Code of 1954* as amended by the Tax Reform Act unless otherwise indicated. Hereinafter, the *Internal Revenue Code of 1954* will be referred to as I.R.C.

[2] 3B J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 22.01, at 6; § 22.02, at 9 (1966).

[3] Pub. L. 91-172 (Dec. 30, 1969), 83 Stat. 487. Hereinafter, the Tax Reform Act of 1969 will be referred to as the T.R.A.

As it was originally passed by the House, the T.R.A. would have changed the holding period for long-term treatment to more than 12 months. *See* H.R. REP. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 153 (1969) [hereinafter cited as H.R. REP. No. 91-413]. The Senate did not agree, however. *See* S. REP. No. 91-552, 91st Cong., 1st Sess. 200 (1969) [hereinafter cited as S. REP. No. 91-552]. Thus, as finally enacted the T.R.A. did not change the six-month holding period for long-term treatment. H.R. REP. No. 91-782, 91st Cong., 1st Sess. 320 (1969) [hereinafter cited as CONF. COMM. REP.].

Further, it should be noted that, in the case of property acquired from a decedent within the meaning of section 1014(b), subsection 1223(11) enacted after the T.R.A. and effective with respect to decedents dying after December 31, 1970, neutralizes the more-than-six-month holding period requisite for long-term treatment. Pub. L. 91-614, §§ 101(g) & (j) (Dec. 31, 1970), 84 Stat. 1836.

[4] I.R.C. § 62(3).

[5] For the definition of net short-term capital loss and net long-term capital gain, respectively, see *id.* § 1222(6), (7).

[6] *Id.* § 63. Without regard to other deductions, taxable income would then include the remaining half of the excess of net long-term capital gain over net short-term capital loss. *See* 3B MERTENS, *supra* note 2, § 22.07, at 31-32.

such gain could be a maximum of 35 percent—half the marginal 70 percent rate. Prior to the T.R.A., the alternative method provided in section 1201 (b) a flat 25 percent rate of tax on the entire excess of net long-term capital gain over net short-term capital loss. The statutory scheme here required that the taxpayer first compute a partial tax on ordinary taxable income, using the rates in section 1, from which the entire excess of net long-term capital gain over net short-term capital loss has been excluded. Thereafter, the taxpayer computed a tax at a flat 25 percent rate on the entire excess net long-term capital gain. The total of the partial tax and the tax on the entire excess net long-term capital gain constituted the tax liability for the year.[7]

Again, prior to the T.R.A., taxpayers with effective marginal rates above 50 percent could receive the blessing of a 25 percent ceiling rate on excess net long-term capital gains by using the alternative method.[8] The T.R.A. reduced, but did not eliminate, the blessing by altering the alternative method's fixed 25 percent rate in some instances. For most taxpayers the 25 percent ceiling rate is retained, and as to them the T.R.A. changed nothing. For other taxpayers having huge amounts of excess net long-term capital gain over net short-term capital loss, the ultimate rate of tax graduates to a ceiling rate of 35 percent.

THE ALTERNATIVE METHOD UNDER THE T.R.A.: SECTION 1201(b)

The T.R.A. retained the flat 25 percent tax rate, but limited its application to gain which does not exceed a specified amount or to gains derived in a specified manner.[9] We now explore the detailed mechanics of section 1201(b) as modified by T.R.A.

The first clause of section 1201(b), introducing a new term, provides: "If . . . a taxpayer other than a corporation has a *net section 1201 gain*

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[7] *See* 3B MERTENS, *supra* note 2, § 22.07, at 33.

[8] When the individual's marginal tax rate applicable to such excess was less than 50 percent, the section 1202 deduction method would produce greater tax savings than the alternative tax-rate method because the effective rate on such excess would be less than 25 percent.

[9] Congress modified the alternative method for several related reasons. The relatively low 25 percent rate was considered to be too much of a good thing for high-bracket taxpayers and at variance with the philosophy of the progressive rate structure which taxes individuals according to their ability to pay. In addition, the low flat rate was thought to go beyond the purpose of the section 1202 deduction of not taxing income accrued over several years as though it were earned in a single taxable year. H.R. REP. NO. 91-143, pt. 1, at 144; S. REP. NO. 91-552, at 191. *See* Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

The effect of the 25 percent flat rate of tax can be seen in the following illustrations. If a taxpayer were in the 60 percent bracket the alternative method would give him an advantage that would be the equivalent of about a 58 pecent section 1202 deduction or an inclusion in income of only about 42 percent of his excess net long-term capital gain over net short-term capital loss. Thus, on $100,000 of excess net long-term capital gain, the alternative method would produce a tax of $25,000. To yield the same result the section 1202 deduction would have to be about 58 percent, computed as follows:

. . . ."[10] The italicized phrase is simply a new name for a familiar concept, the excess of the net long-term capital gain over the net short-term capital loss.[11] To the extent that such excess gain is $50,000 or less ($25,000 in the case of a married taxpayer filing a separate return) the 25 percent ceiling rate is retained.[12] Even if the taxpayer has net long-term capital gain in excess of net short-term capital loss above the $50,000 ceiling, the 25 percent rate applies with respect to such excess gain up to the $50,000 ceiling. Gains in excess of $50,000, disregarding transitional rules,[13] are subjected to rates up to a maximum of 35 percent. In the case of a taxpayer having ordinary income and net section 1201 gain in excess of $50,000,[14] a three-step computation is generally required. Disregarding the transitional rules of section 1201(d)(1) and (2),[15] the three steps may be summarized:

$100,000	(excess net long-term capital gain)
—58,000	(58 percent deduction)
42,000	(42 percent inclusion of the excess net long-term capital gain)
x .60	(60 percent assumed marginal tax rate)
$25,200	(Tax)

Utilizing the same figure of $100,000 of excess net long-term capital gain, this advantage of the maximum 25 percent rate would be even greater in the case of a higher-bracket taxpayer. If a taxpayer were in the 70 percent bracket, it would be the equivalent of about a 64 percent section 1202 deduction or an inclusion of only about 36 percent of such excess in income:

$100,000	(excess net long-term capital gain)
—64,000	(64 percent deduction)
36,000	(36 percent inclusion of the excess net long-term capital gain)
x .70	(70 percent assumed marginal tax rate)
$25,200	(Tax)

Hence, as the individual's marginal tax rate increased, the percentage of his excess net long-term capital gain that was taxed decreased. Likewise, there was a greater decrease in the overall effective rate on all the individual's income than that effected by the section 1202 deduction method as the amount of the excess net long-term capital gain increased.

As a policy decision in the T.R.A., Congress rejected the regressive nature of the alternative method's flat 25 percent tax rate except for amounts of gain up to $50,000.

[10] I.R.C. § 1201(b) (emphasis added).

[11] *Id.* § 1222(11).

[12] *Id.* §§ 1201(b)(2), 1201(d)(3).

[13] *Id.* § 1201(d)(1), (2).

[14] *See id.* § 1201(d)(3). To the extent that there is gain qualifying under the transitional rules of sections 1201(d)(1) and (2), the applicable ceiling limit of section 1201(d)(3) is reduced. Although the gain qualifying as subsection (d) gain under sections 1201(d)(1) and (2) can exceed $50,000, the effect of this will be that no gain can then so qualify under section 1201(d)(3). *See* notes 15 & 22 *infra*.

[15] The term "subsection (d) gain," a new concept introduced by the T.R.A., is defined in section 1201(d) as the sum of the long-term capital gains for the taxable year arising from: (a) sales and other dispositions pursuant to binding contracts entered into before October 10, 1969 with respect to amounts received before January 1, 1975, including gain reported under the installment method of section 453; (b) certain corporate liquidations; and (c) in the case of individuals, any other source but not to exceed $50,000 ($25,000 in the case of a married taxpayer filing separately).

Step 1. Compute a tax on ordinary taxable income, without regard to any net section 1201 gain.[16]

Step 2. Compute a tax of 25 percent on all net section 1201 gain. This is identical to prior law, but the friendly 25 percent rate is limited to $50,000 of net section 1201 gain.[17]

Step 3. Compute a tax on net section 1201 gain in excess of $50,000 at the section 1 rate but not in excess of a ceiling rate of 29 1/2 percent for 1970; 32 1/2 percent for 1971 and 35 percent for 1972 and all subsequent years.[18]

Steps 1 and 2 taken together are identical to the alternative method prior to T.R.A. The $50,000 ceiling limit and step 3 are new. The tax liability is the sum of steps 1 and 2, and step 3 if required.

Step 1 requires that all net section 1201 gains be removed from ordinary taxable income. The statute assumes that the taxpayer has already used the 50 percent deduction required by section 1202[19] and section 1201 (b)(1) takes out the remainder of such gains. This leaves only ordinary taxable income on which the tax is computed using section 1 rates. This is only a partial tax because, as yet, no tax has been computed on the net section 1201 gain. The object of the second step and the third step, when required, is to compute the tax on the entire excess of net long-term capital gain over net short-term capital loss, *i.e.*, net section 1201 gain.[20]

Step 2, set out in section 1201(b)(2), prescribes a flat 25 percent rate of tax for all "subsection (d) gain." The term is defined in section 1201(d) by reference to the source of the long-term capital gain and the amount of such gain. The source provisions are grandfather savings provisions relating to (1) installment sales effected prior to T.R.A. and to (2) gains realized in certain corporate liquidations. These provisions are discussed in a footnote.[21] Regardless of source, however, net section 1201 gains which do not exceed $50,000 ($25,000 in the case of a married taxpayer filing a separate return) qualify for the friendly 25 percent tax rate,[22] but only to the extent that such gain is not pre-empted by the source provisions of section 1201(d)(1) and (2).[23] Thus, a taxpayer having gains

(a) and (b) above are the transitional rules of sections 1201(d)(1) and (2), respectively, while (c) above is contained in section 1201(d)(3).

16 *Id.* § 1201(b)(1).

17 *Id.* §§ 1201(b)(2), 1201(d).

18 *Id.* §§ 1201(b)(3), 1201(c)(1), 1201(c)(2)(A), (B).

19 *See id.* §§ 62(3), 63.

20 *Id.* §§ 1222(11), 1201(b)(2), (3).

21 *See* note 15 *supra.*

22 I.R.C. §§ 1201(b)(2), 1201(d)(3). Within this $50,000 ceiling limitation the amount of the "subsection (d) gain" will always equal or exceed the "net section 1201 gain" because the former is the sum of all the long-term capital gains while the latter is the excess of the net long-term capital gain over the net short-term capital loss. *Compare id.* § 1201(d), *with id.* § 1222(6), (7), (11).

23 *Id.* § 1201(d)(3). It should be noted that while gains meeting the transitional rules of section 1201(d)(1) and (2) (see note 15 *supra*) are not limited as to amount, such gains operate to reduce dollar for dollar the gains which, regardless of source, qualify for the $50,000 quantitative limitation. Thus, if gains qualifying as to source equal or exceed $50,000, then the full amount of the section 1201(d)(1)

all of which qualify as subsection (d) gain is taxed at the flat 25 percent rate. He is unaffected by T.R.A. because steps 1 and 2 are the same as prior law.

For taxpayers who have net section 1201 gain in excess of subsection (d) gain, the third step is required.[24] For most individuals this means that net section 1201 gain exceeds $50,000 ($25,000 in the case of a married taxpayer filing a separate return). The flat 25 percent tax rate always applies up to this ceiling limitation.[25] Above that, the third step supplies a recipe for computing the tax on net section 1201 gain.[26]

The obvious congressional purpose implicit in the third step is to phase out the alternative tax on net section 1201 gain that exceeds $50,000. As to such gain in excess of $50,000 one can discern the same approach as that used in the section 1202 deduction method. In effect, the statutory scheme is to subject one-half of such gain to the full blast of the section 1 rates applicable to ordinary taxable income. The effect is to apply half the section 1 rate, which might be as high as 35 percent, to the entire amount of net section 1201 gain in excess of $50,000.[27] The recipe here is constructed to assure that such gain in the third step will be taxed at one-half the taxpayer's highest effective marginal rate.[28] The ceiling rate, eventually 35 percent, is phased in through three transitional annual steps: for 1970, a flat ceiling rate of 29 1/2 percent; for 1971 32 1/2 percent.[29] Thereafter the statute sets no specific ceiling. Consequently for 1972 and subsequent years, the ceiling becomes 35 percent by virtue of the interaction of sections 1201(c)(1) and 1.

The step 3 tax is calculated as follows:

(a) Compute the section 1 tax on the individual's taxable income which includes one-half the entire net section 1201 gain.

(b) Compute a tax using section 1 rates on the sum of:
   (1) the amount subject to tax under step 1 (under section 1201(b)(1) this is the amount of the individual's ordinary taxable income which does not include any of the net section 1201 gain), plus
   (2) 50 percent of the subsection (d) gain (this amount will always be $25,000).

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and (2) gain is taxed at 25 percent, *but* no other gains can qualify since section 1201(d)(3) gives way to sections 1201(d)(1) and (2). *See* note 14 *supra.*

[24] I.R.C. § 1201(b)(3).

[25] *Id.* § 1201(b)(2).

[26] *Id.* § 1201(c).

[27] *Id.* §§ 1201(c)(1), 1.

[28] *See* H.R. REP. No. 91-413, pt. 1, at 146; S. REP. No. 91-552 at 192-93. This is identical to the tax computed under the section 1202 deduction method under which the maximum rate that the excess of net long-term capital gain over net short-term capital loss could be taxed would be 35 percent (applying the highest marginal tax rate of 70 percent under section 1 with its assumed section 1202 deduction).

[29] I.R.C. § 1201(c)(2).

(c) Subtract the tax computed under (b) above[30] from the tax computed under (a) above. The result constitutes the step 3 tax for 1972 and subsequent years.

The amount computed under step 3 is a tax on the excess of net section 1201 gain over $50,000 using the section 1202 deduction method as to such excess. This eliminates the old alternative method with its 25 percent ceiling rate and, instead, subjects the excess to the highest individual tax rate with its assumed section 1202 deduction.

Examples of the Alternative Method Under the T.R.A.[31]

EXAMPLE 1 (Where only steps 1 and 2 apply). In 1971, *T* has $100,000 of ordinary income plus $50,000 of net section 1201 gain. *T*'s tax liability under the alternative method is $65,590, computed as follows:

Step 1. Taxable Income (includes one-half of the net section 1201 gain:[32]	$125,000	
Less (see § 1201(b)(1)):	—25,000	
Ordinary Taxable Income:	100,000	
Section 1(c) Tax:		$53,090
Plus		
Step 2. Tax of 25 percent of the net section 1201 gain of $50,000:[33]		+12,500
T's tax liability:		$65,590[34]

Because the net section 1201 gain is exactly equal to the subsection (d) gain, step 3 is inapplicable here.[35] This will be the usual situation in view of the fact that more than $50,000 of net section 1201 gain is required before the step 3 computation becomes necessary.[36] Accordingly, most taxpayers will not be affected by the revisions to the alternative method under the T.R.A.

EXAMPLE 2 (Where steps 1, 2 and 3 apply). In 1972, *T* has $100,000 of ordinary income plus $100,000 of net section 1201 gain. *T's* tax liability under the revised alternative method is $83,090 computed as follows:

[30] This tax computed under (b) of step 3 is identical to the tax computed under the section 1202 deduction method within the $50,000 ceiling limitation.

[31] All of these examples assume that *T* is unmarried and neither a head of household nor a surviving spouse. All deductions are disregarded except for the section 1202 deduction. Accordingly, the regular section 1 tax will be determined under the table in section 1(c), as amended by the T.R.A., effective for taxable years beginning after 1970. Pub. L. 91-172, § 803(f) (Dec. 30, 1969), 83 Stat. 487. *See also* text accompanying note 15 *supra.*

[32] *See* I.R.C. §§ 62(c), 63 & 1202.

[33] *See* note 22 *supra.*

[34] The tax determined under the section 1202 deduction method would be $70,590.

[35] I.R.C. § 1201(b)(3). *See id.* § 1201(d)(3).

[36] *See* note 24 and accompanying text *supra.*

Step 1. Taxable Income:	$150,000		
Less (§ 1201(b)(1)):	—50,000		
Ordinary Taxable Income:	100,000		
Section 1(c) tax:			$53,090
	Plus		
Step 2. Tax of 25 percent of the lesser of net section 1201 gain ($100,000) or the subsection (d) gain ($50,000):			12,500
	Plus		
Step 3. (a) Taxable Income	$150,000		
Section 1(c) tax:		$88,090	
(b) Ordinary Taxable Income (see Step 1):	100,000		
Plus 50 percent of the subsection (d) gain of $50,000	+25,000		
	125,000		
Section 1(c) tax:		—70,590	
(c) Excess of (a) above over (b) above (tax on the amount of excess net section 1201 gain over $50,000)			+17,500[37]
T's tax liability			$83,090

This tax of $83,090 should be compared with the tax computed under the section 1202 deduction method which is $88,090. The difference of $5,000 represents the maximum tax savings that can be obtained by any taxpayer through the use of the alternative method (instead of the section 1202 deduction method) after it becomes fully effective in 1972, and it assumes an applicable marginal tax rate of 70 percent.[38] The actual tax

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[37] As already noted, the effect of step 3 is to subject the excess of net section 1201 gain over $50,000 to the highest marginal rate applicable to the individual under section 1 with its assumed section 1202 deduction. See text accompanying notes 8-10 *supra*. This can be demonstrated by comparing the step 3 tax computed in Example 2 with the following. *T* is in the 70 percent bracket so that the maximum rate applicable to the entire excess net section 1201 gain over $50,000 should be 35 percent (excess net section 1201 gain over $50,000 less section 1202 deduction of one-half of such excess x 70 percent):

Excess of the net section 1201 gain ($100,000) over $50,000:	$50,000
Maximum rate (35 percent):	x .35
Step 3 tax:	$17,500

[38] When the applicable marginal tax rate is less than 70 percent, the savings will, of course, be less than $5,000 since the section 1202 deduction method will produce a maximum rate of less than 35 percent, thus reducing the difference between it and the 25 percent rate of the alternative method within the $50,000 limitation.

saving occurs within the $50,000 ceiling limitation since the 25 percent rate still applies up to that point. Under the section 1202 deduction method the entire net section 1201 gain may be taxed at a maximum rate of 35 percent (if we assume the highest marginal rate of 70 percent x 50 percent in view of the section 1202 deduction). The difference between these two percentages (35 percent - 25 percent) is 10 percent which, when applied to the $50,000 limitation, produces the maximum tax savings of $5,000 (10 percent x $50,000).[39]

EXAMPLE 3 (Where Steps 1, 2 and 3 and the transitional rule apply). Assume the same facts as in Example 2 except that the year is 1971. *T's* tax liability under the alternative method would be $81,840, computed as follows:

Step 1. (Unchanged from Example 2 above):	$53,090
Plus	
Step 2. (Unchanged from Example 2 above):	12,500
Plus	
Step 3. (Before application of the transitional rule,[40] the step 3 tax is the same as in Example 2 above—$17,500). Since the year is 1971, the step 3 tax cannot exceed 32-1/2 percent of the excess of the net section 1201 gain ($100,000) over the subsection (d) gain ($50,000), or $50,000. Thus, 32-1/2 percent x $50,000:	+16,250
T's tax liability:	$81,840

The alternative method[41] as revised by the T.R.A. amending section 1201 (b) applies to tax years beginning after 1969.[42]

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[39] The section 1202 deduction method may effect greater tax savings than the revised alternative method in other situatons. Thus, when the individual's marginal rate is less than 50 percent, the section 1202 deduction method is always more favorable.

[40] I.R.C. § 1201(c)(2)(B).

[41] Two related matters should be noted. First, the T.R.A. amended section 1302 to permit one-half of the excess of net long-term capital gain over net short-term capital loss for the computation year to qualify for the benefits of income averaging, generally effective for computation years beginning after 1969. Pub. L. 91-172, §§ 311(b) & (e) (Dec. 30, 1969), 83 Stat. 487. If the taxpayer elects to average his income, then the revised alternative method of section 1201(b) is not available to him. I.R.C. § 1304(b)(5). In view of the fact that capital gains are now averageable, income averaging may operate to mitigate the extra tax burden on such gains caused by the revisions to the alternative method.

Second, the new minimum tax on preferences imposes an additional 10 percent tax on various items, one of which is one-half of the excess of the net long-term capital gain over net short-term capital loss (this is the amount of the section 1202 deduction). *Id.* §§ 56(a), 57(a)(9)(A). Although this new tax will generally affect only higher-bracket taxpayers due to a minimum $30,000 exemption, where it does apply it must be added to the tax computed under the section 1202 deduction method or under either the alternative method or the income averaging provisions in order to determine the total tax cost of long-term capital gains. *See id.* § 56(a)(1), (2).

[42] Pub. L. 91-172 ,§ 511(d) (Dec. 30, 1969), 83 Stat. 487.

THE CAPITAL LOSS DEDUCTION AND CARRYOVER OF INDIVIDUAL TAXPAYERS

THE CAPITAL LOSS DEDUCTION: SECTION 1211(b)

Background and Prior Law

The discussion whether a loss is a capital loss[43] or an ordinary loss is meaningless unless the loss is taken into account in computing taxable income.[44] The losses discussed here are only those that are deductible, *i.e.* taken into account in computing taxable income. Thus for example, a loss realized on the sale of a personal residence is not deductible,[45] and the character of the loss as capital loss is superfluous.[46] If a loss is an authorized deduction, the material discussed here determines how the deduction is treated. We assume that the loss is deductible and that the flavor of the loss is a capital loss.

If a loss arising from the sale or exchange of a capital asset is deductible, an individual may deduct such loss from gross income.[47] This is only the beginning of the story, however, because of statutory limits on the extent to which capital losses may be used as deductions from income other than long-term or short-term capital gains.[48] Noncorporate taxpayers may deduct capital losses in excess of capital gains from ordinary income only to a limited extent. The deduction is restricted to an amount not to exceed the lesser of $1000 or taxable income, specially computed.[49] In other words, an individual having taxable income in excess of $1,000 is allowed to offset his capital losses against his capital gains, and, if the losses exceeded the gains, he could deduct up to $1,000 of the excess from his ordinary gross income.

Prior to enactment of the T.R.A., the character of the loss as either long-term or short-term made little difference. In addition, under prior law, if a husband and wife filed separately, each was permitted to deduct his or her own excess losses up to the $1,000 limit, thereby obtaining for the

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[43] For the definitions of short-term and long-term capital loss, respectively, see I.R.C. § 1222(2), (4).

