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The Deep Structure of Capital Gains

William D. Popkin*

The capital gains preference has been viewed as a means by which taxpayers are spared being taxed fully in a single year for income earned over a number of previous years. This Article argues that the tax preference for capital gains was intended to provide economic incentives by encouraging transferability, risk, and investment, not to achieve equity by a crude form of income averaging. This Article critically evaluates judicial doctrine in light of these economic policies and concludes that courts have not effectively bridged the gap between policy and the statutory language and structure. The author explains how the tax treatment of capital gains could be improved and examines the obstacles to improvement.

INTRODUCTION

THE TAX preference for capital gains\(^1\) has been available to individuals since 1921\(^2\) and to corporations since 1942.\(^3\) The broad contours of eligibility are clear enough: gain from salary, dividends, interest, and sales of inventory is ordinary income, while gain accruing to long term investments is capital gain.\(^4\) Preferentially treated capital gain arises only from the sale or ex-

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1. Preferentially treated long term capital gains are usually referred to as "capital gains" and that practice is followed here. Short term capital gains have been variously taxed as ordinary income or as a less favorably treated category of capital gains. See generally Wells, Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948, 2 NAT'L TAX J. 12 (1949).


4. See AMERICAN LAW INSTITUTE, DISCUSSION DRAFT OF A STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 1 (1960) [hereinafter cited as A.L.I.].
change of a capital asset held for more than one year. Gain from the sale of inventory is ordinary income because inventory is not a capital asset. Salary, dividends, and interest are ordinary income because they do not derive from a sale or exchange.

This broad statutory definition, however, has never prevented the courts from limiting the scope of the capital gains preference by such techniques as denying capital gains on the sale of rights to future income or contract rights to deal with others, or by narrowly construing the statutory term "sale." Yet the courts have never convincingly reconciled the language of the statute with the tax policy supporting the capital gains preference. Little has been done to link doctrine to an underlying theory of capital gains, and the few attempts made have been misguided.

The dominant judicial justification for capital gains is that they relieve the taxpayer from the oppressive effects which the progressive tax rate structure would have on accrued gain bunched into the year of sale. The preference supposedly provides a crude form of income averaging, more closely approximating the tax which would have been due if it had been imposed as the gain accrued. The preference is also said to be economically beneficial in that the removal of the bunching burden imposed by progressive rates on accrued income encourages the disposition of those items defined as capital assets. Unfortunately, these justifications do not accord with either the legislative history or the statutory scheme. The capital gains preference was not intended as a form of income averaging. Its purpose instead was to provide an economic incentive to transfer risky investments—not to further tax equity. The incentive would be necessary even if tax rates were not progressive, or if no gain had been bunched into a single year.

This Article reinterprets existing doctrine in light of statutory

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6. Id. § 1221(1) (1976).
7. See generally id. § 1222 (1976).
10. See, e.g., Commissioner v. Ferrer, 304 F.2d 125, 130-31 (2d Cir. 1962).
purpose and provides a framework for evaluating and revising eligibility rules for capital gains treatment. The Article initially discusses the history of the capital gains preference in the United States as an economic incentive. Next it considers the lock-in problem, analyzing the courts’ failure to develop doctrines limiting the capital gains preference to its original purpose of removing obstacles to transferability. The Article proceeds with an examination of the risk requirement for capital gains eligibility. Focusing on the sale of a carved-out income interest doctrine, the Article emphasizes that a distinction must be made between gain accruing due to risk and gain accruing due to the mere passage of time. The Article then addresses the investment requirement for capital gains treatment and the doctrinal confusion which this requirement has engendered. Finally, the Article considers the difficulties of implementing the economic incentive rationale and concludes with a discussion of future possibilities.

I. ECONOMIC INCENTIVE OR INCOME AVERAGING

With few exceptions, there has never been much doubt in the United States of the propriety of including capital gains in the income tax base. This contrasts sharply with a European tradition of excluding capital gains from income, essentially because they could not reasonably be considered available for consumption. The only important tax equity question which arose in this

13. See infra notes 19-43 and accompanying text.
14. See infra notes 44-84 and accompanying text.
15. See infra notes 70-84 and accompanying text.
16. See infra notes 85-162 and accompanying text.
17. See infra notes 163-203 and accompanying text.
18. See infra notes 204-24 and accompanying text.
21. See L. Seltzer, supra note 20, at 11; Nelson, supra note 20, at 208-09. For interesting arguments that capital gains should be excluded from the income tax base because people do not treat them as available for ordinary consumption, see M. David, Alternative Approaches to Capital Gains Taxation 50 (1968); L. Seltzer, supra, at 8-10; Blum, A Handy Summary of the Capital Gains Arguments, 35 TAXES 247, 250-51 (1957);
country was whether progressive tax rates might subject realized capital gains to a much higher tax than if the appreciation in value had been taxed annually as it accrued. Responding to this concern, in 1920 the House passed a bill which would have reduced the tax on gain attributable both to investments and personal services if such gain accrued over more than three years. But the 1921 statute, the first to provide for preferential tax rates on capital gains, did not address the issue of bunched personal service income, and dealt with capital gains only because of the economic impact of bunching. It was feared that if high tax rates applied to the proceeds of such sales, taxpayers would be “locked in” to their investments and retain them well beyond their economic usefulness. Bunching caused an economic, not an equity, problem.


Consumption tax advocates took the argument one step further and maintained that the act of saving, not the compulsion to save, justified excluding capital gains from the tax base. See Fisher, Comment on President Plehn’s Address, 14 Am. Econ. Rev. 64, 66–67 (1924); Goode, supra, at 6–7, 9.

Two other arguments have been made for giving further preferential treatment to capital gains. The first is relief from inflation. See J. Meade, The Structure and Reform of Direct Taxation 101–05 (1978); Brinner, Inflation and the Definition of Taxable Personal Income, in Inflation and the Income Tax 121, 126–32 (H. Aaron ed. 1976); Groves, Taxation of Capital Gains, in 2 Tax Revision Compendium 1193, 1198–99 (1959) (further preferential treatment is unnecessary in times of moderate or light inflation). A Senate amendment to the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 U.S.C.), would have indexed the basis of corporate stock and real estate where these assets were capital assets or assets used in a trade or business and held for more than one year. The basis adjustment would not have been used for determining depreciation but only for computing gain or loss on sale or disposition. This inflation adjustment did not appear in the final version of the Act. See H. Con. Rep. No. 760, 97th Cong., 2d Sess., reprinted in 1982 U.S. Code Cong. & Ad. News 1190, 1257. Had it appeared, a major argument for preferential capital gains treatment would have been eliminated.

A second argument is that the increase in value due to a decline in interest rates should not be taxed. See Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081, 1109–12 (1980).

22. See Wells, supra note 1, at 13–14 (discussing legislative history of H.R. 14198, 66th Cong., 2d Sess. (1920)). Backward proration of income was not adopted because of its administrative complexity. Treasury Study, supra note 12, at 21.


24. Some commentators find the legislative history ambiguous. See, e.g., M. David, supra note 21, at 37; Miller, The “Capital Asset” Concept: A Critique of Capital Gains Taxa-
The concern with economic impact was apparent not only from the legislative history but from the context and structure of the statute. In 1921, as now, a crucial political concern was the reduction of tax burdens to stimulate economic activity. To that end, the capital gains preference was one of several provisions, including tax deferral of like-kind and reorganization exchanges, designed to facilitate economically desirable transfers. As with capital gains, some courts have interpreted the tax deferral provisions as implementing a tax equity principle whereby the taxpayer should not be taxed when retaining a continuity of interest in the underlying investment. However, nothing of the sort...

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27. See Finales Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933) (dicta) (continuity of interest required to defer tax on proceeds from a corporate reorganization); Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959) (neither paper gains nor paper losses should be recognized in like-kind exchanges).
characterizes the history of these two provisions. Like-kind property was expansively defined in a manner inconsistent with the theory that the taxpayer was continuing his prior investment in the same form.\textsuperscript{28} The permissive like-kind standard contrasted with the stricter "similarity" requirement used to determine when a taxpayer could defer taxes by reinvesting the proceeds of an involuntary conversion.\textsuperscript{29} The involuntary conversion section suggests continuity of interest, but the expansive definition of like-kind assets eligible for tax deferral on voluntary exchanges implemented the broader legislative purpose of encouraging economically desirable exchanges.\textsuperscript{30} Similarly, the reorganization provisions were adopted primarily to encourage corporate restructuring.\textsuperscript{31}

The subsequent history of the capital gains preference is also marked by a concern for economic incentives. Not until 1934 did

\begin{footnotesize}
\textsuperscript{28} In 1921, tax-deferred like-kind exchanges included exchanges of securities. \textit{See} I.T. 1377, 1-2 C.B. 24 (1922); G.C.M. 1637, 6-1 C.B. 166 (1927); \textit{see also} Greene v. Commissioner, 15 B.T.A. 401 (1929), aff'd, 42 F.2d 852 (2d Cir. 1930). This provision was later repealed because deductible losses and tax-free gains were too easy to arrange. \textit{See} Act of March 4, 1923, Pub. L. No. 545, 42 Stat. 1560; H.R. Rep. No. 1432, 67th Cong., 4th Sess. 1-2 (1923), \textit{reprinted in} 1939-1 (pt. 2) C.B. 845, 846. After an initial period of uncertainty, the exchange of new and used property was also included in like-kind exchanges. \textit{See} I.T. 2573, 10-1 C.B. 215 (1931), aff'd I.T. 2536, 6-1 C.B. 168 (1927), rev'd Mim. 3641, 7-1 C.B. 86 (1928), and I.T. 2419, 7-1 C.B. 231 (1928). Current regulations generously define assets eligible for the like-kind exchange rules. \textit{See} Treas. Reg. § 1.1031(a)-(a), (b) (1982); \textit{see also} Starker v. United States, 602 F.2d 1341, 1352-53 (9th Cir. 1979).


Although expressing uncertainty as to the historical reason for the reorganization provisions, one commentator notes that their dominant effect is to encourage a select group of transactions. Sandberg, \textit{The Income Tax Subsidy to "Reorganizations"}, 38 COLUM. L. REV. 98, 99-102 (1938).
\end{footnotesize}
Congress seriously consider the unfairness of bunching capital gains at the time of sale. From 1922 through 1933, the tax rate on capital gains was 12.5%. The 1934 Act adopted a different approach which provided for successively smaller percentages of capital gains to be included in income as the holding period of the asset lengthened. This approach was intended to correct the increasing inequity presumably arising from greater amounts of annual accrued gain being subjected to higher progressive rates in the year of sale. This experiment was short-lived, however, because it increased disincentives to sell. The multi-step reduction of taxable gain was therefore modified in 1938. In 1942, multi-step reduction was abolished and the required holding period shortened to six months, thus eliminating any pretense of income averaging. The separate policies underlying income averaging for bunched income and the capital gains preference are now explicitly recognized in Code provisions making capital gains eligible for both special income-averaging benefits and the capital gains preference.

33. Revenue Act of 1934, ch. 277, § 117(a), 48 Stat. 680, 714 (current version at I.R.C. § 1202(a) (Supp. V 1981)) (establishing five gradations in determining the percentage of capital gains to be included as income, ranging from 100% inclusion for assets held not more than one year to 30% inclusion for assets held more than 10 years).
34. See Treasury Study, supra note 12, at 25–27; H. SIMONS, supra note 20, at 160–61 (commenting that the 1934 Act made capital gains treatment more progressive).
35. See Revenue Act of 1938, ch. 289, § 117(b), 52 Stat. 447, 501 (current version at I.R.C. § 1202(a) (Supp. V 1981)); see also Kent, The Question of Taxing Capital Gains: I. The Case for Taxation, 7 LAW & CONTEMP. PROBS. 194, 198–99, 205–06 (1940) (acknowledging criticism of the 1934 Act for failing to provide sufficient investment incentives, but arguing that the 1934 Act needed only to be liberalized in its capital loss treatment to provide the necessary incentives). See generally Wells, supra note 1, at 23–25 (reviewing legislative history of the 1938 Act's capital gains treatment).

