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Can You Have Your Cake and Eat It Too? Achieving Capital Gain Treatment While Keeping the Property

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Can You Have Your Cake and Eat It Too? :

Achieving Capital Gain Treatment While Keeping the Property

By

Ronald H. Jensen

I. Introduction

Although it is a commonplace—indeed, a statutory requirement—that capital gain treatment is available only if there is a "sale or exchange,"[1] a surprisingly large body of caselaw accords that treatment to recoveries for damage to property even if the taxpayer continues to own the property.[2] Perhaps even more surprising, the IRS has generally—though not always[3]—acceded to this treatment in litigation,[4] audits,[5] various unpublished rulings[6] and an acquiescence in a Tax Court decision which endorsed that result.[7] Stranger still is the apparent failure of the courts and the IRS to even recognize they are ignoring a requirement of the Code.

For example, a field service advice issued in 2002 concerned a taxpayer who bought land that was subsequently determined to be contaminated.[8] The taxpayer obtained a settlement from the seller for the costs it incurred in cleaning up the land. The IRS ruled as follows:

> Because land is a capital asset, the settlement proceeds represent amounts for injury or damage to a capital asset. Therefore, the proceeds should be treated as a recovery of Taxpayer's basis in the land. Any settlement proceeds in excess of Taxpayer's basis in the land should be treated as capital gain.[9]

The IRS allowed the taxpayer capital gain treatment even though no sale or exchange occurred and the taxpayer continued to own and use the property following receipt of the settlement. Indeed, the IRS did not even allude to the "sale or exchange" requirement.

More recently, it has been suggested that these cases and rulings provide authority for granting capital gain treatment to shareholders who obtain settlements for corporate fraud that exceed their basis in the stock even though they continue to own the stock.[10] The commentator advocating this position, a practitioner, wrote that there "have been a sufficient number of taxpayer victories on capital gain treatment in lawsuit recoveries that I (most of the time) don't worry too much about lingering authorities erecting a sale or exchange hurdle."[11]

I will attempt to show in this article that the cases and rulings dispensing with the need for a sale or exchange are unjustified under the statutory scheme and prevailing capital gain jurisprudence, and further that such holdings constitute bad policy.

Part II will set forth a number of examples, based largely on decided cases, where it has been held or contended that recoveries in excess of basis qualify for capital gain treatment even though the taxpayer did not sell or exchange the property. These cases will illustrate the contexts in which this issue arises and will provide a basis for analysis. Part III will review how the courts have construed the phrase “sale or exchange.” Part IV will explore in depth the policy issues involved in according capital gain treatment to recoveries when no sale or exchange occurs. Part V will consider whether the full amount of the recovery should be taxed when received or rather (as under current law) treated as a return of capital with only the excess over basis treated as taxable gain. Part VI will apply the analysis developed in this article to the examples in Part II. Finally, Part VII will consider whether section 1234A provides, as some have suggested, an additional basis for claiming capital gain treatment for a recovery for damage to property.

II. Some Examples of Capital Gain Treatment in the Absence of a Sale or Exchange

Most of the following cases illustrate situations where the courts or the IRS have simply ignored the need for a sale or exchange for capital gain treatment. The others are hypothetical situations included for analysis.

(1) *Restraint of Trade and Price Fixing.* Taxpayer was an electrical contractor. An illegal combination of his competitors prevented him from bidding on numerous contracts and caused his bids on other jobs to be rejected. As a result, taxpayer’s business goodwill, in which he had no basis, was damaged. Nevertheless he continued in business. Taxpayer

sued and recovered damages for the injury to his goodwill. *Held*: Entire recovery was taxable as long-term capital gain.[12]

(2) *Interference with Bank's Operations*. In a dispute with the taxpayer-bank, the Federal Reserve Bank over an 18-month period sent its agents to the taxpayer's premises to demand payment in cash of all checks drawn on the bank. This caused adverse comment and embarrassment to the taxpayer. Taxpayer sued for damage to its business goodwill, in which it had no basis, and ultimately received a settlement. Taxpayer continued in business following the recovery. *Held*: Entire amount of settlement qualified as long-term capital gain.[13]

(3) *Patent infringement*: Taxpayer recovered damages from defendant for injury to its "corporate capital structure" and its "goodwill" as a result of defendant's infringement of taxpayer's patent. Taxpayer retained and continued to exploit its patent following the recovery. Taxpayer had no basis in its goodwill or capital structure. *Held*: Entire recovery qualified as long-term capital gain.[14]

(4) *Corporate fraud:* Taxpayer bought stock in XYZ Corp. for $100 a share and the stock subsequently appreciated to $1000 a share. As a result of bad management and fraud the stock declined to $200 a share. Taxpayer sued management and obtained a recovery of $300 a share. Taxpayer retained the stock.[15] *Result*: There is no court or administrative ruling involving a shareholder's recovery for corporate fraud, but the logic

of the above cases suggests that taxpayer has a capital gain of $200 a share [$300 a share recovery – basis of $100 a share = gain of $200 a share].[16]

(5) *Soil Erosion*: Taxpayer purchased five condominium units from seller. Thereafter, soil erosion caused by drainage diffusion was detected. Taxpayer sued the seller of the units and recovered $100,000. Although there was damage from the soil erosion, it was still possible to rent the units.[17] *Result*: Although no case has so held, it appears based on the above cases that the recovery would first be applied against basis with any excess taxed as capital gain.

(6) *Trademark infringement*: Taxpayer-corporation alleged that defendant's trademark, when used in connection with the sale of batteries, infringed its trademark. Taxpayer sued for damage to its trademark and associated goodwill. The case was settled for a cash payment to the taxpayer of $5,000,000. As part of the settlement, the defendant was allowed to continue to use its trademark in connection with the sale of its batteries and other products. Taxpayer had no basis in its trademark or the associated goodwill. *Held*: The entire recovery qualified as long-term capital gain.[18]

III. What Is a Sale or Exchange?

The Internal Revenue Code grants a preferential tax rate on an individual's net long-term capital gain to the extent it exceeds any net short-term capital loss.[19] A long-term capital gain is defined as a gain "from the *sale or exchange* of a capital asset held for more than 1 year."[20] Consequently, a "sale or exchange" is a *sine qua non* for qualifying for the preferential tax rates.

What then is a "sale or exchange?" The courts have construed the term narrowly. In the leading case of *Helvering v. William Flaccus Oak Leather Co.*, the taxpayer collected insurance proceeds for the destruction of its plant by fire.[21] The Court rejected the taxpayer's assertion the proceeds qualified as a long-term capital gain, holding that the phrase "sale or exchange" should be given its ordinary meaning.[22] The Court held that the destruction of the building coupled with collection of the insurance proceeds could not be considered a "sale," nor could it be regarded as an "exchange" because that term "implie[d] reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of property."[23] The Court also noted that where Congress intended for "ambiguous transactions" to be treated as sales or exchanges, it had expressly so provided.[24] Its failure to do so in the factual setting of *Flaccus* constituted "convincing evidence" that Congress did not intend for capital gain treatment to apply in that situation.[25]

Although the Supreme Court took a restrictive view of a "sale or exchange" in *Flaccus*, it has held that a "sale" encompasses involuntary or forced transfers of property, such as foreclosures.[26] Lower courts, taking their clue from *Flaccus*, have held that a "sale" also includes a taking of property by eminent domain.[27]

These cases impose a dual requirement for capital gain treatment: the taxpayer's interest in his or her property must terminate *and* such interest must be transferred, either voluntarily or involuntarily, to another person or entity. In *Flaccus*, the taxpayer's investment in the building terminated with its destruction by fire. However, there was no "sale or exchange" because the taxpayer's interest in the building was conveyed to no one—it had ceased to exist. In foreclosures and eminent domain takings, however, the taxpayer's interest in the property both terminates and is transferred to another party, the purchaser at the foreclosure sale in one case and the government entity exercising eminent domain in the other. Hence the taxpayer qualifies for capital gain treatment.

Consider how the examples listed in Part II fare under these requirements. In none of the cases was the taxpayer's interest in the underlying property terminated. Moreover, with the possible exception of the trademark infringement case (to be discussed in greater depth in Part VI) no property interest of the taxpayer was transferred to another party. As in *Flaccus,* the taxpayer had simply received compensation for a loss or damage to his or her property. In short, the cases simply do not satisfy the "sale or exchange" requirement.

In *Flaccus*, the Court eschewed judicial enlargement of the phrase "sale or exchange" beyond its commonly understood meaning since Congress had manifested its intent to be the arbiter of when "ambiguous transactions" should be treated as sales or exchanges through its enactment of specific provisions governing such cases.[28] What was true in 1941 when *Flaccus* was decided is even truer today. *Flaccus* cited three sections of the Code characterizing “ambiguous transactions” as sales or exchanges.[29] A recent edition of a popular income tax casebook lists eleven such sections.[30] The case for judicial expansion of the “sale or exchange” concept is, if anything, weaker than when *Flaccus* was decided.

In recent years some courts have relaxed the “sale or exchange” concept in one respect. Courts previously distinguished between payments received for the cancellation or surrender of a contractual right or claim (e.g., a payment received for giving up a right to buy a mine’s output) and payments received for transfer of the right to a third party. Courts have held there is no sale in the first situation because the “property” (i.e., the right to buy the coal) “disappears” or is “extinguished” but have found a sale in the second instance because the property interest (i.e., the right to buy the coal) continues to exist in the hands of the transferee.[31] However, Judge Friendly, speaking for the Second Circuit in 1962 in *Commissioner v. Ferrer*, rejected this distinction as “formalistic:”[32] “Tax law is concerned with substance, here the voluntary passing of ‘property’ rights allegedly constituting ‘capital assets,’ not with whether they are passed to a stranger or to a person already having a larger ‘estate.’”[33]

Although Judge Friendly’s opinion enlarged the “sale or exchange” concept beyond the way it was previously understood,[34] his revised formulation would not cover recoveries for damage or injury to property. When a taxpayer surrenders a contractual right, the taxpayer terminates his or her interest in that right. When a taxpayer receives compensation for injury to his or her property but keeps the property, the taxpayer’s interest in the property is not terminated. Moreover, when a taxpayer surrenders a contractual right to the other contracting party (e.g., surrender of a right to buy the mine's output to the mine owner), there is, in the words of the *Ferrer* case, a "passing of 'property' rights . . . to a person already having a larger estate" (i.e., the mine owner).[35] When payments are received for damage or injury to a taxpayer's property, the taxpayer transfers no interest in his or her property to the payor.

Running through all these cases is the concept that a transfer of the taxpayer's interest in property is the irreducible minimum of a sale or exchange. One commentator has justified this requirement on the ground that one "of the prime (supposed) purposes of the capital gains rules—to facilitate movements of capital in the marketplace—would not be implicated when the asset [is not] "transferred." . . . . [The "sale or exchange" requirement] is one way the statute ensures that the capital-gains provisions apply only to assets that come within its historical pedigree."[36]

Is it possible that some of the cases in Part II may be viewed as constructive sales?" Consider Example (1), *Restraint of Trade and Price Fixing*, where a taxpayer lost potential customers to an illegal combination of his competitors that prevented him from bidding on numerous contracts and caused his bids on other jobs to be rejected. Could one say that the taxpayer in effect "sold" his right to the customers he lost to his competitors when he settled the lawsuit for a cash payment?

The Service rejected a similar contention in Revenue Ruling 74-251.[37] A lawsuit brought on behalf of taxpayer, a mutual fund, alleged that the shareholders of its investment advisor had improperly appropriated for their own benefit a portion of the taxpayer's "capital fabric, [its] intangible right to select its investment advisor."[38] A settlement was reached in which the shareholders of the investment advisor paid the mutual fund a sum of money.[39] The fund argued that "the taking of its right by [the investment advisor's] shareholders, and their subsequent payment for it in [the] form of a settlement, is tantamount to a sale of such right."[40] The ruling rejected this argument stating that while "it may be true that [the investment advisor's] shareholders *used* [the taxpayer's] right to select an investment advisor to produce a profit for themselves, they clearly did not purchase such right upon the settlement of the litigation."[41]

This holding seems clearly correct under Supreme Court precedent. In *Flaccus*[42] and again in *Commissioner v. Brown*,[43] the Supreme Court stated that "sale" and "exchange"—as used in the capital gain provisions—are to be given their common and ordinary meanings. Settling a lawsuit for misappropriation of the mutual fund's right to select its investment advisor, as in Revenue Ruling 74-251, or settling a claim for stealing the taxpayer's customers by unlawful practices, as occurred in Example (1), hardly seems a "purchase" or a "sale" as those terms are commonly understood.