[44] For limitations on the types of losses that are deductible by individuals, see, *e.g.*, *id.* § 165(c). For an application of similar limitations under section 23(e) of the Internal Revenue Code of 1939, see Eli Winkler, 2 T.C. 735 (1943), *aff'd per curiam*, 143 F.2d 483 (2d Cir. 1944).

[45] *E.g.*, Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962); Treas. Reg. § 1.165-9(a) (1960).

[46] Specific non-recognition provisions can prevent losses from being taken into account in computing taxable income. *See, e.g.*, I.R.C. § 1031 providing for non-recognition of gains or losses on certain exchanges. *See also id.* § 351(a). Other losses incurred on the sale or exchange of property between related taxpayers are disallowed as deductions. *Id.* § 267(a)(1), (b).

[47] *Id.* § 62(4).

[48] For the definitions of short-term and long-term capital gain, respectively, see *id.* § 1222(1), (3).

[49] *See* 3B MERTENS, *supra* note 2, § 22.07, at 37-38.

family unit a deduction of up to $2,000 against ordinary income not otherwise available on a joint return.[50]

In view of the fact that only one-half of the excess of net long-term capital gain over net short-term capital loss is subject to tax,[51] Congress felt that it was inconsistent to permit the excess of net long-term capital loss[52] over net short-term capital gain[53] to be deductible dollar-for-dollar against ordinary income within this $1,000 limitation.[54] And, in addition to the congressional dislike of married taxpayers obtaining, in effect, a combined $2,000 ceiling for their excess capital losses by filing separately, the treatment of married persons as two separate taxpayers for this purpose operated to discriminate in favor of those living in community property states and against those living in non-community property states.[55] Accordingly, the T.R.A. addressed itself to these deficiencies.

The Capital Loss Deduction Under the T.R.A.

Under the T.R.A. the deductible capital losses of individuals continue to be allowed in full to the extent of the capital gains.[56] But now if the capital losses exceed the capital gains, then such excess losses are deductible from ordinary gross income only to the extent of the smallest of

(a) the taxable income[57] specially computed as under prior law,[58] or
(b) $1,000[59] (or $500 in the case of a married taxpayer filing separately[60]) or
(c) the sum of[61] (1) the excess of the net short-term capital loss over the net long-term capital gain,[62] and (2) *one-*

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[50] H.R. REP. No. 91-413, pt. 1, at 146-47; S. REP. No. 91-552 at 195-96.
[51] I.R.C. § 1202.
[52] For the definition of net long-term capital loss, see *id.* § 1222(8).
[53] For the definition of net short-term capital gain, see *id.* § 1222(5).
[54] H.R. REP. No. 91-413, pt. 1, at 147; S. REP. No. 91-552 at 196.
[55] The Senate Finance Committee report explained this discrimination:

> Spouses living in non-community property States must have separate losses in order to claim them on separate returns and be eligible for the double deduction. Thus, they must either sell assets held in joint tenancy or each must sell his own assets. Moreover, unless husbands and wives in non-community property States have approximately equal incomes, they may lose more from filing separate returns than they gain from the additional $1,000 capital loss deduction. This is not true, however, in community property States where the community income is divided between the spouses. Moreover, in community property states, husbands and wives filing separate returns are automatically eligible for the benefit of the double deduction since gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law. S. REP. No. 91-552 at 196.

[56] I.R.C. § 1211(b)(1).
[57] *Id.* § 1211(b)(1)(A).
[58] For this purpose taxable income is computed without regard to capital gains and losses and the section 151 exemptions or deductions in lieu thereof. *Id.* § 1211(b)(3).
[59] *Id.* § 1211(b)(1)(B).
[60] *Id.* § 1211(b)(2).
[61] *Id.* § 1211(b)(1)(C).
[62] *Id.* § 1211(b)(1)(C)(i).

> *half* of the excess of the net long-term capital loss over the net short-term capital gain.[63]

Thus, long-term capital losses continue to offset capital gains in full. Only 50 percent of the excess net long-term capital loss can be deducted from ordinary income within the $1000 limitation, however. Short-term capital losses, on the other hand, are unaffected as they can offset capital gains in full, and any excess net short-term capital loss remains fully deductible from ordinary income subject to the $1000 limit. Furthermore, the double ceiling for married taxpayers filing separately has been eliminated.[64]

Application of Section 1211(b)

The capital loss deduction of section 1211(b) as amended by the T.R.A. is illustrated by the following example.[65]

EXAMPLE 1. In 1970 *T*, an unmarried individual, entered into transactions with these results:

	Long-Term	*Short-Term*
Capital Gains:	$1,000	$ 600
Capital Losses:	($2,000)	($1,000)
	($1,000)	($ 400)

The total amount[66] of the net long-term and net short-term capital

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[63] *Id.* § 1211(b)(1)(C)(ii).

[64] Section 1212(b)(3), added by the T.R.A., provides for a transitional rule as to capital loss carryovers:

> In the case of any amount which, under . . . [section 1212(b)(1)] and section 1211(b) (as in effect for taxable years beginning before January 1, 1970), is treated as a capital loss in the first taxable year beginning after December 31, 1969, . . . [section 1212(b)(1)] and section 1211(b) (as in effect for taxable years beignning before January 1, 1970) shall apply (and . . . [section 1212(b)(1)] and section 1211(b) as in effect for taxable years beginning after December 31, 1969, shall not apply) to the extent such amount exceeds the total of any net capital gains (determined without regard to this subsection) of taxable years beginning after December 31, 1969.

Presumably, capital losses carried over from 1969 and prior years to 1970 and subsequent years would continue to be deductible against ordinary income (assuming taxable income exceeds $1,000 and that there are no capital gains in 1970 or subsequent years) to the extent of $1,000 by each married taxpayer filing separately under this transitional rule. Thus, capital loss carryovers from pre-1970 taxable years to post-1969 taxable years would not be subject to the $500 limitation of section 1211(b)(2) applicable to married taxpayers filing separate returns. See note 105 *infra.*

In the following example assume that for all years mentioned *T* is married filing separately and has taxable income in excess of $1000. In 1969, *T* incurs a $2,000 capital loss, his only capital transaction for such year. *T* would deduct $1,000 of that loss from his ordinary income in 1969 and carry over to 1970 the remaining $1,000. If in 1970 *T* has no other capital gains and losses, *T* can apparently deduct the remaining $1,000 of the capital loss from ordinary income, unaffected by the $500 limitation of section 1212(b)(2). *See* H.R. REP. No. 91-413, pt. 2, at 108, 110 Example (5); S. REP. No. 91-552 at 197.

[65] In this example it is assumed that *T's* taxable income exceeds $1,000, computed without regard to capital gains and losses and without regard to section 151 deductions.

[66] There are capital losses totalling $3,000 of which $1,600 is offset against the

losses combined which is deductible by *T* from ordinary income in 1970 is $900, computed as follows:

Section 1211(b)(1)(C):[67] *The sum of*

(i) the excess of net short-term capital loss ($400) over net long-term capital gain (0):	$400
and	
(ii) one-half (50%) of the excess of net long-term capital loss ($1,000) over net short-term capital gain (0):	+500
Total amount deductible from ordinary income:	$900[68]

While it has always been obvious that in certain circumstances it is better to have a short-term rather than a long-term capital loss,[69] Example 1 shows that the T.R.A. makes short-term losses advantageous for another reason—it takes $2 of long-term capital loss to accomplish what $1 of short-term capital loss can do within the $1,000 limitation on deductions from ordinary income.[70]

Section 1211(b) as amended by the T.R.A. is generally applicable to losses realized in taxable years beginning after 1969.[71]

The Capital Loss Carryover: Section 1212(b)[72]

Prior Law

Generally, prior to the T.R.A., capital losses, to the extent they exceeded capital gains plus $1,000,[73] could be carried over in full to succeeding years, retaining their long-term[74] and short-term[75] nature, until ex-

capital gains, leaving excess capital losses of $1,400 consisting of $1,000 net long-term capital loss and $400 net short-term capital loss.

[67] The taxable income and $1,000 limitations of sections 1211(b)(1)(A) and 1211(b)(1)(B), respectively, are not applicable because they are each in excess of the limitation of section 1211(b)(1)(C). *See* note 65 *supra*.

[68] *Accord*, H.R. Rep. No. 91-413, pt. 2, at 109 Example (3). Under prior law *T* would have obtained a $1,000 deduction from ordinary income and carried over a $400 long-term capital loss to the succeeding year. *See* 3 J. Rabkin & M. Johnson, Federal Income, Gift and Estate Taxation § 34.11(3), at 3489 (1969).

[69] Thus, for example, if in a given taxable year a taxpayer already has both a $500 long-term capital gain and a $500 short-term capital gain, and he also has a potential $500 capital loss which he could make either long-term or short-term, the taxpayer will derive more of a tax benefit from a short-term loss. This is due to the section 1202 deduction. If it were a long-term loss, it would offset the $500 long-term gain, leaving the $500 short-term gain fully taxable as ordinary income. *See* I.R.C. § 1222(7), (8). But if the loss were a short-term loss, it would offset the $500 short-term gain, leaving the $500 net long-term gain subject to the section 1202 deduction so that only $250 of it would be taxable. *See id.* § 1222(5), (6).

[70] *See also* Example 2 at text accompanying notes 86-92 *infra*.

[71] Pub. L. 91-172, § 513(d) (Dec. 30, 1969), 83 Stat. 487.

[72] For purposes of this discussion of the capital loss carryover, it is assumed that the individual's taxable income (computed without regard to capital gains and losses and the section 151 exemptions or deductions) is greater than $1,000.

[73] This is the net capital loss. *See* I.R.C. § 1222(10).

[74] The excess of the net long-term capital loss over the net short-term capital gain for the taxable year constituted the long-term capital loss carryover to the succeeding year. *See id.* § 1212(b)(1)(B), *amended by* Revenue Act of 1964, Pub. L. 88-272, § 230(a)(2) (Feb. 26, 1964), 78 Stat. 19.

[75] The excess of the net short-term capital loss over the net long-term capital gain for the taxable year constituted the short-term capital loss carryover to the suc-

hausted. In any taxable year where there were both net long-term and net short-term capital losses, the net short-term capital loss was given priority with respect to the $1,000 deduction from ordinary income. If the net short-term capital loss did not fully consume the $1,000 limit, the net long-term capital loss was applied to the residue for purposes of determining the amount of the short-term and long-term capital loss carryovers. This was achieved by treating the amount allowed within the $1,000 limitation as a short-term capital gain.[76]

The Capital Loss Carryover under the T.R.A.

Under the T.R.A.,[77] the excess of net long-term capital loss over net short-term capital gain for the taxable year is a long-term capital loss carryover to the succeeding year.[78] Only one-half of the excess of net long-term capital loss over net short-term capital gain can be deducted from ordinary income up to the $1,000 limit, however.[79] In order to be consistent with section 1211(b)(1)(C)(ii) which reduces the benefit of long-term losses, it was necessary to prevent the other disallowed one-half of such excess net long-term capital loss from being carried over. The T.R.A. accomplishes this by treating both the allowed one-half and the disallowed one-half as a short-term capital gain[80] for purposes of computing the long-term capital loss carryover.[81] On the other hand, the short-term capital loss carryover[82]—the excess of net short-term capital loss over net long-term capital gain[83]—is generally unaffected by the T.R.A.[84]

As under prior law, when there are both net long-term and net short-term capital losses, the net short-term capital loss has priority within the $1,000 limitation on deduction from ordinary income for purposes of deter-

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ceeding year. *See* I.R.C. § 1212(b)(1)(A), *amended by* Revenue Act of 1964, Pub. L. 88-272, § 230(a)(2) (Feb. 26, 1964), 78 Stat. 19.

[76] See 3B MERTENS, *supra* note 2, § 22.09, at 44-45; 3 RABKIN & JOHNSON, *supra* note 68, § 34.11(3), at 3489.

[77] As under prior law there must be a "net capital loss" which is defined as "the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211." I.R.C. § 1222(10). *See also id.* § 1212(b)(1).

[78] *Id.* § 1212(b)(1)(B).

[79] *See* note 63 and accompanying text *supra.*

[80] It should be emphasized that these are only items of short-term capital gain and *not* the *net* short-term capital gain. *Compare* I.R.C. § 1222(1), *with id.* § 1222(5).

[81] *Id.* §§ 1212(b)(1)(B), 1212(b)(2)(B)(i), (ii); H.R. REP. No. 91-413, pt. 1, at 148. But the excess of net long-term capital loss (over net short-term capital gain), to the extent that it is allowed as a deduction from ordinary income within the $1,000 limitation, only operates to disallow an equal amount of such excess; any remaining excess will be available as a long-term capital loss carryover. *See* H.R. REP. No. 91-413, pt. 1, at 148; S. REP. No. 91-552 at 197; Example 3 at text accompanying notes 93-101 *infra.*

[82] See note 77 *supra.*

[83] I.R.C. § 1212(b)(1)(A).

[84] *See id.* § 1212(b)(2)(A). As before, the amount allowed as a deduction from ordinary income within the $1,000 limitation of section 1211(b)(1)(B) is treated as a short-term capital gain. *Id.* § 1212(b)(2)(A).

mining the amount of the respective carryovers.[85] Both the long-term and short-term capital loss carryovers to the succeeding taxable year are treated as if incurred in such year, and they may be carried over until exhausted.[86]

Examples of the Capital Loss Carryover

EXAMPLE 2. Assume the same facts as in Example 1.[87] In this situation there is no long-term capital loss carryover to 1971. Since it takes $2 of long-term loss to produce a $1 deduction from ordinary income within the $1,000 limitation, the $1,000 net long-term capital loss is wholly consumed by the $500 deduction allowed from ordinary income. The remaining disallowed portion[88] of the $1,000 long-term loss ($500) is not carried over because it is treated as a constructive short-term capital gain for purposes of calculating the carryover,[89] and is, therefore, wasted. The statutory computation is as follows:

Net long-term capital loss		($1,000)
Actual short-term capital gain:	$600	
Amounts treated as short-term capital gain.		
(1) Amount allowed against ordinary income under section 1211(b):[90]	900	
(2) Excess of (1) above ($900) over net short-term capital loss (determined without regard to section 1212 (b)) ($400):[91]	+500	
Total short-term capital gain:	$2000	
Less: short-term capital loss:	-(1000)	
Net short-term capital gain:		$1,000
Long-term capital loss carryover:[92]		— 0 —

EXAMPLE 3. In 1970, *T*, an unmarried individual, entered into transactions with these results:

	Long-Term	*Short-Term*
Capital Gains:	$ 500	$400
Capital Losses:	($2,000)	($800)
	($1,500)	($400)

There is a $1,500 net long-term capital loss and a $400 net short-term capital loss. The amount determined under section 1211(b)(1)(C) is

85 *Id.* § 1212(b)(2)(A), (B). *See id.* § 1222(5), (6).
86 *Id.* § 1212(b)(1)(A), (B). *See* note 72 and accompanying text *supra.*
87 *See* text accompanying notes 65-71 *supra.*
88 *See* I.R.C. § 1211(b)(1)(C)(ii).
89 *Id.* § 1212(b)(2)(B)(ii).
90 *Id.* § 1212(b)(2)(B)(i).
91 *Id.* § 1212(b)(2)(B)(ii). This is the disallowed one-half of the excess net long-term capital loss (over net short-term capital gain) within the $1,000 limitation on deduction from ordinary income.
92 *Id.* § 1212(b)(1)(B).

$1,150,[93] but the deductible amount from ordinary income is limited to $1,000.[94] The amount of the long-term capital loss carryover to 1971 is $300. Since the full $400 of net short-term capital loss is deducted from ordinary income within the $1,000 limit first,[95] this leaves $600 out of such $1,000 limit available for the net long-term capital loss. This $600 ordinary income deduction uses up $1200 of the net long-term capital loss,[96] leaving $300 available for the long-term capital loss carryover to 1971. The statutory computation is as follows:

Net long-term capital loss:		($1,500)
Actual short-term capital gain:	$400	
Amount treated as short-term capital gain:		
(1) Amount allowed against ordinary income under section 1211(b):[97]	1,000	
(2) Excess of (1) above (1,000) over net short-term capital loss (determined without regard to section 1212(b)) (400):[98]	+ 600	
Total short-term capital gain:	$2,000	
Less: short-term capital loss:	(800)	
Net short-term capital gain		1,200
Long-term capital loss carryover:[99]		($300)

If in 1971, *T* had no other capital gains and losses, he could deduct $150 of the $300 long-term capital loss carryover from ordinary income under section 1211(b)(1)(C).[100] But if in 1971, *T* also had capital gain of $300 or more, the $300 long-term capital loss carryover could be fully utilized in offsetting such gain, and there would be no deduction from ordinary income.[101]

Effective Date and Transitional Rule

Section 1212(b) as amended by the T.R.A. is applicable to taxable years beginning after 1969.[102] Congress provided a transitional rule to cover those cases where there is a net capital loss arising in 1969 or prior

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93 The sum of the excess of net short-term capital loss ($400) over the net long-term capital gain ($0), or $400, plus one-half of the excess of net long-term capital loss ($1,500) over the net short-term capital gain ($0), or $750, is $1,150.

94 I.R.C. § 1211(b)(1)(B).

95 *See* note 85 and accompanying text *supra.*

96 *See* text accompanying note 70 *supra.*

97 *See* note 90 *supra.*

98 *See* note 91 *supra.*

99 *See* note 92 *supra. Accord,* H.R. REP. No. 91-413, pt. 2, at 109 Example (4).

100 *See* H.R. REP. No. 91-413, pt. 2, at 108-09 Example (2). The remaining $150 of the long-term capital loss carryover would be wasted. *See* note 89 and accompanying text *supra.*

101 I.R.C. §§ 1211(b)(1), 1212(b)(1)(B).

102 Pub. L. No. 91-172, § 513(d) (Dec. 30, 1969), 83 Stat. 487.

years which is carried over to 1970 or subsequent years.[103] Generally, under this rule, the law in effect prior to the amendment by the T.R.A. applies to such capital loss carryovers.[104] Thus, if in 1970 *T* had a long-term capital loss carryover from 1969 of $2,000 and no other capital gains and losses, he would be permitted to deduct $1,000 from ordinary income and carry over the remaining portion of $1,000 to 1971; if in 1971 there were no other capital gains and losses, *T* could deduct $1,000 from ordinary income.[105]

SECTION 1231 AND CASUALTY LOSSES

IN GENERAL

Section 1231, applying balance sheet notions, requires netting of recognized gains and losses arising in certain transactions. If the gains exceed the losses for the taxable year, each gain or loss is treated as a long-term capital gain or loss. The result is net long-term capital gain. If the gains do not exceed the losses, each such gain or loss is an ordinary gain or loss. The result is either a wash, *i.e.* where such gains and losses are equal in amount, or a net ordinary loss, deductible in full from ordinary income.

Congress tinkered with section 1231 in the T.R.A. but made no substantial change in the scheme of the statute. Accordingly, we deal initially with section 1231 as it appeared prior to the T.R.A. Thereafter, the T.R.A. amendments are discussed.[106]

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[103] I.R.C. § 1212(b)(3). *See* note 64 *supra.*

[104] Presumably, section 1212(b)(3) means that the prior law governing both the amount of the capital loss carryovers and deductibility from ordinary income applies to pre-1970 carryovers to post-1969 years. See note 64 *supra.*

[105] *See* H.R. REP. No. 91-413 pt. 2, at 110 Example (5). One of the questions unanswered by the transitonal rule is whether the long-term capital loss carryover from a pre-1970 year or the long-term capital loss first arising in the current post-1969 year is to be accorded priority on deduction from ordinary income within the applicable statutory limitation where the individual has no other capital gains or losses. Assume that in 1970 an individual has a current long-term capital loss of $1,000 and a long-term capital loss carryover from 1969 of $1,000 and no other capital gains or losses. Can he deduct the 1969 $1,000 long-term capital loss carryover in full from ordinary income in 1970 thereby leaving the $1,000 current long-term capital loss (which, if accorded priority, could only be deducted to the extent of $500 with the remaining $500 being wasted under sections 1211(b)(1)(C)(ii) and 1212(b)(2)(B)(ii), respectively) to be fully carried over to 1971 when he may be able to offset it against capital gains (and thus avoid a loss of benefit)? The better answer would appear to be that the pre-1970 long-term capital loss carryover should be accorded priority on deduction from ordinary income in a post-1969 year in this situation, applying a first-in, first out type of analysis similar to that utilized in carrying over net operating losses. *See* Treas. Reg. § 1.172-6, T.D. 6486, 1960-2 CUM. BULL. 78, 85-90. This conclusion is confirmed in a ruling issued by the Internal Revenue Service on April 19, 1971. Rev. Rul. 71-195, 1971 INT. REV. BULL. No. 16, at 26.

[106] The Code specifically excepts from the definition of capital asset both "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" and "property, used in . . . [the taxpayer's] trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business." I.R.C. § 1221(1), (2). Unlike the first category of property which is also excluded from the operation of section

Since only recognized gains and recognized losses are tossed into the section 1231 pot, to the extent that a gain or loss is not recognized[107] it can have no effect.[108] The property subject to section 1231 includes property used in the trade or business, whether realty or depreciable property, held for more than 6 months.[109] To a limited extent the provision may also apply to capital assets held for more than 6 months.[110] Once the type of property and the requisite holding period are identified, we need only consider the transactions to which section 1231 applies. Under section 1231, there is a netting of the recognized gains[111] and losses from the sale or exchange of property used in the trade or business,[112] plus the recognized gains[113] and losses from the compulsory or involuntary conversion of such property and of capital assets held for more than 6 months *into other property or money.* If the aggregate gains exceed the aggregate losses, each such gain or loss is characterized as long-term capital gain or loss, respectively. But if the aggregate gains do not exceed the aggregate losses, each such gain or loss is deemed to be ordinary.[114] Certain problems in the interpretation and application of section 1231, as it relates to casualty losses[115] soon developed, however.

1231 by section 1231(b)(1)(B), the latter category may qualify for capital treatment under section 1231(a), subject to the various recapture provisions of the Code. *See, e.g., id.* §§ 1245; 1250. The question whether property is held "*primarily* for sale to customers in the ordinary course of his trade or business" is beyond the scope of this article. For the meaning of the word "primarily," see Malat v. Riddell, 383 U.S. 569 (1966). Insofar as the first category applies to real estate sales, see Rubin, *Capital Gain Treatment of Real Estate Sales: Implications of the Malat Case,* TUL. 16TH TAX INST. 421 (1966).