Although the origins of the capital gains preference as a tax incentive are clear, the conditions for granting the incentive are less obvious. A pressing concern in 1921 was overcoming obstacles to transferability—often referred to as the lock-in problem—but two other conditions were important considerations in the development of judicial doctrine. First, the gain should result from taking a significant economic risk. The legislative history contains no explicit discussion of risk as a condition for preferential treatment, but stimulating economic productivity by encouraging the free flow of capital into business enterprises was a background consideration during the hearings on the Revenue Act of 1921.39

Second, the taxpayer entitled to the capital gains preference should have made a significant investment, either through out-of-pocket payment, liquidation of other assets, or a commitment of credit. This criterion, like risk, cannot be attributed to specific legislative history, but can be inferred both from examples in the committee reports and the statutory structure. The reports refer to farms and mineral properties, both of which often involve significant investment, as illustrations of capital assets.40 Moreover, the term "gain" necessarily implies a basis, typically equal to investment and/or commitment of credit.41 Later statutory developments also support this inference. The business assets which were afforded hybrid ordinary-loss/capital-gain treatment in 1942—land and depreciable assets—both require significant investment. A 1942 House committee report, which ushered in the modern capital gains structure, suggested that capital gains were to arise from out-of-pocket payment or liquidation of other assets.42

The three aspects of the economic incentive—transferability, risk, and investment—make up the deep structure of the capital gains preference. Despite their willingness to interpret the statu-

39. See Secretary Letter, supra note 25, at 10-12. Excessive speculation, however, has not been favored. Treasury Study, supra note 12, at 22-23.
tory language so as to implement what they perceive to be the legislative purpose, the courts have not rigorously applied capital gains doctrine to implement this structure. A recurring question throughout this Article is whether there might not be good reasons for this judicial confusion. The judicial process, even in statutory interpretation, provides an opportunity for policies to thrive or decay, and the confusion which this Article detects may be a sign of the imminent demise of at least some of the policies underlying the capital gains preference.

II. TRANSFERABILITY

When the capital gains preference was initially adopted in 1921, Congress was concerned primarily with the lock-in effect caused by imposing ordinary tax rates on the sale of a capital asset. The ordinary rates were expected to create an excessive barrier to sale and therefore prevent the conversion of capital assets. Had this concern been pursued seriously, two conditions on eligibility for the capital gains preference would have been imposed. First, ordinary tax rates would have to pose a significant barrier to transferring the capital asset. Second, the seller would have to transfer risks in the sold property. Neither of these conditions has been rigorously applied.

A. Measuring the Lock-in Effect of Ordinary Tax Rates

Determining whether ordinary tax rates hinder sales requires comparing the value of the tax on a sale at ordinary rates with the present value of the tax payable if the asset were retained. Any additional tax due if the asset is retained is the tax payable on future income (equal to accrued gain). Thus, the lock-in effect, which analyzes the tax consequences of selling versus retaining the asset, does not depend on accrual of gain long before a sale or on the progressive tax rate structure, as judicial rhetoric about bunching tends to suggest. The capital gains preference is designed to prevent bunching of future income in the year of sale;

44. See Revenue Act of 1921, ch. 136 § 206(b), 42 Stat. 227, 233 (current version at I.R.C. § 1202(a) (Supp. V 1981)).
45. See supra notes 23–31 and accompanying text.
46. See A.L.I., supra note 4, at 7–10, 149–52.
47. See id. at 10 n.1.
48. See supra note 12 and accompanying text.
this occurs at the time of sale regardless of gradual gain accrual and the progressive rate structure. The lock-in effect arises from accelerating the tax due on future income to the year of sale.

When the lock-in effect is analyzed in this way, two factors emerge which facilitate transferability. First, the present value of the tax on sale proceeds might be very low because the tax is deferred for a long period. Second, the present value of the tax payable on future income if the asset were retained (equal to accrued gain) might be very high, either because a short period of future income is sold or because future income is skewed toward the years immediately following the sale year. Tax doctrine, however, has been more concerned with the rhetoric than the reality of the lock-in effect. Thus, sales of entire investments are eligible for the capital gains preference even when the income period sold is short.\textsuperscript{49} Similarly, the noninterest element of installment sales is eligible for both capital gains treatment and deferral,\textsuperscript{50} even when deferral substantially mitigates the lock-in effect.\textsuperscript{51}

If the lock-in effect evoked more serious concern, an effort would be made to measure the relationship between the tax on the sale proceeds and the tax on income which would have accrued in the absence of a sale. When deciding whether to sell an asset, the taxpayer entertains the option of either paying tax on the gain now, or retaining the property and paying tax on the income equal to the gain as it accrues in the future. The lock-in effect is computed by measuring the difference between the present value of the tax due on sale of the asset, and the present value of the tax due on future income (equal to accrued gain) which would be earned if the asset were retained, all divided by the present value of the tax due on sale.\textsuperscript{52}


\textsuperscript{50} See 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 15.01, 15.11 (rev. ed. 1982).

\textsuperscript{51} See I.R.C. § 453 (West Supp. 1983) (providing for installment method to apply to installment sales, with no exception in situations where the lock-in effect is reduced); \textit{see also} Chirelstein, \textit{supra} note 24, at 4-5 (periodic payments do not preclude capital gains treatment).

\textsuperscript{52} See \textit{supra} notes 46-47 and accompanying text.
\[
\frac{T_s - T_r}{T_s} = 1 - \frac{T_r}{T_s}
\]

where \(T_s\) equals the present value of the tax upon sale and \(T_r\) equals the present value of the tax upon the gain which would accrue as future income were the asset retained instead of sold. The amount derived measures, as a fraction of the present value of the tax on sale,\textsuperscript{53} the extra tax burden resulting from accelerating tax by selling the property.\textsuperscript{54} In the extreme case where the fixed total yield of an asset is only exhausted over an infinite number of equal annual payments, the lock-in effect is 100%. In this case, full tax impact on the gain is felt in the year of sale, and the future annual income attributable to the retention of the asset is spread out for so long that the extra tax on any year's income is negligible. As the number of years of future income declines, however, the amount of taxable income attributable to each future year grows, thereby increasing the present value of the tax on that income (\(T_r\)) and decreasing the lock-in effect. Similarly, when sale proceeds are taxed over an extended period,\textsuperscript{55} the present value of the tax on the sale proceeds (\(T_s\)) declines, thereby reducing the lock-in effect. If the capital gains preference, which currently stands at 40% of ordinary rates,\textsuperscript{56} is taken as defining a

\textsuperscript{53} Multiplying by 100 gives the lock-in effect as a percentage.

\textsuperscript{54} See generally A.L.I., supra note 4, at 7–10, 149–52. Another way to understand the benefit of retaining the asset is to focus on the extra income, after tax, that is earned because a tax is not paid on a sale. Eventually, the tax which would have been paid at the time of sale, coupled with a tax on the income it produces, must be paid, but the increased after-tax earnings are kept by the taxpayer. The present value of those extra earnings reduces the total burden of the tax due. Thus, the reduced tax burden of retention is the same whether examined from the perspective of present value of the future taxes or from the perspective of a reduced tax burden resulting from additional after-tax earnings in the future. Both methods of computing the lock-in effect produce identical results.

One commentator, however, suggests an entirely different approach. See Note, A Spreading of Receipts Formula, supra note 24, at 736–48. The author advocates measuring the lock-in effect by the dispersion of future income flows anticipated at the time of investment. Id. at 741. If the dispersion exceeds some predetermined period, the sale would produce capital gains. Id. at 741–42. The suggested time periods, however, are those used to implement depreciation and assignment-of-income policy, not necessarily lock-in policy. See id. at 745–46. The author suggests that sale of a uniform 5.2-year income stream would deserve capital gains. Id. at 745. As Table 1 illustrates, however, that period is too short to produce an excessive lock-in effect, even if the before-tax riskless discount rate were 20%. See Table 1, infra text accompanying note 61.

\textsuperscript{55} This would occur, for example, in the case of an installment sale. See supra notes 50–51 and accompanying text.

\textsuperscript{56} See I.R.C. § 1202(a) (Supp. V 1981). The assumption of a 40%-of-ordinary-rates capital gains preference is made throughout the Article, although it should be noted that corporate capital gains are taxed differently. They are subject to a 28% maximum tax, see
tolerable level of lock-in effect, it follows that the capital gains preference will be applied only when the lock-in effect resulting from ordinary tax rates exceeds 40%.

The formula for making these computations is complex. Nevertheless, assuming that the sale proceeds and the income flow from the sold property are to be received and taxed in equal annual installments, the number of years of income which must be

\[ (A) \quad \left( \frac{G}{P} \cdot \frac{1}{r} \right) \sum_{i=S}^{S+P-1} \frac{1}{(1+r)^i}, \]

where \( G \) equals the gain, \( P \) equals the number of annual periods over which the sale proceeds will be received, \( r \) equals the tax rate (assumed to be constant), \( S \) equals the year in which payment of the sale proceeds commences (if commencing at the time of sale, \( S = 0 \)), and \( r \) equals the after-tax discount rate (assumed to be constant), and

\[ \sum_{i=S}^{S+P-1} \frac{1}{(1+r)^i} \]

means the sum of the quantities in the formula with \( i \) (the index of time beginning when payment of sale proceeds commences) increasing from \( S \) to \( S + P - 1 \) during periods \( S \) to \( (S + P - 1) \).

The formula for computing the present value of the tax on gain as it accrues in the future (\( T_r \)), assuming future income is received in equal annual amounts, is

\[ (B) \quad \left( \frac{G}{Y} \cdot \frac{1}{r} \right) \sum_{i=1}^{Y} \frac{1}{(1+r)^i}, \]

where \( G \), \( r \), and \( Y \) have the same meaning as above, \( Y \) equals the number of years of future income sold, and \( i \) increases from 1 to \( Y \).

Substituting formula (A) for \( T_s \) and formula (B) for \( T_r \), the general lock-in formula,

\[ (1 - \frac{T_r}{T_s}) \text{, equals } 1 - \frac{P}{Y} \cdot \frac{\sum_{i=1}^{Y} \frac{1}{(1+r)^i}}{\sum_{i=S}^{S+P-1} \frac{1}{(1+r)^i}}. \]
sold before the lock-in effect is excessive becomes readily calculable, provided the correct discount rate is known. Column A of Table 1 indicates the minimum number of years of income which must be sold before the lock-in effect is excessive, assuming that the 40% capital gains rate sets the standard for an undesirable lock-in effect, that the ordinary tax rate is 40%, and that the installment method of reporting income is used. The Table furnishes this data for sale proceeds received in one, five, and ten equal installments, starting either at the time of sale or one year thereafter. If future income is skewed toward the early years after the sale, or if taxation of the sale proceeds is deferred even further, as in the case of an open transaction,58 the number of years of future income which must be sold before the lock-in effect is excessive would be even greater. Table 1 reports that figure for three different situations: Column B assumes that the sale proceeds are reported on the open transaction method, with gain recognized after one-half the sale proceeds are collected; Column C assumes an accelerated receipt of future income at a rate equivalent to that used to compute double declining balance depreciation;59 and Column D assumes a combination of the open transaction method of Column B, and the accelerated receipt of

\[ \text{If all of the sale proceeds are received at the time of sale, } P = 1 \text{ and } S = 0 \text{ and the general lock-in formula simplifies to} \]

\[ 1 - \frac{1}{Y} \cdot \sum_{i=1}^{Y} \frac{1}{(1+r)^i} \cdot \]


59. The problem of determining how future income will be received is analogous to that of overcoming the presumption of straight line depreciation (in order to justify use of the income forecast depreciation method) by showing that receipt of income is not expected in equal annual amounts. See, e.g., Temp. Treas. Reg. § 15a.453-1(c)(6)-(7) (1981); see also Rev. Rul. 78-28, 1978-1 C.B. 61, 61.