IV. Should Recoveries for Damages to One's Property in Excess of Basis Receive Capital Gain Treatment?

This Part explores whether there is any policy or equitable reason for creating, either judicially or legislatively, an exception to the rule that the capital gain tax preference is available only if there is a sale or exchange.

A. Does a Taxpayer's Recovery for Property Damage Come Within the Purposes for Which the Capital Gain Tax Preference Was Enacted?

Twice since 1986, Congress has reduced the maximum tax rate applicable to most long-term capital gains: first in 1997 when the rate was reduced to 20%[44] and then in 2003 when the rate was further reduced to 15%.[45] On both occasions, the applicable committee reports justified the tax preference on the same two grounds: to encourage saving, investment and risk taking by increasing the after-tax return on investments thereby stimulating the economy and to mitigate the so-called "lock-in" effect.[46] Notably the committee reports made no reference to the "bunching of income" rationale that has sometimes been used to justify the capital gain tax preference.[47] This rationale justifies the preference as an ameliorative to the plight of the taxpayer who has held property for many years during which it has slowly appreciated and then sells the property thereby recognizing all the appreciation in a single year and causing the taxpayer to be pushed into an abnormally high tax bracket.[48]

Providing relief for taxpayers with bunched income no longer seems to be among Congress's purposes in adopting the capital gain tax preference. Even when the 1954 Code was in effect, many tax commentators had concluded that relief from bunching was, at most, a minimal concern of Congress.[49] Today, there is much more reason to believe the Congress was unconcerned about bunched income when it enacted the current capital gain provisions.

The tax rate schedule on ordinary income has been greatly flattened and the tax brackets widened. This has substantially diminished the likelihood that recognition of a capital gain will push a taxpayer into a significantly higher bracket and has reduced the cost in additional tax if it does.[50] In 1954, the top tax rate on ordinary income was 91% for individuals;[51] today it is 35%.[52] Moreover, most persons experiencing capital gains are already in relatively high tax brackets so bunching is not likely to cause the taxpayer to be pushed into a substantially higher bracket.[53] Indeed, capital gain tax rates are so low today that they will almost always overcompensate the taxpayer for any bunching. For example, a taxpayer who realizes a capital gain and whose marginal tax rate on ordinary income is between 25% and 35% will pay a tax of 15% on the gain.[54] In other words, the capital gain tax will probably be less than what the tax would have been if the appreciation in the asset had been taxed as ordinary income as it accrued.[55] Likewise, taxpayers who experience a capital gain and whose marginal tax rate on ordinary income is between 10% and 15% will generally pay a tax of 5% (0% beginning 2008) on any capital gain and will therefore most likely also be overcompensated for any bunching.[56]

Other reasons suggest that the current capital gain tax regimen was not designed to deal with the problem of bunched income. The holding period required for long-term capital gain relief is a mere one year and a day.[57] Thus a taxpayer whose property reflects just one year's appreciation can qualify for the preference. Finally, the complete absence of any reference to bunched income in the two most recent committee reports suggests this is no longer a Congressional concern. Indeed, the sole reference the author has been able to find in a report of a tax writing committee on the bunched income issue was in 1921—more than 85 years ago.[58]

Let's consider the two reasons for capital gain treatment given in the two most recent committee reports.

Spurring the economy. Granting capital gain treatment to lawsuit recoveries will do nothing to spur the economy. People obviously do not consider the relatively arcane tax issue discussed in this article when deciding to invest or not. It would be shocking if one percent of the investors were even aware of the issue. Thus, the way this issue is resolved will have no effect on the amount of money people invest in the economy. Moreover, such recoveries are rare. Rarer still are the occasions when the recovery exceeds the investor's basis in the property—the only time when the capital gain vs. ordinary income issue arises. The occasions on which both conditions are satisfied (i.e., a recovery *and* one that exceeds the taxpayer's basis) are too few in number, too unpredictable and too random to have any effect on the level of investment and savings in the economy.

Mitigating the lock-in effect. A taxpayer who owns an appreciated asset is said to be "locked-in" when he or she is deterred from selling even though superior investment opportunities exist because of the tax he or she would have to pay on the gain.[59] The lock-in effect is said to have two deleterious consequences. First, it hurts the economy since capital is inhibited from flowing to its most productive uses,[60] and secondly, taxable sales are inhibited thereby reducing overall tax revenue.[61]

The "lock-in" argument for the capital gain tax preference is that the lower tax rates will induce or encourage taxpayers to sell appreciated assets when superior alternative investment opportunities exist by removing the disincentive of high tax rates. But this has no relevance to cases where a taxpayer receives recoveries for damage or injury to his property. In these cases, the taxpayer has not been "encouraged" or "induced" to transfer property or to do anything else; and in fact, the taxpayer has done nothing. The injury or damage to the taxpayer's property, which gave rise to the recoveries, was perpetrated by someone else and was an event over which the taxpayer exercised no control. As far as the taxpayer was concerned, the injury was both involuntary and undesired.

In addition, the preferential tax rates in the cases being considered did nothing to facilitate or encourage the flow of capital to its most productive uses. In these cases, the taxpayer *retained* the property while enjoying the preferential tax rate. There was no movement of capital and none was encouraged. Indeed, the current law works at cross purposes to the objective of unlocking capital by awarding a tax preference to a taxpayer who retains an appreciated asset.

B. Damage to Different Types of Property

(1) Damage to Goodwill—The ”Substitute for Ordinary Income” Rationale

Virtually all the cases granting capital gain treatment involve recoveries for damage to goodwill or similar intangibles.[62] Examples (1) through (3) and (6) in Part II are illustrative of these cases. Note that in each case, the taxpayer retained the underlying property, that is, the business that generated the goodwill.

A recovery for damaged goodwill is simply a prepayment of amounts which, if received in the normal course, would be taxable as ordinary income. “Goodwill” has been defined by the IRS and others as the ability of a business to earn profits in excess of the fair return on net tangible assets.[63] When a business’s goodwill is damaged, its ability to earn income is reduced.[64] Therefore, a recovery for the damage to goodwill is a replacement of the future profits that will no longer be earned because of the damage, reduced to present value.[65] Bestowing capital gain treatment on such a recovery transmutes amounts that would otherwise be taxed as ordinary income into capital gain.

The courts’ practice of allowing taxpayers to quantify damage to goodwill by introducing evidence on the amount of income earned before and after the injury shows the ordinary income nature of such recoveries. One court, in responding to the IRS’s contention that the use of such evidence showed that the amount of the recovery was lost profits, stated that "[p]rofits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery."[66] What the court apparently did not realize is that goodwill is simply the present value of future anticipated earnings. It has no "independent" existence apart from earnings.[67] In contrast, many state courts recognize the identity of goodwill and future income by prohibiting a party from recovering damages for both loss of goodwill and loss of future profits for the same time period, noting that to do so would constitute a double recovery.[68]

Many commentators have criticized the "substitute for ordinary income" rationale as articulated by the Supreme Court in cases such as *Commissioner v. P.G. Lake, Inc.*[69] as being too broad.[70] They point out that the rationale, applied literally, "would negate the possibility of capital gain treatment" since "any asset can be described as a right to future income, and since any sale for value yields the present-value equivalent of the future income from the asset." [71] For example, the price received for the sale of stock reflects, among other items, the corporation's retained earnings which if distributed would be taxable as ordinary income. More broadly, the value of any income-producing asset consists largely, if not entirely, of the present value of its anticipated future earnings.[72]

Most commentators have distinguished these examples from *P.G. Lake, Inc*. and similar cases denying capital gain treatment by pointing out that such cases involved "carve outs," that is, a sale of a partial interest unaccompanied by the disposition of the underlying property.[73] Professor Del Cotto would deny capital gain treatment in *P.G. Lake, Inc*. because, as the Supreme Court itself emphasized, there was no conversion of the taxpayer's capital investment.[74] In Del Cotto's view, a taxpayer's investment is in the income-producing property—not the income it throws off.[75] Just as there is no conversion of a fee owner's investment when he "sells" a lease to a lessee (i.e., rents the property)—since he retains ownership of the underlying real estate—there was no conversion of the taxpayer's capital in *P.G. Lake, Inc* where the taxpayer also retained ownership of the property that produced the income.[76] Professor Chirelstein justifies the result in *P.G. Lake, Inc*. by noting that if a shareholder could receive capital gain treatment by "selling" a right to his dividends for a fixed term, the shareholder could again "sell" his rights to the dividends for another fixed term when the original term expired, and could repeat this process indefinitely.[77] The result would be that "periodic investment income could be converted into capital gain contrary to the evident intent of Congress."[78] These problems do not exist where the taxpayer does not retain an interest in the underlying property.[79]

The issue in this section, though, is not whether the cases being considered here are governed by the holding of *P.G. Lake, Inc.*, either as baldly stated by the Supreme Court or as limited by the commentators, although they may be.[80] It has already been shown that these cases do not involve sales or exchanges and thus do not merit capital gain treatment under the statute. The issue here is not a legal one but whether there is any equitable or policy reason justifying a departure, either by the legislature or the courts, from that requirement. In assessing this issue, two factors seem to be of paramount importance.

First, bestowing capital gain treatment on such recoveries does not further the purposes for which the preference was enacted.[81] The prospect of a recovery in excess of basis is too remote, uncertain and speculative to affect investment decisions. Indeed, it is unlikely that a prospective investor even thinks about the tax ramifications of such a recovery when deciding to invest. Likewise, according capital gain treatment in these cases does not encourage or induce the taxpayer to unlock capital. The damage to the taxpayer's property which gave rise to the recoveries was perpetrated by someone else. The taxpayer was not "encouraged" or "induced" to do anything and did nothing.

Secondly, according capital gain treatment to such recoveries would bestow the capital gain tax preference on amounts that would otherwise be taxed as ordinary income.[82] There is no good reason why amounts otherwise taxable as ordinary income should receive preferential treatment simply because the payment is accelerated, unless there is a countervailing consideration. Furthering the purposes of the capital gain preference may constitute such a consideration, but as shown above that is not the case here.

It is of course possible that the recovery will present a "bunching of income" problem although with the current tax rate schedule this is less likely to occur, and if it does, the impact is not likely to be severe. As noted above, it does not seem that the current capital gain structure was intended to deal with this problem.[83] In any event, it would be bad tax policy for the judiciary to extend capital gain treatment to recoveries for damage to goodwill out of a misguided attempt to do justice. To do so would confer benefits on many undeserving taxpayers. It would, for example, permit most taxpayers to pay a lower rate of tax on the capital gain than their normal rate of tax thus overcompensating them for the bunching.[84] It would permit taxpayers who had held their property for little as a year and a day and other short periods, and who therefore are not the victims of bunching, to receive the benefit as well as those who had held their property for many years.[85]

Taxpayers can always assure themselves of capital gain treatment for the recovery even under the rule proposed above by selling the underlying property, assuming it is a capital asset, on or before receipt of the recovery. In one case, the IRS proposed, and the court agreed, that a lawsuit recovery with respect to real property received after the taxpayer sold the property qualified for capital gain treatment.[86] In another case, the court noted there was no requirement that a payment be paid by the buyer for it to be considered part of the amount realized on the sale.[87] These cases are correct and should be followed. When these conditions have been satisfied, the taxpayer has both terminated his interest in the property and transferred it to another. Capital gain treatment is therefore appropriate.

The tax effects when this strategy is used are as follows. If the sale of the underlying property results in a gain, the combined amount of that gain and the recovery will be taxed as capital gain. Likewise, if the sale of the underlying property results in a loss that is less than the recovery, the net amount will be taxed as a capital gain. On the other hand if the sale of the underlying property results in a loss that exceeds the recovery, then the net amount will be a capital loss. Even here the recovery is effectively treated as a capital gain since its effect is to offset the capital loss. Taxpayers wishing to resume ownership of the investment may do so by repurchasing the property. However, if a loss is realized on the sale of the underlying property, taxpayers wishing to obtain the tax benefit of that loss must ensure that the sale and repurchase have economic substance[88] and, in the case of stock or securities, that they do not run afoul of the "wash sale" provisions.[89]

An intriguing issue is whether a taxpayer whose goodwill has been partially damaged can obtain capital gain treatment under section 1231(a)(3)(A)(ii). To oversimplify a complex provision, it provides for capital gain treatment in the case of an "involuntary conversion (as a result of destruction in whole or in part . . . of . . . any capital asset which is held for more than 1 year and is held in connection with a trade or business . . . ."[90] Goodwill is a capital asset.[91] Can a taxpayer therefore successfully claim that damage to its goodwill constitutes a partial destruction of a capital asset? This is unlikely.