[107] *E.g.,* I.R.C. §§ 1031 (non-recognition in whole or in part of gain realized in a "like kind" exchange of property held either for productive use in a trade or business or for investment), 1031(c) (non-recognition of loss in such an exchange where the property received consists, in part, of non-like-kind property), 1033.

[108] *Id.* § 1231(a)(1); Treas. Reg. § 1.1231-1(d)(4) (1957). Similarly, losses that are not deductible because disallowed by section 267(a)(1) or because the transaction does not qualify for deduction by an individual under section 165(c) do not enter into the section 1231 pot. I.R.C. § 1231(a)(1); Treas. Reg. § 1.1231-1(d)(1), (2) (1957).

[109] I.R.C. § 1231(b)(1). Whether an activity constitutes a trade or business for income tax purposes has long baffled the courts and is beyond the subject of this article. *Compare* Leland Hazard, 7 T.C. 372 (1946), *with* Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam,* 218 F.2d 603 (2d Cir. 1955). Prior to the T.R.A. the holding period for livestock was 12 months or more. I.R.C. § 1231(b)(3).

[110] Note that, regardless of holding period, property used in a trade or business which is real property or depreciable property is not a capital asset. I.R.C. § 1221(2). *See* note 106 *supra.*

[111] This includes only the gain remaining after the application of the various recapture provisions of the Code. *See, e.g.,* I.R.C. §§ 1245(d), 1250(i); Treas. Reg. § 1.1245-6(a) (1965); Treas. Reg. § 1.1250-1(c)(1) (1971).

[112] *See* I.R.C. § 1231(b).

[113] *See* notes 107 & 111 *supra.*

[114] I.R.C. § 1231(a). *See generally* Surrey, *Definitional Problems in Capital Gains Taxation,* 69 HARV. L. REV. 985, 996-97 (1956).

[115] The question of what constitutes a casualty loss is beyond the scope of this article. *See generally* Champagne, *Casualty Losses,* TUL. 13TH TAX INST. 445 (1964); Deming, *Establishing Casualty and Disaster Losses,* N.Y.U. 21ST INST. ON FED. TAX. 143 (1963); Rabin, *Casualties and Disaster Losses Are Deductible: The Do's and Don'ts,* S. CAL. 16TH TAX INST. 463 (1964). The interaction of sections

PRIOR LAW

Wholly Uninsured Casualty Losses to Personal-Use Assets

Ever since the predecessor of section 1231[116] was enacted in 1942,[117] the Treasury consistently maintained that wholly uninsured casualty losses to personal-use assets (capital assets not held for the production of income such as a personal residence or a non-business automobile) came within the operation of that section.[118] This long-standing position and the reenactment without substantial change of the predecessor statute in section 1231 of the 1954 Code,[119] plus the fact that the Technical Amendments Act of 1958 specifically excluded from section 1231 wholly uninsured casualty and theft losses to business assets and capital assets held for the production of income, tended to indicate that Congress believed that the 1958 Act did not modify the Treasury's position.[120] In other words, wholly uninsured casualty and theft losses to personal-use assets were within the scope of section 1231.[121] Some courts have ignored this history and have relied, instead, on the exact language of the statute, holding that wholly uninsured casualty losses to personal use assets did not come within section 1231 because the taxpayer received no insurance compensation, and, therefore, the asset could not be deemed to have been converted *into other property or money.*[122] The majority of courts considering this issue have

165(c) and 1231(a)(1) should be noted, however. *See* note 108 *supra.* Unlike the sale of a personal residence at a loss, for example, an individual may deduct a casualty loss to a personal residence. I.R.C. § 165(c)(3). *See* Ray Durden, 3 T.C. 1 (1944). *See also* note 45 and accompanying text *supra.* Thus, while the condemnation of such a personal residence at a loss would otherwise appear to be within the reach of section 1231(a), since it is not a casualty loss, it is not deductible under section 165(c). *See* Rev. Rul. 70-16, 1970 INT. REV. BULL. No. 2, at 6. Accordingly, such a condemnation loss will not be within the scope of section 1231(a). I.R.C. § 1231(a)(1); Treas. Reg. § 1.1231-1(d)(1) (1957). On the other hand, gain from the condemnation of a personal residence may be within the ambit of that section. I.R.C. § 1231(a). *See also id.* § 1034(i).

[116] Int. Rev. Code of 1939 § 117(j), 53 Stat. 47.

[117] Revenue Act of 1942, Pub. L. 753, § 151(b), 56 Stat. 846.

[118] *See, e.g.,* Treas. Reg. 103, § 19.117-7, T.D. 5217, 1943 CUM. BULL. 314; Treas. Reg. § 1.1231-1(e)(1) (1957). Of course, a casualty loss to a capital asset held for only six months or less could never come within the scope of section 1231. I.R.C. § 1231(a).

[119] The United States Supreme Court has stated that "treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." Helvering v. Winmill, 305 U.S. 79, 83 (1938). *See* Crane v. Commissioner, 331 U.S. 1, 7-8 (1947).

[120] *See, e.g.,* Weyerhaeuser Co. v. United States, 402 F.2d 620 (9th Cir. 1968); Pennsylvania Power & Light Co. v. United States, 411 F.2d 1300 (Ct. Cl. 1969) (as to taxable years prior to the effective date of the Technical Amendments Act of 1958, wholly uninsured casualty losses to business property within section 1231).

[121] The Senate Report to the Technical Amendments Act of 1958 states: "On the other hand, the amendment does not apply to loss arising from the destruction or theft of the taxpayer's uninsured personal automobile." S. REP. No. 1983, 85th Cong., 2d Sess. 203 (1958).

[122] *E.g.,* Maurer v. United States, 284 F.2d 122 (10th Cir. 1960); Oppenheimer v. United States, 220 F. Supp. 194 (W.D. Mo. 1963) (both cases involved pre-1958 taxable years).

held, in agreement with the Commissioner,[123] that such losses were subject to section 1231.[124]

The impact of the divergent views is illustrated in the following example. In 1968 *T*, a sole proprietor, had only a section 1231 gain of $10,-000 from the sale of business realty,[125] plus a wholly uninsured casualty loss of $5,000[126] on his non-business car, both assets having been held more than 6 months. The minority view, as represented by *Maurer v. United States*,[127] would exclude the casualty loss from the section 1231 netting. Accordingly, it would be deductible from ordinary income. Thus, the $10,000 gain—the only section 1231 transaction—would be long-term capital gain one-half of which would be deductible.[128] The remaining $5,000 of the gain would thereafter be eliminated *in toto* by the $5,000 casualty loss deduction,[129] leaving no taxable income. On the other hand, the majority view[130] would treat the casualty loss as a section 1231 transaction so that after the netting process there would be a $10,00 long-term capital gain and a $5,000 long-term capital loss. Offsetting these two items would produce a net long-term capital gain of $5,000[131] of which one-half is deductible,[132] leaving $2,500 taxable gain.

Wholly Uninsured Casualty Losses to Business and Income-Producing Assets

Related to the foregoing were the problems created by the Technical Amendments Act of 1958[133] which carved-out of section 1231 casualty and theft losses to business property and capital assets held for the production of income and held for more than 6 months as to which the taxpayer was "not compensated for by insurance *in any amount*." The consequence of this amendment was that such losses would always be ordinary losses[134]

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[123] Rev. Rul. 61-54, 1961-1 CUM. BUL. 398.

[124] *E.g.*, Campbell v. Waggoner, 370 F.2d 157 (5th Cir. 1966); Morrison v. United States, 355 F.2d 218 (6th Cir.), *cert. denied*, 384 U.S. 986 (1966); E. Taylor Chewning, 44 T.C. 678 (1965), *aff'd per curiam*, 363 F.2d 441 (4th Cir.), *cert. denied*, 385 U.S. 930 (1966).

[125] It is assumed that, if this business realty is depreciable, only straight-line depreciation has been claimed and that the asset has been held for more than one year so that there is no recapture under section 1250 of any portion of the gain as ordinary income. *See* I.R.C. §§ 1250(a)(1), (2), 1250(b)(1).

[126] This is the amount remaining after the $100 floor of section 165(c)(3) has been applied. *See id.* § 1231(a)(1).

[127] 284 F.2d 122 (10th Cir. 1960).

[128] I.R.C. § 1202.

[129] *Id.* §§ 165(a) & 165(c)(3).

[130] *See* notes 121 & 124 and accompanying text *supra*.

[131] *See* I.R.C. § 1222(7).

[132] *Id.* § 1202.

[133] Pub. L. 85-866, § 49, 72 Stat. 1642 (1958), effective for taxable years beginning after December 31, 1957. The general purpose of this amendment was to permit self-insured business taxpayers to deduct such casualty and theft losses in full against their ordinary income without regard to their overall gain and loss position under section 1231. S. REP. No. 1983, 85th Cong., 2d Sess. 203 (1958).

[134] A casualty loss not otherwise within the ambit of section 1231 and for which

deductible under section 165.[135] Thus, a business taxpayer sustaining casualties to two similar business properties, one of which was wholly uninsured (producing a loss) and the other fully insured (producing a gain consisting of the excess of the insurance proceeds received over the adjusted basis),[136] could deduct the uninsured loss in full against ordinary income[137] without regard to the section 1231 netting process, while treating the gain realized with respect to the insured property as long-term capital gain under section 1231.[138]

The extent to which a taxpayer insured his business property was generally deemed to be irrelevant if he received insurance compensation for any part of his casualty loss, however small.[139] Thus, if a taxpayer insured a business asset against casualty only to the extent of 5 percent of its total value and recovered only that much, the deductibility of that loss against ordinary income was made to turn on his overall gain and loss position under section 1231[140] despite the fact that this was little different in practical effect from an uninsured loss.

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the taxpayer receives insurance compensation is not a "sale or exchange" as required by section 1222 for capital loss treatment. *See* Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

[135] *See* S. REP. No. 1983, 85th Cong., 2d Sess. 203 (1958).

[136] It is assumed that section 1033, dealing with the elective non-recognition of gain on the involuntary conversion of property which is replaced within the specified time period by property similar or related in service or use, does not apply. *See* I.R.C. § 1231(a)(1).

[137] *Id.* §§ 165(a) & 165(c)(1).

[138] H.R. REP. No. 91-413, pt. 1, at 158-59; S. REP. No. 91-552 at 205.

[139] This statement is qualified in situations where the business property sustaining the casualty loss is insured under a policy containing a deductible clause by the recent case of American S.S. Co. v. United States, 427 F.2d 235 (2d Cir. 1970). In that case dealing with post-1957, pre-1970 taxable years the corporation owned and operated commercial vessels which were insured against casualty damages under policies containing $25,000 deductible clauses for each occurrence. Under the policies the corporation acted as a self-insurer for all casualty losses of up to $25,000 for each occurrence, with the insurer being obligated to bear the losses only to the extent that they exceeded $25,000. During the years in question the corporation sustained a total of $1,312,556 in casualty losses which individually were less than $25,000 each. The corporation also sustained an additional $430,084 in casualty losses which totaled more than $25,000 in each case.

Since the corporation's section 1231 gains exceeded its section 1231 losses in any event, it naturally wished to exclude as much of the casualty losses as possible from section 1231. The government conceded that each occurrence resulting in a total casualty loss of less than $25,000 was a loss excludable from section 1231 since "not compensated for by insurance in any amount." However, the government argued that, in those instances where the corporation had received payments from the insurer for occurrences resulting in losses greater than $25,000 each, then each of the $25,000 deductible amounts thereby borne by the corporation could not be excluded from section 1231 since as to each such loss the corporation had received some, however small, insurance compensation.

The Second Circuit disagreed with the government, holding that casualty losses borne by the corporation under such threshhold deductible clauses were not within the operation of section 1231 despite the fact that the corporation received compensation for the excess of each such loss over the deductible amount. In dicta the court indicated that casualty losses borne by a taxpayer under policies providing for compensation only up to a certain percentage of each loss or up to a specified maximum dollar figure, unlike those resulting from threshold deductible clauses, do come within section 1231.

[140] H.R. REP. No. 91-413, pt. 1, at 159; S. REP. No. 91-552 at 205.

Believing that (1) a taxpayer should not be allowed to deduct an uninsured casualty loss to business property in full from ordinary income when he also has a larger casualty gain on insured business property and that (2) the distinction between casualty losses to uninsured and partially insured business property was unrealistic, and (3) wishing to resolve any remaining doubts on the issue of whether a wholly uninsured casualty loss to a personal use asset was within the scope of the statute, Congress amended section 1231 in the T.R.A.[141] The impact of the resolution of the third issue is nullified to some extent, however, by the modifications made in the section 1231 netting process.[142]

CASUALTY LOSSES UNDER THE T.R.A.

The amendment recently enacted takes a new approach to an old problem. Today, wholly uninsured casualty losses to personal-use assets can no longer escape the clutches of section 1231.[143] The statute, in a two-step approach, requires that casualty gains and losses[144] be netted, in a type of sub-netting process, which, depending on the outcome of net gain or loss, is or is not then required to be layered into the general section 1231 pot. If the casualty gains equal or exceed the casualty losses, then such gains and losses enter the section 1231 netting process. The nature of all such gains and losses will depend on the ultimate question whether the gains, including gain from the sale or exchange of business property,[145] exceed the losses, including the casualty losses. If, in the preliminary netting relating to casualties, the losses exceed the gains, then all such gains and losses are considered ordinary gains and losses, outside section 1231, since they do not enter the general netting process of section 1231. The new rules can be summarized as follows:[146]

> (1) all casualty-theft gains and losses on business, production of income and personal use property, whether insured to any extent or wholly uninsured, are first separately netted;
>
> (2) if the aggregate casualty-theft losses do not exceed the aggregate casualty-theft gains, then all such casualty-theft gains and losses are then subjected to the regular section 1231 netting process with the other section 1231 gains and losses with characterization depending on the outcome as before;

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[141] H.R. REP. No. 91-413, pt. 1, at 159; S. REP. No. 91-552 at 205-06.

[142] *See* Example 1 at text following note 149 *infra.*

[143] I.R.C. § 1231(a)(2).

[144] Gains and losses arising from theft are also encompassed in this new subnetting process. *Id.*

[145] This would also include gain from the *condemnation* of business property and capital assets held for more than 6 months. I.R.C. § 1231(a). Even prior to the enactment of the rule now embodied in section 1231 a condemnation was held to constitute a "sale." *See* Hawaiian Gas Prod. v. Commissioner, 126 F.2d 4 (9th Cir. 1942).

[146] The enumerated steps assume that (a) all assets have been held more than 6 months (exception for livestock under section 1231(b)(3)), (b) "business property" satisfies the definition of section 1231(b)(1), and (c) all gains and losses referred to are recognized and allowable. *See* I.R.C. § 1231(a)(1).

> (3) but if the aggregate casualty-theft losses exceed the aggregate casualty-theft gains, then such casualty-theft gains and losses are treated as not being within the operation of section 1231.[147] The consequence of this is that each such gain and loss will be ordinary due to the lack of a 'sale or exchange.'[148]

The effect of these revisions is illustrated by the following examples.[149]

EXAMPLE 1. Assume the same facts as in the prior example,[150] except that the year is 1970. Since the casualty losses ($5,000) exceed the casualty gains (0), the casualty loss of $5,000 does not come within section 1231. Hence, it will be an ordinary loss deductible under section 165(a).[151] As in the prior example, the $10,000 will be long-term capital gain (since it was produced by the sole section 1231 transaction), and, after applying the section 1202 deduction, the end result will be the same—there is nothing taxable from these items.[152] Thus, in this situation, we have a result similar to that reached in *Maurer* under the prior law.

EXAMPLE 2. Assume the facts as in Example 1 except that *T* also has a $7,000 casualty gain (excess of insurance proceeds received over adjusted basis) from the destruction of an insured business asset. Because the casualty losses ($5,000) do not exceed the casualty gains ($7,000), they are subject to the regular section 1231 netting process with the non-casualty section 1231 gains ($10,000) and losses (0). Since the aggregate section 1231 gains ($17,000) exceed the aggregate section 1231 losses ($5,000), each such gain and loss is long-term capital in nature.[153] There is a net long-term capital gain of $12,000[154] of which one-half ($6,000) is deductible,[155] leaving the remaining $6,000 as taxable.[156] Section 1231 (a) as amended by the T.R.A. applies to tax years beginning after 1969.[157]

LIVESTOCK

BACKGROUND AND PRIOR LAW

We may be accustomed to regarding factories, machinery and delivery trucks as property used in the taxpayer's trade or business. Such property is depreciable[158] and, upon a taxable sale or exchange, if the gains ex-

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[147] *Id.* § 1231(a) (last sentence).
[148] *See* Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).
[149] These examples assume the same facts set out in note 146 *supra* and, in addition, that sections 1033 and 1250, where relevant, do not apply.
[150] *See* text following note 124 *supra.*
[151] *See* I.R.C. § 165(c)(3).
[152] *See* Proposed Treas. Reg. § 1.1231-1(g) Ex. (4) & (7), 35 Fed. Reg. 18975 (1970).
[153] I.R.C. § 1231(a).
[154] *Id.* § 1222(7).
[155] *Id.* § 1202.
[156] *Accord,* Proposed Treas. Reg. § 1.1231-1(g) Ex. (6), 35 Fed. Reg. 18975 (1970).
[157] Pub. L. 91-172, § 516(d)(2) (Dec. 30, 1970), 83 Stat. 487.
[158] I.R.C. § 167(a)(1).

ceeded the losses, the net gain is treated as long-term capital gain under section 1231(a).[159] It may surprise a few to discover that in some circumstances, section 1231 also includes livestock as property used in the trade or business.[160] This means, of course, that a taxpayer owning livestock subject to section 1231 could trade deductions from ordinary income in return for long-term capital gain.[161]

This is largely history, but in the past, a taxpayer could make a brief investment in a breeding herd of livestock,[162] deduct operating expenses of raising the herd,[163] and, in addition, recoup a part of his initial investment by depreciation deductions.[164] He then could close out the investment by sale at capital gains rates.[165] The ultimate tax benefit was available only if the livestock was held for draft, breeding or dairy purposes[166] and then only if held for a year or more.[167] The net effect was a conversion of ordinary income into capital gain with significant savings for high-bracket taxpayers.[168]

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[159] Such gain is presently subject to the recapture provisions of sections 1245 and 1250, however.

[160] I.R.C. § 1231(b)(3).

[161] The tax benefit suggested in the text was not unique to the cattle industry. The automobile sales and rental industry discovered the game long ago. *See, e.g.*, Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).

[162] For purposes of section 1231(b)(3), livestock, as defined in the regulations, includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals and other mammals but does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc. Treas. Reg. § 1.1231-2(a) (1957). For criticism of the regulation in limiting livestock to mammals, see J. O'BYRNE, FARM INCOME TAX MANUAL 210 (4th ed. 1970).

[163] "Under general principles of accounting . . . it would be expected that expenses incurred by ranchers in raising breeding livestock should be charged to capital account, even though the ranchers employed the cash method of accounting." United States v. Catto, 384 U.S. 102, 109-10 (1966). The regulations permit the deduction of such costs as current expenses, however. *Id.* at 106; Treas. Reg. § 1.162-12 (1958). *See* H.R. REP. No. 91-413, pt. 1, at 62, 70; S. REP. No. 91-552 at 95, 101.

For an exhaustive treatment of farm income taxation in general, see O'BYRNE, *supra* note 162. For a scholarly article on the effect of the T.R.A. on the tax shelters available in farm-ranch operations and similar matters, see Hjorth, *Farm Losses and Related Provisions*, 25 TAX L. REV. 581 (1970). In the following discussion it is assumed that the operations of the taxpayer involving livestock constitute a trade or business and not a "hobby." *See* I.R.C. § 183; O'BYRNE, *supra* note 162, at 5-18.

[164] *See also* Treas. Reg. § 1.165-6(a)(2) (1960).

[165] Thus, where the taxpayer held livestock primarily for draft, breeding, or dairy purposes, under section 1231(b)(3) prior to the T.R.A. it would constitute property used in the trade or business subject to characterization under section 1231(a) if held for at least one year from the date of acquisition. *See* H.R. REP. No. 91-413, pt. 1, at 69-70; S. REP. No. 91-552 at 100. There was no recapture of depreciation as ordinary income to the extent of the gain, if any, on the sale of the purchased breeding stock because livestock was specifically excluded from the operation of section 1245 prior to the TRA H.R. REP. No. 91-413, pt. 1, at 68; S. REP. No. 91-552 at 99.

[166] For a discussion of this requirement, see O'BYRNE, *supra* note 162, at 183-84, 197-208. Livestock cannot qualify as section 1231 property if held primarily for sale to customers in the ordinary course of the trade or business. I.R.C. § 1231(b)(1)(B).

[167] I.R.C. § 1231(b)(3) (prior to the T.R.A.).

[168] The mathematics of the savings possible to highbracket taxapyers are illustrated in the committee reports. Assume that a taxpayer in the 70 percent bracket sells a cow (a section 1231 asset), which cost him $800 in deductible expenses to

Congress was provoked by these "short-term, tax-motivated investments in livestock" fostered principally by the shortness of the 12-month holding period of section 1231(b)(3). This section did not adequately achieve its intended goal of helping to ensure that animals were, in fact, being held primarily for draft, breeding or dairy purposes (instead of primarily for sale in the ordinary course of business).[169] Consequently, Congress amended 1231(b)(3) and related sections of the Code.[170]

LIVESTOCK UNDER THE T.R.A.

The Holding Period

Under the T.R.A. the minimum holding period for cattle and horses is increased to 24 months from the date of acquisition[171] although the old 12-month holding period is retained for other types of livestock.[172] The legislative history indicates that the mere satisfaction of the respective holding period requirements does not conclusively demonstrate that the livestock is held for the requisite purposes. Instead, that determination must be made "on the basis of all the facts and circumstances."[173] Section 1231(b)(3) as amended by the T.R.A. is applicable to livestock acquired after 1969.[174]

Section 1245

The T.R.A. now makes depreciable livestock[175] subject to the recap-

raise, for $1,000. The tax saving arising from the ability to deduct the $800 from ordinary non-farm income is $560 (70 percent x $800), while the maximum tax on the $1000 long-term capital gain (raised livestock usually has a zero basis) would be $250 (alternative tax rate of 25 percent under section 1201(b) prior to the T.R.A.). Thus the net savings is $310 ($560-$250). *See* H.R. REP. No. 91-413, pt.1, at 63; S. REP. No. 91-552 at 96.