Predicting the pattern of future taxable income to be derived from stock is very difficult. The timing of dividends might depend on shareholder control and, in any event, does not necessarily follow the pattern of corporate earnings. It seems likely that future taxable income would be deferred because of shareholder control over dividend distributions. One workable approach is offsetting the possibility of accelerated income against deferral of dividend distributions, thereby assuming that future income always accrues to stock in equal annual amounts, as in Columns A and B of Table 1.
future income of Column C.\textsuperscript{60}

\textsuperscript{60} The formulas in note 57, \textit{supra}, are modified when receipt of income flows and taxable sale proceeds are not expected in equal annual amounts. In this situation, the present value of the tax on sale proceeds ($T_s$) equals

\begin{equation}
\sum_{i=S}^{s+r-1} \frac{G \cdot P\%_i \cdot t}{(1 + r)^i},
\end{equation}

where $S, P, G, t, r,$ and $i$ have the same meaning as in note 57, \textit{supra}, and $P\%_i$ is the percentage of total sale proceeds taxable in year $i$.

The present value of the tax on gain as it accrues in the future ($T_r$) equals

\begin{equation}
\sum_{i=1}^{r} \frac{G \cdot Y\%_i \cdot t}{(1 + r)^i},
\end{equation}

where $Y, G, t, r,$ and $i$ have the same meaning as in note 57, \textit{supra}, and $Y\%_i$ is the percentage of total future income attributable to year $i$. 
### Table 1
Minimum Number of Years of Income Sold for Excessive Lock-in Effect, Depending on Number of Payments of Sale Proceeds, When Payments Begin, Method of Reporting Sale Proceeds, Pattern of Future Income from Property, and Before-Tax Riskless Discount Rate, Assuming 40% Ordinary Tax Rates and Capital Gains Taxed at 40% of Ordinary Tax Rates

<table>
<thead>
<tr>
<th>Before-Tax Riskless Discount Rate</th>
<th>1 Payment</th>
<th>5 Payments</th>
<th>10 Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year Payments Begin</td>
<td>Year Payments Begin</td>
<td>Year Payments Begin</td>
</tr>
<tr>
<td>0 (time of sale)</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>A/ B/ C/ D</td>
<td>28/ -37/ -</td>
<td>30/ -40/ -</td>
<td>33/36/44/48</td>
</tr>
<tr>
<td>.0666</td>
<td>19/ -25/ -</td>
<td>21/ -28/ -</td>
<td>23/27/31/36</td>
</tr>
<tr>
<td>.1</td>
<td>14/ -19/ -</td>
<td>16/ -22/ -</td>
<td>19/22/25/30</td>
</tr>
<tr>
<td>.1333</td>
<td>11/ -15/ -</td>
<td>14/ -18/ -</td>
<td>16/19/22/27</td>
</tr>
<tr>
<td>.1666</td>
<td>9/ -12/ -</td>
<td>12/ -16/ -</td>
<td>14/17/19/25</td>
</tr>
<tr>
<td>.2</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A = Installment method; future income in equal annual amounts.
B = Open transaction method; future income in equal annual amounts.
C = Installment method; future income accelerated at rate of double declining balance depreciation.
D = Open transaction method; future income accelerated at rate of double declining balance depreciation.

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61. Under the installment method, a percentage of each payment is reported as taxable gain equal to the total gain divided by total sale price. Under the open transaction method, taxable gain is deferred until sale proceeds exceed basis. Table 1 assumes basis is one-half the sale price; therefore, gain is recognized after collection of one-half the sale proceeds. The open transaction and installment methods produce the same result when there is a single payment.
For example, a sale generating five equal annual installment payments commencing at sale, when the property is expected to produce equal annual accruals of future income, would result in an excessive lock-in effect only if the property produced income for at least fourteen years, assuming a 20% before-tax discount rate and a 40% ordinary tax rate. Had the sale been taxed on the open transaction method with a basis of one-half the sale price, or had the future income been expected to accrue at the same accelerated rate as that used to compute double declining balance depreciation, or if these factors were present together, the minimum number of years of income that would have to be sold before the lock-in effect became excessive would be seventeen, nineteen, and twenty-five, respectively. Lower discount rates, later starting dates for the payments, and extended installment payment periods are among the factors that further increase the length of time that may pass before the lock-in effect becomes excessive.62

To use the above analysis as a tool for formulating tax policy, it is necessary to determine the discount rate for computing the present value of taxes payable on deferred gain. The after-tax riskless discount rate is the appropriate standard, since it parallels the return rate on taxpayer investment used to finance future tax obligations.63 That rate is a function of the before-tax riskless discount rate and the taxpayer's tax bracket, which must both be determined with certainty prior to the sale if the incentive effects of the capital gains provisions are to prove functional. Ten-year Treasury bond interest rates prior to the time of sale, coupled with the assumption that all taxpayers are in one particular tax bracket, are useful criteria for achieving the requisite certainty. The fairest tax bracket assumption would be 40%, as in Table 1. This might result in a windfall to higher bracket taxpayers since it assumes greater after-tax returns than that which higher bracket taxpayers would actually experience. Under the 40% bracket assumption, a serious lock-in effect occurs on the sale of a shorter period of income than would be the case if the after-tax return had been lower, because the lock-in effect is greater as after-tax return rates increase. This windfall, however, may be negligible, because upper bracket taxpayers are more likely to invest in riskless tax-exempt bonds, thereby increasing their after-tax return rate.

The converse of a possible upper bracket windfall is serious

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62. For example, the comparable figures for a 13.33% before-tax discount rate and a ten-year installment sale are 25, 33, 34, and 48 years, respectively. See Table 1.
63. A.L.I., supra note 4, at 152.
lock-in for investors in brackets below 40%. Table 1 does not outline this specific effect, because it assumes lower after-tax returns than those available to low bracket taxpayers. There are few such investors to worry about, however, except for those whose tax brackets are artificially lowered through tax preferences. The 40% tax bracket assumption is therefore a practical compromise.\(^{64}\)

Even if this complex analysis of the lock-in effect were not rig-

\(^{64}\) The following Regulation would implement the policy against excessive lock-in effect.

\textit{Regulation 1.1221-X.}

(a) \textit{General rule.} Income from the sale of an asset shall not be treated as gain from the sale of property (and therefore shall be ineligible for capital gains treatment) unless the lock-in effect of the sale exceeds .40, and unless the conditions of section (f) are met.

(b) \textit{Determination of lock-in effect.} Except as provided in section (e), the lock-in effect shall be determined in accordance with Treasury Tables based on the simplified formula in section (d)(ii). [See Table 1, supra text accompanying note 50, for an illustration]. For purposes of this formula, it is assumed that the taxpayer is in the 40% tax bracket. The discount rate is the average monthly interest rate paid on ten-year Treasury bonds. The average monthly interest rate shall be the mean of the six most recent monthly interest rates published by the Treasury more than three months prior to the date of sale. Because this simplified formula assumes equal annual receipt of both sale proceeds and future income, section (e) provides for direct application of the basic lock-in determination formula for computing the lock-in effect.

(c) \textit{Definition of time period of income sold.} For purposes of applying the lock-in determination formula, the time period of income sold shall be the number of years of income sold, determined as follows:

<table>
<thead>
<tr>
<th>Sale agreement</th>
<th>Time period of income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carved-out income interest for specified time period</td>
<td>Time period specified in contract</td>
</tr>
<tr>
<td>Carved-out income interest not for specified time period</td>
<td>Time within which receipt of all income to be produced by the asset can reasonably be expected</td>
</tr>
<tr>
<td>Entire asset sold</td>
<td>Time within which receipt of all income to be produced by the asset can reasonably be expected</td>
</tr>
</tbody>
</table>

(d) \textit{Lock-in determination formula.}

(i) \textit{Basic formula.} The basic formula for computing the lock-in effect is

\[
\left(1 - \frac{T_r}{T_s}\right). \quad T_r \quad \text{and} \quad T_s \quad \text{are determined as follows:}
\]

\[
T_r = \sum_{i=1}^{Y} \frac{G \cdot Y \cdot Y_i \cdot t}{(1 + r)^{Y+i}}, \quad \text{and}
\]

\[
T_s = \sum_{i=s}^{P \cdot s - 1} \frac{G \cdot P \cdot Y \cdot Y_i \cdot t}{(1 + r)^{Y+i}}
\]

where \(G\) equals gain, \(Y\) equals the time period of income sold, \(r\) equals the tax rate, \(r\) equals the after-tax discount rate, \(S\) equals the annual period when payment of the sale proceeds begins (\(S\) equals 0 at time of sale), \(P\) equals the number of annual periods in which sale proceeds are received, \(Y\%)\) equals
oriously incorporated into judicial doctrine, it nonetheless fur-
nishes a background consideration for judicial interpretation of
capital gains policy by casting doubt on the fairness of combining
deferral and capital gains. For example, recent Treasury reg-
ulations concerning the installment method of reporting gain for-
bid the use of the open transaction method of reporting income
(whereby taxpayers may both defer tax until the cost of the sold
asset is recovered and receive capital gains) except in extraordi-
nary circumstances involving contingent payments. Instead, the
value of the fixed payment obligation is used to determine capital
gain in the year of sale, thereby closing the transaction for tax
purposes, absent the election of the installment method. Be-

the percentage of income received in year \(i\), and \(P\%), equals the percentage of
sale proceeds taxable in year \(i\).

(ii) Simplified formula. The following simplified formula, which is de-

\[
1 - \frac{P}{Y} \cdot \sum_{i=-1}^{\gamma} \frac{1}{(1+r)^i}.
\]

(e) Direct application of the basic formula.

(i) If the taxpayer demonstrates that the taxable sale proceeds or anticip-
pated income flow from an asset will not be received in equal annual
amounts, so that the lock-in effect as determined in subsection (d)(i) of this
Regulation exceeds .40, then any gain resulting from the sale of the asset
shall be treated as income from the sale of property (and therefore eligible
for capital gains treatment), provided the gain would otherwise be capital
gain under these Regulations and by statute. The standard of proof required
of the taxpayer to overcome the presumption of equal anticipated income
flow shall parallel that required of the taxpayer seeking to utilize the income
(1981).]

(ii) If the government demonstrates that the taxable sale proceeds or anticip-
pated income flow from an asset will not be received in equal annual
amounts, so that the lock-in effect as determined in subsection (d)(i) of this
Regulation does not exceed .40, then the sale of the asset shall not be treated
as the sale of property and afforded capital gains treatment. For this pur-
pose, the taxpayer will be presumed to be in the 40% tax bracket. The gov-
ernment's burden of proof in this regard is a preponderance of the evidence.

(f) Carved-out income interests. If the sale is of a carved-out income interest,
the sale shall not be eligible for capital gains treatment unless the seller elects to
accrue income to the retained remainder interest in accordance with § 1.446-X of
these Regulations [see infra note 159].

Treatment for Deferred Payment Sales After the Installment Sales Act of 1980, 34 TAX LAW.
605, 648-49 (1981) (the regulation should not be authoritative since it is inconsistent with

cause these regulations prevent simultaneous deferral and capital gains treatment, they should be upheld.

Similar considerations suggest that a recent amendment to section 453 allowing use of the installment method for contingent payment sales is likely to curtail the use of the open transaction method. Prior to this amendment, the government disallowed installment reporting when payments were contingent. The open transaction method, combining excessive deferral and capital gains, was therefore the only alternative to taxing the seller on the value of the contingent obligations in the year of sale, despite valuation uncertainties and the lack of cash with which to pay the tax. By allowing the installment method alternative, pressure to permit the open transaction method should be greatly reduced.