The allowance of capital gain treatment for partial destruction was undoubtedly intended to apply when an *identifiable* part of the property was destroyed. Thus, if the third floor of an office building was destroyed by fire while the first two floors escaped damage, the recovery for the third floor (less its allocable basis) would qualify for capital gain treatment since the fire *partially* destroyed the building. The difficulty in the case of goodwill is the inability to identify the specific part of the goodwill destroyed. Goodwill is viewed as an indivisible whole, not an aggregation of discrete, identifiable sub-units.[92] In *Mathey v. Commissioner*, the taxpayer argued that infringement of its patent and the resulting loss in its value constituted a partial destruction of the patent.[93] The court rejected the claim stating that "there has been no showing that *any particular part* of the patent . . . was destroyed or converted (emphasis added)."[94]. Significantly, none of the courts granting capital gain treatment for a recovery for damage to goodwill have relied on section 1231(a)(3)(A)(ii) but rather on the general principles discussed in this article.

If a taxpayer's goodwill were completely destroyed, there would be no need to identify a specific part of the goodwill as destroyed, and capital gain treatment under section 1231(a)(3)(A)(ii) would seem appropriate.

(2) Damage to Income-Producing Business or Investment Property

Although the capital gain issue mostly arises in cases involving damage or injury to the taxpayer's goodwill, the above analysis can also be applied to recoveries for damage to any type of income-producing property. For present purposes, we may assume (subject to later refinement) that the value of income-producing property is the sum of all future income from the property discounted to present value.[95] A loss in value for injury or damage to such property reflects the loss in its earning capacity. Consequently, a recovery is simply the present value of the income that will not be earned because of the damage. Put differently, it is a substitute for earnings that would have been taxed as ordinary income. The result here should be the same as it was in the case of recoveries for damage to goodwill—no capital gain treatment.

(3) Damage to Non-Income Producing "Personal" Property

Suppose H owns his residence and that his property is contaminated by waste discharged by an adjoining landowner. H sues and recovers a judgment for the amount of decline in the property's value caused by the contamination. The amount of the recovery exceeds H's basis in the property.[96]

At first it would seem that the "substitute for ordinary income" rationale could not be applied here, since H is not being compensated for something that would have been taxed as ordinary income. However, the loss in the value of H's property simply reflects a decline in the property's "use value," that is, the amount it could be rented for. (Expressed differently, the loss in the property's value is the sum of all future losses in potential rent discounted to present value.) H, who is knowledgeable about tax matters, replies this makes no difference because the imputed rental value of owner-occupied real property is not taxable to the owner. Consequently, the amount received by H cannot be viewed as a substitute for ordinary income and should not be taxed as such.

H is correct that the imputed rental value of owner-occupied income is not taxed by the IRS to the owner.[97] Yet it is also clear that "imputed rent" comes within the concept of "income" under modern tax caselaw[98] and is also "income" in the economic sense.[99] It is, for example, a clear "accession to wealth" since the taxpayer's use of his property as his residence benefits him by relieving him of the need to spend his own funds for lodging.[100] The primary reason for not taxing imputed rental today is administrative—not conceptual.[101] If imputed rental were to be taxed, every taxpayer in the United States who owns his or her residence would need to compute the property's imputed rental income. This would entail not only determining its gross rental value but also all allowable deductions. Such an expansion of the "taxable income" concept would substantially increase, perhaps to the breaking point, both the compliance burdens of the taxpayers and the IRS's monitoring responsibilities. Another reason for not taxing imputed rental value might be a concern that "the entire concept would be regarded by taxpayers as somewhat strange and theoretical."[102]

These reasons do not justify taxing recoveries as anything other than ordinary income. The valuation problem no longer exists when there is a recovery. The recovery fixes the amount of the loss. Indeed, we can have some confidence in the accuracy of the amount determined since it was either determined by the parties themselves dealing at arm's length or by a neutral third-party fact finder (e.g., a judge, jury or arbitrator). It may be true that taxpayers frequently find the concept of a non-cash benefit, such as imputed rental value, being taxable "strange and theoretical."[103] However, the recoveries under discussion are almost always paid in cash, and taxpayers have come to regard any cash receipt as presumptively taxable. This is especially true when—as is almost always the case—the taxpayer is free to spend the cash in any manner he or she wishes. Finally, they might very well find it "strange," although welcome, that such a taxable cash receipt qualifies for capital gain treatment.

When a taxpayer receives a payment for damage to his residence, he or she is in effect being compensated for a reduction in the property's use value (i.e., its imputed rent). Economically, the amount of the damage is the present value of the all future reductions in the imputed rent. Such imputed rent is "income" in an economic sense. Moreover, the imputed rent, if it were taxed, would be "ordinary income" since it is considered expended for the use of property.[104] Consequently, a taxpayer who receives a recovery for damage to his residence is receiving a substitute for "ordinary income," and it should be taxed as such.

(4) Damage to Business or Investment Property Not Generating Current Income

A different analysis is required when the property does not throw off any income. Consider taxpayer T who buys a "growth stock" in a company that has a no-dividend policy but instead plows all earnings back into the business. T's purpose in buying the stock was to realize capital gains upon the sale of the stock in the future. Assume further that a group of executives "loot" the company causing a loss in the stock's market value. A class action is brought against the executives who settle the claims by making a large cash payment to the shareholders. Because T "got in on the ground floor," she has a low basis. Her share of the recovery exceeds her basis. How should such excess be taxed?

T would object to taxing the excess as ordinary income. She would argue that the stock paid no dividends and thus the only income she could ever realize from the stock (i.e., gain on its sale) would be a capital gain. Thus the recovery (i.e., compensation for the loss in the value of the stock) is not a substitute for ordinary income but is rather a substitute for an amount that would have been taxed as capital gain.

Consider another example. O owns Blackacre, a parcel of unimproved land, which he is holding for future appreciation. O derives no income from Blackacre. O's plan is to sell the property for a capital gain when its value reaches a certain level. O's neighbor pollutes O's land. O sues and receives a settlement for the pollution from his neighbor that exceeds his basis.

Like T, O would vigorously object to treating the excess as ordinary income. O would argue that he was receiving no income from the property and that the only income that he might potentially receive (i.e., gain from the sale of Blackacre) would qualify for capital gain treatment. The recovery for loss in the value of Blackacre is not a substitute for ordinary income but is instead a recovery for an amount that would otherwise be taxed as capital gain. T and O would also argue that taxing the recoveries as ordinary income is especially unfair since the recoveries did not result from their voluntary actions but from the actions of others. The income has been thrust upon them.

The trouble with these arguments is that they depend upon an unacceptable but unavoidable degree of speculation. One may invest in a stock that currently pays no dividends with the hope and expectation that the company's earnings will be plowed back into the business thereby boosting the stock's value and ultimately resulting in a capital gain upon the stock's sale. However, one can never be sure that the earnings currently being accumulated by the corporation will not some day be paid out as dividends. Microsoft, Inc. paid no dividends for the first 28 years of its existence.[105] It then adopted a practice of regular quarterly dividends beginning in 2003 that continues through today, and in 2004, it paid a mammoth one-time special dividend of $32 billion, the largest payout in corporate history.[106]

Likewise, there is no assurance that the realization of gain on land currently held as an investment will be taxed as capital gain. The cases are legion where a taxpayer bought and held land as an investment (i.e., a capital asset) intending to sell it at some later time for capital gain but who then changed his purpose and became a "developer." The taxpayer will realize ordinary income on the sale of the lots.[107] Moreover, the *entire* gain is ordinary income even if the overwhelming bulk of the appreciation occurred when the property was held as an investment.[108]

Obviously, the case for denying capital gain treatment is not as clear here as it was in the case of recoveries for damage to goodwill. There is a certain unfairness in taxing as ordinary income a recovery for an amount which had it been realized as anticipated would have qualified for capital gain treatment; the taxpayer may feel that his anticipated capital gain has been transmuted into ordinary income. However, bestowing capital gain treatment on these recoveries, as in the cases discussed above, does nothing to further the preference's purpose of encouraging the mobility of capital and stimulating the economy. Further, taxpayers in these situations are unable to demonstrate that their recoveries actually represent amounts that would ultimately be taxed as capital gain. Capital gain treatment is a tax preference and the taxpayers must be able to demonstrate their entitlement to it. This is properly a heavy burden. As the Supreme Court has noted, since capital gain treatment "is an exception from the normal tax requirements of the Internal Revenue Code, the definition of capital asset must be narrowly applied and its exclusion interpreted broadly. This is necessary to effectuate the basic congressional purpose."[109] The scales still tip against allowing capital gain treatment.

As noted above, a taxpayer can still assure herself of capital gain treatment in these cases by selling the underlying income-producing property on or before receipt of the recovery.[110]

(5) Damage to Mixed Property

Up to this point, we have artificially divided property and their associated recoveries into two neat categories: (1) income-producing property where the recovery is a substitute for amounts that would be taxed as ordinary income if received in the normal course; and (2) property generating no current income where the recovery is a substitute for amounts that would likely, though not necessarily, be taxed as capital gain. Needless to say this is an artificial division. The current value of a property generally reflects both its income-producing potential and its potential for capital gain.[111] We can now deal with these "mixed" cases. To the extent that a recovery compensates for a decline in income-producing capacity, the recovery should be taxed as ordinary income since it is a substitute for amounts that would have been received and taxed as ordinary income. To the extent that the recovery compensates for a loss of potential future capital gain, ordinary income treatment is still appropriate because the taxpayer will be unable to demonstrate with certainty that the forgone income would have been taxed as capital gain.

(6) Damage to Real Property or Depreciable Property Used in a Trade or Business and To Personal Property—Preemption by Statute

Generally, the above analyses are equally valid when applied to real property or depreciable property used in the taxpayer's trade or business as to other property. However, this type of property raises a distinct issue. Section 1231 governs the tax treatment of a disposition or deemed disposition of real property and depreciable property used in the taxpayer's trade or business that the taxpayer has held for more than one year. To oversimplify this complex provision, section 1231(a)(3)(A)(ii), calls for capital gain treatment where there is a compulsory or involuntary conversion of such property into money or other property "as a result of destruction in whole or in part . . . ." The IRS and the courts have liberally construed "destruction." Physical obliteration is not required. It is sufficient if the property is rendered unfit for its intended purpose.[112] Nevertheless, the word “destruction” is not infinitely malleable. “Damage” and “destruction” are not coextensive, and not every case of “damage” amounts to “destruction.” [113]

How should a recovery be taxed if the damage does not rise to the level of either partial or complete destruction? Under the cases discussed in this article, the amount of the recovery in excess of basis would be taxed as capital gain even though it would not qualify for such treatment under section 1231. This disparity is bothersome. Congress has passed a comprehensive statute specifying when gains from involuntary conversions of this type of property are to be taxed as a capital gain. It seems improper for the courts, applying their own rule, to accord capital gain treatment to a case when the statute dealing with the same subject matter (i.e., involuntary conversions) would deny it that treatment.[114] Furthermore, section 1231 by requiring “destruction”—rather than mere “damage”—reaffirms the fundamental principle that the taxpayer’s interest in the property must terminate to qualify for capital gain treatment. The congressional rule, section 1231, should prevail.

A similar point can be made about “personal” property, that is, property not used in a trade or business and not acquired in a transaction entered into for profit. Section 165(h)(2)(B) provides individuals with capital gain treatment if the gains arising from the involuntary conversion of such property due to a casualty exceed the taxpayer’s personal casualty losses. However, not every case of property damage amounts to a casualty. “Casualty” denotes an “identifiable event of a sudden, unexpected, or unusual nature …

[but] damage or loss resulting from progressive deterioration of property through a steadily operating cause would not be a casualty loss."[115] Thus loss to property caused by a flood is a casualty loss, but a loss caused by the gradual erosion or inundation occurring at normal water levels is not. Suppose a residence is damaged by gradual erosion occurring at normal water levels and the recovery exceeds basis. The gain would clearly not qualify for capital gain treatment under Section 165(h)(2)(B) since there is no casualty, but it would under the general principles established by the cases discussed in this article. Capital gain treatment should not be allowed. Congress has spoken on when a gain from the involuntary conversion of personal property is to be taxed as a capital gain, and courts should not undermine that rule by extending such treatment to cases not covered by the statute.

(7) Does taxing recoveries as ordinary income create disparate tax treatment for economically identical transactions?

A reviewer of this article in draft form suggested that taxing recoveries as ordinary income could cause economically identical transactions to be taxed in significantly different ways. He posited four thought provoking hypothetical cases. In each instance, a defect is discovered in the taxpayer's land reducing its fair market value from $1,000 to $700. Taxpayer's basis in the land is $100. Under state law, the person who sold the land to the taxpayer is liable for the loss in market value.