169 H.R. REP. No. 91-413, pt. 1, at 70; S. REP. No. 91-552 at 100-01.

170 In addition, section 1231(b)(3) as amended by the T.R.A. increases the purposes for which qualifying livestock can be held to include sporting as well as draft, breeding, or dairy purposes. Under the prior law, race horses held for more than 6 months (but less than 12 months) could qualify as section 1231 property under the general provision of section 1231(b)(1) even though they did not satisfy the special requisites for qualified livestock as set out in section 1231(b)(3). McKinley Kirk, 47 T.C. 177 (1966), *acquiesced in*, 1967-2 CUM. BULL. 2. *See* O'BYRNE, *supra* note 162, at 208-10. Apparently, the purpose behind the amendment was to subject animals held for sporting purposes to the same holding period requirement as livestock within the scope of section 1231(b)(3). Hjorth, *supra* note 162, at 587. *See also* H.R. REP. 91-413, pt. 1, at 70; S. REP. No. 91-552 at 101.

171 I.R.C. § 1231(b)(3)(A).

172 *Id.* § 1231(b)(3)(B). The Senate Finance Committee report indicated that the extension of the holding period to 24 months should be confined to cattle and horses because the principal questions had arisen in regard to these types of livestock, and it was not clear that such a longer holding period was equally applicable to, or desirable for, other livestock. S. REP. No. 91-552 at 101. For speculation as to the reasons for such conclusion, see Hjorth, *supra* note 163, at 588 n.17.

173 H.R. REP. No. 91-413, pt. 1, at 70; S. REP. No. 91-552 at 101. *See* Proposed Treas. Reg. § 1.1231-2(b), 36 Fed. Reg. 1152 (1971).

174 Pub. L. 91-172, § 212(b)(2) (Dec. 30, 1969), 83 Stat. 487. *See* Proposed Treas. Reg. § 1.1231-2(a)(1), (2), 36 Fed. Reg. 1152 (1971).

175 Section 1245 will be generally applicable only to purchased livestock because

ture provisions of section 1245,[176] effective for taxable years beginning after 1969.[177] Under this amendment section 1245 does not recapture pre-1970 depreciation deductions.[178]

Like Kind Exchanges: Section 1031(e)

Normally, the calf crop of a breeding herd consists of approximately an equal number of males and females.[179] Because the procreative capacities of only a relatively few male animals are needed in order to expand the herd,[180] most male calves are sold (before the holding period requisite is satisfied) at ordinary income rates.[181] If, however, such male calves could be exchanged tax-free for female calves under the provisions of section 1031 dealing with "likekind" exchanges of property held for productive use in a trade or business or for investment, then a breeding herd of females could be increased more quickly without tax consequences[182] thereby exacerbating the problem of short-term investments in breeding herds. Despite both the contrary intent of Congress under that section prior to the T.R.A. and the fact that the Internal Revenue Service did not consider such exchanges to be "likekind" (although it had no published position), apparently many taxpayers have thought that male-for-female calf exchanges came within the scope of section 1031.[183]

Therefore, in order to clarify this situation, the T.R.A. amended section 1031 to provide expressly that exchanges of livestock of different sexes are not exchanges of like kind property.[184] Since the amendment is merely declaratory of what Congress intended in the prior law,[185] it is applicable to all years to which the Internal Revenue Code of 1954 applies.[186]

These provisions of the T.R.A. dealing with livestock—the lengthened holding period, the new application of the recapture provisions of section 1245, and the limitation on the applicability of section 1031—taken together with new code section 1251[187] appear to reduce, but do not abolish,

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raised livestock in the hands of a cash basis taxpayer normally has no basis. But to the extent raised livestock has a basis and is depreciated, section 1245 does apply. S. REP. No. 91-552 at 99 n.1.

176 Pub. L. 91-172, § 212(a)(2) (Dec. 30, 1969), 83 Stat. 487. *See* Proposed Treas. Reg. §§ 1-1245-1(a)(2)(ii), 1.1245-2(a)(2)(iii), 1.1245-3(a)(1), (4), 36 Fed. Reg. 1152, 1153 (1971). *See* note 165 *supra.*

177 Pub. L. 91-172, § 212(a)(3) (Dec. 30, 1969), 83 Stat. 487.

178 I.R.C. § 1245(a)(2)(C). For the relationship of section 1245 to section 1251 as they apply to livestock, see O'BYRNE, *supra* note 162, at 562-63; Hjorth, *supra* note 162, at 596-98.

179 H.R. REP. No. 91-413, pt. 1, at 66; S. REP. No. 91-552 at 102.

180 Hjorth, *supra* note 163, at 588.

181 See authorities in the note 179 *supra.*

182 *Id.*

183 *Id.*

184 I.R.C. § 1031(e).

185 S. REP. No. 91-552 at 102.

186 Pub. L. 91-172, § 212(c)(2) (Dec. 30, 1969), 83 Stat. 487.

187 Generally, under section 1251, gain from the sale or other disposition of "farm recapture property" is to be taxed as ordinary income to the extent of the

the desirability of investments in breeding herds by highbracket taxpayers.[188]

REALTY DEPRECIATION AND RECAPTURE

BACKGROUND

In 1954 Congress liberalized the depreciation deduction by injecting into the Code two accelerated methods. The declining balance method and the sum of the years-digits method permit business to recover capital expenditures by a fast writeoff in the early years of the asset life.[189] In general, it is accurate to say that there are now three basic methods of depreciation for federal tax purposes:[190] the straight line method, the declining balance method and the sum of the years-digits method.[191]

The straight line method simply permits the basis of an asset, reduced by salvage value, to be recovered ratably over its useful life. Thus for example, if an asset[192] has a basis of $11,000,[193] a 10-year useful life and a salvage value of $1,000, it may be depreciated at the rate of 10 percent: 10 percent of $10,000 or $1000 can be deducted each year.[194] The straight line method is probably the stodgiest method of depreciation and perhaps for that reason continues to get favorable billing under the T.R.A.

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amount in the individual's "excess deductions account" (EDA) at the close of the taxable year. *See* I.R.C. § 1251(c)(1), (2). The additions to EDA essentially consist of the cash basis taxpayer's post-1969 accumulated net farm losses which have been used to reduce non-farm income. *See id.* §§ 1251(b)(2), (4), 1251(e)(2). Livestock qualifying under section 1231(b)(3) is an item of farm recapture property. *Id.* § 1251(e)(1)(A).

The section will have only limited effect, however, because it does not apply to a taxable year in which the individual does not have over $50,000 ($25,000 if married filing separately) of non-farm adjusted gross income (there are no additions to EDA for such year even though there is a net farm loss deducted from non-farm income). *Id.* § 1251(b)(2)(B)(i). Even if the individual has over $50,000 of non-farm adjusted gross income, only the excess of the farm net loss for the taxable year over $25,000 ($12,500 if married filing separately) is added to EDA. *Id.* § 1251(b)(2)(B)(ii). *See generally* O'BYRNE, *supra* note 162, at 558-66. *See also* note 178 *supra*.

188 Hjorth, *supra* note 163, at 582-83.

189 S. REP. No. 1622, 83d Cong., 2d Sess. 25-26, 200-02 (1954). For a consideration of various aspects of depreciation, see B. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 292-317 (3d ed. 1964); Blum & Dunham, *Income Tax Law and Slums: Some Further Reflections*, 60 COLUM. L. REV. 447 (1960); Sporn, *Some Contributions of the Income Tax Law to the Growth and Prevalence of Slums*, 59 COLUM. L. REV. 1026 (1959).

190 I.R.C. § 167(b).

191 For purposes of this entire discussion it is assumed that sections 167(f) (permitting salvage value to be disregarded up to an amount equal to 10 percent of basis) and 179 (allowing the additional 20 percent first-year depreciation deduction) are inapplicable because we are considering depreciation of realty, not personal property. *See* I.R.C. §§ 167(f)(1), (2), 179(d)(1).

192 The Code allows depreciation deductions only with respect to property used in a trade or business or held for the production of income. *Id.* § 167(a)(1), (2), *See* Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam*, 218 F.2d 603 (2d Cir. 1955); Leland Hazard, 7 T.C. 372 (1946).

193 I.R.C. §§ 1011, 1012, § 167(g). *See also id.* § 1016(a).

194 *See* Treas. Reg. § 1.167(b)-1(b) (Ex. 1) (1956).

The declining balance method[195] is, in general, the most popular mainly because it authorizes large deductions in the early years of the life of an asset. The method is often referred to as the "double-declining balance" (or, "200 percent declining balance") method for the reason that the rate may not exceed twice the rate otherwise allowable under the straight line method applied to the declining balance of the unrecovered basis of the asset. Moreover, although the basis is not reduced by salvage value, the asset may not be depreciated below a reasonable salvage value.[196] If we assume an asset has a basis of $11,000 with a 10-year useful life, under the declining balance method a taxpayer can deduct 20 percent of the unrecovered cost each year. Thus, for the first year, the deduction is $2,200 (20 percent x $11,000). For the second year the deduction is $1,760 (20 percent x $8,800). At the beginning of the third year, the asset has a basis of $7,040 ($11,000-$2,200-$1,760), and for that year the taxpayer can deduct $1,408 (20 percent of $7,040)[197] which is still greater than the corresponding deduction allowable with respect to the same asset under the straight line method.

The third method, sum of the years-digits, is a mechanical proration cost recovery under which a fraction of the basis of the property, reduced by salvage, is recovered each year. The changing numerator of the fraction is the number of remaining years of useful life of the asset. The constant denominator is the sum of the years of total useful life. Thus, for the first year of an asset having a useful life of 10 years, a basis of $11,000 and a salvage value of $1,000, the numerator is 10 and the denominator is 55 (1+2+3+4+5+6+7+8+9+10=55).[198] Hence, $\frac{10}{55}$ x 10,000 = $1,818 depreciation deduction the first year. The next year, the deduction is $1,636 ($\frac{9}{55}$ x 10,000).[199]

For reasons which should be fairly clear, the declining balance and the sum of the years-digits methods are referred to as accelerated depreciation methods.[200] Although the total deduction for depreciation over the life of an asset is the same regardless of the method used, the declining balance and the sum of the years-digits create a greater deduction in the early years of the life of the asset, while the straight line method simply effects a ratable deduction each year.

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195 I.R.C. § 167(b)(2).

196 Hertz Corp. v. United States, 364 U.S. 122 (1960); Treas. Reg. § 1.167(b)-2(a) (1956).

197 *See* Treas. Reg. § 1.167(b)-2(b) Ex. (1) (1956).

198 Another way to determine this denominator is to add the first digit and the last digit and divide the total by 2; then multiply that result by the last digit. Thus, in the textual example, 1 + 10 = 11 ÷ 2 = 5.5 x 10 = 55.

199 *See* Treas. Reg. § 1.167(b)-3(a)(1)(i) Ex. (1) (1956).

200 Both prior to and after the T.R.A. the declining balance and sum of the years digits methods are only available with respect to tangible property having a useful life of at least three years and only if the original use of the property begins with the taxpayer. Treas. Reg. § 1.167(c)-1(a)(1), (2) (1956).

PRIOR LAW

Real property[201] used in a trade or business or held for the production of income,[202] normally consisting of buildings, the construction (or acquisition) of which was completed after 1953 (or accomplished after 1953 if the original use commenced with the taxpayer after such date),[203] could benefit from accelerated depreciation under the double-declining balance or sum of the years-digits methods.[204] Even where the original use of such property did not commence with the taxpayer,[205] it could be depreciated under the 150 percent declining balance method.[206] The property would usually be acquired through debt financing, sometimes involving only a small equity investment as downpayment. But even so, the resulting depreciation deductions allowed are based upon total cost, which for tax law purposes includes the purchase money indebtedness.[207] Thus, with a relatively small equity investment, taxpayers are able to acquire sizeable depreciation deductions which, economically, serve to help finance the mortgage payments and offset other income. The deductions here are paper deductions—not cash expenditures—and frequently exceed the economic depreciation inherent in the property. The operation in which such property is used actually may have a positive cash flow and be economically profitable.[208]

The T.R.A. tinkered with these results but, while limitations are imposed, similar consequences can be achieved today. In addition, prior to 1964 the entire gain from the sale of such property could be long-term capital in nature under section 1231.[209] After section 1250 was enacted in 1964[210] such gain was recaptured as ordinary income, to the extent of the

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201 Land, except for the improvements or physical development added to it, is not depreciable. Treas. Reg. § 1.167(a)-2 (1956).

201 I.R.C. § 167(a)(1), (2).

203 This type of property will be referred to hereafter as new real property.

204 I.R.C. §§ 167(b)(2), (3), 167(c). *See* H.R. REP. No. 91-413, pt. 1, at 165; S. REP. No. 91-552 at 211.

205 This type of property will be referred to hereafter as used real property.

206 *See* Treas. Reg. § 1.167(b)-0(b) (1956); H.R. REP. No. 91-413, pt. 1, at 165; S. REP. No. 91-552 at 211.

207 S. REP. No. 830, 88th Cong., 2d Sess. 131 (1964).

208 H.R. REP. No. 91-413, pt. 1, at 165; S. REP. No. 91-552 at 212.

209 S. REP. No. 830, 88th Cong., 2d Sess. 131 (1964).

210 Revenue Act of 1954, § 231(a), Pub. L. 88-272 (Feb. 26, 1964), 78 Stat. 100. Based upon considerations similar to those behind the enactment of section 1245 (generally applicable to depreciable personality, but *see* note 212 *infra*) in 1962, section 1250 (applicable to depreciable realty) was created to deal with the problem of the conversion of ordinary income into long-term capital gain arising by virtue of section 1231 (always assuming that the gains exceeded the losses in the regular section 1231 netting provision) with a consequent escape of income from taxation. *See* S. REP. No. 830, 88th Cong., 1st Sess. 131 (1964).

This is illustrated by the following example as to depreciable personalty. Assume that on January 1, 1958 *T* purchased for 12,000 (and placed in service) a machine to be used in his trade or business, giving it a 4-year useful life and a $2,000 salvage value. *T* depreciated the machine under the straight line method at the rate of $2,500 per year. On January 1, 1962 *T* sold the machine for $4,000 at which time his adjusted basis was $2,000 ($12,000 less $10,000 depreciation for four years).

Thus, *T* has not only recouped his unrecovered cost of $2,000 in the sale

excess of the post-1963 accelerated depreciation claimed over straight-line depreciation.[211] The recapture was reduced, after the property was held for 20 months, at the rate of 1 percent per month. Thus, if the property was held for 10 years there would be no recapture.[212]

Concerned with both (1) the prevalence of the substantial dealing in tax losses produced by depreciable realty and (2) the opportunities available for the conversion of ordinary income into capital gain[213] and desiring to stimulate low income housing construction and rehabilitation of existing buildings, Congress, in the T.R.A., restricted the use of accelerated depreciation methods (although providing an incentive for rehabilitation expenditures) and tightened up the recapture rules as to depreciable realty.[214]

Realty Depreciation Under the T.R.A.: Section 167(j)

New Depreciable Realty

Generally, under the amendments enacted by the T.R.A., new[215] depreciable realty constituting section 1250 property[216] which is bought or constructed after July 24, 1969, cannot be depreciated under either the double-declining balance or the sum of the years digits methods. Instead,

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price of $4,000 but also an additional $2,000 which he had previously deducted from his ordinary business income under section 167(a)(1). Yet under section 1231, *T* was not required to restore this additional $2,000 to ordinary income but was, instead, permitted to treat it as long-term capital gain (subject to tax on only one-half under section 1202). Hence, it amounted to a conversion of ordinary income into long-term capital gain. The recapture scheme of section 1250, however, is much more limited than that of section 1245 (see note 212 *infra*)—and it remains so under the T.R.A.—due to the likelihood that depreciable realty may appreciate in value over a long period of time. *See* notes 211, 212 & 241 and accompanying text *infra*.

211 *See* Treas. Reg. § 1.1250-1(b)(5)(ii) (1971). If the property was not held for more than one year, the entire post-1963 depreciation claimed was recaptured as ordinary income to the extent of the gain. I.R.C. § 1250(b)(1).

212 *See* Treas. Reg. § 1.1250-1(b)(5)(iii) (1971) and authorities cited in note 208 *supra*. Any gain not recaptured under section 1250 could be subject to the provisions of section 1231, assuming that section 1239 did not apply to override section 1231. *See* Treas. Reg. §§ 1.1250-1(b)(3)(ii) (Ex.), 1(c)(1), (4) (1971). This still remains true under the amendments of the T.R.A.

In contrast, under section 1245, dealing generally with depreciable personalty, all post-1961 depreciation claimed (including straight line depreciation) is recaptured to the extent of the gain on the sale (or other disposition) of such property. *See* I.R.C. § 1245(a)(2)(A). For an excellent discussion of both section 1245 and 1250 as they existed before the T.R.A., see Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 Tax L. Rev. 285 (1965). For the definition of section 1245 property (which also includes certain types of depreciable realty), see I.R.C. § 1245(a)(3).

213 *See* notes 210-212 and accompanying text *supra*.

214 *See* H.R. Rep. No. 91-413, pt. 1, at 165-67; S. Rep. No. 91-552 at 212-14.

215 *See* notes 203 & 204 and accompanying text *supra*. Generally, property is considered new if its original use commences with the taxpayer. *See* Treas. Reg. § 1.167(c)-1(a)(2) (1956); Proposed Treas. Reg. § 1.167(j)-1(a)(2)(ii), 36 Fed. Reg. 99 (1971).

216 For the definition of section 1250 property, see I.R.C. § 1250(c); Treas. Reg. § 1.1250-1(e)(1), (3) (1971).

only the 150 percent declining balance method, its equivalent or the straight line method may be utilized.[217] A specific exception is made for *new* residential rental property,[218] however, so that it may continue to be depreciated under the double-declining balance or the sum of the years digits method.[219] This is important to developers and builders of multiple apartment structures who may continue, unscathed, to use the 200 percent declining balance method.

Used Depreciable Realty

As to used[220] depreciable realty constituting section 1250 property[221] which is acquired after July 24, 1969, the 150 percent declining balance method is no longer available. The only method permitted is straight line depreciation or its equivalent.[222] In this regard it should be noted that any realty which is converted from personal use to business or income-producing use after July 24, 1969 is treated as used property.[223] Like the pro-

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217 I.R.C. § 167(j)(1). *See* Proposed Treas. Reg. § 1.167(j)-2(b)(3), 36 Fed. Reg. 100 (1971). New depreciable realty the construction of which was begun (or as to which a binding written contract for construction or for permanent financing thereof was entered into) before July 25, 1969 may be depreciated under either the double-declining balance or sum of the years digits methods. I.R.C. § 167(j)(3).

218 A building is deemed to be "residential rental property" for the taxable year only if 80 percent or more of the "gross rental income" therefrom for such year is from "dwelling units" as defined in new section 167(k)(3)(C). I.R.C. § 167(j)-(2)(B). For the definiiton of "gross rental income" and related recordkeeping requirements, see Proposed Treas. Reg. §§ 1.167(j)-3(b)(2) to (5), 36 Fed. Reg. 100-01 (1971). It should be emphasized that this 80 percent residential rental income test is to be applied on a year-to-year basis. *See* Proposed Treas. Reg. § 1.167(j)-3(b)(6), 36 Fed. Reg. 101 (1971).

A change in the computation of the depreciation deduction for a building from year-to-year arising from its qualification or disqualification in any year as residential rental property is not a change of accounting method requiring the consent of the Commissioner under section 446(e). I.R.C. § 167(j)(2)(C). *See* Proposed Treas. Reg. § 1.167(j)-3(c)(1). 36 Fed. Reg. 101 (1971). For computation of the depreciation deduction in such case, see Proposed Treas. Reg. § 1.167(j)-3(c)(2), 36 Fed. Reg. 101 (1971).

A "dwelling unit" must contain both kitchen and sleeping facilities. Proposed Treas. Reg. § 1.167(k)-3(c)(1), 35 Fed. Reg. 12403 (1970). But the term does not encompass units in hotels, motels and like establishments in which the normal rental term for more than one-half of such units therein is less than 30 days. Transient rental income flunks the test. Proposed Treas. Reg. § 1.167(k)-3(c)(2), 35 Fed. Reg. 12403 (1970). *See generally* Kelley, *Proposed Regs on Depreciating 1250 Property Contain Unexpected Limitations*, 34 J. TAX. 232 (1971).

219 I.R.C. §§ 167(j)(2), 167(b), (c).

220 This is property the original use of which does not commence with the taxpayer. *Id.* § 167(j)(5). *See* notes 205 & 215 and accompanying text *supra*.

221 *See* note 216 *supra*.

222 I.R.C. § 167(j)(4). *See* Proposed Treas. Reg. § 1.167(j)-5(a), 36 Fed. Reg. 103 (1971). Used depreciable realty acquired after July 24, 1969 pursuant to a binding written contract entered into before (or for permanent financing entered into before) July 25, 1969 may be depreciated under the 150 percent declining balance method. I.R.C. § 167(j)(6)(C).

223 I.R.C. § 167(j)(6)(B). For example, this would encompass property owned and formerly used by the taxpayer as a personal residence and now rented out. For the basis for depreciation of such property, see Treas. Reg. § 1.167(g)-1 (1964). For the adjusted basis of such property for purposes of determining loss on sale, see *id.* § 1.165-9(b)(1960).

vision applicable to new residential rental property, a similar but more limited exception is made for *used* residential rental property.[224] Thus, if the used residential rental property has a useful life of 20 years or more in the hands of the taxpayer as of the time of acquisition, a 125 percent declining balance method of depreciation or its equivalent or the straight line method is allowed.[225]

Although the residential rental property exceptions to the T.R.A. amendments restricting the use of accelerated depreciation methods were generally intended to encourage the construction of low and moderate income housing,[226] the statute is not so limited. Consequently, these exceptions apply to all residential rental property, however high-priced and luxurious. Section 167(j) is effective with respect to taxable years ending after July 24, 1969.[227]

Depreciation of Rehabilitation Expenditures on Low-Income Rental Housing Under the T.R.A.: Section 167(k)

In an effort to encourage the rehabilitation of slum and other substandard rental housing properties, the T.R.A. created a new code section which permits a taxpayer to compute his depreciation deductions attributable to "rehabilitation expenditures" incurred on "low-income rental housing" under the straight-line method utilizing a 60-month useful life with no salvage value.[228] The provision is elective.[229]

Rehabilitation expenditures must be capital in nature and incurred for property or improvements with a useful life of 5 years or more in connection with the rehabilitation of an existing building.[230] Low-income rental housing[231] is any building the dwelling units[232] of which are held for rental

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224 Used residential rental property must meet all the requirements of "residential rental property" as set out in section 167(j)(2)(B). I.R.C. § 167(j)(5). *See* note 218 *supra*.