B. Transferring Risks

The second requirement which should be satisfied if the capital gains preference is to prevent a serious lock-in effect is that the seller transfer risks in the sold property to the buyer. The courts have implemented this policy by applying the retained income doctrine to sales in which the proceeds are contingent upon the profitability of the sold asset. Under the doctrine, the contingent payment transaction is deemed not to be a disposition by sale or exchange, and therefore no capital gain is recognized. However,
the retained income doctrine has been inconsistently applied. Sale proceeds contingent upon the exploitation of a sold franchise, trade name, or trademark are treated as ordinary income, while similar payments in the nature of royalties are treated as capital gains if the taxpayer disposes of substantially all his rights in the property. The sale of passive investments for a share of investment income produces ordinary income, but the sale of a controlling business interest to a tax-exempt organization in return for a share of the profits produces capital gain unless the sale price exceeds the value of the property. Moreover, when the sale price to a tax-exempt organization exceeds the fair market value of the business, that portion of the sale proceeds which represents the difference between the fair market value and the basis might be eligible for long term capital gains treatment.

policy dealing with transferability. For a discussion of the denial of capital gains for dispositions which are not sales, see infra notes 182–83 and accompanying text.

71. I.R.C. § 1253(c) (1976).
73. See, e.g., Silverstein v. United States, 293 F. Supp. 1106, 1109–10 (N.D. Ill. 1968) (no capital gains preference allowed where remainderman continued to make annual payments to life beneficiary); Lazarus v. Commissioner, 58 T.C. 854, 873 (1972) (transfer of stock to foreign situs trust with reservation of right to $75,000 of annual income produced ordinary income), aff’d, 513 F.2d 824 (9th Cir. 1975); Hrobon v. Commissioner, 41 T.C. 476, 497 (1964) (net distributions from trust held to be ordinary income); Rev. Rul. 68-183, 1968-1 C.B. 308, 309 (transfer of stock to a trust where grantor still received annual payments yielded ordinary income); see also Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654, 657-58 (10th Cir. 1962) (taxpayer’s relinquishment of right to issue sublicenses in return for percentage of royalties from third party licensees produced ordinary income); Voloudenakis v. Commissioner, 274 F.2d 209, 212 (9th Cir. 1960) (taxpayers who transferred use of leased building and retained right to repossess on default were required to treat payments received as ordinary income); Warren v. United States, 171 F. Supp. 846, 849 (Ct. Cl. 1959) (sale of stock to another corporation for cash and overriding gas and oil royalties resulted in ordinary income).
74. See, e.g., Commissioner v. Brown, 380 U.S. at 570–73; Allen v. Commissioner, 34 T.C.M. (CCH) 242, 258–62 (1975); see also Commissioner v. Carter, 170 F.2d 911, 912 (2d Cir. 1948). In Carter, a majority shareholder who had owned her shares for more than ten years received, upon dissolution of the corporation, oil brokerage contracts of uncertain value. The Second Circuit affirmed the Tax Court, 9 T.C. 364 (1947), and held that $35,000 subsequently realized from commissions on the brokerage contracts was taxable as long term capital gain.
76. See, e.g., Berenson v. Commissioner, 507 F.2d 262, 268 (2d Cir. 1974). The subsequent history of Berenson illustrates the difficulty of apportioning sale proceeds between ordinary income and capital gain. See 37 T.C.M. (CCH) 415, 417–18 (1978), rev’d and remanded, 612 F.2d 695, 699–701 (2d Cir. 1979). Giving capital gains treatment to retained income is inconsistent with I.R.C. § 1239(a) (Supp. V 1981), which taxes as ordinary income the gain from sale of a depreciable asset to a related party. In both situations, future
The obvious reluctance to apply the retained income doctrine rigorously may be due partly to the difficulty of applying uncertain risk-shifting criteria. The risk-shifting standard requires that the seller transfer his risk in the sold asset in order to qualify for the capital gains preference. The situation is analogous to distinguishing between debt and equity, because in both cases the seller is claiming that he is extending credit instead of retaining an ownership interest. Determining whether the seller is a creditor or the owner of a retained interest requires establishing whether the buyer's indebtedness to the seller is the equivalent of the seller's having retained an interest in the sold property. A risk-shifting standard would require separating transactions into sale and retained income components whenever the seller receives both a cash downpayment and a profit participation; otherwise courts must make a case-by-case determination whether the downpayment is sufficient to justify capital gains treatment for the entire sale proceeds. Moreover, courts may be reluctant to take these steps for fear of discouraging economically desirable sales.

Administrative and economic reasons do not entirely explain the underdevelopment of the retained income doctrine. The courts' failure to develop the doctrine can also be traced to an incomplete understanding of the lock-in problem. Courts have freely assumed that past accrued gain justifies preferential tax rates, even though receipt of sale proceeds is similar to retention of the asset. Yet, at the very least, one would readily expect denial of the capital gains preference when both an income interest is retained and most of the payments are long deferred. Both circumstances are likely to be present when the unpaid purchase price exceeds the value of the asset; in such cases there is no justification for allocating sale price between retained income interest, income is retained within a single economic unit. See also I.R.C. § 341(a), (e)(4)(C) (1976) (applying collapsible corporation rules to liquidations of depreciable property, even though sale of the stock would result in capital gain).


78. Cf. LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940) (payment for all assets of corporation in bonds, even though secured solely by the purchased assets, gave rise to creditor status for buyer, and seller retained no proprietary interest in enterprise; transaction was thus deemed "sale or exchange" and not reorganization).

79. Allocating basis between the sale and retained income elements of a transaction creates another potential problem. The simplest method is to allocate basis entirely to the sale, and avoid amortizing any of the basis against the retained income interest.

80. See, e.g., Commissioner v. Brown, 380 U.S. at 575.

81. See supra note 12 and accompanying text.
taxable as ordinary income, and sale proceeds, taxable as capital
gains.\textsuperscript{82}

Thus far, this Article has suggested that the failure to apply the
lock-in criteria rigorously is attributable either to complexity or to
faulty analysis. A third explanation for this failure is suggested by
the following example. Assume that a $50,000 investment in a
risky venture entitles a taxpayer to a fixed dollar return of $10,000,
payable out of future profits if and when they materialize. Upon
materialization, but prior to collection of the profits, the taxpayer
sells his claim. Case law supports the taxpayer's right to capital
gains treatment on the sale\textsuperscript{83} but analysis of the lock-in effect does not.
When income will be realized so shortly after the sale, the
difference between taxing the sale proceeds and taxing the re-
tained income at ordinary rates would probably be so negligible
that the lock-in effect is minimal, eliminating the need for capital
gains treatment. If this seems a startling result, it may be a sign of
the waning influence of the lock-in effect as a rationale for the
capital gains preference.\textsuperscript{84}

III. GAIN ACCRUAL BY RISK VERSUS
GAIN ACCRUAL BY TIME

A taxpayer must take risks to be eligible for the capital gains
preference. The most important doctrine implementing this pol-
cy is the disallowance of the capital gains preference when the
accrual is due merely to the passage of time.\textsuperscript{85} The leading case
articulating the doctrine\textsuperscript{86} deals with original issue discount,\textsuperscript{87}

\textsuperscript{82} See supra note 76 and accompanying text. For a discussion of whether retained
ordinary income should be offset by depreciation deductions, see infra note 141.

\textsuperscript{83} See, e.g., Pacific Fin. Corp. v. Commissioner, 12 T.C.M. (CCH) 419, 425 (1953).
But see Pounds v. United States, 372 F.2d 342, 351 n.7 (5th Cir. 1967) (no "sale or ex-
change" in a transaction involving sale of a right to proceeds).

\textsuperscript{84} Judicial reluctance to apply the lock-in criteria to deny capital gains on the sale of
a successful risky investment does not necessarily undermine the general applicability of
the lock-in criteria. The taxpayer who holds a risky investment for a long period is not in
the same position as one whose risky future income flow is likely to arise, if at all, soon
after the investment is made. Case law has always been sympathetic to the investor whose
original investment purpose persists for a long time, as evidenced by decisions that have
considered original investment purpose relevant despite evidence that the sale may have
been in the ordinary course of business. See, e.g., Biedenharn Realty Co. v. United States,
526 F.2d 409, 421–22 (5th Cir. 1976).


\textsuperscript{87} See id; see also Rosen v. United States, 288 F.2d 658, 660 (3d Cir. 1961); Stanton v.
Commissioner, 34 T.C. 1, 6 (1960). But see Commissioner v. Calkins, 144 F.2d 482, 484
(6th Cir. 1944). See generally de Kosmian, supra note 86; Wolf, Original Issue Discount:
whereby the borrower agrees to repay more than he borrows in exchange for a reduced interest rate. The gain equal to the discount which accrues to the lender in lieu of interest is ordinary income. Similarly, gain on the sale of life insurance policies and annuities is ordinary income when it merely represents accrued interest. In contrast, gain attributable to defaulted interest realized after purchasing an outstanding debt, and gain derived from an investment in a promise to pay a fixed sum out of speculative profits is eligible for the capital gains preference.

Before and After National Alfalfa, 28 TAX LAWYER 325 (1975) (reviewing the judicial and legislative treatment of original issue discount).

89. See, e.g., Commissioner v. Phillips, 275 F.2d 33, 35-37 (4th Cir. 1960) (taxpayer sold policy 12 days before maturity; gain was taxed at ordinary rates); Nesbit v. Commissioner, 43 T.C. 629, 629-32 (1965) (gain on endowment policies was ordinary income); Barrett v. Commissioner, 42 T.C. 993, 998-99 (1964), aff'd, 348 F.2d 916 (5th Cir. 1965); Jones v. Commissioner, 39 T.C. 404, 409-10 (1962) (portion of gain from assignment of endowment policy which accrued prior to sale was ordinary income); Crocker v. Commissioner, 37 T.C. 605, 610-13 (1962); Roff v. Commissioner, 36 T.C. 818, 823-25 (1961), aff'd, 304 F.2d 450 (3d Cir. 1962).
92. See, e.g., Lubin v. Commissioner, 335 F.2d 209, 213 (2d Cir. 1964) (difference between loan and face value of notes treated as gain on investment acquired with loan proceeds); Pacific Fin. Corp. v. Commissioner, 12 T.C.M. (CCH) at 4-25 (sale of fixed-dollar claim to risky movie profits produced capital gain).

The concept of risk is also used to determine whether collection of a debt acquired from a creditor at a discount is first a recovery of capital or is part capital and part income. When the risk is very great, the proceeds are generally treated as a recovery of cost. Compare Willhoit v. Commissioner, 308 F.2d 259, 263-64 (9th Cir. 1962) (cost recovery), rev'd, 17 T.C.M. (CCH) 1024 (1958); Phillips v. Frank, 295 F.2d 629, 633-34 (9th Cir. 1961) (same), with Ehlers v. Vinal, 382 F.2d 58, 62-63 (8th Cir. 1967) (allocation between interest and principal); Darby Inv. Corp. v. Commissioner, 37 T.C. 839, 844-45 (1962) (same), aff'd per curiam, 315 F.2d 551 (6th Cir. 1963); Rev. Rul. 64-162, 1964-1 (pt. 1) C.B. 304, 304-05 (same).

A similar risk-based distinction is made when the debt consists of taxable sale proceeds. When collection is very risky at the time the debt is acquired, the cost of the debt, which equals the value at which it was included in income, is recovered first. See, e.g., Phillips v. Frank, 295 F.2d at 633-34; Underhill v. Commissioner, 45 T.C. 489, 492 (1966). But see Waring v. Commissioner, 412 F.2d 800, 801 (3d Cir. 1969) (cost recovery method used by taxpayer was accepted by government without regard to risk, so that all collections after cost had been recovered were taxable as ordinary income). The amount of ordinary income first recoverable as cost by deferring taxable gain until debt collections exceed cost has been greatly reduced by two recent amendments to the Code and Regulations. First, it is less likely that debt will be taxed when received because the installment method is avail-
Determining whether the risk level is sufficient to justify capital gains treatment may prove difficult in individual cases. The difficulty stems from the same problems that arise in distinguishing debt from equity and in other circumstances requiring definitional distinction between creditor and owner status.\(^9\) Arbitrary line-drawing where important tax consequences are at stake strains these definitions. Nevertheless, risk is a relevant criterion for determining whether capital gains treatment is appropriate. The problem is one of application, not theory.