(1) Taxpayer sells the land along with his claim for damages for a total consideration of $1000: $300 for the claim and $700 for the land. Taxpayer realizes a capital gain of $900.

(2) Taxpayer recovers $300 from the seller in the lawsuit and then sells the land for its reduced value of $700. If the recovery is taxed as ordinary income, the taxpayer will have $300 of ordinary income on the recovery and $600 of capital gain on the sale.

(3) Taxpayer spends $300 to fix the defect in the land increasing its fair market value to $1000 and his basis in the land to $400. He then recovers $300 in the suit (reducing his basis to $100 again) and then sells the land for $1000. The taxpayer recognizes a capital gain of $900.

(4) Taxpayer recovers $300 from the seller in the lawsuit, uses the $300 to fix the defect (thereby increasing his basis in the land to $400), and then sells the land for $1000. If the recovery is taxed as ordinary income, the taxpayer will recognize $300 of ordinary income on the recovery and $600 of capital gain on the subsequent sale.

The reviewer states that while the economic consequences in all four cases are the same, capital gain treatment is accorded to the full amount realized in two cases but is partially denied in the others.

All four cases assume that the taxpayer ultimately sells the property. However, except for the first case, it is not clear whether the taxpayer's ultimate sale of the property occurs in connection with the recovery. In the three other cases, the taxpayer—so far as the facts reveal—was free when he received the recovery to keep the property for a year or for twenty years, or indeed for the rest of his life. *However, the relationship between the recovery and the ultimate sale is crucial*. Suppose the recovery occurs in Year 1 and the sale, which is unconnected with the recovery, occurs in Year 5. The recovery should clearly be taxed as ordinary income. The principal purpose of the capital gain tax preference is to encourage taxpayers to shift capital to its most productive uses by reducing the tax cost they incur in selling their property.[116] Here the taxpayer was not "encouraged" or "induced" to do anything and in fact did nothing. The action that gave rise to the recovery was not that of the taxpayer but rather the wrongful act of a third party. Moreover, the taxpayer did not convert his investment but continued to hold it for five years until he sold it in an unrelated transaction. The policy of the capital gain provision is simply not implicated in this situation.

Perhaps implicit in the above hypotheticals is the notion that since the recovery reduces the amount that may be realized on a future sale of the property, it should be accorded the same tax treatment as if it were realized on such a sale. However, amounts realized from property often reduce the amount that may be realized in a future sale, yet such amounts are typically taxed as ordinary income. Perhaps the most common example is corporate stock. A corporation by retaining earnings bolsters the value of its stock and thereby increases the amount its shareholders may receive by selling their stock. Contrariwise, a corporation by paying out its earnings as dividends reduces the amount that its shareholders will realize by selling their stock. Nevertheless dividends are taxed as ordinary income. Or consider an inventor who receives a patent on his invention. If the inventor makes an outright sale of the patent, the amount realized—which of course is simply the discounted value of its anticipated future income—qualifies for capital gain treatment.[117] On the other hand, the inventor may license the patent for a period, say five years, and then sell the patent. The licensing of the patent for five years reduces the amount that will be realized on the patent's disposition; nevertheless the royalties received during those years are taxable as ordinary income.

These examples illustrate that merely because a payment reduces the amount that may be realized on a future sale (and hence the amount that qualifies as a capital gain) does not entitle it to capital gain treatment. In the two examples given above, the reason for denying capital gain treatment to the payments (i.e., dividends and royalties), even though they reduce the amount that may be realized on the ultimate sale of the property, is that the goal of the capital gain tax preference—to encourage the flow of capital—was not achieved when the amounts were received.

However, capital gain treatment *is* appropriate when a recovery occurs (or its value is realized) in connection with the sale or exchange of the underlying property. In such cases, the taxpayer is terminating his investment in the property and transferring it to another. The policy of the capital gain preference of encouraging the conversion of capital is therefore achieved.[118] The trick is to identify when a recovery is received (or its value realized) in connection with a sale or exchange of the underlying property. The hypothetical cases above are helpful in illustrating the need to identity such situations so that disparate tax treatment can be avoided when the policies of the capital gain tax preference are fulfilled.

The policy is satisfied if the claim is sold along with the underlying property as in Case (1). Moreover, as pointed out elsewhere in this article, it is satisfied if the underlying property is sold *before* the recovery is received.[119] In both instances, the taxpayer has completely and unambiguously terminated his investment in the underlying property. Closer cases may be envisioned. Suppose a taxpayer whose property is damaged puts it up for sale and simultaneously pursues his claim for damages. The taxpayer recovers the claim a few days *before* he sells the property. Here, at least some uncertainty existed at the time of the recovery whether the property would be sold. Assuming the taxpayer can establish that his offer to sell the underlying property was made in good faith and that the sale in fact occurs within a reasonable time after the recovery is received, capital gain treatment seems appropriate. In other cases, it may be more difficult to determine whether the sale and the recovery are sufficiently intertwined to justify capital gain treatment. Probably the best solution is for the courts to resolve this question by applying principles analogous to those of the step transaction doctrine. Courts are accustomed to handling problems of this nature, for example, in determining whether a redemption of a taxpayer's stock and the subsequent sale of his or her remaining stock are parts of a single, integrated transaction thereby qualifying the redemption as a complete termination of interest.[120]

Cases (3) and (4) raise another issue. By spending $300 to fix the defect *before* receipt of the recovery in Case (3), the entire $900 receives capital gain treatment, while in Case (4) where the taxpayer fixed the defect *after* receiving the recovery he has $300 of ordinary income and $600 of capital gains. However, the underlying cause for the disparate treatment is not the treatment of the recovery but the rule that a taxpayer generally may not increase his basis in property until he makes (and in the cash of a cash-basis taxpayer, pays for) an improvement in the property.[121] Even if recoveries were always taxed as capital gain, disparate treatment could still occur. For example, assume the $300 recovery occurs in Year 1 and the property is sold in Year 2. If the defect in the land is fixed before the recovery, the taxpayer would have *no* income in Year 1. [The improvement would increase taxpayer's basis in the land to $400 so the $300 recovery would merely reduce his basis back to $100.] On the other hand, if the recovery occurred before correction of the problem, the taxpayer would have a $200 capital gain in Year 1 [i.e., the $300 recovery minus basis of $100].

Since the disparity in results inheres in the timing of the improvement, its existence does not resolve whether a recovery should receive capital gain treatment. That issue can be decided only in light of the policies underlying the capital gain preference. Where the recovery occurs in connection with a sale of the underlying property, those policies are satisfied. Otherwise they are not and ordinary income treatment is proper.

V. Should a Taxpayer Be Allowed to First Offset the Amount Recovered for Damage to Property Against Basis, or Should the Entire Recovery Be Taxed?

The previous discussion necessarily raises the issue of whether the taxpayer should even be allowed to offset a recovery against his or her basis in the property. Perhaps the taxpayer should be required to recognize the entire recovery as income. One could certainly make a plausible argument—somewhat along the lines of those made in the prior sections—that since the taxpayer continues to own the property and since the recovery is a realization with respect to the property, almost invariably in the form of money, it should be taxed in full as income.

There are a number of reasons why this argument should not prevail. The relevant statutory provisions are different. Qualification for the preferential tax rate requires a "sale or exchange."[122] In contrast, the statute providing for a reduction in basis requires only that an item be "properly chargeable to the capital account"—a more elastic concept than "sale or exchange."[123]

The most important consideration though is fairness. Consider this example. C buys a business and pays $1,000,000 for its goodwill. A competitor unfairly disparages the business causing the value of its goodwill to plunge to $700,000. C sues and recovers $300,000 for the damage to the goodwill. Requiring the $300,000 to be taxed in this case seems intuitively unjust. C has not realized any economic gain; he has simply recovered the amount of his loss.[124] It is a "wash." Put differently, requiring C to recognize the $300,000 recovery has the immediate result of taxing income twice—one of the purposes that basis is designed to avoid.[125]. The $1,000,000 of cash C used to buy the goodwill has presumably already been taxed (e.g., as compensation, profits, etc.). Requiring C to pay tax on the $300,000 he recovered for the damage to the goodwill makes him pay a tax on that amount again.

An argument might be made that allowing the taxpayer to simply reduce basis instead of recognizing the recovery as income undermines congressional policy. It would run as follows. Allowing a taxpayer to offset the recovery against the basis of the damaged property (the "basis offset approach") is the functional equivalent of first allowing a deduction for the loss in value and then taxing the recovery as income (the "deduction/income approach").[126] The law, however, prohibits a deduction for a mere decline in value.[127] The basis offset approach thus undermines congressional policy by indirectly allowing a deduction that Congress did not authorize.

The fallacy in this syllogism lies in its premise. The basis offset approach is not the same as the deduction/income approach; its effect is far more limited.[128] The basis offset approach never provides the taxpayer with an overall deduction, since the implicit deduction for the loss is limited to the amount of the recovery. This method merely relieves the taxpayer from recognizing income when there is no economic gain. In contrast, allowing the deduction and taxing the recovery—the deduction/income approach—would allow a full deduction for the loss in value, and if the loss exceeds the recovery, will give the taxpayer an overall deduction.[129]

Assume that taxpayer D bought a stock for $200,000. Corporate insiders looted the corporation causing D's stock to lose $60,000 in value. D recovers $40,000 from the insiders as her portion of a settlement of a class action lawsuit brought against them.

Under the deduction/income approach, D would have a deduction of $60,000 for the loss in value and would then be taxed on the $40,000 recovery, resulting in an overall deduction of $20,000. In contrast, D would have no net deduction under the basis offset approach. The only tax effect of the basis offset approach is to reduce D's basis by the $40,000 recovery. Thus the implicit deduction is limited to the amount of the recovery, that is, $40,000. Overall D has $20,000 less taxable income under the deduction/income approach than under the basis offset approach. This reduced taxable income is counterbalanced by $20,000 of less basis,[130] but a $20,000 reduction in taxable income is worth far more than an extra $20,000 of basis.

To determine whether the basis offset approach undermines congressional policy requires an examination of the policies underlying the denial of a deduction for a loss in value. The denial is rooted in the realization doctrine.[131] Just as a taxpayer does not recognize unrealized appreciation, so he or she may not recognize an unrealized loss. The realization doctrine is defended today on the ground of administrative efficiency. Requiring taxpayers to value all their assets annually would be costly and burdensome.[132]

Determining value would often be difficult and contentious. Further the IRS lacks to the resources to effectively monitor and enforce such a system. None of these problems arise under the basis offset approach. Use of this approach does not require taxpayers to value all their assets annually nor does it perceptibly increase the enforcement burdens on the IRS. The offset basis approach and the realization doctrine can live quite comfortably together; there is no conflict between them. The basis offset approach method is just and proper and has been consistently allowed by the IRS.[133]

There is, however, a problem with the approach that seems to have gone unrecognized. In many cases, taxpayers may have been able to offset the recovery with an excessive amount of basis. This, in turn, may allow taxpayers to improperly avoid recognizing taxable income. Consider this situation. E buys a business and pays $300,000 for its goodwill. After acquiring the business, E through an aggressive advertising campaign and the hard work of his talented staff and employees, is able to increase the business's goodwill to $1,000,000. E's unscrupulous competitor begins a campaign disparaging E's business, thereby reducing the value of the goodwill to $800,000. E sues and receives $200,000 for damage to goodwill. Because advertising and employee salaries are deductible, E has a zero basis in the goodwill that was created after E's acquisition of the business.

It is probable that E will be allowed to offset the entire $200,000 recovery against the $300,000 basis he has in the purchased goodwill with the result that none of the $200,000 is taxable. This does not reflect economic reality. The campaign of disparagement reduced the earning capacity of E's business as a whole. It harmed both the goodwill E purchased and the goodwill he and his business were able to create. Clearly an allocation is required. In the absence of any other information, the allocation should be pro-rata. Thirty percent of the recovery and thirty percent of the basis should be allocated to the purchased goodwill, since thirty percent of the business's entire goodwill was purchased [$300,000 out of $1,000,000], and the remainder of those items should be allocated to the self-created goodwill. As shown below, a proper allocation results in a significant amount of taxable income.