225 I.R.C. § 167(j)(5). *See* Proposed Treas. Reg. § 1.167(j)-6(a), 36 Fed. Reg. 103 (1971).

226 *See* H.R. REP. No. 91-413, pt. 1, at 166; S. REP. No. 91-552 at 212-13.

227 Pub. L. 91-172, § 521(g) 91st Cong., 1st Sess. (1969), 83 Stat. 654. *See* Proposed Treas. Reg. § 1.167(j)-7, 36 Fed. Reg. 104 (1971).

228 I.R.C. § 167(k)(1). This applies only to expenditures incurred after July 24, 1969 and before January 1, 1975, such limitation being due to the desire of Congress "to evaluate the effectiveness and the cost of this new incentive." S. REP. No. 91-552 at 214. For the purposes of determining whether the expenditures have been incurred within the foregoing time limit, accrual method of accounting concepts apply even if the taxpayer is otherwise on the cash basis method of accounting. Proposed Treas. Reg. § 1.167(k)-1(a)(2), 35 Fed. Reg. 12401 (1970).

229 For the manner of, information required, and time for making the election, and revocation thereof, see Proposed Treas. Reg. § 1.167(k)-4, 35 Fed. Reg. 12403 (1970).

230 I.R.C. § 167(k)(3)(A). Such expenditures do not include the cost of acquisition of the land or the building itself or any interest therein such as a leasehold interest. *Id.*; Proposed Treas. Reg. § 1.167(k)-3(a)(1), 35 Fed. Reg. 12402 (1970).

231 *See* Proposed Treas. Reg. § 1.167(k)-3(b)(1), 35 Fed. Reg. 12402 (1970).

232 See note 218 *supra*.

occupancy by families or individuals of low or moderate income[233] as prescribed by regulations consistent with the Housing and Urban Development Act of 1968.[234]

Generally, expenditures qualify for the benefits of this rapid writeoff provision only to the extent that they come within both maximum and minimum limitations. Thus, qualifying expenditures attributable to any dwelling unit in a building (1) cannot exceed a total amount of $15,000 for all years, and (2) must exceed $3,000 over a period of two consecutive years including the taxable year.[235] The depreciation deductions authorized by section 167(k) are in lieu of any other deductions for such expenditures.[236] The section is effective with respect to taxable years ending after July 24, 1969.[237]

REALTY DEPRECIATION RECAPTURE UNDER THE T.R.A.: SECTION 1250

In General

Section 1250 recapture is applicable only where the taxpayer has disposed of[238] section 1250 property[239] at a gain[240] after 1963.[241] The re-

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[233] For the definition and application of "low and moderate income" and the requirement of income certification, see Proposed Treas. Reg. § 1.167(k)-3(b)(2) to (5), 35 Fed. Reg. 12402-03 (1970).

[234] I.R.C. § 167(k)(3)(B). There is no requirement that the building constitute low-income rental housing before the rehabilitation so long as it does so qualify after the completion of the rehabilitation. *See* Proposed Treas. Reg. § 1.167(k)-3(a)(1), 35 Fed. Reg. 12402 (1970).

[235] I.R.C. § 167(k)(2). These limitations do not apply to the building as a whole but only to any particular dwelling unit in the building concerned. *Id.* For allocation of expenditures attributable to more than one dwelling unit, see Proposed Treas. Reg. § 1.167(k)-2(d), 35 Fed. Reg. 12402 (1970).

The maximum and minimum limitations are illustrated by the following example. In four consecutive taxable calendar years commencing in 1971 the taxpayer has the following rehabilitation expenditures attributable to the same single dwelling unit (in a building consisting of six dwelling units), respectively: $750; $2,000; $4,000; $11,000. The expenditure of $750 in 1971 does not qualify because that plus the $2,000 expenditure in 1972 does not satisfy the $3,000 minimum limitation for two consecutive taxable years. Assuming that the taxpayer makes the election for 1972, 1973 and 1974, the $2,000 and $4,000 expenditures for 1972 and 1973, respectively, do qualify. But the expenditure of $11,000 in 1974 will qualify only to the extent of $9,000 in view of the aggregate maximum limitation of $15,000 per dwelling unit for all years. *See* Proposed Treas. Reg. § 1.167(k)-2(c)(2)(Ex.), 35 Fed. Reg. 12401 (1970); H.R. REP. No. 91-413, pt. 2, at 118.

The remaining expenditure of $2,000 for 1974 may qualify for the regular depreciation allowance authorized by section 167(a), however. Proposed Treas. Reg. § 1.167(k)-2(c)(1), 35 Fed. Reg. 12401 (1970). Presumably, the $750 expenditure for 1971 (which did not qualify for the section 167(k) election) may also qualify for the regular depreciation allowance of section 167(a).

[236] I.R.C. § 167(k)(1). *See* Proposed Treas. Reg. § 1.167(k)-1(a)(1), 35 Fed. Reg. 12401 (1970).

[237] Pub. L. 91-172, § 521(g) 91st Cong., 1st Sess. (1969), 83 Stat. 654. Additionally, it should be noted that the rehabilitation expenditures deduction of section 167(k) involving section 1250 property is an item of tax preference to the extent it exceeds straight line depreciation for the year in question based on its actual useful life. I.R.C. § 57(a)(2). *See* Proposed Treas. Reg. § 1.167(k)-1(a)(3), 35 Fed. Reg. 12401 (1970). Hence, it is subject to the new minimum tax of section 56(a). *See* note 41 *supra*.

[238] Section 1250 is generally applicable to all "dispositions," not merely "sales," of

capture will normally occur only if some type of accelerated depreciation[242] has been claimed[243] with respect to such property.[244] Broadly stated, the effect of section 1250 is to treat the gain[245] from the sale or other disposition of such property as ordinary income to the extent of the excess[246] of the post-1963 accelerated depreciation claimed over straight

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such property. I.R.C. § 1250(a)(1), (a)(2)(A). *See* Treas. Reg. § 1.250-1(b)(1), (2)(i) (1971); Proposed Treas. Reg. § 1.1250-1(a)(1)(i), (2)(i), 36 Fed. Reg. 4388-89 (1971). *Cf.* Treas. Reg. § 1.1245-1(a)(3) (1965). For exceptions and limitations to the applicability of section 1250, see I.R.C. § 1250(d).

[239] *See* note 216 *supra.*

[240] Section 1250 does not apply where such property is disposed of at a loss. *See* Treas. Reg. § 1.1250-1(b)(5)(i) (1971); Proposed Treas. Reg. § 1.1250-1(a)(5)(i), 36 Fed. Reg. 4390 (1971).

[241] Section 1250 only applies where the disposition of such property occurs after 1963. I.R.C. § 1250(a)(2)(A). *See id.* § 1250(a)(1).

[242] Generally, where only straight line depreciation has been claimed on property held for more than one year, there is no recapture. If such property has been held for one year or less, then all depreciation claimed is subject to recapture. *Id.* § 1250(b)(1). As to rehabilitation expenditures on section 1250 property (held for more than one year after such expenditures incurred) where there is an election under section 167(k), however, the excess of the section 167(k) depreciation over the straight line depreciation based upon the actual useful life of that asset (assuming an actual useful life of more than 60 months) is subject to recapture. *Id.* § 1250(b)(4); Proposed Treas. Reg. § 1.1250-2(b)(6) Ex. (3), 36 Fed. Reg. 4391 (1971). *See* I.R.C. § 1250(a)(1)(C) (last sentence).

[243] In contrast to section 1016(a)(2) and like section 1245(a)(2), if the amount of depreciation claimed (and allowed) is less than the amount allowable, then only the amount so claimed is taken into account under section 1250. I.R.C. §1250(b)(3) (last sentence).

[244] For the special rules applicable where section 1250 property consists of more than one element, see *id.* § 1250(f); Treas. Reg. § 1.1250-5 (1971).

[245] The amount recaptured as ordinary income under any provision of section 1250 is always limited by the amount of gain resulting from the disposition. *See* I.R.C. § 1250(a)(1) and (2). Any gain recaptured under section 1250 is recognized notwithstanding any other section of the statute. *Id.* §§ 1250(a)(1) (last sentence); 1250(a)(2) (last sentence). For the exceptions and limitations on the applicability of section 1250, see *id.* § 1250(d). Section 1250 "shall apply notwithstanding any other provision of this subtitle." *Id.* § 1250(i).

[246] This is essentially the "additional depreciation" which consists of the excess of the "depreciation adjustments" over straight line depreciation. *Id.* § 1250(b)(1). "Depreciation adjustments" means the post-1963 depreciation deductions "(whether in respect of the same or other property)" and allowed "to the taxpayer or any other person" which are reflected in the adjusted basis of such property. *Id.* § 1250(b)(3).

The phrase "(whether in respect of the same or other property)" indicates that the additional depreciation taken into account when section 1250 property is disposed of can include additional depreciation claimed on other formerly-owned property. Thus, for example, where the taxpayer has disposed of old section 1250 property for new section 1250 property in a like kind exchange under section 1031 or in a qualified section 1033 transaction and there is no recognized gain on such disposition under section 1250(d)(4), the additional depreciation taken into account on any later disposition of the new section 1250 property will include additional depreciation attributable to the old section 1250 property. *See* Treas. Reg. § 1.1250-3(d)(5)(iii) Ex. (1) (1971). For the amount of the latter, see I.R.C. § 1250(d)(4)(E).

Similarly, the phrase "to the taxpayer or any other person" means that, when section 1250 property is disposed of, the additional depreciation to be taken into account can include additional depreciation claimed on that property by an earlier owner. Thus, for example, where the taxpayer acquired the section 1250 property by gift and there is no recognized gain on such disposition by the donor under section 1250(d), the additional depreciation to be taken into account on any subsequent disposition by the taxpayer-donee includes the additional depreciation claimed by the donor. *See* Treas. Reg. § 1.1250-2(d)(3)(i), (ii) (Ex.) (1971).

line depreciation.[247] The lurking recapture is subject to reduction or phasing-out at varying rates (based upon the holding period of the asset)[248] in certain cases, determined by when the asset was acquired, when it was disposed of, and the type of property involved.[249] When the disposition is other than by sale, exchange or involuntary conversion, the fair market value of the property is treated as the amount realized for purposes of computing the recapture gain.[250] Gain resulting from the sale or exchange of section 1250 property that is not recaptured may qualify for long-term capital gain treatment under section 1231.[251]

The T.R.A. Amendments

By virtue of the T.R.A. amendments, dispositions of section 1250 property are segregated into pre-1970[252] and post-1969 categories with the latter being further bifurcated into pre-1970 and post-1969 depreciation claimed divisions.[253] Generally, where section 1250 property is disposed of after 1969, 100 percent[254] of the excess of post-1969[255] accelerated depreciation claimed over straight line depreciation will be recaptured as ordinary income to the extent of the gain.[256] As to the excess for pre-1970

247 For purposes of section 1250 (as to both pre-1970 and post-1969 additional depreciation), in determining what straight line depreciation would have been, the calculation is based upon the same useful life and salvage value used by the taxpayer under his accelerated method. I.R.C. § 1250(b)(1) (last sentence). If the taxpayer's accelerated method is such that it did not take into account either the asset's useful life (units of production method) or salvage value (declining balance method), then a "proper" useful life or salvage value is utilized. *See* Treas. Reg. § 1.1250-2(b)(3) (1971). Where the property was acquired prior to 1964, see Treas. Reg. § 1.1250-2(b)(5), (6) (1971).

248 The holding period is not determined by section 1223 but by section 1250 itself. I.R.C. § 1250(e). *See* Treas. Reg. § 1.1250-4 (1971).

249 This reduction or phase-out is accomplished by applying the "applicable percentage." *See* I.R.C. §§ 1250(a)(1)(C), 1250(a)(2)(B).

250 *See id.* § 1250(a)(1)(B); Treas. Reg. § 1250-1(b)(4) (1971); Proposed Treas. Reg. § 1.1250-1(a)(4), 36 Fed. Rg. 4389 (1971).

251 *But see* note 212 *supra.*

252 Thus, where section 1250 property is disposed of prior to 1970, only the excess of the post-1963 accelerated depreciation claimed over straight line depreciation is recaptured as ordinary income to the extent of the gain with, however, such excess being reduced at the rate of one percent per month after the property has been held for 20 months. I.R.C. § 1250(a)(2). *See id.* § 1250(a)(1). And, where section 1250 property is disposed of after 1969 pursuant to a binding written contract entered into before July 25, 1969, the same rule applies as to both pre-1970 and post-1969 depreciation claimed by the disposing taxpayer. *Id.* § 1250(a)(1)(C)(i).

253 Where a taxpayer acquires section 1250 property by purchase (so that his basis is determined solely by reference to its cost under section 1012) after 1969, there will generally be no pre-1970 depreciation claimed as to such asset that is relevant to that taxpayer's subsequent disposition of it at a gain. *See* Treas. Reg. § 1.1250-2(e)(1)(i) (1971) and note 245 *supra.* Hence, the calculations of section 1250(a)(2) can be ignored. I.R.C. § 1250(a)(2)(A)(i).

254 This 100 percent rule is basically applicable to commercial and industrial buildings in view of the other exceptions contained in section 1250(a)(1)(C)(ii), (iii), (iv).

255 I.R.C. § 1250(a)(1)(A).

256 *Id.* § 1250(a)(1)(C)(v). Although the recapture rule of section 1250(a)(1) applies to additional depreciation claimed for periods after 1969, it can be involved with property acquired both before and after December 31, 1969 as long as the

(but post-1963) periods, the old recapture percentage phase-out rules of section 1250 apply.[257] Thus, such excess is reduced, after the property has been held 20 months, at the rate of one percent per month.[258]

Hence, the principal effect of the T.R.A. amendments is to eliminate completely the phase-out of the old recapture percentage insofar as post-1969 additional depreciation is concerned. Generally, this rule is easily applied to section 1250 property acquired after 1969.[259] Where the property was acquired before 1970 (and disposed of after 1969) so that there is both pre-1970 and post-1969 additional depreciation claimed as to such asset, its application becomes more complicated. In such cases the post-1969 additional depreciation is recaptured first, to the extent of the gain. If there is any gain still available, then the pre-1970 additional depreciation is recaptured (as limited by the old phase-out rule) to the extent of such remaining gain.[260] Any gain left over is subject to other provisions of the Code—probably section 1231.[261]

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property is disposed of after that date. See, however, the exception of section 1250 (a)(1)(C)(i) referred to in note 252 *supra*.

[257] This assumes that there is unused gain remaining after the recapture rule of section 1250(a)(1) (dealing with the excess post-1969 accelerated depreciation claimed) has been applied. *See* I.R.C. § 1250(a)(2)(A).

[258] *Id.* § 1250(a)(2)(B).

[259] *See* note 252 *supra*.

[260] *See* I.R.C. §§ 1250(a)(1), 1250(a)(2)(A).

[261] *See* Proposed Treas. Reg. § 1.1250-1(a)(3)(iii) Ex. (2), 36 Fed. Reg. 4389 (1971) and notes 212 & 251 and accompanying text *supra*.

The application of amended section 1250 where such property is disposed of after 1969 and there is both pre-1970 and post-1969 additional depreciation involved is illustrated by the following example. Assume that *T*, a 45-year-old individual, a cash basis-calendar year taxpayer, acquired and placed in service a small (wood-construction) rental office building (the original use of which commenced with *T*) on January 1, 1964 for $60,000 cash. *T* sold the building on January 1, 1971 to an unrelated individual for $40,000 cash. During the seven years that he held the building *T* made no improvements and had claimed the maximum allowable depreciation under the sum of the years-digits method (utilizing a 25-year useful life and a $10,000 salvage value) in the total amount of $23,800 (of which $20,850 was claimed for 1964 through 1969 and $2,950 was claimed for 1970). If *T* had used the straight line method he would have had depreciation deductions of $2,000 per year for those seven years.

What is the amount of T's gain that will be ordinary income to him under section 1250? T's realized gain from the sale is $3,800 [$40,000 amount realized less $36,200 adjusted basis ($60,000 cost basis less $23,800 depreciation allowed)]. The "additional depreciation" attributable to periods after 1969 is $950 ($2950 accelerated depreciation claimed for 1970 less $2,000 straight line depreciation). *See* I.R.C. § 1250(b)(1). The "applicable percentage" in this case is 100 percent. *See id.* § 1250(a)(1)(C)(v). Since the additional depreciation of $950 is less than the realized gain of $3,800, 100 percent of the former, $950, constitutes ordinary gain to *T* attributable to post-1969 additional depreciation. *See id.* § 1250(a)(1). This leaves $2,850 (out of the total realized gain of $3,800) available for recapture of pre-1970 additional depreciation. *See id* § 1250(a)(2)(A).

The additional depreciation attributable to pre-1970 (but post-1963) periods is $8,850 ($20,850 accelerated depreciation claimed for 1964 through 1969 less $12,000 straight line depreciation). The applicable percentage in this case is 36 percent [100 percent less 64 percent (84-20)]. *Id.* § 1250(a)(2)(B). Why? Although the additional depreciation attributable to pre-1970 periods covers only six years in this case, the holding period of the asset in its entirety (84 months) governs even though it encompasses the post-1969 period. *See* H.R. REP. No. 91-413, pt. 2, at 119. Since the $2,850 remaining available gain is less than the $8,850 pre-1970

The T.R.A. amendments to section 1250, however, also set out three major exceptions to this provision for 100 percent recapture of post-1969 additional depreciation.[262] First, where section 1250 property is built or acquired prior to 1975 and with respect to which (1) a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or is similarly assisted by direct loan or tax abatement under state or local laws) and (2) the owner is limited as to the rate of return on his investment and as to the rental charges, then the rule for the phase-out of the recapture of pre-1970 additional depreciation applies to post-1969 additional depreciation. Thus, the post-1969 additional depreciation will be reduced at the rate of one percent for each full month after the property has been held for 20 months.[263] Congress believed that, because the NHA programs presently provide only a 6 percent rate of return, their chief attractiveness to investors lies in the favorable tax consequences which should therefore be continued to foster such investment.[264]

The second exception relates to "residential rental property" as defined in section 167(j)(2)(B).[265] In this case the post-1969 additional

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additional depreciation, 36 percent of the former is $1026 which constitutes ordinary gain to *T* attributable to pre-1970 additional depreciation. *See* I.R.C. § 1250(a)(2). Thus, out of the $3,800 realized gain, there is a total amount of $1,976 that is ordinary gain under section 1250 while the remaining gain of $1,824 will be subject to section 1231.

[262] *See* notes 252 and 254 *supra*.

[263] I.R.C. § 1250(a)(1)(C)(ii).

[264] STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270 91st Cong,. 1st Sess., 84 (1969). In addition, the T.R.A. created a new code section allowing investors in low-income housing projects (with respect to which (1) a mortgage is insured under either section 221(d)(3) or 236 of the National Housing Act and (2) the owner is limited both as to the rate of return on his investment and as to rental charges) to defer recognition of gain on the sale of such projects by reinvesting the proceeds in other like low-income housing projects under rules similar to section 1034. *See* I.R.C. § 1039. Such a disposition and reinvestment also constitutes a new exception to section 1250. *See id.* § 1250(d)(8).

[265] The issue as to this exception is whether it applies to only new residential rental property or to both new and used residential rental property. For the definition of new and used property, respectively, see notes 215 & 220 *supra*. *See also* notes 218, 219, 224 & 225 and accompanying text *supra*. The statute itself specifically states "residential rental property (as defined in section 167(j)(2)(B))." I.R.C. § 1250(a)(1)(C)(iii). The problem arises because, although section 167 (j)(2)(B) does define residential rental property in terms of the 80 percent test of gross rental income, it does so "for purposes of" new residential rental property only and is contained within the confines of that specific statutory exception permitting continued use of the double-declining balance and sum of the years-digits methods of depreciation. *See id.* § 167(j)(2). The lesser statutory exception for used residential rental property is contained in section 167(j)(5) although it refers to section 167(j)(2)(B) for the definition of residential rental property setting out the 80 percent test.

On the basis of the statute alone one might conclude (but with some doubt) that section 1250(a)(1)(C)(iii) was intended to apply only to new residential rental property, thus leaving used residential rental property to the 100 percent recapture provision for post-1969 additional depreciation. *See id.* § 1250(a)(1)(C)(v). The legislative history only compounds the confusion. The Senate Finance Committee report clearly indicates that its recapture percentage phase-out rule applied to new residential rental property. S. REP. No. 91-552 at 214. The Conference Committee report, however, stated that it "generally follows the Senate amendment" but

modifies the recapture rules pertaining to residential housing by allowing

depreciation is phased-out at the rate of one percent for each full month after the property has been held for 100 months. Thus, there is no recapture if the property is held for 16 years 8 months.[266]

Section 1250 property with respect to which a section 167(k) depreciation deduction for rehabilitation expenditures was allowed qualifies as the third exception to 100 percent recapture of post-1969 additional depreciation. In this situation, like that of residential rental property, the post-1969 additional depreciation is reduced at the rate of one percent for each full month in excess of 100 months after the date on which the property was placed in service.[267]

Although Congress has restricted the use of accelerated depreciation methods generally and enlarged the scope of the recapture provisions of section 1250, it is clear that the T.R.A. is far more lenient than some prophets had predicted prior to its enactment.[268] It is possible that this leniency on the part of Congress may even help to mitigate the residental rental housing shortage.[269]

TRANSFERS OF FRANCHISES, TRADEMARKS AND TRADE NAMES

Background

Generally, gain realized from a transfer of property is accorded long-term capital gain treatment only if the transfer constitutes a "sale or exchange"[270] and the property is a "capital asset held for more than six months."[271] With the rapid growth of franchising in recent years, courts have been faced with the task of determining the existence of these elements in deciding whether the proceeds of a franchise or subfranchise transfer result in capital gain or ordinary income to the transferor.

a 1-percent-per-month reduction in the amount to be recaptured as ordinary income after the property has been held for 100 full months. Other real property is subject to full recapture, thus eliminating the phaseout of recapture after 10 years for nonhousing under the Senate amendment. CONF. COMM. REP. 322.

The references in the Conference Committee report to "residential housing" and to "nonhousing" imply an intent to change the Senate amendment so as to encompass all residential rental property. However that may be, under the wording of the statute the question remains for which there is no clear answer.

[266] I.R.C. § 1250(a)(1)(C)(iii).

[267] *Id.* § 1250(a)(1)(C)(iv).