Conversely, application of the sale of a carved-out interest doctrine\(^9\) is simple—whenever a property owner sells a right to income for a lesser duration than his own, he is taxed at ordinary rates on the proceeds from the sale of the carved-out interest.\(^9\) This doctrine originated in the early case of Burnet v. Harmel,\(^9\) and was more recently formulated in Commissioner v. Gillette Motor Transport, Inc.\(^9\) and Commissioner v. P.G. Lake, Inc.\(^9\) These decisions are markedly deficient in legal or policy justifications. Harmel was decided on the ground that no "sale" had occurred,\(^9\) while Gillette turned on a denial that "property" had been sold.\(^10\)

The P.G. Lake Court seemed to hold that a sale or exchange of a capital asset cannot take place if the sale proceeds are the equivalent of future income.\(^10\)
P.G. Lake illustrates the problematical nature of the sale of a carved-out interest doctrine. To deny capital gains solely because a right to future income has been sold completely undermines the rationale behind the capital gains preference because all sale proceeds are the present value of the future income to be derived from the property.\textsuperscript{102} However, P.G. Lake is not entirely wrong. When a carved-out interest is sold, some future income should be taxed as ordinary income, and that is the gain accruing due to the mere passage of time. When a seller carves out an income interest he carves out a remainder interest as well. The value of the remainder interest is discounted to account for the absence of income between the sale of the carved-out interest and the expiration of that interest. The remainder interest value increases over time until vesting as a function of the diminishing carved-out interest period. This increase in value is the future income that should be taxed as ordinary income, given its similarity to the gain realized in an original issue discount.\textsuperscript{103}

To understand the advantages of the foregoing analysis, consider the taxpayer who invests $100 in corporate stock. The $100 cost stems from the following assumptions: $20 expected annual before-tax income in perpetuity,\textsuperscript{104} a 20% before-tax discount rate for riskless long term investment, and a 50% tax rate. The $100 cost equals the expected after-tax income ($10) divided by the after-tax discount rate (10%).\textsuperscript{105} The curious treatment of the sale of a carved-out interest is illustrated by an example whereby the seller of a capital asset is taxed even though he has realized no gain because market forces—either expected income flow or interest rate—have not changed. We will therefore assume that the taxpayer who has purchased $100 of corporate stock carves out

\textsuperscript{102} E.g., P.G. Lake, 356 U.S. at 266, United States v. Dresser Indus., 324 F.2d 56, 59 (5th Cir. 1963) ("sale was not merely the present sale of the right to be paid in the future, . . . [but was the sale of] an asset, a right, a property which could produce income"); see also Note, A Spreading of Receipts Formula, supra note 24, at 732-33 (present value discount factor must reflect risks attendant to retaining asset).

\textsuperscript{103} See supra notes 86-88 and accompanying text.

\textsuperscript{104} The $20 expected annual income figure is the weighted average of all possible payouts, adjusted for the investor's risk aversion and for dispersion of the payouts around the average payout. Risk is therefore accounted for in the income figure, not in the discount rate. See V. Brudney & M. Chirelstein, Corporate Finance 59-70 (2d ed. 1979) (certainty equivalent method of valuation).

\textsuperscript{105} The initial cost is independent of the tax rate because changes in the tax rate create offsetting changes in both the after-tax income and after-tax discount rate. For example, a 40% instead of a 50% tax rate results in $12 after-tax income (not $10) divided by a 12% after-tax discount rate (not 10%), which also equals $100.
and sells a ten-year income flow to a buyer with the same characteristics as the seller, and that market forces remain static. In this scenario, the price for the ten-year income flow will be $83.85, which represents the present value of ten years' income after depreciation,\textsuperscript{106} assuming a $20 expected annual return before tax and depreciation and a 20% before-tax discount rate.\textsuperscript{107} These assumptions provide insight into what happens to the retained remainder interest. Gain will accrue to the remainder at a 20% before-tax rate, compounded annually on the remainder's value at the time of sale—an annual increment which equals the carved-out asset's annual depreciation while in the buyer's hands.\textsuperscript{108} Table 2 presents these figures.

106. The sinking fund method of depreciation is used, resulting in higher net income allocable to the earlier years of the asset's life. See generally M. CHIRELSTEIN, FEDERAL INCOME TAXATION 136-37 (3d ed. 1982); Blum, Accelerated Depreciation: A Proper Allowance for Measuring Net Income???, 78 MICH. L. REV. 1172, 1174–81 (1980). A different depreciation method for tax purposes would change the annual after-tax return and could therefore affect the purchase price of the income interest. Sinking fund depreciation complements the accrual of income to the remainder interest at compound interest rates. The compound interest accrual method, which results in less income accruing in the earlier years, has recently been adopted for computing original issue discount. See Tax Equity and Fiscal Responsibility Act of 1982, § 231(a), 16 U.S.C. § 1232A(a)(1), (3) (West Supp. 1983).

107. See supra notes 104–05 and accompanying text.

108. The most controversial aspect of these assumptions is that future income is expected to accrue in equal annual amounts. Similar questions have arisen in computing tax depreciation: instead of assuming equal annual income, which would result in sinking fund depreciation, the government permits the more generous straight line depreciation method because it is simple to administer. See Blum, supra note 106, at 1183–84. The justification for allowing straight line depreciation appears to be that, given the uncertainty of future income, the equal annual income assumption is not so superior that administrative ease should be sacrificed. See id. Nonetheless, the equal annual income assumption is the most reasonable if its administrative difficulties can be surmounted. This Article will therefore employ that assumption in discussing the correct taxation of the buyer of the carved-out income interest and the owner of the retained remainder interest; issues of administrability will be discussed later. See infra notes 146–50 and accompanying text.
Table 2

**BEFORE-TAX RETURN TO TEN-YEAR INCOME AND RETAINED REMAINDER INTERESTS, ASSUMING $20 BEFORE-TAX EXPECTED RETURN, 20% BEFORE-TAX RISKLESS DISCOUNT RATE, AND SINKING FUND DEPRECIATION**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expected Before-Tax Return</th>
<th>Income Accruing to $83.85 Investment in Income Interest</th>
<th>Income Accruing to $16.15 Investment* in Remainder</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Depreciation</td>
<td>Income</td>
</tr>
<tr>
<td>1</td>
<td>$ 20</td>
<td>3.23</td>
<td>16.77</td>
</tr>
<tr>
<td>2</td>
<td>20</td>
<td>3.88</td>
<td>16.12</td>
</tr>
<tr>
<td>3</td>
<td>20</td>
<td>4.65</td>
<td>15.35</td>
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<td>4</td>
<td>20</td>
<td>5.58</td>
<td>14.42</td>
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<td>20</td>
<td>6.70</td>
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</tr>
<tr>
<td>6</td>
<td>20</td>
<td>8.04</td>
<td>11.96</td>
</tr>
<tr>
<td>7</td>
<td>20</td>
<td>9.65</td>
<td>10.36</td>
</tr>
<tr>
<td>8</td>
<td>20</td>
<td>11.57</td>
<td>8.43</td>
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<tr>
<td>9</td>
<td>20</td>
<td>13.89</td>
<td>6.11</td>
</tr>
<tr>
<td>10</td>
<td>20</td>
<td>16.67</td>
<td>3.33</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$200</td>
<td>$83.85</td>
</tr>
</tbody>
</table>

* $16.15 is what remains of the $100 original investment cost after subtracting the $83.85 cost allocable to the income interest.

Thus, when a taxpayer with a $100 investment sells ten years' income for $83.85, the carved-out income interest doctrine produces the following results: (1) the sale proceeds are ordinary income; (2) the buyer acquires a depreciable income interest; and (3) the retained remainder interest has a $100 basis.

A more obvious method would be to allocate to the carved-out income interest its proportionate share of the underlying asset's basis, just as a sold portion of any property is allocated its share of the total property's basis. Under this method, assuming static...
market forces stabilize the underlying asset's value, the $83.85 sale proceeds would be offset by an equal amount of basis and no gain would accrue. The same result follows under the statute when a donee of a carved-out interest sells his interest at the same time the donee of the remainder interest sells his, or when a bondholder sells a carved-out income interest. Why, then, does

114. The basis of the carved-out interest would be calculated by dividing the value of the carved-out interest by the value of the entire asset, and multiplying this fraction by the total cost. If the asset from which the income interest was carved was expected to produce equal annual income flows in perpetuity and the carved-out income interest was for a fixed period of years, a table based on the before-tax riskless discount rate prevailing at the time of sale can be devised to specify that percentage of total cost attributable to the basis of the carved-out interest. Table 3, infra, provides those percentages for discount rates of 8%, 10%, 12%, 15%, 20%, respectively.

If the income interest is for an unspecified duration, receipt of income is not expected in equal annual amounts, or the asset from which the interest was carved is not a perpetual income interest, the table would not be accurate. Instead, the basis formula must be applied. Determining the value of the entire asset may be difficult. When the income interest is carved out of an asset which is not expected to produce income perpetually, the procedure described infra note 150 can be used to compute this value. When the carved-out income interest does not extend over a fixed period of years, or when equal annual income is not expected, the value of the entire interest would have to be estimated.

Table 3
Percentage of Total Cost Attributable to Income Interest, Depending on Discount Rate in Year of Sale

<table>
<thead>
<tr>
<th>Length of Income Interest in Years</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>15%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>7.41</td>
<td>9.09</td>
<td>10.71</td>
<td>13.04</td>
<td>16.67</td>
</tr>
<tr>
<td>2</td>
<td>14.27</td>
<td>17.36</td>
<td>20.28</td>
<td>24.39</td>
<td>30.56</td>
</tr>
<tr>
<td>3</td>
<td>20.62</td>
<td>24.87</td>
<td>28.82</td>
<td>34.25</td>
<td>42.13</td>
</tr>
<tr>
<td>4</td>
<td>26.50</td>
<td>31.70</td>
<td>36.45</td>
<td>42.82</td>
<td>51.77</td>
</tr>
<tr>
<td>5</td>
<td>31.94</td>
<td>37.91</td>
<td>43.26</td>
<td>50.28</td>
<td>59.81</td>
</tr>
<tr>
<td>6</td>
<td>36.98</td>
<td>43.55</td>
<td>49.34</td>
<td>56.77</td>
<td>66.51</td>
</tr>
<tr>
<td>7</td>
<td>41.65</td>
<td>48.68</td>
<td>54.77</td>
<td>62.41</td>
<td>72.09</td>
</tr>
<tr>
<td>8</td>
<td>45.97</td>
<td>53.35</td>
<td>59.61</td>
<td>67.31</td>
<td>76.74</td>
</tr>
<tr>
<td>9</td>
<td>49.98</td>
<td>57.59</td>
<td>63.94</td>
<td>71.57</td>
<td>80.62</td>
</tr>
<tr>
<td>10</td>
<td>53.68</td>
<td>61.45</td>
<td>67.80</td>
<td>75.28</td>
<td>83.85</td>
</tr>
<tr>
<td>11</td>
<td>57.11</td>
<td>64.95</td>
<td>71.25</td>
<td>78.51</td>
<td>86.54</td>
</tr>
<tr>
<td>12</td>
<td>60.29</td>
<td>68.14</td>
<td>74.33</td>
<td>81.31</td>
<td>88.78</td>
</tr>
<tr>
<td>13</td>
<td>63.23</td>
<td>71.03</td>
<td>77.08</td>
<td>83.75</td>
<td>90.65</td>
</tr>
<tr>
<td>14</td>
<td>65.95</td>
<td>73.67</td>
<td>79.54</td>
<td>85.87</td>
<td>92.21</td>
</tr>
<tr>
<td>15</td>
<td>68.48</td>
<td>76.06</td>
<td>81.73</td>
<td>87.71</td>
<td>93.51</td>
</tr>
<tr>
<td>16</td>
<td>70.81</td>
<td>78.24</td>
<td>83.69</td>
<td>89.31</td>
<td>94.59</td>
</tr>
<tr>
<td>17</td>
<td>72.97</td>
<td>80.22</td>
<td>85.44</td>
<td>90.71</td>
<td>95.49</td>
</tr>
<tr>
<td>18</td>
<td>74.98</td>
<td>82.01</td>
<td>87.00</td>
<td>91.92</td>
<td>96.24</td>
</tr>
<tr>
<td>19</td>
<td>76.83</td>
<td>83.65</td>
<td>88.39</td>
<td>92.97</td>
<td>96.87</td>
</tr>
<tr>
<td>20</td>
<td>78.55</td>
<td>85.14</td>
<td>89.63</td>
<td>93.89</td>
<td>97.39</td>
</tr>
</tbody>
</table>

116. Id. § 1232B(b)(3) (West Supp. 1983). For a discussion of the defects in the rules applicable to sale of an income interest in a bond, see infra notes 151-55 and accompanying text.
the sale of a carved-out interest doctrine require taxing the entire sale proceeds as ordinary income?