Purchased Goodwill

Basis in purchased goodwill	$300,000
Less: Portion of recovery allocable	
to purchased goodwill (30%)	60,000
Basis in purchased goodwill as adjusted	$240,000

Self-Created Goodwill

Portion of recovery allocable	
to self-created goodwill (70%)	$140,000
Less: Basis in self-created goodwill	-0-
Taxable income	$140,000

This sort of misallocation appears to have occurred in *State Fish Corp. v Commissioner*,[134] although to only a minor degree. Taxpayer bought a business for $25,000 of which $18,000 was allocated to goodwill in the purchase agreement. After the sale, the seller successfully solicited customers away from the taxpayer' business in violation of his covenant not to compete. The taxpayer sued and recovered about $9,500 for damage to the business's goodwill. The court permitted the taxpayer to offset the entire $9,500 against his $18,000 basis in goodwill resulting in no taxable income. However, the facts showed that not only did the seller successfully solicit individuals and businesses who were customers before the sale but also "new customers acquired by [the taxpayer] after purchasing the business." It seems probable that the new customers reflect new goodwill and that it was error to allow the taxpayer to offset his entire award against the goodwill existing at the time of the sale.

This phenomenon may occur in different contexts. Suppose a company buys a patent. To convert the patent into a popular selling product on the mass market, the company incurs large expenditures for labor and advertising. Since these items are deductible, the company has a zero basis in the goodwill it creates. The company subsequently receives a recovery from a competitor for unfair disparagement. Allocating the entire recovery against the company's basis in the patent while ignoring its self-created goodwill will produce the same type of distortion illustrated above.

The IRS may decide to go along with the commonly accepted approach in most cases in view of the difficulties of proof and the limited amount of money involved. Nevertheless, the principle discussed above is valid, and the IRS should be permitted to press for allocating a recovery between purchased and self-created goodwill where it determines that the tax dollars at stake are sufficiently high. Establishing an allocation would not appear to be an insurmountable task.[135]

VI. Discussion of Examples Presented in Part II

With the possible exception of Example 6 (trademark infringement), capital gain treatment should be denied in each of the examples mentioned in Part II for the simple reason that no sale or exchange took place. A sale or exchange is a precondition to capital gain treatment, and the caselaw makes it clear that the recoveries in all the examples (again with the possible exception of Example 6) do not constitute a sale or exchange. Since there is a clear failure to satisfy the statute, the focus of this Part will be on the policy issues involved.

First note that in none of the examples (again with the possible exception of Example 6) is the policy of the capital gain preference of encouraging the mobility of capital furthered since the taxpayer may, under current rules, enjoy the preference while retaining the property.

Examples 1 through 3—involving restraint of trade, interference with banking operations and patent infringement—present the weakest cases for capital gain treatment. Each involved recoveries for damage to the taxpayers' goodwill, that is to say, loss of future earnings, and consequently the recoveries are simply substitutes for amounts that would otherwise be taxed as ordinary income.

In Example 4—the corporate fraud example—the taxpayer's stock lost value because of the fraud and mismanagement of insiders. The taxpayer recouped his loss in a lawsuit award. Unlike Examples 1 through 3, the award is not clearly a substitute for an amount otherwise taxable as ordinary income (i.e., dividends); it may well be a replacement for lost future capital gains. Many companies in the recent corporate fraud scandals followed a no-dividend policy, and their shareholders looked for gain upon the future sale of their stock as their only potential reward for their investment. However, as pointed out above, there can be no assurance that a no-dividend policy would remain in effect forever or that the shareholders' anticipated capital gains would ever materialize. In light of this uncertainty—combined with the fact that bestowing the capital gain preference here does not further the congressional purposes for enacting it—the taxpayer should lose. The long-term capital gain tax rate is an extraordinary preference, and the taxpayer should clearly establish his or her entitlement to it. The recovery should be taxed as ordinary income.

The analyses above apply with equal force to Example 5—the soil erosion example—and should lead to ordinary income treatment. But an additional element is present. Section 1231 provides for capital gain treatment when real property used in a trade or business is involuntarily converted as a result of the property's destruction in whole or in part. In this example, the taxpayer's property was damaged but not “destroyed,” since the condominium units could still be rented. To allow capital gain treatment here would contravene congressional purpose by allowing it in an involuntary conversion not meeting the requirements of the statute.

Example 6—the trademark infringement case—deserves closer examination. The case on which this example was based grew out of the decision by Standard Oil of New Jersey to change the brand name it used on its products from Esso to Exxon.[136] The taxpayer, a manufacturer of storage batteries that carried the trademark “Exide,” asserted that the value of its trademark and associated goodwill would be damaged if Standard Oil used the Exxon trademark in connection with the sale of its batteries.[137] The dispute was settled by Standard Oil’s paying $5,000,000 to the taxpayer.[138] Significantly, the settlement agreement permitted Standard Oil to use the term “Exxon” “anywhere in the world in connection with any goods, products or services.”[139] The court found the $5,000,000 payment constituted compensation for damage to the taxpayer’s Exide trademark and associated goodwill and that it qualified for capital gain treatment to the extent it exceeded taxpayer’s basis.[140]

If that were all, the court’s decision would have to be rejected: compensation for damage to goodwill is simply a substitute for amounts that would be taxed as ordinary income. But that is not all: the agreement also allowed Standard Oil to use the Exxon trademark throughout the world in connection with its batteries. The $5,000,000—or at least a significant part of it—may therefore be viewed as consideration for a transfer of an interest in the Exide trademark to Standard Oil in which case it would qualify as long-term capital gain. Standard Oil must have found substantial merit in taxpayer's claim that its Exide trademark included the right to use of the word "Exxon." Otherwise, it would not have paid the taxpayer $5,000,000. Under the law then and now, a transfer of an interest in a trademark will generally qualify for capital gain treatment unless the transferor retains significant powers over the transferred interest.[141] In the latter case, the transfer will be deemed a license and payments received under it will be taxed as ordinary income.[142] Although the court did not pass on whether taxpayer had transferred an interest in its Exide trademark to Standard Oil, it rejected the IRS's contention that the settlement agreement was a mere license.[143]

Note also the difference in this example and the prior ones. In the previous examples, the taxpayer did not transfer any interest in its property to the other party in exchange for the payment; that was why there was no "sale or exchange." In this case, there was a transfer of a property interest and a concomitant receipt of money—in other words, a "sale."

To the extent the $5,000,000 may properly be viewed a payment in exchange for a transfer of an interest in a trademark, capital gain treatment was appropriate.

VII. Is the Taxation of Recoveries for Property Damage Governed by Section 1234A?

Section 1234A accords capital gain (and capital loss) treatment to:

. . . gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

(1) a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . . .

At least one commentator has speculated on whether that this section furnishes taxpayers with an extra string to their bows in their quest for capital gain treatment.[144] The argument for applying this section apparently is that the wrongdoer's payment of damages in satisfaction of his or her liability *terminates* the taxpayer's *right* to collect damages. This position should be rejected.

This position entails an unnatural reading of the statute. When a taxpayer collects payment for damage to property, we do not commonly say that his rights are being terminated or cancelled; on the contrary, we say his rights are being enforced. Payment of damages is not described, in common usage, as a termination of plaintiff's rights but as a satisfaction of those rights.

Instead, the statute seems to contemplate the release or termination of a specific right granted in a contract or other arrangement of the parties. This interpretation seems borne out by the legislative history. All the examples in the committee reports explaining section 1234A cite only cases involving contractual arrangements and their terminations: settlement of a contract to deliver a capital asset, release of a lessee from a requirement that the premises be restored to their initial condition upon the lease's expiration, cancellation of contract making taxpayer sole booking agent for an entertainer, etc.[145] Nothing in the legislative history suggests that section 1234A was intended to cover enforcement of tort claims arising from damage to one's property. The terms cancellation, lapse, expiration and termination are those traditionally used in capital gains litigation involving contracts.[146]

Furthermore, a taxpayer's recovery for damage to his or her property does not entail any of the problems section 1234A was enacted to resolve. The committee reports list two reasons (in addition to giving more certainty to the law) for the enactment and amendment of section 1234A: (1) to ensure that similar economic transactions are taxed in the same manner; and (2) to deny taxpayers the option of choosing capital gain treatment in the event of a gain and ordinary loss treatment in the case of a loss.[147]

The concern that economically identical transactions might be taxed differently arose because some courts accorded capital gain treatment for payments received for "sale" of contractual rights (e.g., a transfer of a right to buy a mine's output) but denied such treatment to payments received for cancelling those rights (e.g., a mine owner's payment to terminate the right). This concern echoes Judge Friendly's complaint that the distinction was formalistic, because in both cases, the taxpayer (e.g., the party possessing the right) was transferring property rights, the only difference being the identity of the transferee; in one case “a stranger” (e.g. the buyer of the right) and in the other “a person already having a larger ‘estate’” (e.g., the mine owner).[148] Section 1234A resolved this inconsistency by providing that cancellation of a right or obligation would give rise to capital gain or loss.

The concern that the law (prior to section 1234A) permitted opportunistic tax elections by taxpayers is explained in the following excerpt:

> [P]resent law effectively provides, in many cases, taxpayers with an election to treat the transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that can offset higher-taxed ordinary income and not be subject to limitations on use of capital losses. The effect of an election can be achieved by selling the property right if the resulting transaction results in a gain or providing for the extinguishment of the property right if the resulting transaction results in a loss.[149]

Section 1234A eliminated this abuse by providing for capital gain treatment whether the property was sold or terminated.

Neither of these concerns is relevant to recoveries for injury or damage to one’s property. No matter how the transaction is structured—either as collection of the recovery by the taxpayer or as a sale of taxpayer’s right to the recovery—the tax result (i.e., capital gain or ordinary income) will be the same. The identity of results precludes taxpayers from making the type of opportunistic tax elections described in the committee reports.

If a recovery of damages is taxed as capital gain (as under current law), a sale of the right to the recovery will be also taxed as capital gain.[150] On the other hand, if the recovery is taxed as ordinary income (as advocated in this article), the proceeds from the sale of the taxpayer's right to the recovery will almost certainly also be taxed as ordinary income under the "substitute for ordinary income" doctrine.[151] A sale of a right to ordinary income, unaccompanied by a transfer of the underlying property, is a classic "carve out" and results in ordinary income.

Unlike the income interest sold in *P.G. Lake, Inc.* the value of the right to pursue a taxpayer's claim for damage to goodwill or other property may be highly speculative and prosecution of the claim will often entail substantial personal services by the holder of the right. Does this difference make the "substitute for ordinary income" doctrine inapplicable? It does not appear to do so. Even if no carve out is involved, a taxpayer's sale of the right to engage in a profit-seeking activity requiring personal services (e.g., a management contract with an insurance company where compensation is based on premiums) is generally held to produce ordinary income.[152] The rationale for these holdings is that the amount received merely represents a substitute for the ordinary income that the taxpayer would realize if he or she retained the right.[153] Professors Chirelstein[154] and Del Cotto[155] have each criticized these holdings arguing that such contractual rights should be viewed as "investments" since they are capable of market appreciation and depreciation like a stock or a bond.[156] Professor Del Cotto also argued that selling such an arrangement constitutes a conversion of an investment since it shifts the market risk to the buyer.[157] There arguments have not taken hold,[158] and their adoption today would "virtually turn the case law . . . on its head."[159]

Finally the concern expressed in the committee reports that a transaction not amounting to a sale or exchange (e.g., termination of the contract rights) will generate an ordinary loss[160] cannot occur when a taxpayer receives a recovery for damage to property that he or she retains. If the recovery is less than taxpayer's basis, the only consequence is that the taxpayer's basis is reduced by the amount of the recovery. Since the taxpayer still retains the underlying property, there is no closed or completed transaction and hence no loss may be recognized.[161]

VIII. Conclusion

Although the Internal Revenue Code makes a "sale or exchange" a precondition to long-term capital gain treatment, courts and the IRS have frequently accorded such treatment to recoveries for damage to the taxpayer's property, even where the taxpayer retains the property and engages in no sale or exchange. This article has examined whether any policy or equitable reason justifies this disregard of the statutory injunction. None has been found. According capital gain treatment to the recoveries does not further either policy of the tax preference: to spur investment and to encourage the mobility of capital. Furthermore, the recovery will often—especially in the case of damage to goodwill—merely represent an acceleration of amounts otherwise taxable as ordinary income. Since these transactions do not further the policies of the capital gain tax preference, no good reason exists to permit the actual or potential transmutation of ordinary income into capital gain.

The IRS should explicitly state that, absent a specific statutory exception, a transaction will not qualify for capital gain treatment unless there is a "sale or exchange" and revoke all contrary rulings and acquiescences. Courts similarly should repudiate cases granting capital gain relief without a sale or exchange. These actions will add clarity and coherence to the law, implement sound policy and comply with the Code's explicit direction.

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[1] *See, e.g.*, I.R.C. § 1222 (3) (defining "long-term capital gain" as "gain from the sale or exchange of a capital asset held for more than 1 year"). Unless otherwise indicated, all references to Code or to a section are to the Internal Revenue Code of 1986 as currently in effect or to a section thereof.