[268] Compare the affect of section 1250 with that of its companion, section 1245, as set out in note 212 *supra.*

[269] In addition, it should be noted that "additional depreciation" as defined in section 1250(b)(1) and (4) is an item of tax preference subject to the new minimum tax of section 56(a). I.R.C. § 57(a)(2). For the amount of the charitable deduction arising from the gift of section 1250 property to a qualified charitable organization, see I.R.C. § 170(e)(1); Taggart, *The Charitable Deduction,* 26 TAX. L. REV. 63, 70-72, 101-13 (1970).

[270] I.R.C. § 1222(3), (11).

[271] *See id.* §§ 1221, 1222(3); note 3, *supra.* Of course, other sections of the Code may provide long-term capital gain treatment in certain cases, *See, e.g.,* I.R.C. § 1231.

The primary difficulty concerned whether the transfer qualifies as a sale or simply amounts to a form of rental arrangement, *i.e.* a license. This was largely so because of the inherent nature of franchises which normally provide for retention by the transferor of various rights in the subject matter of the franchise as well as restrictions on the manner in which the transferee is to conduct his business. Retention of such control by the transferor tended to make the transfer look less like a "sale" and more like a mere "license," with the consequence that the proceeds would be ordinary income instead of capital gain. The focus of judicial attention on the sale versus license question obscured the other issue of whether the franchise was a capital asset in the hands of the transferor.[272]

Although the courts have generally agreed that the retention by the transferor of significant rights or powers would preclude the transfer from being a sale, there has been considerable conflict and confusion over just what combinations of rights or powers were substantial or significant enough to require this conclusion.[273] This is well-illustrated by the famous or notorious series of Dairy Queen cases,[274] each involving similar territorial franchise agreements, in which the result seemed to depend, in large part, upon the accident of jurisdictional residence.[275] Even if the franchise transfer was deemed to be a sale, there was the further problem whether all or only part of the proceeds were attributable to the sale when the payments were partially of a periodic or continuing nature based upon the use or productivity of the subject matter of the franchise.[276]

In order to eliminate the confusion of existing law,[277] to reemphasize the importance of the capital asset issue, and to correlate the treatment of

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272 H.R. REP. No. 91-413, pt. 1, at 160-62; S. REP. No. 91-552 at 207-08.

273 H.R. REP. No. 91-413, pt. 1, at 160; S. REP. No. 91-552 at 207.

274 *See* United States v. Wernentin, 354 F.2d 757 (8th Cir. 1965) (license); Estate of Gowdey v. Commissioner, 307 F.2d 816 (4th Cir. 1962) (sale); Dairy Queen, Inc. v. Commissioner, 250 F.2d 503 (10th Cir. 1957) (sale).

275 *Compare* Moberg v. Commissioner, 305 F.2d 800 (5th Cir. 1962) (sale) *with* Theodore E. Moberg, 35 T.C. 773 (1961), *aff'd in part*, 310 F.2d 782 (9th Cir. 1962) (license), both of which involved the same franchise agreements, the only difference being that Vern H. Moberg resided in Texas while his brother-partner Theodore E. Moberg resided in Washington.

276 *See* H.R. REP. No. 91-413, pt. 1, at 162-63; S. REP. No. 91-552 at 208-09. There were several types of payments involved in the Dairy Queen cases. In some there was a fixed price (consisting of both a lump-sum and a "gallonage" payment of so many cents per gallon of mix used) plus a continuing gallonage payment. *See* Moberg v. Commissioner, 305 F.2d 800, 802 n.3 (5th Cir. 962); Theodore E. Moberg, 35 T.C. 773, 777 (1961). In others there were essentially only lump-sum payments plus a continuing gallonage payment. *See* cases cited in note 274 *supra.*

In those cases holding the franchise transfer to be a sale, to the extent the gallonage payment was part of the fixed price it was attributable to the sale (capital gain) Moberg v. Commissioner, *supra* at 806; but the gallonage payment was not attributable to the sale (ordinary income in the nature of a continuing royalty) to the extent it was not part of the fixed price, Moberg v. Commissioner, 365 F.2d 337 (5th Cir. 1966), or where the agreement generally provided only for lump-sum payments plus the continuing gallonage payment. Estate of Gowdey v. Commissioner, 307 F.2d 816 (4th Cir. 1962). *Contra*, Dairy Queen, Inc. v. Commissioner, 250 F.2d 503 (10th Cir. 1957), *rev'g* 26 T.C. 61 (1956).

277 The congressional action may have been, in part at least, a response to the

the payments under the franchise agreement by both the transferor and the transferee, Congress enacted new code section 1253, dealing with transfers of franchises and also tacking on transfers of trademarks and trade names.[278]

UNDER THE T.R.A.: SECTION 1253

Section 1253 provides that the "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 with respect to the subject matter of the franchise, trademark, or trade name."[279] The provision is negatively phrased; it does not affirmatively set out what is a sale or exchange of a capital asset in connection with a franchise transfer. At the very least the consequence of this is that, assuming the requisites of section 1253(a) to be satisfied, capital gain treatment is not guaranteed to the transferor unless the franchise is a capital asset[280] or a section 1231 asset.[281]

One of the requirements of capital asset status is that the property must not be "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[282] The House and Senate Committee Reports encourage the courts to deal with this requirement in the

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sentiments reflected in Judge Brown's concurring opinion in the final edition of *Moberg* in the Fifth Circuit where he registered

> some amazement that a time when all are encouraged to use inventive resourcefulness in finding ways to keep our vaunted judicial system from breaking down from its own weight as law collides with the explosion of population, these contracts which are essentially the same have occupied the attention of so many Judges as they struggle a decade and a half later, not merely to decide, but to decide upon what theory they are to decide, the tax consequences of Dairy Queen which probably 'tastes good like Dairy Queen should,' but which taxes good—to Taxpayer or Government alike—depending on the accident of residence . . . .
>
> . . . I would doubt that these issues have been sufficiently grave or important as to occupy the attention of no less than 18 Circuit Judges, one District Judge whose 'extremely able decision' was last found to be both wrong and right, and an undisclosed number of Tax Court Judges.
>
> Won't we have to find another, better way? 365 F.2d at 341.

[278] H.R. REP. No. 91-413, pt. 1, at 161-64; S. REP. No. 91-552 at 208.

[279] I.R.C. § 1253(a).

[280] *See* H.R. REP. No. 91-413, pt. 1, at 163.

[281] It is interesting to note that the operative bite of section 1253(a) simply provides that a transfer of a franchise shall not be treated as "sale or exchange of a capital asset." It is clear that the fulcrum of the provision attacks the "sale or exchange" aspects, but even so it seems to be poorly worded since it adds "of a capital asset." Query whether one might argue that section 1253(a) has no application to a transfer of a franchise that is clearly a section 1231 asset? *Cf.* I.R.C. §§ 1239(a), 1245(a), 1250(a)(1)-(2). One can only speculate at this point; but, in our opinion, it would seem that section 1253(a) should apply equally to a transfer of a franchise constituting a section 1231 asset.

[282] *Id.* § 1221(1). *See id.* § 1231(b)(1)(B). Prior to the T.R.A. only a relatively small number of cases have dealt with the question of whether the transferor was in the business of selling franchises, trademarks or trade names due to the concentration of attention on the sale versus license issue. *See, e.g.,* Vern H. Moberg, 22 T.C.M. 1483 (1963), *aff'd,* 365 F.2d 337 (5th Cir. 1966) (capital asset); Dairy Queen, Inc., 18 T.C.M. 322 (1959) (capital asset).

future, listing the following factors to be considered, among others, in making this determination: (1) the length of the holding period as bearing on the issue whether the property was acquired with an intention to sell it; (2) the number of sales in a particular year as relevant to the issue whether the property was held primarily for sale; and (3) whether the franchise territory was divided into subfranchises for marketing purposes and for sale to individuals as being related to the question whether the property was being held primarily for sale in the ordinary course of business.[283]

DEFINITIONS

Franchises and Patents

"Franchise" is defined as including "an agreement which gives one of the parties to the agreement the right to distribute, sell, *or* provide goods, services, or facilities, within a specified area."[284] A patent is essentially "a grant to the patentee, his heirs or assigns, for the term of seventeen years . . . of the right to exclude others from making, using, or selling the invention throughout the United States . . . ."[285] Generally speaking and without regard to other limitations, for there to be a "sale" of a patent, instead of a mere "license," the transfer of such property should include the assignment to the transferee of the *exclusive* right, or an undivided interest therein, to make, use *and* sell the subject matter of the patent within a specified area of the United States,[286] under the general capital gain rules[287] and under the special rules of section 1235.[288]

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[283] H.R. REP. No. 91-413, pt. 1, at 163-64; S. REP. No. 91-552 at 209.

[284] I.R.C. § 1253(b)(1) (emphasis added). This would include distributorships, subdistributorships, subfranchises and other similar exclusive-type contractual arrangements to operate a business within a particular area. H.R. REP. No. 91-413, pt. 1, at 164; S. REP. No. 91-552 at 211. Section 1253 does not apply to a transfer of a franchise to engage in a professional sport. I.R.C. § 1253(e).

[285] 35 U.S.C. § 154 (Supp. V, 1965). *See* American Foundry & Mfg. Co. v. Josam Mfg. Co., 79 F.2d 116, 117 (8th Cir. 1935); Wine Ry. Appliance Co. v. Baltimore & O.R. Co., 78 F.2d 312, 316 (4th Cir. 1935). An excellent treatise on patent law is A. DELLER'S WALKER ON PATENTS (1964).

[286] *See* Waterman v. Mackenzie, 138 U.S. 252 (1891); *but see* 57 A.B.A.J. 621 (1971).

[287] *E.g.*, Watson v. United States, 222 F.2d 689 (10th Cir. 1955); Edward C. Myers, 6 T.C. 258 (1946). *See* United States v. General Elec. Co., 272 U.S. 476 (1926); Waterman v. Mackenzie, 138 U.S. 252 (1891). For the provisions generally applicable, see I.R.C. §§ 1221, 1222 & 1223.

A patent is intangible personal property which may be depreciable. Treas. Reg. § 1.167(a)-3 (1956). Accordingly, where the transferor has used the patent in his trade or business and held it for more than six months, section 1231 can apply. *See* United States Mineral Prod. Co., 52 T.C. 177, 194 (1969). For the applicability of section 1239, see Estate of William F. Stahl, 52 T.C. 591 (1969), *rev'd in part*, —F.2d—, 27 A.F.T.R.2d 71-1077 (7th Cir. 1971). Section 1245 may also apply. *See* I.R.C. § 1245(a)(3)(A); Treas. Reg. § 1.1245-3(b)(2)(1965).

[288] *But see* Franz Martini, 38 T.C. 168 (1962); Treas. Reg. § 1.1235-2(b)(1), T.D. 6263, 1957-2 Cum. Bull. 570. See generally, Fawick v. Commissioner, 27 A.F.T.R.2d 71-381 (6th Cir. 1971). Section 1235 essentially provides that gain from a transfer by a holder to an unrelated person of "all substantial rights to a patent" is to be accorded long-term capital treatment, even though the payments in consideration of the transfer are either payable periodically over a period coterminus with the transferee's use of the patent or are contingent on the productivity, use or disposition

Given the broad language of the franchise definition and its use of the disjunctive word "or," it would seem that it might encompass patent transfers.[289] This is of crucial importance because all amounts received or accrued on account of the disposition of a franchise which are contingent on its productivity, use or disposition are treated as ordinary income to the transferor regardless of whether or not the transfer itself is a sale under section 1253(a).[290] The issue is joined when one realizes that payments received in return for a patent transfer are often based, under the transfer agreement, on the use or productivity of the patented article.

It is clear that failure to transfer all substantial rights to the patent results in ordinary income.[291] This is not changed by the enactment of section 1253. Where there is a transfer of all substantial rights to a patent in return for payments coterminus with the life of the patent or contingent on the use, productivity or disposition of the patent, however, such payments might conceivably be ordinary income under section 1253(c), regardless of section 1235 or the general capital gains provisions. In the past, it has been possible to obtain capital gain treatment, despite the method or form of payment, under section 1235.[292] Alternatively, where the transfer is not one described in section 1235 (as, for example, where the transferor is not

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of the transferred property. I.R.C. § 1235(a), (d). For the definition of a "holder," see *id.* § 1235(b).

Contrary to the general capital gain rules, if the transaction satisfies the provisions of section 1235, it is immaterial that (1) the taxpayer is a professional inventor or is holding the patent primarily for sale to customers in the ordinary course of his trade or business, (2) the patent is held for only six months or less, and (3) the payments resemble royalties. 3B MERTENS, *supra* note 2, § 22.134, at 824-25.

[289] *See* Hall, *Capital Gains and Losses,* 23 TAX LAW. 565, 570 (1970).

[290] I.R.C. § 1253(c). *See* S. REP. No. 91-552 at 210; CONF. COMM. REP. 320; STAFF OF JOINT COMM. ON INT. REV. TAXATION, Summary of H.R. 13270, 91st Cong., 1st Sess., 81 (1969).

[291] *See* text accompanying notes 284-86 *supra.*

[292] I.R.C. § 1235(a)(1), (2). Section 1235 was enacted to ensure, among other things, that the sale of patents by certain holders would not be denied sale or exchange status solely by reason of the method of payment. S. REP. No. 1622, 83d Cong., 2d Sess. 438 (1954). For years prior to 1950 it had been held that where the payment was contingent on the use or productivity of the patented article capital treatment was not precluded. *E.g.,* Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953); Edward C. Myers, 6 T.C. 258 (1946), *acquiesced in,* 1946-1 CUM. BULL. 3. *See* Commissioner v. Celanese Corp. of America, 140 F.2d 339 (1944).

In 1950, however, the Internal Revenue Service changed its position and held that for taxable years beginning after May 31, 1950 payments measured by the production, sale or use of the patented article or payable periodically over a period coterminus with the transferee's use of the patent would constitute ordinary income. Mim. 6490, 1950-1 CUM. BULL. 9. *See also* 1950-1 CUM. BULL. 7 substituting nonacquiescence to *Edward C. Myers, supra.*

The congressional response was section 1235 of the Internal Revenue Code of 1954. The Internal Revenue Service continued to treat such payments made after May 31, 1950 and prior to the effective date of section 1235 as ordinary income, however. Rev. Rul. 55-58, 1955-1 CUM. BULL. 97. In turn, Congress amended the Internal Revenue Code of 1939 by adding section 117(q) containing the substance of the provisions of section 1235, effective for amounts received in taxable years beginning after May 31, 1950. 3B MERTENS, *supra* note 2, § 22.134, at 823. Finally, in 1958 the Internal Revenue Service revoked Mimeograph 6490 and Revenue Ruling 55-58. Rev. Rul. 58-353, 1958-2 CUM. BULL. 408.

a "holder" as defined in section 1235(b)),[293] capital gain treatment maybe obtained under general capital gain principles.[294] This result may now be changed if section 1253 overrides these alternatives. But for a literal reading of section 1253(c), this would seem to be nonsense.[295]

The legislative history is illuminating on this problem. The House bill provided a specific exception to the operation of this section for amounts received in connection with franchise transfers attributable to the transfer of all substantial rights to a patent, the committee report indicating that

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[293] Treas. Reg. § 1.1235-1(b) (1957):

> If a transfer is not one described in . . . [section 1235], section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfer shall be determined under other provisions of the internal revenue laws.

In a case involving an indirect transfer of a patent by a holder to a related person in return for payments contingent upon its productivity, use or disposition, the Tax Court has held that section 1235 is the holder's exclusive provision for qualifying for capital gain treatment. In other words, that the general capital gain provisions outside section 1235 may not be resorted to in this situation. Myron C. Poole, 46 T.C. 392 (1966).

The Senate Finance Committee report to section 1235 stated that

> It is the intention of your committee that, if the mode of payment is as described in . . . [section 1235(a)], the sale of a patent by any 'holder' must qualify under the section in order for such 'holder' to obtain capital gain treatment. However, the benefits of this section are to be limited to those individuals and transfers qualifying under its terms. In enacting this section, for the specific purposes set forth in this report, your committee has no intention of affecting the operation of existing law in those areas without its scope. For example, the tax consequences of the sale of patents in years to which this section is inapplicable, or by individuals who fail to qualify as 'holders,' or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted. S. REP. No. 1622, 83d Cong., 2d Sess. 441 (1954).

In addition to the first sentence of the foregoing quotation from the committee report, *Poole* was based upon the fact that, if the general capital gain rules outside section 1235 were to apply, the effect would be to nullify section 1235(d). Myron C. Poole, *supra* at 404. This holding seems eminently reasonable. *See* 3B MERTENS, *supra* note 2, § 22.134, at 825-26; Mertens, The Law of Federal Income Taxation (Code Commentary), Ch. 1, Subch. P at 58.

But the Internal Revenue Service refuses to follow it, gratuitously ruling that a transfer of a patent by a holder to a related party for contingent amounts can qualify for capital gain treatment under the general provisions of the Code outside section 1235. Rev. Rul. 69-482, 1969-2 CUM. BULL. 162. However, in making this ruling, it should be noted that the Internal Revenue Service neglected to mention the first sentence of the above quotation from the committee report although it quoted most of the remainder. The *Poole* deicsion has subsequently been followed by the Tax Court. See William W. Taylor, 29 T.C.M. 1488 (1970). In view of the contrary regulation and the current attitude of the Internal Revenue Service, however, the issue cannot be regarded as free from doubt. See generally, Thomson v. United States, 25 A.F.T.R.2d 70-697, 703-06 (E.D.N.Y. 1969).

[294] Treas. Reg. § 1.1235-1(b) (1957); Rev. Rul. 69-482, 1969-2 CUM. BULL. 164; Rev. Rul. 58-353, 1958-2 CUM. BULL. 408. *See* the cases cited in note 292 *supra* and the portion of the committee report quoted in note 293 *supra*. Thus, where the transferor is a corporation (and therefore not a "holder" as defined in section 1235(b)), section 1235 is inapplicable and the general capital gain rules outside that section apply. E.I. duPont de Nemours & Co. v. United States, 432 F.2d 1052, 1054 n.2 (3d Cir. 1970).

[295] "God . . . hath made us able ministers of the new testament; not of the letter, but of the spirit: for the letter killeth, but the spirit giveth life." 2 *Corinthians* 3:6.

such "amounts, as in the case with the transfer of a patent under section 1235, would be entitled to capital gain treatment."[296] Section 1253 as passed by the Senate and as finally enacted, however, deleted this exception, apparently because "patents are treated specifically in section 1235 of the code."[297] In view of this history it would seem that section 1253(c) does not override section 1235.[298] Only a slightly stronger case for section 1253 can be made with respect to the general capital gain provisions which are outside the scope of section 1235, although Congress probably did not foresee nor intend such a result.

Trademark, Trade Name and Transfer

The statute does not define either "trademark" or "trade name." The Senate Finance Committee report refers to the Trademark Act of 1946 to define "trademark" as including "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."[299] The term "trade name" also encompasses a trade brand.[300]

"Transfer" is defined by the statute to include "the renewal of a franchise, trademark or trade name."[301] The significance of this is that franchises already outstanding and existing prior to the effective date of this section will come within the scope of section 1253 when they are subsequently renewed.

THE TRANSFEROR

Retention of "Any Significant Power, Right, or Continuing Interest"

In order for the transfer of a franchise, trademark or trade name to qualify as a "sale or exchange," the transferor can not retain "any significant power, right, or continuing interest" with respect to its subject matter[302] because such a retention is likely to be the equivalent of continuing active operational control inconsistent with a "sale" of property.[303] But precisely what constitutes such a power, right or interest? The statute answers this question in somewhat equivocal fashion by enumerating certain specific rights each separately constituting a "significant power, right, or continuing interest" with respect to the interest transferred but pref-

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[296] H.R. REP. No. 91-413, pt. 1, at 164.
[297] STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270, 91st Cong., 1st Sess., 82 (1969).
[298] *See* Hall, *supra* note 287.
[299] S. REP. No. 91-552 at 211.
[300] *Id.*
[301] I.R.C. § 1253(b)(3).
[302] *Id.* § 1253(a).
[303] *See* H.R. REP. No. 91-413, pt. 1, at 162; S. REP. No. 91-552 at 208-09; CONF. COMM. REP. 319.

acing the list with the statement that such term "includes, but is not limited to" those rights enumerated.[304] These rights are:

> (1) the right to disapprove any assignment of all or part of such interest;[305]
>
> (2) the right to terminate at will;[306]
>
> (3) the right to set the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote the same;[307]
>
> (4) the right to require that the transferee sell or advertise only products or services of the transferor;[308]
>
> (5) the right to require that the transferee purchase substantially all of his supplies and equipment from the transferor;[309]
>
> (6) the right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.[310]

It is apparent that, since the normal franchise agreement involves the retention of the right to set the standards of quality, described in (3) above, in order to ensure continued profitability and protect the reputation of the product or service, the effect here is to disqualify most franchise arrangements from capital gain treatment.[311]

Payments Contingent on the Productivity, Use or Disposition of the Subject Matter of the Interest Transferred

The right set out in (6) above deserves special consideration. Payments which are contingent on the productivity, use or disposition of the subject matter of the interest transferred include those

> 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

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[304] I.R.C. § 1253(b)(2).

[305] *Id.* § 1253(b)(2)(A). *But cf.* Treas. Reg. § 1.1235-2(b)(3)(i) (1957).

[306] I.R.C. § 1253(b)(2)(B). *Cf.* Treas. Reg. § 1.1235-2(b)(4) (1957). Presumably, neither the retention of a security interest nor the retention of rights to terminate for nonperformance and to inspect the franchisee's books would be considered significant because they are not inconsistent with a sale. *See* STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270, 91st Cong., 1st Sess., 81 (1969). *Cf.* Treas. Reg. § 1.1235-2(b)(2)(i), (ii) (1957).

[307] I.R.C. § 1253(b)(2)(C).

[308] *Id.* § 1253(b)(2)(D).

[309] *Id.* § 1253(b)(2)(E).

[310] *Id.* § 1253(b)(2)(F).