The answer is grounded on policy—the doctrine thwarts tax evasion. When basis is allocated to the carved-out income interest, it becomes highly improbable that the remainderman will report the gain accruing to his interest as ordinary income. A similar problem in the original issue discount context\(^{117}\) resulted in statutory changes providing for the annual accrual of original issue discount as ordinary income\(^{118}\) and enlisting the aid of the third-party corporate borrower in reporting and collecting the tax on that income.\(^{119}\) However, no third party exists to facilitate tax reporting and collection when gain accrues to a remainder interest. Thus, a simple solution to the problem of taxing the remainderman’s gain might appear from the fact that the sale proceeds equal the amount of income expected to accrue to the seller as remainderman, assuming stable market forces. The simple solution is to tax the sales proceeds as ordinary income in the year of sale, which is exactly what the sale of a carved-out income interest doctrine does. The proceeds from the sale of a carved out income interest are indeed future income, but are taxed before their accrual to the remainderman in order to solve a difficult administrative problem.

This analysis puts the doctrine’s validity at issue. To be sure, the analogy between original issue discount and gain accruing to a discounted remainder interest is not perfect; the remainder interest might be in property such as land or stock, which fluctuates in value, whereas original issue discount arises on debt, a fixed-dollar obligation. Of course, fluctuation in value does not by itself prevent accrual of ordinary income, as reflected in the taxing of original issue discount despite fluctuation in the value of the debt.\(^{120}\) Fluctuating value might more seriously hinder the taxing of accrued income, however, when the obligation is not a promise to pay a fixed sum. The investor in a fixed-sum obligation will receive the total amount accrued as ordinary income.\(^{121}\) When the investment is contingent on profits, however, the remainder-

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120. See supra notes 86–88 and accompanying text.

121. See supra note 94 and accompanying text.
man is less certain to realize the amount accrued without any change occurring in the value of the underlying property.

Assume, for example, that the expected before-tax return on the stock in the above scenario has increased from $20 to $24 per year, while the riskless before-tax discount rate remains 20%. The total value of the underlying investment would increase to $120, the income interest would sell for $100.62, and the value of the remainder interest would equal $19.38. Given no further change in the rate of return or in the discount rate, income totaling $100.62 would accrue over ten years to the $19.38 remainder interest at an expected before-tax rate of return of 20%, compounded annually. Yet, should the income prospects or interest

122. See supra text accompanying notes 104-07.
123. 83.85% of $120 equals $100.62. See Table 3, supra note 114.
124. $120 minus $100.62 equals $19.38.
125. Table 4a, infra, adapts Table 2, supra text accompanying note 108, to a $24 before-tax return and a $100.62 cost for the income interest. All other assumptions are the same as those in Table 2. Gain on sale of the income interest is $16.77 ($100.62 minus $83.85). The remainderman's basis would increase by the income accruing to that interest at a 20% compound annual interest rate ($16.15 plus $100.62 of taxable income equals $116.77). Assuming no further change in value, the remainderman would own an investment worth $120 after ten years, with an as yet unrealized gain of $3.23. In contrast, Table 4b presents the figures for a $30 expected before-tax return and a 27.1% discount rate. The value of the income interest is virtually the same as when the expected return is $24 and the discount rate is only 20%. However, the annual income computations are different. Gain on the sale of the income interest is computed using a $90.91 basis, and equals $9.73 ($100.64 minus $90.91). The remainderman's basis increases to $109.73 ($9.09 plus $100.64 of taxed income). Assuming no further change in value, after ten years the remainderman would own an investment worth $110.70, with an unrealized gain of $.97.

### Table 4a

**BEFORE-TAX RETURN TO TEN-YEAR INCOME AND REMAINDER INTERESTS ASSUMING $24 BEFORE-TAX EXPECTED RETURN, 20% BEFORE-TAX RISKLESS DISCOUNT RATE, AND SINKING FUND DEPRECIATION**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Income</th>
<th>Income Accruing to Income</th>
<th>Income Accruing to Income</th>
<th>Income Accruing to Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expected Before-Tax Return</td>
<td>$100.62 Investment in Income Interest</td>
<td>$16.15 Investment in Remainder</td>
<td>Income</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>Depreciation</strong></td>
<td><strong>Income</strong></td>
<td><strong>Income</strong></td>
</tr>
<tr>
<td>1</td>
<td>$24</td>
<td>$3.88</td>
<td>$20.12</td>
<td>$3.88</td>
</tr>
<tr>
<td>2</td>
<td>24</td>
<td>4.65</td>
<td>19.35</td>
<td>4.65</td>
</tr>
<tr>
<td>3</td>
<td>24</td>
<td>5.58</td>
<td>18.42</td>
<td>5.58</td>
</tr>
<tr>
<td>4</td>
<td>24</td>
<td>6.70</td>
<td>17.30</td>
<td>6.70</td>
</tr>
<tr>
<td>5</td>
<td>24</td>
<td>8.04</td>
<td>15.96</td>
<td>8.04</td>
</tr>
<tr>
<td>6</td>
<td>24</td>
<td>9.65</td>
<td>14.36</td>
<td>9.65</td>
</tr>
<tr>
<td>7</td>
<td>24</td>
<td>11.57</td>
<td>12.43</td>
<td>11.57</td>
</tr>
<tr>
<td>8</td>
<td>24</td>
<td>13.89</td>
<td>10.11</td>
<td>13.89</td>
</tr>
<tr>
<td>9</td>
<td>24</td>
<td>16.67</td>
<td>7.34</td>
<td>16.67</td>
</tr>
<tr>
<td>10</td>
<td>24</td>
<td>20.00</td>
<td>4.00</td>
<td>20.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$240</strong></td>
<td><strong>$100.62</strong></td>
<td><strong>$139.38</strong></td>
<td><strong>$100.62</strong></td>
</tr>
</tbody>
</table>
rates change after sale of the income interest, the value of the underlying asset upon expiration of the interest will not have increased by the amount predicted on the premise that market forces would remain static. The question therefore becomes whether it is fair to tax the gain accruing to the remainder interest as ordinary income when the underlying asset's value upon expiration of the income interest is subject to such uncertainty.\(^\text{126}\)

Taxing this gain as ordinary income is not unfair, however, because the analogy between income accruing to the remainder interest and return on a risky investment, which is eligible for capital gains, is erroneous. Although the remainderman might not realize the precise amount of income accruing at the prevailing discount rate when the income interest was sold, a substantial amount of income is still almost certain to accrue. This should be sufficient reason to tax the return as though it were original issue discount.\(^\text{127}\) The income accruing to the remainder interest is sim-

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126. Another possible argument against taxing the gain accruing to the remainder interest as ordinary income is that the gain is analogous to market discount, which produces capital gain unless the market discount arises from coupon stripping, see I.R.C. § 1232B(a) (West Supp. 1983). However, there is no clear holding that market discount is capital gain. See Weisner v. Commissioner, 20 T.C.M. (CCH) 1150, 1151 (1961); Rev. Rul. 60-210, 1960-1 C.B. 38, 39 (alternative to capital gains on market discount is tax-exempt interest); (capital gains treatment permitted on very risky investment); see also United States v. Midland-Ross Corp., 381 U.S. 54, 58 n.4 (1965) (failing to reach the question). Moreover, market discount arises from fluctuations in interest rates after an investment is made, but gain accrues to a retained remainder interest although interest rates may remain constant. The sole rationale for permitting capital gains treatment on market discount appears to be special solicitousness for the bond market.

127. See Jones v. Commissioner, 330 F.2d 302, 302 (3d Cir. 1964), vacating and remand-
ilar to defaulted interest accruing after purchasing a debt. Such interest is taxed as ordinary income—not as a return of capital—despite the risk associated with recovering the total amount due. The better way to account for fluctuating value is to permit ordinary instead of capital loss treatment on the amount by which the original cost of the remainder interest, plus previously taxed accrued income, exceeds the value of the interest upon sale.

Further support for taxing the gain accruing to a discounted remainder interest as ordinary income can be found outside the realm of capital gains. Other branches of tax law deal similarly with this problem. One example is the income taxation of gifts of a term and remainder interest, wherein the donee of the term interest may not depreciate his basis. The purpose of this rule is to ensure that the gain accruing to the remainder interest does not go untaxed; this is accomplished by taxing the term interest owner on that gain instead of permitting the respective owners to split the tax obligation. Another example is the assignment-of-income doctrine as applied to a gift of a term interest and a retained remainder. Instead of allocating all the income to the term interest owner, as in the case of a gift of both term and remainder

In 40 T.C. 249 (1963). In Jones, the remainder interest was contingent, thus increasing the risk, but the purchaser's interest was insured. But see Hood v. Commissioner, 20 T.C.M. (CCH) 1140, 1144 (1961).

The issue is not whether the income accruing to the remainder is interest, but whether it should be treated as ordinary income; the reference to interest is only by way of analogy. Nonetheless, courts and commentators have erroneously urged that the income must be interest or else be capital gain. See Note, The Favorable Tax Treatment of Remainder Interest Investment, 24 Tax L. Rev. 527, 537-43 (1969). This mistake was also made in Jones, and perpetuated by the tax court on remand, 25 T.C.M. (CCH) 701, 706 (1966).

128. See First Ky. Co. v. Gray, 309 F.2d 845, 847 (6th Cir. 1962); Motel Corp. v. Commissioner, 54 T.C. 1433, 1440 (1970); Tobey v. Commissioner, 26 T.C. 610, 618 (1956); cf. Treas. Reg. § 20.2032-1(f)(1) (1980) (value fluctuation attributable to passage of time, such as that affecting life estates and remainder interests, is excluded in determining value of estate six months after death).

129. This, in effect, is the result under I.R.C. § 1232B(c) (West Supp. 1983). That section taxes as ordinary income the gain realized by the purchaser of a remainder interest in a bond when the bond is sold, up to the difference between the fair market value of the bond when the remainder interest was acquired and the purchaser's cost. If market interest rates rise after the purchase, the gain taxed as ordinary income will be less than the income which would have accrued annually based on the assumption that the interest rates remained stable.