[2] Big Four Industries, Inc. v. Commissioner, 40 T.C. 1055 (1963), *acq.* 1964-2 C.B. 4; Inco Electroenergy Corporation v. Commissioner, 1987 Tax Ct. Memo LEXIS 434 (1987); Durkee v. Commissioner, 162 F.2d 184 (6th Cir. 1947), *on remand*, 8 T.C.M. (CCH) 701 (1949), *aff'd*, 181 F.2d 189 (6th Cir. 1950); Telefilm, Inc. v. Commissioner, 21 T.C. 688 (1954), *rev'd on an unrelated issue*, 55-1 U.S. Tax Cas. (CCH) ¶ 9453 (9th

Cir. 1955); Wheeler v. Commissioner, 58 T.C. 459, 461 (1972); Gail v. United States, 58 F.3d 580 (10th Cir.1995). In a number of other cases, the courts have recognized this principle but ruled against the taxpayer because of the particular facts of the case. *See, e.g.*, Bresler v. Commissioner, 65 T.C. 182, 184 (1975), *acq*., 1976-2 C.B.1.

[3] In Rev. Rul. 74-251, 1974-1 C.B. 234, 234. the IRS stated that "[u]nless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a law suit does not in itself constitute as sale or exchange."

[4] The IRS accepted the principle that a lawsuit recovery in excess of basis qualified for capital gain treatment in the cases cited in *supra* note 2.

[5] Robert W. Wood, *Litigation Settlements, Sales and Exchanges, and Section 1234A*, 109 TAX NOTES 776 (2005). Mr. Wood, a practitioner as well as an adjunct professor of tax law and a frequent contributor to TAX NOTES, states that he sees "the IRS agreeing (on an informal level as least) that a sale or exchange is often not required" *Id.* at 777.

[6] Field Serv. Adv. Mem. 2002-28-005, 2002 FSA LEXIS 53 (Mar. 29, 2002); Priv. Ltr. Rul. 93-08-013 (Nov. 24, 1992); Unnumbered Field Serv. Adv. Mem., 1998 FSA LEXIS 466 (May 8, 1988) (recognizing principle).

[7] Big Four Industries, Inc. v. Commissioner, 40 T.C. 1055 (1963), *acq.* 1964-2 C.B. 4

[8] Field Serv. Adv. Mem. 2002-28-005 (Mar. 29, 2002), 2002 FSA LEXIS 53.

[9] Field Serv. Adv. Mem. 2002-28-005 (Mar. 29, 2002), 2002 FSA LEXIS 53, at *10 - *11.

[10] Robert W. Wood, *Capital Gain or Ordinary Income: How Securities Lawsuit Recoveries Are Taxed*, 108 TAX NOTES 767, 768 (2005) ("The better view is that a disposition of the stock isn't needed . . . "). The extraordinarily large settlements currently being paid, combined with the low prices that some investors paid for their stock, make this issue timely. *See, e.g.*, *Citigroup's WorldCom Payment Is Finalized at $2.58 Billion*, Factiva (Nov. 8, 2004) *at* LEXIS Corporate Library, Wall Street Journal File; *CIBC to Pay $2.4 Billion Over Enron—Canadian Bank Is Settling Investors' Fraud Claims; Spotlight on Merrill, CSFB*, Factiva (Aug. 3, 2005) *at* LEXIS Corporate Library, Wall Street Journal File (reporting that Canadian bank paid $7.12 billion to settle investors' fraud claims).

[11] Wood, *supra* note 5, at 777.

[12] This example is based on the facts of Durkee v. Commissioner, 162 F.2d 184 (6th Cir. 1947), *on remand*, 8 T.C.M. (CCH) 701 (1949), *aff'd*, 181 F.2d 189 (6th Cir. 1950).

[13] This example was suggested by the facts of Farmers' & Merchants' Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932).

[14] This example is based on the facts of Big Four Industries, Inc. v. Commissioner, 40 T.C. 1055 (1963), *acq.*, 1964-2 C.B. 4.

[15] This example is based on Example 1 in Wood, *supra* note 10, at 768.

[16] Robert W. Wood contends that there is a capital gain of $300 a share. *Id.* This is contrary to the well-established rule that a recovery is first applied against the taxpayer's adjusted basis in the property and only the excess is taxed as capital gain.

[17] This example was suggested by Kurata v. Commissioner, 73 T.C.M. (CCH) 2929 (1997). However, the legal issue and facts in that case differ somewhat from those in the example.

[18] This example is based on the facts in Inco Electroenergy Corporation v. Commissioner, 1987 Tax Ct. Memo LEXIS 434 (1987).

[19] Long-term capital gains are generally taxed at a maximum rate of 15%, I.R.C. § 1(h)(1), while ordinary income is generally taxed at a maximum rate of 35%. I.R.C. § 1(i)(2).

[20] I.R.C. § 1222(3).

[21] 313 U.S. 247 (1941).

[22] *Id.* at 249.

[23] *Id.*

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[24] *Id.* at 250-51.

[25] *Id.* at 251.

[26] Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Engraving Co. v. Commissioner, 311 U.S. 513 (1941).

[27] Hawaiian Gas Products, Ltd. V. Commissioner, 126 F.2d 4 (9th Cir. 1942); Commissioner v. Kieselbach, 127 F.2d 359 (3d Cir.1942), *aff'd on another issue*, 317 U.S. 399 (1943).

[28] Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 251 (1941).

[29] *Id.* at 250-51.

[30] JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 743-46 (3d ed. 2004).

[31] *See*, *e.g.*, Commissioner v. Pittson Co., 252 F.2d 344 (2d Cir.1957) and cases cited thereat. *See also* H. Rep. No. 105-148, at 451-455 (1997) (discussing cases). These cases have now been effectively overruled by I.R.C. § 1234A which treats gain or loss attributable to the cancellation, lapse, expiration or other termination of a right with respect to a capital asset as capital gain or loss.

[32] 304 F.2d 125, 131 (2d Cir. 1962).

[33] *Id.*

[34] BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 48.1.5 (3d ed. 2007) states that:

> . . . *Ferrer* proved to be a turning point in this area, and later decisions have played down or wholly disregarded the fact that a contract or other business relationship was terminated rather than kept alive. In disappearing asset cases decided after *Ferrer*, capital gain treatment has been denied on the ground that the transferor's rights were not "property " within the meaning of § 1221 or represented only an opportunity to earn income from personal services or because the payment was a substitute for future ordinary income.

However, some cases even after *Ferrer*, particularly those involving financial contracts, continued to turn on whether the contract had been sold or "disappeared." *Id.* at n.37. *See* *also* Tech. Adv. Mem. 2004-27-025, 2003 PLR LEXIS 1842, at *23 (Dec. 9, 2003) (concluding that although "the extinguishment doctrine has faced considerable criticism over its half-century history, yet it remains a current feature of tax law"). Congress believed there was sufficient uncertainty in the law that it enacted I.R.C. § 1234A in 1981 (and revised it in 1997) to provide that gains or losses attributable to the "cancellation, lapse, expiration, or other termination" of a right were taxable as capital gains or losses. H. REP. NO. 105-148, at 453-54 (1997) ("This lack of uniformity has caused uncertainty to both taxpayers and the Internal Revenue Service . . .").

[35] Commissioner v. Ferrer, 304 F.2d 125, 131 (2d Cir. 1962).

[36] JOSEPH M. DODGE ET AL., TEACHERS MANUAL TO FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY ch. 26, p. 9 (3d ed. 2004). In his comment, Professor Dodge was setting forth a rationale for cases holding that no sale or exchange occurs when an asset "disappears," but his analysis also explains the reason for the "transfer" requirement.

[37] 1974-1 C.B. 234.

[38] *Id.* at 234.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249 (1941) ("ordinary meaning.").

[43] Commissioner v. Brown, 380 U.S. 563, 571 (1965) ("common and ordinary meaning").

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[44] Taxpayer Relief Act of 1997, Pub.L.No.105-34, §311(a), 111 Stat. 788, 831-32. (1997).

[45] Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No.108-27, § 301(a)(2)(A), 117 Stat.752, 758 (2003).

[46] **1997 Act**: S. REP. NO. 105-33, at 33 (1997); H.R. REP.NO.105-148, at 340-41 (1997). **2003 Act**: H.R. REP.NO.108-94, 29-30 (2003).

[47] The reports also do not refer to inflation, even though some have argued that a capital gain tax preference is required to lessen the adverse impact of taxing illusory gains that are due solely to a decline in purchasing power. This problem is described in, and the use of the preference as a solution is critiqued in, Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX. L. REV. 319, 337-40. However, commentators who have attempted to discern the intent of Congress in

enacting the provision have generally not found relief from taxing illusory gains to be one of Congress's purposes. None of the following authorities even cites or discusses the illusory gain problem: Louis A. Del Cotto, *"Property" in the Capital Asset Definition: Influence of "Fruit and Tree,"* 15 BUFF. L. REV. 1, 3-7 (1965); MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 17.01 (10th ed. 2005); Note, *Distinguishing Ordinary Income From Capital Gain Where Rights to Future Income Are Sold*, 69 HARV. L. REV. 737 739-43 (1956); Note, *The* P.G. Lake *Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies*, 14 STAN. L. REV.551, 555-60 (1962).

[48] The "bunching" problem is described, and the use of the capital gain tax preference as a solution is critiqued, in Cunningham & Schenk, *supra* note 47, at 328 and in JOSEPH M. DODGE, THE LOGIC OF TAX: FEDERAL INCOME TAX THEORY AND POLICY 319-20 (1989).

[49] Del Cotto, *supra* note 47, at 4 (describing the "bunching" issue as being "of minimal importance today [i.e., 1965]"); Note, *Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are* Sold, 69 HARV. L. REV. 737, 741 (describing the bunched income problem as "not the overriding purpose of the capital gain sections").

[50] Professor Dodge writing in 1989 concluded that "the 'bunching' issue has become largely moot with the adoption of a quasi-flat structure . . . . " DODGE, *supra* note 48, at 320. Likewise, Professors Cunningham and Schenk writing in 1993 stated that "[b]unching currently is not a significant problem." Cunningham & Schenk, *supra* note 47, at 328.

The Tax Reform Act of 1986, which lowered the highest individual marginal tax rate to 28%, repealed the income averaging provisions in the prior law because "in light of the significantly flatter rate structure under the bill, there is no longer a need for income averaging." Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096-97 (1986) (28% tax rate); Tax Reform Act of 1986, Pub. L. No. 99-514, §141, 100 Stat. 2085, 2117 (1986) (repeal of income averaging): S. REP. NO. 99-313, at 45 (1986) (reason for repeal).

[51] Internal Revenue Code of 1954, Pub. L. No.83-591. § 1, 68A Stat. 3, 5-7 (1954).

[52] I.R.C. § 1(i)(2).

[53] Cunningham & Schenk, *supra* note 47, at 328-29; DODGE, *supra* note 48, at 319-20.

[54] I.R.C. § 1(h)(1)(C).

[55] Whether this occurs will, of course, depend on the taxpayer's tax rate in the years in which the appreciation occurred. However, the tax rate in the year of realization should indicate, on average, whether the taxpayer is normally in a high income or a low income tax bracket.

[56] I.R.C. § 1(h)(1)(B).

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[57] I.R.C. § 1221(3) (defining "long-term capital gain" as gain from the sale or exchange of property held for more than one year).

[58] H. R. REP. NO. 67-350, pt. 1, at 10-11(1921).

[59] The lock-in effect is described in Cunningham & Schenk, *supra* note 47, at 344-46; DODGE, *supra* note 48, at 322-24. The lock-in effect results from the realization doctrine which precludes taxation of appreciation until it is realized and the step-up in basis that occurs at death in the case of appreciated property. I.R.C. § 1014(a)(1). These two factors often make it more attractive to hold appreciated property than sell it.

[60] Cunningham & Schenk, *supra* note 47, at 345. The authors question this validity of this contention noting that while "an individual may benefit greatly by changing her portfolio, it is not clear that it matters much to society who owns IBM stock." *Id.* Although this observation is obviously correct, it seems to ignore the fact that lower capital gain tax rates may affect the quantity of capital flowing to more productive activities which in turn would reduce the cost of capital for those activities.

[61] The effect that lower capital gains rates have on tax revenue, if any, is unclear Cunningham & Schenk, *supra* note 47, at 352-53. The authors summarize the status of the evidence as follows:

> Despite the chaotic state of the empirical evidence, most research indicates that the revenue maximizing rate for capital gains is likely to be less than the ordinary income rate, although even that is not entirely free from doubt.

Id at 353.