[311] Hall, *supra* note 272. *Compare* Moberg v. Commissioner, 310 F.2d 782 (9th Cir. 1962), *with* Moberg v. Commissioner, 305 F.2d 800 (5th Cir. 1962) (both holding that the "10-paragraph agreement" containing a provision requiring the transferees "to maintain the freezers, building, and equipment in a high state of repair, and to keep the premises clean" was consistent with a "sale.")

based upon production, sale or use, or disposition of the franchise, trademark, or trade name transferred.[312]

If such contingent payments are a "substantial element" under the transfer agreement,[313] then all amounts received by the transferor under the transfer agreement will be ordinary income including both contingent and non-contingent payments in lump-sum form or otherwise.[314] But even if the contingent payments are not a "substantial element," they will still be ordinary income to the transferor although the transfer qualifies as a sale under section 1253(a).[315]

The apparent justification for treating contingent payments as ordinary income in any event is that (1) since continuing payments are normally received over a long period of years, there is no necessity for capital gain treatment in order to prevent bunching of income in one year,[316] and (2) periodic payments are similar to royalty or rental income as well as representing a continuing economic interest in the property transferred.[317]

Other Rights

Since a "significant power, right, or continuing interest" is not limited to the specifically enumerated rights in the statute,[318] it is conceivable that other rights and combinations could be found to be significant. The House Committee Report mentions certain rights the status of which is uncertain, including, among others, (1) the right to prevent the transferee from moving equipment obtained from the transferor outside the transferee's territory, (2) the right to require the transferee to purchase specified (but not substantially all) equipment from the transferor, and (3) the right to pro-

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312 S. REP. No. 91-552 at 210. These types of payments will be referred to hereafter as contingent payments.

313 The statute does not define "substantial element." The provision involving the retention of a right to contingent payments where they are a substantial element was apparently inserted in section 1253(b)(2) in order to resolve the problem of combined methods of payment (fixed amount or lump-sum payments plus contingent payments) since a fixed amount or a lump-sum payment, considered alone, tends to indicate a capital transaction while contingent payments resembling royalties suggest a licensing arrangement. *See* STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270, 81 (1969).

Assuming that "substantial element" is in reference to the total consideration to be received under the transfer agreement, perhaps the case law as to what constitutes a "substantial part of the taxable income to be derived from such property" under the collapsible corporation provision of section 341(b)(1)(A) will be helpful in defining "substantial element." *See* Commissioner v. Zongker, 334 F.2d 44 (10th Cir. 1964) (34 percent is a "substantial part"); Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961) (33⅓ percent is a substantial part"); Heft v. Commissioner, 294 F.2d 795 (5th Cir. 1961) (17.07 percent is not a "substantial part"). *See also* E.J. Zongker, 39 T.C. 1046, 1053 (1963) (implication that more than 20 percent may be a "substantial part").

314 I.R.C. § 1253(a), (c).

315 Note 290 and accompanying text *supra*.

316 *See* Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960).

317 *See* H.R. REP. No. 91-413, pt. 1, at 163; S. REP. No. 91-552 at 208-09. *Compare* I.R.C. § 71(a), *with id.* § 71(c)(1).

318 I.R.C. § 1253(b)(2); text accompanying note 304 *supra*.

hibit the transferee from selling certain products (but not requiring him to advertise and sell only the transferor's products).[319]

The legislative history also refers to activities or conduct of the transferor amounting to active commercial participation in the transferee's business and its management. Where such active participation exists, the reports indicate that it is to be considered the retention of a "significant power, right or continuing interest."[320] Such activities might include "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."[321]

Given the specific rights enumerated in the statute and the uncertain status of the additional rights and conduct constituting active participation set out in the committee reports, it seems clear that the effect of section 1253 will be to deny capital gain treatment to the transferor of a franchise, trademark, or trade name in the usual situation.

THE TRANSFEREE

As previously stated, one of the reasons for enacting section 1253 was to correlate the treatment of payments under the transfer agreement by both the transferor and the transferee.[322] In general, amounts received by the transferor under the transfer agreement are often indeterminate in part and frequently consist of a lump-sum payment or a fixed amount payable in installments, plus contingent payments.[323]

Contingent Payments

All payments made or incurred during the taxable year under the transfer agreement which are contingent on the productivity, use or disposition of the transferred property are currently deductible as business expenses by the transferee under section 162.[324] The reason for this is simply that all such contingent payments are treated as ordinary income (resembling rents or royalties) to the transferor regardless of the outcome under section 1253(a).[325]

Non-Contingent Payments

The treatment by the transferee of non-contingent payments made under the transfer agreement, consisting of the lump-sum payment or the

[319] H.R. REP. No. 91-413, pt. 1, at 162.
[320] *Id.* at 162-64; S. REP. No. 91-552 at 208-09.
[321] S. REP. No. 91-552 at 208. *See also* H.R. REP. No. 91-413, pt. 1, at 162.
[322] *See* S. REP. No. 91-552 at 208.
[323] H.R. REP. No. 91-413, pt. 1, at 163; S. REP. No. 91-552 at 208.
[324] I.R.C. § 1253(d)(1).
[325] See authorities cited in note 290 *supra*.

fixed amount payable in installments, depends upon whether such payments are attributable to a "sale or exchange" as to the transferor under section 1253(a).[326]

1. Where the Transfer Is Not a "Sale or Exchange" as to the Transferor under Section 1253(a). Assuming that the transfer is not a "sale or exchange" as to the transferor under section 1253(a), with respect to a single or lump-sum payment, the transferee may in effect amortize his cost, *i.e.*, deduct it ratably over a 10-year period or over the life of the transfer agreement, whichever is shorter.[327] Again, if the transferee is to pay a fixed amount (principal sum) in approximately equal installments over either the life of the transfer agreement or a period of more than 10 years (whether such period ends before or after the end of the life of the transfer agreement), the transferee may deduct each such payment when made.[328]

2. Where the Transfer is a "Sale or Exchange" as to the Transferor under Section 1253(a). Section 1253 does not specifically deal with the effect on the transferee of non-contingent payments made pursuant to the transfer agreement where the transfer is a "sale or exchange" as to the transferor under section 1253(a). But even so, if there is a "sale" by the transferor, it is clear that the transferee has acquired an intangible asset by purchase, and his basis is cost. The Senate Finance Committee report indicates that it was intended that the deductibility by the transferee be determined under the present law.[329] Under existing law the transferee is permitted to deduct, in the form of depreciation or amortization allowances, the amount paid only if the intangible asset has an ascertainable useful life.[330] Thus, if a franchise has an indefinite useful life, the transferee is not entitled to depreciation or amortization.[331]

Effective Date

Section 1253 generally applies to transfers occurring after 1969. However, section 1253(d)(1) dealing with the deductibility by the transferee of contingent payments shall apply, at the election of the transferee-taxpayer

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[326] *See* S. REP. No. 91-552 at 208; CONF. COMM. REP. 320.

[327] I.R.C. § 1253(d)(2)(A).

[328] *Id.* § 1253(d)(2)(B). Other methods of payment of the principal sum in this situation are deductible by the transferee according to regulations to be prescribed, consistently with the foregoing. *Id.* § 1253(d)(2)(C). The reason for allowing the deduction for installment payments of the principal sum is that as to the transferor the transfer is considered a mere "license" (instead of a capital transaction) producing amounts resembling rents or royalties. *See* text accompanying note 325 *supra.* In view of this the transferee is permitted to deduct them; and, where the payment is a lump-sum, the transferee may amortize it to obtain a like result.

[329] S. REP. No. 91-552 at 210.

[330] Treas. Reg. § 1.167(a)-3 (1956). *See* S. REP. No. 91-552 at 210; CONF. COMM. REP. 320.

[331] Dunn v. United States, 400 F.2d 679 (10th Cir. 1968) (Dairy Queen franchise held to be of indefinite useful life in view of fact that it continued in perpetuity, subject to termination for, among other things, nonpayment of gallonage charges). *Cf.* Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951).

in accordance with regulations to be prescribed, to transfers occurring before 1970 but only with respect to contingent payments made in taxable years ending after 1969 and beginning before 1980.[332]

SALES OF LIFE ESTATES

BACKGROUND AND PRIOR LAW

In general, where a life estate[333] and a remainder interest in the same property have been created by gift, bequest or inheritance, the total basis of the entire property[334] is allocated between the life estate and the remainder under the uniform basis rules. With the mere passage of time the basis of the life estate is decreased and the basis of the remainder is increased correspondingly so that the total basis of the entire property always remains constant.[335] If a life estate in income-producing property is acquired by gift, bequest or inheritance, the life tenant may not recover his portion of such uniform basis through amortization deductions.[336] But if the life tenant acquires his interest by purchase, he may amortize his basis (cost) over the length of the life estate under section 167, thereby reducing the amount of the taxable income received from that interest.[337] If the remain-

[332] Pub. L. 91-172, § 516(d)(3) 91st Cong., 1st Sess. (1969), 83 Stat. 648.

[333] The term "life estate" as used in this background discussion is intended to encompass not only life estates in realty but life interests generally, including life interests in trusts.

[334] The basis of the entire property acquired from a decedent will generally be the fair market value at the date of the decedent's death. I.R.C. § 1014(a), (b)(1). The basis of the entire property acquired by gift is generally the same as the donor's basis (subject to limitations for purposes of determining loss), increased by the amount of gift tax paid. *See id.* § 1015(a), (d).

[335] H.R. REP. No. 91-413, pt. 1, at 156; S. REP. No. 91-552 at 203. *See* Treas. Reg. §§ 1.1014-4,-5, 1.1015-1(b) (1957). This is illustrated by the following example. On January 1, 1960, the decedent dies leaving property by will to *A* for life, remainder to *B*. The fair market value of the property as of such date is $50,000 which constitutes the basis for the entire property. I.R.C. § 1014(a). Assuming no applicable adjustments to the uniform basis in the interim, on January 1, 1964 when *A* is 40 years of age his basis for the life estate is $31,454 (while *B's* basis for the remainder is $18,546); on January 1, 1969 when *A* is 45 years of age his basis for the life estate is $28,832 (while *B's* basis for the remainder is $21,168). *See* Treas. Reg. § 1.1014-5 (1957).

[336] I.R.C. § 273.

[337] *E.g.*, Gist v. United States, 423 F.2d 1118, (9th Cir. 1970); Estate of Daisy F. Christ, 54 T.C. 493 (1970); Allen M. Early, 52 T.C. 560 (1969). *See* H.R. REP. No. 91-413, pt. 1, at 157; S. REP. No. 91-442 at 203.

Generally, the right to amortization deductions revolves around the issue whether the acquisition of the life estate was by "purchase" instead of by "gift, bequest, or inheritance." On this issue *Gist* and *Christ* are of considerable importance in community property states. *See* Freeland, Lind & Stephens, *What are the income tax effects of an estate's sale of a life interest?*, 34 J. TAX. 376 (1971); Johanson, *Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems*, 47 TEXAS L. REV. 1247, 1296-98 (1969).

The *Gist* and *Christ*-type situation involves the following facts. The husband by will establishes a trust the corpus of which is to consist of the entire community property including the one-half interest of the surviving wife. The surviving wife elects after the husband's death to take under the will, instead of claiming her separate community property as she is entitled to do. Pursuant to the terms of the trust, she is entitled to the trust income for life, with the remainder going to named children.

derman is the purchaser of the intervening life estate, amortization is still permitted despite the argument that in such case the life estate and remainder have "merged" thus leaving no separate life estate basis to amortize.[338]

Although the life tenant may not amortize a life estate acquired by gift, bequest or inheritance, upon a sale of a life estate his portion of the uniform basis in the property is applied against the amount realized in determining the amount of the realized gain. This was the law prior to the T.R.A.[339] Beyond that, the sale of a life estate has generally been held to be the sale of a capital asset,[340] producing capital gain[341] or a deductible

Prior to the election the widow had a present legal interest in one-half of the community property, consisting of both the life estate and remainder. After the election she has the right to all the income from the entire community property for life. It is clear that she has purchased a life estate in her husband's half interest in exchange for a remainder interest in her community property. Of course, she has retained a life estate in her own one-half of the community property. *See* Gist v. United States, *supra*, at 1120. Thus, she has really given up only the remainder interest in her own one-half of the community property and received a life estate in her husband's one-half of the community property, but the value of the former may greatly exceed the value of the latter. If this disparity in value exists and taking into account the fact that the remainder goes to named children, the surviving wife will be deemed to have exchanged only a portion of the remainder interest in her own one-half of the community property for (and of value equivalent to) the life estate in the deceased husband's one-half of the community property. The balance of the remainder interest in her own one-half of the community property constitutes a gift. *See* Estate of Daisy F. Christ, *supra*, at 530. For a discussion of the estate and gift tax aspects of *Gist* and *Christ*, see Freeland, Lind & Stephens, *supra.*

In both *Gist* and *Christ* it was held that the surviving wife had acquired the life estate in her husband's one-half of the community property by purchase. Accordingly, she was allowed to amortize the cost of purchasing the life estate under section 167. The cost to the surviving spouse (that portion of the remainder in her own one-half of the community property involved in the non-gift part of the transaction) was determined to be equal to the fair market value of life estate received in the deceased husband's one-half of the community property. *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

In view of the fact that there was an "exchange" here, giving rise to a "purchase," one might assume that the surviving wife could have taxable gain. But the effect of section 1014(b)(6) will probably prevent any taxable gain to the surviving wife on this transaction. Under that section the surviving wife obtains a new fair market value basis (as of the date of her deceased husband's death) for her one-half of the community property even though it is not included in the deceased husband's gross estate. *See* Freeland, Lind & Stephens, *supra.*

For a thorough analysis of the estate and gift tax aspects of widow's election wills generally, see Johnanson, *supra* at 1265-1311. *See also* Christian, *Tax Aspects of Widow's Election*, 1 ARIZ. L. REV. 105 (1959); Thurman, *Federal Estate and Gift Taxation of Community Property*, 1 ARIZ. L. REV. 253 (1959).

[338] Bell v. Harrison, 212 F.2d 253 (7th Cir. 1954); William N. Fry Jr., 31 T.C. 522 (1958); *aff'd*, 283 F.2d 869 (6th Cir. 1960); Rev. Rul. 62-132, 1962-2 CUM. BULL. 73. Where the purchased life estate carries with it the right to receive tax-exempt interest income, section 265(1) does not preclude amortization because that deduction is allowed by section 167 and not section 212. Manufacturers Hanover Trust Co. v. Commissioner, 431 F.2d 664 (2d Cir. 1970); Allen M. Early, 52 T.C. 560 (1969) *See also* Rev. Rul. 61-86, 1961-1 CUM. BULL. 41.

[339] Treas. Reg. §§ 1.1014-5, 1.1015-1(b) (1957); H.R. REP. No. 91-413, pt. 1, at 156-57; S. REP. No. 91-552 at 203. *See* S. SURREY & W. WARREN, FEDERAL INCOME TAXATION: CASES AND MATERIALS 807-08 (1960). Thus, in the example in note 335 *supra*, if *A* sold his life estate in the property on January 1, 1964 for $35,000, his realized gain would be $3,546.

[340] *See* Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 321-27 (1962), and cases cited therein; H.R. REP. No. 91-413, pt. 1, at 157.

[341] *See, e.g.*, Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943).

capital loss.[342] Thus, even where the owner of the fee simple in realty has sold a life estate to another while retaining the remainder, this has been the result[343] although the measuring life of the life estate was that of the purchaser so that at the time of the sale it was not clear that the seller had sold all (or a portion) of the income rights in the property for the seller's own life.[344]

A purchaser of a life estate can amortize his cost over the period of the life estate. The seller could measure his gain or loss on the sale by reference to the allocable portion of the uniform (gift or death) basis. The combined effect resulted in a large part, and in some cases all, of the income from a life estate or similar interest acquired by gift, bequest or inheritance, to escape taxation.[345] While sound tax law would support the purchaser's tax treatment, there is no need to accord the seller, in these circumstances, a basis in the life estate or term interest. Accordingly, Congress pulled the basis rug from under the seller in the T.R.A.[346]

UNDER THE T.R.A.: SECTION 1001(e)

The new code section provides, *inter alia*, that

> In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014 or 1015 (to the extent such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.[347]

The phrase "term interest in property" is defined as a life or a term of years interest in property or an income interest in a trust.[348]

Effect

Generally, under section 1001(e), where the holder of such a "term interest in property" acquired by gift, bequest, inheritance or a transfer in

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[342] *See, e.g.*, McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947). *Cf.* S. REP. No. 91-552 at 203-04.

[343] Estate of Johnson N. Camden, 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943). *Compare* Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 12 (1964), *with* Freeland, Lind & Stephens, *supra* note 337, *and* Johanson, *supra* note 337, at 1296 n.219.

[344] Estate of Johnson N. Camden, 47 B.T.A. 926 (1942) *aff'd per curiam*, 139 F.2d 697 (2d Cir. 1943). *Compare* Blair v. Commissioner, 300 U.S. 5 (1937), *with* Harrison v. Schaffner, 312 U.S. 579 (1941). But if the transfer does not constitute a bona fide disposition of the life estate within the meaning of section 1001, capital treatment may be denied. *See* Silverstein v. United States, 419 F.2d 999 (7th Cir. 1969); Eustice, *supra* note 343, at 12 n.29.

[345] H.R. REP. No. 91-413, pt. 1, at 157; S. REP. No. 91-552 at 203-04.

[346] I.R.C. § 1001(e).

[347] *Id.* § 1001(e)(1).

[348] *Id.* § 1001(e)(2). *See* Maxfield, *Capital Gains and Losses*, 25 TAX L. REV. 565, 578 (1970), which raises the question whether the phrase "term interest in property" would encompass an income interest in property (not in trust) until remarriage.

trust[349] sells it to another,[350] the seller's portion of the uniform basis is disregarded in computing his gain. In other words, the seller's gain will be the entire amount realized[351] from the sale.[352] It should be emphasized that section 1001(e) only affects the prior law by changing the amount of gain realized by the seller.[353] It changes neither the character of the seller's gain[354] nor the right of the purchaser to amortize the cost of the life estate to him.[355]

Remainder Interests

Section 1001(e) does not apply to the disposition of remainder interests in property. This is simply because remainder interests do not fit within the statutory definition of a "term interest in property."[356] This is understandable in light of the fact that Congress was concerned about the fact that income from life estates and similar term interests escaped from taxation.[357]

Single Transactions

When the holder of the "term interest in property," acquired by gift, bequest or inheritance, and the remainderman simultaneously sell their respective interests in a single transaction to another, then section 1001(e) is specifically made inapplicable to the disposition.[358] In these circumstances, the holder of the term interest measures his realized gain resulting from the sale of such interest as the excess of the amount realized over his adjusted basis determined under the uniform basis rules.[359] The reason for this exception is that in one transaction the purchaser has acquired the entire interest in the property and, as under prior law, may not amortize

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[349] *See* H.R. REP. No. 91-413, pt. 1, at 157; S. REP. No. 91-552 at 204.

[350] This assumes that the sale was not part of a single transaction in which both the holder of the term interest in property and the remainderman simultaneously conveyed the entire interest in the property to another. *See* I.R.C. § 1001(e)(3).

[351] For the definition of "amount realized," see *id.* § 1001(b).

[352] *See* authorities cited in note 347 *supra.* Thus, in the example in note 335 *supra,* if *A* were 46 years of age on January 1, 1970 when he sold his life estate in the property to *C* for $35,000 (and *B* retained the remainder), *A's* realized gain would be $35,000, not $6,720.50. *See* H. REP. No. 91-413 pt. 2, at 114. For the effective date of section 1001(e), see note 402 and accompanying text *infra.*

[353] *See* note 339 and accompanying text *supra.*

[354] *See* notes 340-42 and accompanying text *supra.*

[355] *See* notes 336-38 and accompanying text *supra.*

[356] *See* I.R.C. § 1001(e)(2).

[357] *See* note 345 and accompanying text supra.

[358] I.R.C. § 1001(e)(3). *See* H.R. REP. No. 91-413, pt. 1, at 157; S. REP. No. 91-552 at 204. In regard to single transactions, the statute speaks in terms of a transfer "to any person *or persons.*" Apparently this is intended to encompass transfers of the entire interest to a husband and wife as joint tenants with right of survivorship or to two or more persons as tenants in common and the like. *See* S. REP. No. 91-522 at 204; CONF. COMM. REP. 319.

[359] *See* H.R. REP. No. 91-413, pt. 1, at 157; S. REP. No. 91-552 at 204; note 339 and accompanying text *supra.*

the cost of the life estate.[360] Consequently, the life estate income will be taxed to him.[361]

Basis Determined Pursuant to Section 1014 or 1015

Section 1001(e) is applicable only where the adjusted basis of the term interest in property sold is "determined pursuant to section 1014 or 1015"[362] in order to restrict it to such interests acquired by gift, bequest, inheritance or transfers in trust.[363] Thus, where the purchaser from the life tenant resells the life estate, section 1001(e) will not apply because the purchaser has a cost basis under section 1012, not sections 1014 or 1015. Likewise, where the owner acquires the entire interest in property *by purchase* and then "carves out" a life estate and sells it to another while retaining the remainder,[364] section 1001(e) is inapplicable because the seller's basis for the life estate sold is cost, determined under section 1012. This is so because the seller had acquired the entire interest by purchase, in either one transaction or separately.[365]

Portion of the Entire Adjusted Basis of the Property

Not only must the adjusted basis of the term interest in property sold be determined pursuant to section 1014 or 1015, it must be "a portion of the entire adjusted basis of the property" for section 1001(e) to apply.[366] This means that the adjusted basis of the term interest is generally to be computed by apportioning the total basis of the property between the life (or term of years) interest and the remainder interest, under the uniform basis rules.[367] For example, section 1001(e) presumably[368] would apply

[360] The purchase by the remainderman of the intervening life estate which the life tenant had acquired by gift, bequest or inheritance would not come within this single transaction exception to section 1001(e). This is because the purchase was not "a transaction in which the entire interest in property" was transferred, the purchaser already owning the remainder interest prior thereto. *See* I.R.C. § 1001(e)(3). Hence, section 1001(e) applies to the sale of the life estate in this situation. Otherwise, there would be the same escape from taxation of the life estate income as the purchaser in this situation could amortize the cost of the life estate. *See* notes 338, 355 and accompanying text *supra*. *But see* Maxfield, *Capital Gains and Losses*, 25 TAX L. REV. 565, 578 (1970).

[361] H.R. REP. NO. 91-413, pt. 1, at 157; S. REP. NO. 91-522 at 204.

[362] I.R.C. § 1001(e)(1).

[363] *See* H.R. REP. NO. 91-413, pt. 1, at 157; S. REP. NO. 91-552 at 204.

[364] See notes 343, 344 and accompanying text *supra*.

[365] If the owner had acquired the entire interest in one transaction, then the factors contained in the table in regulation 1.1014-5 might be utilized in computing the owner-seller's basis attributable to the carved-out life estate but only in reference to his total cost basis under section 1012. *But see* note 368 and accompanying text *infra*.

[366] I.R.C. § 1001(e)(1).

[367] *See* H.R. REP. NO. 91-413, pt. 2, at 114.