131. If a tax-exempt charity owns the term interest, the statutory scheme backfires and the remainderman's income is not taxed.
interests, the income is fully allocated to the remainder. This result may be partially justified on the theory that the donor is manipulating wealth among family members or enjoying the very act of giving. What ultimately justifies this result, however, is that despite the gift, significant income is accruing to the donor's retained remainder interest. Indeed, if the accrued income is minimal, as when the income interest is for more than ten years, the donor is often not taxed on that income. This result is best explained on the theory that the reason for taxing the donor initially is the significant amount of income accruing to his remainder interest.

There are many other situations where term and remainder interests are split between two taxpayers and either the statute or case law prevents the remainderman's gain from escaping ordinary income treatment. The statute requires that gain on remainder interests in bonds accrue periodically as original issue discount. Courts frequently reach analogous results: a tax-

134. Courts frequently reach analogous results: a tax-
135. When the income interest is for ten years and the tax rate is 50%, the present value of the tax on the income accruing to the remainderman as a percentage of the present value of taxes due on the entire income is either 36.49% or 41.92%, depending upon whether the sinking fund/compound interest or the straight line depreciation method is used. For an 11-year income interest, the figures are 33.24% and 39.34%, respectively; for a 30-year interest, the figures are 5.62% and 16.6%, respectively. This assumes that the income flow accrues perpetually in equal annual amounts. If the income flow is not perpetual or declines over time, the percentage attributable to the remainder declines.
136. I.R.C. § 1232B(a) (West Supp. 1983) (for purchases after July 1, 1982). I.R.C. § 1232B(c) (West Supp. 1983), which covers purchases between August 16, 1954 and July 1, 1982, taxes as ordinary income the gain on disposition of the remainder interest equal to the difference between the value of the bond when the remainder interest was purchased and the purchase price. For example, if the owner of a $1000 bond paying 20% interest detaches 10 years' coupons after the bond has appreciated in value to $1200, the price of the remainder interest would be $193.81. The gain upon sale by the remainder interest's owner (up to the difference between $1200 and $193.81) is taxed as ordinary income. Under the new rule in I.R.C. § 1232B(a) (West Supp. 1983), only the difference between
payers who retain a term interest in a nondepreciable asset and transfers the remainder cannot depreciate the retained term interest; a purchaser of a remainder interest must report as ordinary income that part of the gain which is analogous to original issue discount; and certain sales of term interests are recast as loans. Devising solutions for every situation in which property is split into term and remainder interests is beyond the scope of this Article, but the pervasiveness of the issue suggests that tax-

the redemption price and the purchase price ($1000 minus $193.81) accrues as ordinary income.


Retention-gift situations are similar to sales of a business in exchange for a percentage of profits, see Commissioner v. Brown, 380 U.S. 563 (1965), or sales to family members, see Rev. Rul. 69-74, 1969-1 C.B. 43. Recasting these cases as retention-gift transactions and adopting the proposal in the text would result in taxing the “sale proceeds” as ordinary income, because the “seller” would be treated as the owner of the income interest but denied a basis for depreciation. The Code’s solution to the problem of a bootstrap sale to charity is to allow sale treatment but tax the charity on a declining percentage of the income used to pay the sale price. I.R.C. § 514 (1976 & Supp. V 1981). The income taxable to the charity is roughly equivalent to what an owner of an income interest using sinking fund depreciation would report. See generally, 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.36 (rev. ed. 1980) (describing the sinking fund method of depreciation).


The result reached in Jones would be hard to justify if the owner of the income interest were reporting income unaffected by depreciation. However, the principle of the holding is important if the income interest owner takes depreciation, which is permissible when that interest is purchased.

140. See Bryant v. Commissioner, 46 T.C. 848, 861-62 (1966), aff’d, 399 F.2d 800 (5th Cir. 1968). The sale-retention transaction might also be treated as a loan. See, e.g., Mapco, Inc. v. United States, 556 F.2d 1107, 1110 (Ct. Cl. 1977); Hydrometals, Inc. v. Commissioner, 31 T.C.M. (CCH) 1260, 1265 (1972), aff’d, 485 F.2d 1236 (5th Cir. 1973), cert. denied, 416 U.S. 938 (1974); Martin v. Commissioner, 56 T.C. 1255, 1259 (1971), aff’d, 469 F.2d 1406 (5th Cir. 1972). The buyer must clearly resemble a creditor, however, before the courts will recast a sale as a loan. See Estate of Stranahan v. Commissioner, 472 F.2d 867, 870-71 (6th Cir. 1973).

I.R.C. § 636 (1976) now treats retained production payments on the sale of mineral property as a purchase money mortgage even though the dollar amount to be received is not fixed, see Treats. Reg. § 1.636-3(a) (1980), but the courts seem to take a narrower view of what constitutes a credit transaction.

141. Such an analysis would necessarily address the tax treatment of retained interests disguised as sales. As previously urged, no part of the sale price should be treated as capital gain. See supra text accompanying note 82. This conclusion raises the issue of cost recovery. If the seller is treated as the owner of a retained income interest, determining the correct way for him to recover cost is as problematical as the issue posed by situations
ing income accruing to retained remainder interests poses difficult problems, regardless of the form of the underlying property.

The sale of a carved-out income interest doctrine is an attempt at a simple solution to this problem. Nonetheless, taxing proceeds from the sale of a carved-out income interest as ordinary income creates an unfair acceleration of income because, although the proceeds equal the income which will accrue in the future, they are taxed before the income accrues. The fairness problem is not mooted by invoking cases where cash prepayments for inventory or personal services were taxed as ordinary income. The receipt of cash advances marks an appropriate time to impose tax because the cost of producing the income has not yet been incurred. The sale of a carved-out interest, however, presents an entirely different situation; there, the taxpayer has already incurred a cost to be recovered upon disposition of a capital asset.

One way to remedy the fairness problem would be to tax the entire sale proceeds as capital gains without permitting recovery of basis. This is the usual result when the donee or devisee of a term interest sells that interest. The problem with this solution is that the capital gains preference may overcompensate for the acceleration effect. Assume, for example, that $100 of income will accrue to a remainder interest owned by a taxpayer in the 50% tax bracket. Were the $100 to be received periodically over a future time interval, the total tax would be $50 but the present value of that tax burden would be less than $50. A 50% ordinary income tax on $100 at the time of sale would therefore exceed the present value of the future tax payments. However, since the capital gains

where the remainderman is not likely to report as income the value accruing to his interest. See supra notes 117–19 and accompanying text. The only difference is that the remainderman disguised as buyer is likely to be in a low tax bracket when he participates in a bootstrapping sale whereby the seller retains an income interest. Otherwise, the remainderman would not realize enough income from the property to compensate the seller in the early after-sale years for loss of future income which the remainderman is allowed to keep. Thus, the remainderman is unlikely to be avoiding tax. Under this theory, the seller might be allowed to recover cost through depreciation. It is important, however, to require the seller to use sinking fund depreciation. Straight line depreciation would be too generous, see supra note 108, especially since the remainderman is probably in a low tax bracket and will be paying very little tax on his income.

144. See I.R.C. § 1001(e) (1976 & Supp. V 1981); see, e.g., McAllister v. Commissioner, 157 F.2d 235, 236 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947); Bell’s Estate v. Commissioner, 137 F.2d 454, 458 (8th Cir. 1943); Rev. Rul. 72-243, 1972-1 C.B. 233, 233. However, if the owners of the term and remainder interests sell their interests in the same transaction, both may recover basis. See I.R.C. § 1001(e)(3) (1976).
rate is only 40% of the ordinary rate, a capital gains tax on $100 at the time of sale might or might not exceed the present value of the future tax, depending upon variables such as the interest rate used to discount the future tax payments, the time over which the income will be received in the future, and the pattern of income distribution.

The fairest method for taxing the remainderman is to allow him to avoid the consequences of the sale of a carved-out interest doctrine, on condition that he report the ordinary income accruing annually to the retained remainder interest. This solution is only acceptable if administratively workable. Valuing the retained remainder interest at the time of sale of the carved-out income interest is very difficult. As noted, the accrued income should equal the compound interest, at the riskless discount rate, that will accrue to the remainder interest. However, there is a much easier way to determine the amount of income which should accrue: total income accruing to the remainderman equals the purchase price, and annual income equals the purchaser’s depreciation deduction, computed by the sinking fund method on the assumption that after-depreciation income will accrue to the purchaser at the before-tax discount rate applicable at the time of sale. Accruing that amount to the remainder interest treats the remainderman as if he had deposited the at-sale value of his remainder interest in a bank account earning interest compounded annually at the before-tax riskless discount rate prevailing at the time of sale. If the price of the income interest and the discount rate are known, a table can be constructed specifying the percentage of that price equal to annual sinking fund depreciation and therefore equal to the annual income accruing to the remainderman.

145. I.R.C. § 1202(a) (Supp. V 1981) allows individuals to deduct 60% of their capital gains.

146. Administrative difficulty, not theoretical obstacles, probably explains the prevailing concern over whether gain on the sale of bonds, life insurance, and annuities should be taxed as ordinary income when the sale occurs long before the due date. See, e.g., Commissioner v. Phillips, 275 F.2d 33, 36 n.3 (4th Cir. 1960); Lyon & Eustice, supra note 94, at 372; see also Jones v. Commissioner, 40 T.C. 249, 257 n.1 (resale to remainderman of interest in a trust while life tenant is still alive), vacated and remanded, 330 F.2d 302 (3d Cir. 1963). This concern is misplaced. Although distinguishing ordinary income from gain accruing due to market forces may appear difficult, the difficulty is easily overcome by computing the amount of annual income accrued at an appropriate interest rate.

147. See supra text accompanying note 125.

148. Valuation cannot be avoided, however, when the purchaser buys the right to a risky future income flow with a fixed-dollar ceiling. For example, if a taxpayer pays $100.62 for the right to collect $240 of income produced by an asset when the riskless before-tax discount rate is 20% and the value of the underlying asset $120, the fraction
Table 5 provides these figures for five-, eight-, ten-, twelve-, and fifteen-year income interests, assuming before-tax discount rates of 8%, 10%, 15% and 20%, respectively.

equal to the purchase price divided by value of the underlying asset (100.62/120 = 83.85%) identifies the number of years sold (10); this is accomplished by matching the percentage produced by this fraction with the same percentage appearing under the 20% discount rate column of Table 3, supra note 114, and finding the corresponding number of years in the length of income interest column. Without estimating the value of the underlying asset, there is no way to determine the number of years purchased, and therefore no way to utilize Table 5, infra text accompanying note 149.
## Table

**Percent of Purchase Price for the Income Period Purchased and Before Annual Depreciation and Remainderman**

### Income Period Purchased

<table>
<thead>
<tr>
<th>Year</th>
<th>5-Year Income Interest</th>
<th>8-Year Income Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before-Tax Riskless</td>
<td>Discount Rate</td>
</tr>
<tr>
<td></td>
<td>8%</td>
<td>10%</td>
</tr>
<tr>
<td>1</td>
<td>17.03</td>
<td>16.38</td>
</tr>
<tr>
<td>2</td>
<td>18.41</td>
<td>18.02</td>
</tr>
<tr>
<td>3</td>
<td>19.88</td>
<td>19.81</td>
</tr>
<tr>
<td>4</td>
<td>21.48</td>
<td>21.79</td>
</tr>
<tr>
<td>5</td>
<td>23.20</td>
<td>23.98</td>
</tr>
<tr>
<td>6</td>
<td>13.81</td>
<td>14.08</td>
</tr>
<tr>
<td>7</td>
<td>14.92</td>
<td>15.48</td>
</tr>
<tr>
<td>8</td>
<td>16.12</td>
<td>17.04</td>
</tr>
<tr>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td></td>
<td></td>
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<tr>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>99.98</td>
</tr>
</tbody>
</table>