[62] Big Four Industries, Inc. v. Commissioner, 40 T.C. 1055, 1060 (1963), *acq.* 1964-2 C.B. 4 (damage to "corporate capital" and to "goodwill"); Inco Electroenergy Corporation v. Commissioner, 1987 Tax Ct. Memo LEXIS 434, at *16 (1987) (damage to "trademark and associated goodwill"); Durkee v. Commissioner, 162 F.2d 184, 186 (6th Cir. 1947), *on remand*, 8 T.C.M. (CCH) 701 (1949), *aff'd*, 181 F.2d 189 (6th Cir. 1950) (damage to "good will").

There seem to be two reasons for this phenomenon.

First, a capital gain can occur only when the recovery exceeds the taxpayer's basis in the property. Most taxpayers have a zero basis in their goodwill, since the cost of the advertising and the cost of the other items that generate the goodwill are deductible. Thus, any recovery for damage to goodwill will almost always exceed the taxpayer's basis, and under current law capital gain treatment will result. However, if the taxpayer has a basis in the damaged property, capital gain treatment will result only if the recovery exceeds the taxpayer's basis—something that apparently rarely happens.

Secondly, many cases that might potentially implicate this issue are covered by section 1231(a)(3)(A)(ii) which generally provides for capital gain treatment for the involuntary conversion resulting from the partial or complete destruction of property used in the taxpayer's trade or business rather than the judicial rules that are the focus of this article.

[63] Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.02(f).

[64] *Id*. ("In the final analysis, goodwill is based upon earning capacity.").

[65] The statement in the text is simply a special case of the general principle that the value of an asset is the present value of all future cash flows generated by the asset discounted to present value. RICHARD A BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 73 (5th ed. 1996) ("Value today always equals future cash flow discounted at the opportunity cost of capital").

[66] Farmers' & Merchants' Bank v. Commissioner, 59 F.2d 912, 913 (6th Cir. 1932).

[67] *See* Kenneth M. Kolaski & Mark Kuga, *Measuring Commercial Damages Via Lost Profits or Loss of Business Value: Are These Measures Redundant or Distinguishable?*, 18 J.L. & COM. 1, 21 (1998) ("Most of the confusion . . . between lost profits and loss of business value damages could be resolved if the courts . . . recognized that both of these calculations are measuring the same thing . . . .") Some of the more perceptive modern courts have recognized that "[l]oss of goodwill . . . refers to a loss of future profits."

AM/PM Franchise Ass'n. v. Atlantic Richfield Co., 584 A.2d 915, 924 (Pa. 1990) (quoting Roy Ryden Anderson, *Incidental and Consequential Damages*, 7 J.L. & COM. 327, 420 (1987)). The court also held that "the phrase 'good will damages' is coextensive with prospective profits . . . ." *AM/PM Franchise Ass'n.*, 584 A.2d at 924.

[68] *See, e.g.*, Protectors Ins. Serv. v. United States Fid. & Guar. Co., 132 F.3d 612, 617 (10th Cir. 1998) (holding that where owner "is awarded the fair market value of the business without [taking into account] the injury," he cannot also receive lost profits as he "has been made whole because that value takes into account the prospect of future profits . . . ").

[69] 356 U.S. 260 (1958). In this case, the taxpayer had sold an "oil payment" (i.e., the right to the income from a working interest in an oil lease) that was to last until the amounts received from the oil payments totaled $600,000. This was reasonably determined to occur, and did occur, in about three years. The Court ruled that the payments were taxable as ordinary income since they were a substitute for ordinary income.

[70] DODGE, *supra* note 48, at 258.

[71] *Id.*

[72] *See supra* note 65 and accompanying text.

[73] CHIRELSTEIN, *supra* note 47, at ¶ 17.03.

[74] Del Cotto, supra note 47, at 19.

[75] *Id.*

[76] *Id.* at 19-20.

[77] CHIRELSTEIN, supra note 47, at ¶ 17.03.

[78] *Id.*

[79] Professor Dodge argues that capital treatment in *P.G. Lake, Inc*. was "plainly not appropriate" because "[c]arve-out transactions do not increase the mobility of capital; they retard it and encourage the fractionalization of interests in property." DODGE, *supra* note 48, at 258.

[80] In light of Professor Del Cotto's emphasis on the taxpayer's retention of the income producing property, he apparently would have accorded ordinary income treatment to a recovery for damage to goodwill, since the property producing the income, i.e., the underlying business, is retained by the taxpayer. Professor Del Cotto envisioned the possibility that the income interest might be so speculative that the granting of it to the transferee could result in his having an interest in the enterprise lasting its entire existence

making him or her in effect a co-owner. In that case, Professor Del Cotto would find a partial conversion of the taxpayer's capital investment. Del Cotto, *supra* note 47, at 20-21. This situation never arises in the case of lawsuit recoveries, since the party paying the recovery acquires no beneficial interest in the business.

In determining whether taxpayer has converted a capital investment, Del Cotto would also look to whether the taxpayer transferred a substantial risk to the buyer of the income interest. Del Cotto, *supra* note 47, at 20 ("The lack of any risk to the purchaser . . . indicates absence of any investment having been bought or sold.") No risk of loss or hope of gain is transferred by the taxpayer to the party paying the recovery, since the payor receives no beneficial interest in the business.

Professor Chirelstein would likewise probably find recoveries for damage to goodwill taxable as ordinary income. This would particularly be true if the recovery was based on the premise that the damage would last for only for a limited time. In that case, as in *P.G. Lake, Inc.*, a taxpayer retaining the business could, after the damage ceased, repeatedly sell rights to income for limited time periods. This would, but for the holding in *P.G. Lake, Inc.*, cause all the taxpayer's income (including the income that was replaced by the damage award) to be taxed as capital gain.

The situation is more complex if the damage to the goodwill was computed on the premise that that the damage was permanent. The award means in effect that a portion of the business's income earning capacity was found to have been permanently destroyed, or put differently, a portion of the business's stream of earnings has come to an end. Obviously, the taxpayer cannot sell and resell income interests from the *destroyed portion* of the income stream. However, ordinary income treatment is probably still appropriate. First, the taxpayer could engage in the repeated sale of income interests from the *undamaged portion* of the income stream. This would cause all of the taxpayer's income (i.e., the income from the undamaged portion of the income stream *and* the income replaced by the damage award) to be taxed as capital gain. Secondly, the taxpayer may, contrary to the assumption in the damage award, be able to regenerate the lost goodwill. The award represents only an estimate of the duration of the lost goodwill and should not be binding on the IRS.

For cases involving destruction of a business and its goodwill, see *infra* notes [90-94] and accompanying text.

[81] *See* discussion *supra* Part IV.A.

[82] *See supra* notes 63-68 and accompanying text.

[83] *See supra* notes 49-58 and accompanying text.

[84] *See supra* notes 54-56 and accompanying text.

[85] *See supra* notes 57 and accompanying text.

[86] Wheeler v. Commissioner, 58 T.C. 459 (1972).

[87] Victor E. Gidwitz Family Trust v. Commissioner, 61 T.C. 664, 674 (1974).

[88] BITTKER & LOKKEN, *supra* note 34, at ¶ 44.8.6 (2007)

[89] I.R.C. § 1091.

[90] I.R.C. § 1231(a)(3)(A)(ii). Section 1231(a) provides that if "section 1231 gains" exceed "section 1231 losses," the resulting gains and losses are treated as a long-term capital gains and long-term capital losses, and if "section 1231 gains" do not exceed "section 1231 losses" the resulting gains and losses are treated as ordinary income and losses. I.R.C. § 1231(a)(1), (2). Section 1231 gains and losses consist of recognized gains or losses arising from the sale or exchange of property used in the taxpayer's trade or business and from certain involuntary conversions of property used in the taxpayer's trade or business; or of a capital asset held for more than one year in connection with the taxpayer's trade or business or a transaction entered into for profit. I.R.C. § 1231(a)(3). Generally, "property used in the trade or business" means depreciable property or real property held for more than one year that is used in the taxpayer's trade or business. I.R.C. § 1231(b).

[91] Rev. Rul. 55-79, 1955-1 C.B. 370 (stating that "intangible assets such as goodwill, constitute capital assets"); Better Beverages, Inc. v. United States, 619 F.2d 424, 425 n.2 (5th Cir. 1980) (stating "goodwill is a capital asset").

[92] Thus a taxpayer who suffers damage to self-created goodwill is permitted to offset any recovery against the taxpayer's entire basis in the goodwill, not just against that portion of the basis that is equal to the percentage of goodwill that was damaged. *See* State Fish Corp. v Commissioner, 48 T.C. 465 (1967), *acq.*, 1968-2 C.B.3, *clarified*, 49 T.C. 13 (1967).

In cases involving claimed loss deductions under I.R.C. § 165, the courts have frequently described intangibles resembling goodwill (e.g., customer lists) as being "indivisible assets." Thus the loss of a single customer on the list is not viewed as the *loss* of a separate asset entitling the taxpayer to a deduction but *merely as a decline in the value* of the customer list viewed as a whole. Under this approach, the taxpayer does not qualify for a deduction, since no deduction is allowed for a mere decline in the value of an asset. *See, e.g.*, Golden State Towel & Linen Service, Ltd. v. United States, 179 Ct. Cl. 300, 373 F.2d 938 (1967) (customer list); Field Serv. Adv. Mem. 2000-01-002, 1999 FSA LEXIS 247 (Sept. 10, 1999) (subscriber accounts and assembled workforce).

[93] 10 T.C. 1099 (1948), *aff'd.*, 177 F.2d 259 (1st Cir. 1949).

[94] 10 T.C. at 1105.

[95] *See supra* note 65 and accompanying text.

[96] For purposes of this example, it is assumed that the contamination occurred as part of a progressive, gradual process and was therefore not a "casualty." *See infra* note 115 and accompanying text. Consequently, the taxpayer could not treat the gain as a casualty gain qualifying for capital gain treatment under I.R.C. § 165(h).

[97] BITTKER & LOKKEN, *supra* note 34, at ¶ 5.3.1 (stating that a major source of "untaxed income . . . [is] taxpayers' use of their own residences . . . . ").

[98] There seems little doubt following the Supreme Court's decision in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) that the imputed rental value of owner-occupied real property constitutes "income" within the meaning of the Sixteenth Amendment notwithstanding the Court's dictum to the contrary in Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934). BITTKER & LOKKEN, *supra* note 34, at ¶ 5.3.3.

[99] For arguments that imputed rental income of owner-occupied real property constitutes income in the economic sense, see Melvin I. White, *Consistent Treatment of Items Excluded and Omitted from the Individual Income Tax Base in* HOUSE COMMITTEE ON WAYS AND MEANS, 86TH CONG., TAX REVISION COMPENDIUM 317, 322-23 (Comm. Print 1959); CHIRELSTEIN, *supra* note 47, at ¶ 1.03; DODGE, *supra* note 48, at 151-52; Richard

Goode, *Imputed Rent of Owner-Occupied Dwellings Under the Income Tax*, 15 J. FIN. 504, 504 (1960).

[100] Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (defining amounts that are "accessions to wealth, clearly realized and over which the taxpayers have complete dominion" as income).

[101] Mark A. Haskell & Joel Kauffman, *Taxation of Imputed Income: The Bargain-Purchase Problem*, 17 NAT'L TAX J. 232, 232 (1964) (stating that most economists agree that imputed income should be included in tax base and thus "[c]ontroversy is most likely to arise over practical, not theoretical questions").

[102] CHIRELSTEIN, *supra* note 47, at ¶ 1.03.

[103] *Id.*

[104] *Cf.* Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (holding that amount received by taxpayer for use of its property was ordinary income).

[105] Microsoft was founded in 1975. *See* http://www.microsoft.com/presspass/insidefacts_ms.mspx. For Microsoft, Inc.'s dividend history, see http://www.microsoft.com/msft/FAQ/dividend.mspx.

[106] *See* Gary Rivlin, *Microsoft to Pay Special Dividend to Stockholders*, N.Y. TIMES, July 21, 2004, at A1 (describing $32 billion payout as "largest cash grant in corporate history"). For Microsoft, Inc.'s dividend history, see http://www.microsoft.com/msft/FAQ/dividend.mspx.

[107] *See*, *e.g.*, Industrial Life Ins. Co. v. United States, 344 F. Supp 870, 878-79 (D.S.C. 1972), *aff'd.*, 481 F. 2d 609 (4th Cir. 1973) (finding that although taxpayer "originally purchased the land . . . as an investment," gain on sale was ordinary income because "real question is … the purpose for which it is being held at time of sale" and taxpayer was then selling lots in ordinary course of business); Winston v. Commissioner, 15 T.C.M.(CCH) 477 (1956).