[368] It might be thought that section 1001(e) was intended to apply only to already-existing or established life estates and not those created by the "carve-out" and sold by the owner of the entire interest in the property. There is no such limitation in the statute itself, however, and the sale of such carved-out life estates clearly comes within the purposes of that section. Congress was attempting to prevent the escape

where the taxpayer acquires the entire interest by gift, bequest or inheritance and then "carves out" a life estate and sells it to another while retaining the remainder.[369]

Prior to the "carve out" and sale, the taxpayer's ownership of the entire interest in the property, such as a fee simple in realty, can be viewed as ownership of potential separate parts of that fee simple—the life estate and the remainder—to each of which the appropriate portion of the taxpayer's total basis for the fee simple can be allocated. In this situation the taxpayer's basis for that entire interest in the property is determined under section 1014 or 1015. And as of the moment that he changes the life estate from merely potential to actual by creating it in the "carve-out," his basis for the entire property would be divided between such life estate and remainder under the uniform basis rules. Thus, his adjusted basis for the life estate sold would be a portion of the entire adjusted basis of the property.[370]

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of life estate income from taxation arising from the seller's being able to offset his portion of the uniform basis attributable to the life estate against the sale proceeds. See note 345 and accompanying text *supra*. That will be the precise situation here unless section 1001(e) applies.

[369] *But see* note 365 and accompanying text *supra*.

[370] *See* Freeland, Lind & Stephens, *supra* note 337. This is of significance in community property states in cases similar to *Gist* and *Christ* involving widow's election wills, at least insofar as the estate of the deceased husband is concerned. *See* note 337 *supra*.

In the *Gist-Christ* situation the transaction is divisible into two parts, only one of which—the exchange portion (not the gift portion)—is here relevant. Since the surviving wife by electing to take under the will is deemed to have exchanged a portion of the remainder interest in her own one-half of the community property in return for (and of value equivalent to) the life estate in the deceased husband's one-half of the community property, there is obviously an exchange on the other side—the estate's side. The estate has exchanged a life estate in the deceased husband's one-half of the community property in return for (and of value equivalent to) a portion of the surviving wife's remainder interest in her own one-half of the community property. In effect, the estate has "carved out" a life estate from its ownership of the entire interest in the property (consisting of the deceased husband's one-half of the community property) and sold it to another while retaining the remainder.

Since the estate takes a fair market value date-of-death basis for the deceased husband's one-half of the community property under section 1014, all the ingredients for the applicability of section 1001(e) appear to be present. Thus, that portion of the estate's fair market value date-of-death basis for the deceased husband's one-half of the community property attributable to the life estate therein would be disregarded. The consequence is that, although probably unforeseen by Congress, the estate will have realized gain on this exchange equal to the *entire* amount realized. *See* Freeland, Lind & Stephens, *supra* note 337. The amount realized by the estate would appear to be equivalent to the fair market value of the life estate in the deceased husband's one-half of the community property. *See* United States v. Davis, 370 U.S. 65 (1962).

This realized gain would be recognized unless some specific non-recognition provision of the Code applied. I.R.C. §§ 1001(c), 1002. *See* text following note 377 *infra*. In certain circumstances section 1031(a) might protect the estate. That section provides in part that "[n]o gain . . . shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." The regulations provide that the exchange of a leasehold with 30 years or more to run for real estate can be a "like kind" exchange. Treas. Reg. § 1.1031(a)-1(c) (1956). *See* Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952) (sale and leaseback of property for a term of not

Where the purchaser, *P*, of a life estate makes an *inter vivos* gift of that life estate to *X* who thereafter sells it to a third person, *Y*, section 1001(e) is not applicable to the sale by *X* to *Y*. In this case *P* would have a cost basis for the life estate under section 1012 which *X* would obtain[371] under section 1015(a) for gain purposes. Since *X*, in effect, has a basis derived from *P's* cost basis, it would not be a portion of the entire adjusted basis of the property, determined the uniform basis rules, even though *X* had acquired the life estate by gift. Here, unlike the remainder interest, *X's* basis for the life estate would be unaffected by the mere passage of time.[372]

On the other hand, suppose that *P* had acquired his life estate by bequest or devise from a decedent, *D*, who, prior to his death, owned the entire interest in the property.[373] If *P* then made an *inter vivos* gift of that life estate to *X* who thereafter sold it to *Y*, presumably section 1001(e) would apply to the sale by *X* to *Y*. Here, on *D's* death the entire interest in the property takes a new fair market value date-of-death basis under section 1014 which is apportioned between *P's* life estate and the remainder interest under the uniform basis rules. *X* would then obtain *P's* basis under section 1015[374] so that *X's* basis would thus be a portion of the entire adjusted basis of the property because it would apparently be affected by the mere passage of time, similarly to the remainder.

Another example of this requirement would be where a decedent, *D*, had himself been devised an estate for a term of years in certain property[375] and then by will passed the balance of that term to *X* who thereafter sold it to *Y*. The basis of the property to *X* would be determined under section 1014, *but*, because it would be the fair market value at the date of *D's* death and without regard to *D's* basis therein, it would not be a portion of the entire adjusted basis of the property. *X's* basis fixed at fair market value would be unaffected by the mere passage of time, in contrast to the remainder, and section 1001(e) would be inapplicable. If *X* had ac-

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less than 25 years and not more than 95 years held to come within the substantially similar predecessor of section 1031(a)).

The exchange of a life estate (which in the particular case could last more than 30 years) for a remainder interest in property might be similar enough to the regulations to be of "like kind." Although the estate may have received from the surviving wife property to be held for investment, query whether the estate has given up property held for investment? In the strictest sense the estate has given up a life estate *in* property that might be held for investment, not the property held for investment itself. Accordingly, unless there is no meaningful distinction between the two, section 1031(a) would not seem to be applicable. *See also* Rev. Rul. 71-122, 1971 INT. REV. BULL. No. 10, at 13.

[371] *See* notes 337, 338 & 355 and accompanying text *supra*.

[372] *See* notes 335 & 367 and accompanying text *supra*.

[373] The decedent-owner also by will created a remainder interest in the property in *R*.

[374] Section 1015(a) provides in part that "[i]f the property was acquired by gift . . . the basis shall be the same as it would be in the hands of the donor. . . ."

[375] The will under which *D* had acquired his estate for a term of years also devised the remainder interest in that property to *R*.

quired the balance of that term by an *inter vivos* gift from *D*, however, then section 1001(e) would apply to the later sale by *X* to *Y* because in that event *X* would take *D's* basis under section 1015(a).[376]

NONRECOGNITION DISPOSITIONS UNDER THE T.R.A.

As already noted, section 1001(e) only affects the amount of the realized gain; it does not purport to deal with the question of recognition of that realized gain.[377] What is the precise effect, then, of a disposition of a "term interest in property" acquired by gift, bequest or inheritance where a nonrecognition provision[378] of the Code is applicable to the disposition? Stated more concretely, can the holder of a devised life estate avoid the effect of section 1001(e) by transferring all his rights therein to a corporation in accordance with the non-recognition provision of section 351(a)?

The issue can be illustrated by the following example. Assume that the decedent-owner of a purchased fee simple in commercial realty by will left a life estate in that property to *T* with remainder to *X*. At a time when his basis for that life estate is $50,000 but its fair market value is $100,000, *T* transfers all his rights in such life estate to a corporation solely in exchange for stock with a fair market value of $100,000, the transfer qualifying under section 351(a).[379] Four years later *T* sells the stock for $100,000 cash. What is the effect, if any, of section 1001(e) on this entire sequence of events?

Although section 1001(e) technically applies to *T's* transfer of the life estate to the corporation since it is a "disposition" of property,[380] it is clear that *T's* realized gain of $100,000[381] will not be recognized.[382] This does not solve the problem, however. Does section 1001(e) operate to give *T* a zero basis for the stock he received in the section 351 transfer? If it does, then the subsequent sale of the stock will produce the same effect as if there had been no non-recognition on the original transfer to the corporation.

Under section 358(a)(1) *T's* basis for the stock received in the section 351 transfer will be the same as *T's* basis for the life estate transferred.

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[376] *D's* basis in the estate for a term of years is determined under section 1014 because such interest was acquired by will and constitutes a portion of the entire adjusted basis of the property since the prior decedent had divided his ownership of the entire interest into the estate for a term of years and the remainder, thereby bringing into play the uniform basis rules.

[377] *See* I.R.C. §§ 1001(c), 1002.

[378] For some sections of the Code providing for non-recognition, see *id.* §§ 332, 351, 354, 361, 721, 1031, 1033, 1034, 1036, 1038, 1039.

[379] For the transfer to qualify under section 351, see particularly, Treas. Reg. § 1.351-1(a)(1)(ii) (1955); Hertz, *Getting Property Into and Out of the Corporation*, N.Y.U. 21ST INST. ON FED. TAX. 347, 358 n.26 (1963).

[380] I.R.C. § 1001(e)(1).

[381] *See id.* § 1001(a), (e)(1).

[382] *Id.* § 351(a). *See also id.* §§ 1001(c), 1002.

What is *T's* basis for the life estate transferred—$50,000 or zero? In other words, which of these alternatives is carried over as *T's* basis for the stock received under section 358(a)(1)? Section 1001(e)(1) disregards basis "[i]n determining gain or loss from the sale or other disposition of a term interest in property" under specified conditions. Thus, the provision operates in certain circumstances to disregard a basis that otherwise clearly exists.[383] Since the section applies only for purposes of determining gain or loss from the sale or disposition of a term interest in property, here the transfer of the life estate to the corporation,[384] it is difficult to see how the section could apply, in view of the statutory language, for another (albeit related) purpose—that of determining *T's* basis for the stock received under section 358(a)(1). Hence, although *T's* $50,000 basis for the life estate transferred would be disregarded under section 1001(e)(1) for purposes of determining (taxable) gain or loss, for the different purpose of determining *T's* basis under section 358(a)(1) for the stock received his concededly-existing life estate basis of $50,000 should be utilized.[385]

Assuming that *T's* basis for the stock received is $50,000 may the corporation obtain amortization deductions as to the life estate transferred?[386] Generally, this will depend on whether the corporation is deemed to have acquired the life estate by some means other than gift, bequest or inheritance[387]—such as by purchase.[388] In this case the corporation has acquired the property from *T* with a carryover basis—the same basis as *T* had for the life estate.[389]

In other sections of the Code, Congress has specifically provided that where the basis of the property in question is determined by reference to its basis in the hands of the person from whom it was acquired—in other words, a carryover basis—the acquisition is not by "purchase."[390] That

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[383] *See* id. § 1001(e)(3).

[384] The words "from the sale or other disposition of a term interest in property" strongly suggest that the gain or loss is to be determined as of the time of the disposition of the term interest and not at any later date when other property (although acquired in a nonrecognition exchange for the term interest) is sold.

[385] For the same reasons, the basis of the corporation for the life estate received should be $50,000. *See* I.R.C. § 362(a)(1). Seemingly implicit in section 1001(e) is the notion of a recognized gain. The committee reports refer to the effect of section 1001(e) as requiring the entire amount received from the sale of a term interest "to be taxable" to the seller. *See* S. REP. No. 91-552 at 204; CONF. COMM. REP. 318; STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270, 91st Cong., 1st Sess., 79 (1969). To be taxable the gain must clearly be recognized. Therefore, in support of the conclusion that *T's* basis for the stock received, and the corporation's basis for the life estate transferred, should be $50,000, it could also be argued that the operative effect of section 1001(e) should be confined to situations where the gain is recognized.

[386] Although the corporation has given up stock worth $100,000 in order to obtain the life estate, the corporation's basis for the life estate in this situation is limited to $50,000 under section 362(a)(1); presumably, only that amount could be amortized. *See* note 385 *supra*.

[387] *See* I.R.C. § 273.

[388] *See* note 337 and accompanying text *supra*.

[389] *See* note 386 *supra*.

[390] *See, e.g.* I.R.C. §§ 179(d)(2)(C)(i), 334(b)(3)(A)(i).

should not be determinative in this instance, however, because the corporation's acquisition of the life estate in a section 351 transfer was not by gift, bequest or inheritance. Moreover, the section 351 transfer does constitute an "exchange" as to *T*,[391] so that as to the corporation the transfer should also be treated as an exchange. While such an "exchange" itself may imply an acquisition by "purchase" in the absence of a contrary statutory provision, the existence of an "exchange" alone should entitle the corporation to amortization.[392] Thus, the corporation should be able to amortize its $50,000 basis for the life estate.

Since *T* has no recognized gain on the transfer of the life estate to the corporation and assuming that *T* will obtain a $50,000 basis for the stock received under section 358(a)(1), is it possible for the government to contend that section 1001(e) is directly applicable to *T's* subsequent sale of that stock some four years later? Immediately two objections come to mind. (1) Is *T* selling a "term interest in property" when he sells stock owned absolutely by him?[393] Only if the separate corporate entity is ignored[394]—that is, only by disregarding the difference between ownership of stock in a corporation and ownership of its underlying assets including the transferred life estate[395]—could this objection be ineffective.[396] (2) Beyond that, is the adjusted basis of the stock "determined pursuant to section 1014?"[397] In this case *T's* adjusted basis for the stock is determined pursuant to section 358(a)(1) and not section 1014 unless the phrase "determined pursuant to section 1014" is construed to require relation back to *T's* basis for the life estate since section 358(a)(1) carries that basis over as *T's* basis for the stock. It seems likely that these objections would normally present too great an obstacle to the application of section 1001(e) to *T's* stock sale.

In summary, *T* would have no recognized gain on the section 351(a) transfer of the life estate to the corporation and apparently would take a $50,000 basis under section 358(a)(1) for the stock received. On the sale of that stock some four years later *T* would presumably have $50,000 of long-term capital gain ($100,000 amount realized less $50,000 adjusted basis),[398] thus avoiding the effect of section 1001(e). The corporation

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391 *Id.* § 358(a).
392 *See* Allen M. Early, 52 T.C. 560, 565 (1969).
393 *See* I.R.C. § 1001(e)(2).
394 *See generally* Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943); National Investors Corp. v. Hoey, 144 F.2d 466, 467-68 (2d Cir. 1944).
395 R. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 67-68 (1949). *See also* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY xv, 64-65 (rev. ed. 1968).
396 Assuming that the corporation has a bona fide eixstence, engaging in some activity other than avoiding taxation so that notions akin to piercing the corporate veil cannot be brought into play, the separate corporate entity should be recognized. See cases cited in note 394 *supra*.
397 *See* I.R.C. § 1001(e)(1).
398 The collapsible corporation provisions of section 341 would not apply in this

would be able to amortize its $50,000 basis for the life estate transferred. It appears that in this situation[399] section 1001(e) is emasculated.[400] There is a chink in the new armour.[401]

Section 1001(e) applies to sales or other dispositions occurring after October 9, 1969.[402]

LETTERS, MEMORANDA AND SIMILAR PROPERTY

BACKGROUND

A copyright, a literary, musical or artistic composition, or similar property held either by the creator or by a person whose basis for gain purposes is determined, in whole or in part, by reference to the creator's basis, is treated as a non-capital asset, and thus produces ordinary gain when sold.[403] Under the law prior to the T.R.A., however, a letter or memorandum or a collection of such property was not excluded from the definition of a "capital asset," and, hence, the sale of such property at a gain resulted in capital gain.[404] In view of the basic similarity between the two—both being created by the personal efforts of the taxpayer or by a person from whom the taxpayer has a carryover basis, Congress thought it necessary to treat the sellers of such property alike.[405]

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case. *Id.* § 341(a)(3). Absent some such exception, however, the use of a corporation for this purpose followed by a sale of the stock would be susceptible to attack under section 341 depending upon the particular circumstances. Even if section 341 applied to the sale of the stock by *T*, however, the effect would only be to turn long-term capital gain into ordinary gain. *Id.* § 341(a). Considering the amount of such gain and the applicable tax bracket, this result might still be more attractive than the disregarding of basis in toto under section 1001(e).

[399] If *T* had transferred the inherited life estate to a partnership, instead of a corporation, in exchange for a partnership interest, no gain would be recognized to *T* on such transfer. *Id.* § 721. *T's* basis for his partnership interest would be the same as his basis for the life estate. *Id.* § 722. The partnership's basis for the life estate would be the same as *T's* basis for the life estate. *Id.* § 723. Since it is an "exchange" as to the partnership, the partnership would presumably be allowed to amortize its basis for that life estate. *See id.* § 721. Subject to certain limitations, if *T* subsequently sold his partnership interest, he would be eligible for capital gain treatment. *See id.* § 741. Thus, where a partnership is involved, objections could be made to the applicability of section 1001(e) similar to those where a corporate entity is the transferee of a life estate.

[400] Based upon the particular situation, there are other factors that should be considered before entering into such a transaction, such as: (1) the danger of terminating a Subchapter S election by the recipient-corporation: *see id.* § 1372(e)(5); (2) the danger of the recipient-corporation becoming a personal holding company: *see id.* § 543(a)(2); and (3) the fact that by placing the life estate in a corporation the income therefrom will be subject to tax at both the corporate and shareholder levels which may, in turn, reduce the price that a purchaser would pay for the stock.

[401] *See* text accompanying note 345 *supra*. *Contra*, Proposed Treas. Reg. §§ 1.1001-1(f)(1) & (2), 1.1014-5(c) (Ex. 6) (June 24, 1971).

[402] Pub. L. 91-172, § 516(d)(1) 91st Cong., 1st Sess. (1969), 83 Stat. 648.

[403] This specific exclusion from capital asset status, sometimes referred to as the "Eisenhower Amendment," first appeared in the Revenue Act of 1950. 3B MERTENS, *supra* note 2, § 22.19, at 113-14 & n.37.

[404] H.R. REP. No. 91-413, pt. 1, at 148; S. REP. No. 91-552 at 198-99.

[405] H.R. REP. No. 91-413, pt. 1, at 149; S. REP. No. 91-552 at 199.

UNDER THE T.R.A.

Sales

Under the Code as amended by the T.R.A. a letter, memorandum, or similar property[406] held by either

> (1) the creator or the person for whom the property was prepared or produced,[407] or
>
> (2) a person whose basis for such property for gain purposes is determined (in whole or in part) by reference to its basis in the hands of a person described in (1) above

is not a "capital asset."[408] Therefore, the gain from the sale of such property is ordinary income.[409] Conforming amendments were made to section 1231[410] and section 341.[411] These amendments of the T.R.A. apply to sales or other dispositions occurring after July 25, 1969.[412]

Charitable Contributions

As part of a major revision of the charitable contributions deduction for gifts of appreciated property in the T.R.A.,[413] Congress provided that the amount of the charitable deduction otherwise to be taken into account "shall be reduced by . . . the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution) . . . ."[414] This provision clearly applies to charitable gifts of letters and memoranda which are non-capital assets in the hands of the donor.[415] This means that the appreciation in value of such property will not

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[406] Similar property would include

> a draft of a speech, a manuscript, a research paper, an oral recording made for dictation purposes, a transcript of an oral interview, a personal or business diary, a log or journal, a corporate archive including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch.

Proposed Treas. Reg. § 1.1221-1(c)(2), 35 Fed. Reg. 18974 (1970).

[407] A letter or memorandum addressed to a person is considered to be prepared or produced for that person. Proposed Treas. Reg. § 1.1221-1(c)(2), 35 Fed. Reg. 18974 (1970); H.R. REP. No. 91-413, pt. 1, at 149; S. REP. No. 91-552 at 199.

[408] I.R.C. § 1221(3).

[409] Assuming that the taxpayer is neither the creator nor the person for whom the letter or memorandum was produced and that section 1221(1) is not applicable, gain from the resale of such property by a purchaser would be capital gain because such purchaser would have a cost, not a carryover, basis. *Id.* § 1221(3)(C).

[410] *Id.* § 1231(b)(1)(C).

[411] *Id.* § 341(e)(5)(A)(iv).

[412] Pub. L. 91-172, § 514(c) (Dec. 30, 1969), 83 Stat. 643. For subsequent characterization of payments received after the amendment of subsection (3) of section 1221, but pursuant to a contract of sale made prior to the effective date of the law, see Picchione v. Commissioner, 27 A.F.T.R.2d 71-888 (1st Cir. 1971), *petition for cert. filed*, 39 U.S.L.W. 3550 (U.S. June 7, 1971) (No.1789).

[413] *See* Taggart, *The Charitable Deduction*, 26 TAX L. REV. 63, 101-26 (1970).

[414] I.R.C. § 170(e)(1)(A).

[415] *See* S. REP. No. 91-522 at 199; STAFF OF JOINT COMM. ON INT. REV. TAXATION, SUMMARY OF H.R. 13270, 91st Cong., 1st Sess., 76 (1969).

be taken into account in determining the amount of the contribution; instead, the charitable deduction will, at best, be limited to the donor's basis.[416] In most cases, neither the creator of a letter or memorandum nor the person for whom it was prepared or produced will have much, if any, of a cost basis with respect to such property; in this situation the charitable contributions deduction would be minimal or nonexistent.[417]

The provisions of section 170(e) as enacted by the T.R.A. are applicable to contributions of a letter, memorandum, or similar property paid after July 25, 1969.[418]

CONCLUSION

The Tax Reform Act of 1969, often billed as the most massive revenue reform measure in many years, appears more like a patchwork effort. Congress tinkered with numerous provisions and added others, but amendment is not necessarily reform; indeed, it may result in only cluttering up further an already too complex statute. The period of gestation for the Tax Reform Act was only eleven months and perhaps expediency became a substitute for quality. A thorough reform remains to be done.

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416 Taggart, *supra* note 413 at 102.

417 Generally, as stated in the Senate Finance Committee report, the effect of this provision will be that "to the extent papers, memorandnms [*sic*], etc. have no cost basis, no charitable contribution deduction will be available with respect to gifts such property." S. REP. No. 91-552 at 199. Assuming, however, that he is neither the creator nor the person for whom such property was prepared or produced, the charitable gift of letters or memoranda by the inheritor thereof will not be subject to section 170(e)(1)(A) (assuming a holding period of more than six months; *but see* I.R.C. § 1223(11)) because he would have a fair market value date-of-death basis under section 1014. Accordingly, the letters or memoranda would generally be long-term capital assets in his hands. *See id.* § 1221(3); note 414 and accompanying text, *supra.* But, in this event, see the reduction in the amount of the charitable contribution deduction provided for in section 170(e)(1)(B). *See* Taggart, *supra* note 413, at 103.

418 Pub. L. 91-172, § 201(g)(1)(B) 91st Cong., 1st Sess. (1969), 83 Stat. 564.