[108] BITTKER & LOKKEN, *supra* note 34, at ¶ 47.2.4 (stating that a change in the status of property from an investment to inventory "causes the taxpayer's entire gain to be taxed as ordinary income no matter how much of it is attributable to a gradual increase in value while the property was held as an investment").

[109] Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46 (1955).

[110] *See supra* notes 86-89 and accompanying text.

[111] *See* JOHN D. AYER, GUIDE TO FINANCE FOR LAWYERS § 10.04 (2001) for a formula that attempts to take both of these elements into account in valuing common stock.

[112] Rev. Rul. 89-2, 1989-1 C.B. 259; Rev. Rul. 66-334, 1966-2 C.B. 302.

[113] Kurata v. Commissioner, 73 T.C.M. (CCH) 2929 (1997) (lessor of condominiums, who recovered damages for soil erosion, failed to establish their "destruction in whole or in part" under § 1033 where evidence showed they could still be rented).

[114] *Cf.* United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989) (holding it improper for court to rely upon pre-existing judicial rule for interpretative guidance when subsequently enacted statute unambiguously provided for different treatment.)

[115] Rev. Rul. 76-134, 1976-1 C.B. 54.

[116] *See supra* notes 46, 59-61 and accompanying text.

[117] I.R.C. § 1235.

[118] This principle is recognized in Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G.Lake Case*, 17 Tax L. Rev. 293 (1962). The authors assert that if the taxpayer in Commissioner v. P.G.Lake, Inc., 356 U.S. 260 (1958) had sold *both* the oil payment right (i.e., the carved-out interest) and the working interest (i.e., the underlying property), it should have been entitled to capital gain

treatment on both sales, even if to different purchasers, at least if both sales occurred at the same time:

> In this case he is disposing of everything he owns, and under the concluding paragraph in I.T. 4003 capital gain treatment should result. In substance, if both of these steps are viewed in their total effect as part of a single transaction, the taxpayer has disposed of his entire property interest in two steps to two different purchasers, a situation which would satisfy the "conversion of capital investment" requirement in *Lake*. But "timing" in this transaction is of the essence, since if the taxpayer had sold his shorter-lived interest [i.e., the carve-out"] before the sale of the longer-lived interest, *Lake* would spell trouble.

Id. at 309 (footnotes omitted).

[119] *See supra* notes 86-89 and accompanying text.

[120] I.R.C. § 302(b)(3). *Compare* Merrill Lynch & Co, Inc. v. Commissioner, 386 F.3d 464 (2d Cir. 2004) (treating constructive redemptions under I.R.C. § 304 and subsequent sale of taxpayer's stock as parts of an integrated plan) with Niedermeyer v. Commissioner, 62 T.C. 280 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir. 1976) (refusing to integrate redemption and subsequent sale of remaining stock because no "firm and fixed" plan to sell stock at the time of the redemption).

[121] Sherwood Memorial Gardens, Inc., 350 F.2d 225 (7th Cir. 1965); Jefferson Memorial Gardens, 390 F.2d 161 (5th Cir. 1968); Hamilton Memorial Gardens, Inc. 394 F.2d 905 (6th Cir. 1968). On the other hand, a taxpayer was allowed to increase basis in his or her property by the anticipated cost of improvements that the taxpayer was obligated to make *See, e.g.*, Birdneck Realty Corporation v. Commissioner, 25 B.T.A. 1084 (1932). However, the IRS initially took the position following enactment of the "economic performance" test in I.R.C. § 461(h) that such treatment was no longer proper. In response to adverse taxpayer comment, the IRS relented in its position and in 1992 issued Rev. Proc. 92-29, 1992-1 C.B. 748, which provided a procedure under which a real estate developer could increase the bases of properties it sold by the anticipated costs of common improvements that the developer was obligated either by law or by contract to make in the future. *See* JACOB RABKIN & MARK H. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 50B.03 (2007).

[122] *See, e.g.*, I.R.C. § 1222 (3).

[123] I.R.C. § 1016(a)(1).

[124] Rev. Rul. 81-277, 1981-2 C.B. 14, 15 ("Payment by the one causing the loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain."); Clark v. Commissioner, 40 B.T.A. 333 (1939), *acq.* , 1957-2 C.B. 4.

[125] DODGE, *supra* note 48, at 21-22.

[126] *See* Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income,* 46 Tax L.Rev. 381, 387 (1991).

[127] In the following cases, loss deductions were denied for declines in value caused by the events shown in the parentheses: Lakewood Assocs. v. Commissioner, 109 T.C. 450 (1997), *aff'd*, 99-1 U.S. Tax Cas. (CCH) ¶ 50127 (4th Cir. 1998) (denial of rezoning application); CRST, Inc. v. Commissioner, 92 T.C. 1249 (1989), *aff'd*, 909 F.2d 1146 (8th Cir. 1990) (deregulation); Beatty v. Commissioner, 46 T.C. 835 (1966) (change in law): Rev. Rul. 84-145, 1984-2 C.B. 47 (deregulation).

[128] Zelenak, supra note 126, at 387.

[129] *Id.*

[130] Under the deduction/income approach, D's basis in the goodwill must be reduced by $60,000 deduction to avoid a possible double deduction. I.R.C. § 1016(a)(1). Under the basis offset approach, the basis need only be reduced by the amount of the recovery, $40,000.

[131] JOHN C. MCCOY, LOSS DEDUCTIONS, Tax Mgmt (BNA) Portfolio No. 527-2nd , at A-3 (2007) states:

> As explained by the U.S. Supreme Court in *Eisner v. Macomber*, mere appreciation in value does not constitute income to the taxpayer until the income is realized . . . . A similar or identical concept applies to losses: losses from the mere fluctuation in value of property owned by the taxpayer will not give rise to a deduction. . . . .
>
> But the underlying concept—realization—is probably the same, however it may be articulated.

(Footnotes omitted).

[132] BITTKER & LOKKEN, *supra* note 34, at ¶ 5.2.

[133] State Fish Corp. v. Commissioner, 48 T.C. 465 (1967), *acq.*, 1968-2 C.B. 3, *clarified*, 49 T.C. 13 (1967). See also, in addition to previously cited authorities, Rev. Rul. 81-152, 1981-1 C.B. 433 (condominium owners not taxed on amounts received from builder for construction defects but must reduce their respective bases in the units by such amounts); Rev. Rul. 81-277, 1981-2 C.B. 14 (taxpayer not taxed on amounts received from contractor for its failure to complete contract but must reduce basis in plant by such amounts).

[134] 48 T.C. 465 (1967), *acq*. 1968-2 C.B. 3, *clarified*, 49 T.C. 13 (1967)

[135] Under I.R.C. § 1060(b), the parties to a sale of a business are required to furnish to the IRS with notice of the amount of the purchase price allocated to goodwill. A reasonable presumption is that any increase in the value of a business's goodwill following the sale is "new goodwill" rather than "purchased goodwill," especially in light of the conclusion of many economists that goodwill is a wasting asset. *See* George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1234 n.252 (1987) (stating that all "economic evidence indicates" that goodwill deteriorates over time and that the "economic analysis of expenditure-created goodwill . . . finds fairly short lives"). The Code treats goodwill as a wasting asset by allowing it to be amortized over 15 years. I.R.C. § 197. The portion of any increase in the value of the pre-existing goodwill attributable to inflation or a change in interest rates would seem to be a matter that could be determined with a reasonable expenditure of effort.

[136] Inco Electroenergy Corporation v. Commissioner, 1987 Tax Ct. Memo LEXIS 434, at *4 (1987).

[137] *Id.* at *2 -*6.

[138] *Id.*at *9.

[139] *Id.* at *11.

[140] *Id.* at *14-*17.

[141] I.R.C. § 1253 (a). *See generally* CHARLES EDWARD FALK, TAX PLANNING FOR THE DEVELOPMENT AND LICENSING OF COPYRIGHTS, COMPUTER SOFTWARE, TRADEMARKS AND FRANCHISES, Tax Mgmt (BNA) Portfolio No. 558 (1997)

[142] I.R.C. § 1253 (a).

[143] Inco Electroenergy Corporation v. Commissioner, 1987 Tax Ct. Memo LEXIS 434, at *17-*19 (1987).

[144] Wood, *supra* note 5, at 777.

[145] H. REP. NO. 105-148, at 451-55 (1997); S. REP. NO. 97-144, at 170-71 (1981).

[146] BITTKER & LOKKEN, *supra* note 34, at ¶ 48.1.5.

[147] H. REP. NO. 105-148, at 453 (1997); S. REP. NO. 97-144, at 170 (1981).

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[148] Commissioner v. Ferrer, 304 F.2d 125, 131 (2d Cir. 1962).

[149] H. REP. NO. 105-148, at 453 (1997). *See also* S. REP. NO. 97-144, at 170 (1981).

[150] The right will qualify as a capital asset because it is “property” and does not fall within any of the eight enumerated cases where property does not qualify as a capital asset. I.R.C. § 1221(a). Since the collection of the recovery by the taxpayer would be taxed as capital gain (under the assumption in the text), the amount realized on its sale would not be a “substitute for ordinary income.”

[151] Some taxpayers have asserted that the “substitute for ordinary income” doctrine is no longer valid in light of the Supreme Court’s decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). That decision, they argue, ushered a more literal approach to the capital gain provisions, and since the doctrine finds no explicit support in the statute’s language, it no longer is good law. However, in a series of cases involving sales by taxpayers of their rights to future lottery payments, the Courts of Appeals for three circuits and the Tax Court have uniformly rejected this contention. Watkins v. Commissioner, 447 F.3d 1269 (10th Cir. 2006); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Womack v. Commissioner, 92 T.C.M. (CCH) 410 (2006).

[152] *See*, *e.g.*, United States v. Woolsey, 326 F.2d 287 (5th Cir. 1963) (sale of management contract with insurance company); United States v. Eidson, 310 F.2d 111 (5th Cir. 1962), *modified*, 312 F.2d 744 (1963) (same); United States v. Bankers Guar. Title & Trust Co. v. United States, 418 F.2d 1084 (6th Cir. 1969) (sale of mortgage service contract); General Guar. Mortg. Co. v. Tomlinson, 335 F.2d 518 (5th Cir. 1964) (same). A

comprehensive listing of cases appears in William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L.REV. 153, 197 n.166 (1983).

[153] *See*, *e.g.*, Bisbee-Baldwin Corp.v. Tomlinson, 320 F.2d 929, 933-34 (5th Cir. 1963) (finding that price received for contract was "a substitute for the income which would have been earned by Bisbee-Baldwin had the contracts not been transferred").

[154] Marvin A. Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 Minn, L. Rev. 1 (1964).

[155] Del Cotto, *supra* note 47.

[156] Chirelstein, *supra* note 154, at 26-29; Del Cotto, *supra* note 47, at 36.

[157] Del Cotto, *supra* note 47, at 20-22, 37-38.

[158] Professor Chirelstein writing in 1964 suggested that some courts might be "more willing than in the past to grant capital gain treatment," Chirelstein, *supra* note 154, at 9, while Professor Del Cotto writing in 1966 despaired of finding any consistency in the decisions. Del Cotto, *supra* note 47, at 53. However, the tide appears to have to turned, and Professor Popkin, writing in 1983, found that ordinary income treatment was the rule in cases involving "the taxpayer's right to earn money by performing personal services . . . . but in rare contract right cases where investment has been proven, the capital gains preference was allowed." Popkin, supra note 152, at 197-98 (1983).

Several circuits have rejected or effectively overruled prior precedent in their own circuits that had allowed capital gain treatment: Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897 (5th Cir. 1962) rejected in Bisbee-Baldwin Corp. V. Tomlinson, 320 F.2d 929, 930-31 (5th Cir. 1963); Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950) effectively overruled in Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10th Cir. 1962). Contract right cases decided since the Chirelstein and Del Cotto articles have generally denied capital gain treatment under the "substitute for ordinary income" rubric. Vaaler v. United States, 454 F.2d 1120 (8th Cur. 1972); Furrer v. Commissioner, 566 F.2d 1115 (9th Cir. 1977); Elliott v. United States, 431 F.2d 1149 (10th Cir. 1970); Michot v. Commissioner, 43 T.C. M. (CCH) 792 (1982).

[159] Note, *Limiting the Substitute-For-Ordinary Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights*, 56 S.C. L. REV. 387, 406 (2004).

[160] H. REP. NO. 105-148, at 453 (1997); S. REP. NO. 97-144, at 170 (1981).

[161] Treas. Reg. § 1.165-1(b) (as amended in 1977); *cf.* Rev. Rul. 68-348, 1968-2 C.B. 141 (holding that shareholder generally cannot recognize loss in corporate liquidation until final distribution made).