149. The simplicity of using this table is best demonstrated when it is used in connection with $8.04, when the discount rate is 20% and the purchase price is $100.62. That figure equals 7.99%
COME INTEREST EQUAL TO PURCHASER'S
'S ANNUAL INCOME, DEPENDING ON INCOME
-TAX RISKLESS DISCOUNT RATE

INCOME PERIOD PURCHASED

<table>
<thead>
<tr>
<th>10-Year Income Interest</th>
<th>12-Year Income Interest</th>
<th>15-Year Income Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before-Tax Riskless</td>
<td>Before-Tax Riskless</td>
</tr>
<tr>
<td></td>
<td>Discount Rate</td>
<td>Discount Rate</td>
</tr>
<tr>
<td></td>
<td>8%  10%  15%  20%</td>
<td>8%  10%  15%  20%</td>
</tr>
<tr>
<td></td>
<td>%   %   %   %</td>
<td>%   %   %   %</td>
</tr>
<tr>
<td>6.91</td>
<td>6.28 4.93 3.85</td>
<td>5.27 4.68 3.44 2.52</td>
</tr>
<tr>
<td>7.45</td>
<td>6.90 5.66 4.63</td>
<td>5.69 5.15 3.96 3.03</td>
</tr>
<tr>
<td>8.05</td>
<td>7.60 6.51 5.55</td>
<td>6.15 5.66 4.56 3.64</td>
</tr>
<tr>
<td>8.70</td>
<td>8.35 7.49 6.65</td>
<td>6.63 6.22 5.24 4.37</td>
</tr>
<tr>
<td>9.39</td>
<td>9.19 8.61 7.99</td>
<td>7.17 6.85 6.03 5.24</td>
</tr>
<tr>
<td>10.13</td>
<td>10.11 9.91 9.59</td>
<td>7.75 7.53 6.94 6.29</td>
</tr>
<tr>
<td>10.95</td>
<td>11.11 11.40 11.51</td>
<td>8.36 8.28 7.97 7.55</td>
</tr>
<tr>
<td>12.78</td>
<td>13.46 15.06 16.57</td>
<td>9.75 10.02 10.55 10.86</td>
</tr>
<tr>
<td></td>
<td></td>
<td>11.38 12.12 13.95 15.65</td>
</tr>
<tr>
<td></td>
<td></td>
<td>12.29 13.34 16.04 18.78</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4a. In Table 4a, sinking fund depreciation in the fifth year of a ten-year income interest is of the purchase price. See supra note 108.
This solution gives rise to four problems. First, the purchase price might be artificially deflated. An election to defer tax might therefore be denied on intrafamily sales. Second, an appropriate riskless discount rate must be determined. To this end, the average interest rate on ten-year Treasury bonds for some period ending prior to the sale of the income interest may be used. Third, the solution invites tax avoidance if the buyer is not required to use sinking fund depreciation but may instead elect the straight line method while the remainderman uses the compound interest method of reporting income illustrated in Tables 2, 4a, and 4b. Because the compound interest method allocates smaller amounts of income to the earlier years, total annual income reported by the seller and buyer in the immediate after-sale years will be lower than if both parties were to use straight line accounting for depreciation and accrual. The buyer's use of straight line depreciation should therefore be conditioned on the seller's use of straight line instead of compound interest accrual, to report income accruing to the retained remainder interest. Fourth, the purchase price of the term interest does not equal the remainderman's expected gain if the asset underlying the carved-out income interest is not expected to produce income perpetually or future income is not expected to accrue in equal annual amounts. In such cases, complicated computations are necessary to predict the remainderman's expected annual gain due to the mere passage of time.  

150. If the asset from which the income interest has been carved is itself of limited duration, the purchase price of the income interest and the before-tax discount rate can be used to determine the expected increase in the value of the remainder interest due to the mere passage of time. The computations would be as follows: 

First, the expected annual income flow must be determined, using the same computation made in determining level payments on a home mortgage. If $R =$ before-tax discount rate, $PP =$ purchase price of the carved-out income interest, $YI =$ years of income sold, and $AI =$ annual income flow, 

$$ AI = (R \cdot PP) + \sum_{F=0}^{YI-1} \frac{PP}{(1+R)^F}, $$

where the expression $\sum_{F=0}^{YI-1} (1+R)^F$ means the sum of the quantities in the formula $(1 + R)^F$ with $F$ increasing annually from 0 to $(YI - 1)$.

Second, using the expected annual income flow figure derived from the first formula, a second computation must be made to determine the present value of the expected flow of income for the entire period of the limited duration asset from which the income interest has been carved. If $Y =$ number of years' income flow from the limited duration asset, and $TV =$ total value of that asset, then
buttable presumption of equal annual income flows in perpetuity should be adopted.

Recent amendments to the Code illustrate the relevance of this Article’s approach to sales of carved-out income interests, and point out the problems that can arise absent careful attention to the underlying structural issues. The new rules require that the seller of a carved-out income interest in a bond allocate basis between the income and remainder interests according to their respective values\textsuperscript{151} and report the difference between the bond’s redemption price and the basis allocable to the retained remainder interest as original issue discount accruing periodically.\textsuperscript{152} The rules do not, however, adequately address all of the problems discussed in this Article. First, the rules are mandatory. Without an election the government will be insufficiently alerted to the trans-

\[ TV = \sum_{r=1}^{\gamma} \frac{AI}{(1+R)^r} . \]

The value of the remainder interest \((RV)\) when the carved-out income interest is sold is \(RV = TV - PP\). The expected value of the remainder interest upon expiration of the carved-out income interest \((VR)\) is

\[ VR = \sum_{r=1}^{\gamma - Y} \frac{AI}{(1+R)^r} . \]

Finally, the expected gain \((G)\) in value due to the mere passage of time is: \(G = VR - RV\).

If the life of the carved-out income interest is long enough but is still a small enough percentage of the total cost of the underlying asset, the purchase price may be a close approximation of the gain expected to accrue to the remainderman. For example, if an eight-year income interest is 25% of the life of the underlying asset, and the before-tax riskless discount rate is 8%, the gain expected to accrue to the retained remainder interest is 84.23% of the purchase price. This percentage increases as the life of the limited duration asset increases, the duration of the carved-out interest decreases, or the before-tax riskless discount rate increases.

Once the gain has been calculated, the amount that accrues each year can be determined by the percentages in Table 5 for the appropriate discount rate and income period during which the gain will accrue, or by straight line accrual, depending upon whether the buyer uses sinking fund or straight line depreciation.

Complexity is also introduced if the future annual income flows are expected to vary. In that case, the remainder interest’s value might not be expected to increase by the amount of the purchase price and the predicted annual accrual of value might be difficult to compute, regardless of whether the underlying asset produces income perpetually. The best way to deal with this problem is to presume equal annual income flows and permit either the taxpayer or the government to rebut the presumption where it would make a significant difference in computing the gain expected to accrue to the remaindeman. This Article proposes a similar solution when fluctuation in expected future income affects computation of the lock-in effect. \textit{See supra} note 64. If total gain accruing to the remainder interest is computed on the basis of fluctuating income, the simplest method of accruing income annually is straight line accrual. \textit{See supra} note 108.


152. \textit{Id.} § 1232B(a), (b)(4) (West Supp. 1983).
action and will have trouble enforcing periodic accruals of income to the remainder interest. Second, the purchaser of the income interest may depreciate his investment using the straight line method, but the owner of the remainder interest must accrue income using the slower compound interest method; the effect is to shelter some income during the early years after sale. These deficiencies suggest an answer to a question left open by the new rules—whether gain on the sale of a carved-out income interest in a bond is capital or ordinary. The potential for tax avoidance that persists in the new rules requires that courts continue to apply the sale of a carved-out income interest doctrine to gain exceeding the basis allocable to the income interest, thereby taxing the gain as ordinary income.

An important conclusion to be drawn from this analysis arises from the contrast between applying the risk criterion, as implemented by the sale of a carved-out income interest doctrine, and applying the lock-in criterion. The overbreadth of the sale of a carved-out income interest doctrine, coupled with the variety of techniques for taxing the gain accruing to a remainder interest as ordinary income, signifies the vitality of the risk criterion as surely as the underapplication of the lock-in criterion indicates the weakness of the policy against tax-created obstacles to transferability. The question common to both areas of the law is whether achieving a better fit between doctrine and underlying policy would so complicate the process as to be counterproductive. If sales of carved-out income interests were primarily ef-

153. Id. § 167(a), (b)(1) (1976).
155. The new rules likely miss the mark because they were drafted primarily to deal with tax deferral by purchasers of remainder interests and the creation of deductible losses by owners of retained remainder interests. H.R. REP. NO. 760, 97th Cong., 2d Sess. 554-55 (1982), reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 970-73. Depreciation methods used by income interest purchasers, and collection of tax on income accruing to owners of retained remainder interests, seem to have escaped notice.
156. See supra notes 94-112 and accompanying text.
157. See supra notes 46-64 and accompanying text; see also supra notes 81-84 and accompanying text.
158. See supra notes 45-46 and accompanying text.
159. The following Regulation would implement this proposal: Regulation 1.446-X.
(a) General Rule. Except as provided in section (b), the sale of a carved-out income interest shall be treated as the sale of property, if the seller elects to accrue income earned on the retained remainder interest in accordance with section (d). The basis of the property is specified in section (c). The tables in sections (c) and (d) depend on the discount rate at the time of sale. This discount rate is the average monthly interest rate paid on ten-year Treasury bonds. The average
forts to avoid taxes by shifting income within a wealthy family,\textsuperscript{160} there might be little reason to tolerate complex taxpayer options for deferring tax. However, sales of carved-out income interests are analogous to loans,\textsuperscript{161} suggesting that they might be a useful financing technique. If they are, accelerating the tax might be an excessive burden and the complex solution no more burdensome, given its advantages, than solutions resorted to in other areas of the law where considerable complexity is tolerated.\textsuperscript{162}

monthly interest rate shall be the mean of the six most recent monthly interest rates published by the Treasury more than three months prior to the date of sale.

(b) \textit{Sale to a Family Member.} Section (a) shall not apply to a sale to a family member as defined in § 267(c)(4).

(c) \textit{Basis.}

(i) \textit{Usual case.} Except as provided in subsection (ii), the basis of the carved-out income interest shall be the percentage of total cost specified in Table A for the appropriate before-tax discount rate. [Table A would be an expanded version of Table 3, supra note 114.]

(ii) \textit{Other cases.} If the carved-out income interest is not for a fixed period of years, or if future income is not expected to accrue in equal annual amounts, or if the property out of which the income interest is carved is not expected to produce income perpetually, the basis of the carved-out income interest shall be a fraction of the total cost, equal to the purchase price of the income interest divided by the value of the asset out of which the interest was carved.

(d) \textit{Income Accruing to the Retained Remainder Interest.}

(i) \textit{Usual case.} Except as provided in subsection (ii), the election provided for in section (a) shall result in annual accrual of income to the retained remainder interest, in an amount equal to a percentage of the sale price of the carved-out income interest, as provided in Table B, for the appropriate period of years and before-tax discount rate, or in an amount equal to a percentage of the purchase price equal to the reciprocal of the number of years for which the carved-out interest will exist (that is, straight line accrual). [Table B would be an expanded version of Table 5, supra text accompanying note 149.]

Straight line accrual is required unless the purchaser of the carved-out income interest uses sinking fund depreciation. If the income interest sold will not run for a fixed period, the number of years sold for purposes of applying Table B shall be determined by matching the percentage of the basis of the entire property represented by the basis of the income interest, and the relevant before-tax discount rate, with the period of years specified in Table A in (c)(i) above.

(ii) \textit{Other cases.} If the future income is not expected to accrue in equal annual amounts, or if the property out of which the income interest is carved is not expected to produce income perpetually, the sale price of the income interest shall not be used to compute the annual income accruing to the remainder interest, unless use of the sale price would provide a satisfactory approximation. [See supra note 150 for a suggestion how the income accruing to the remainder interest would then be determined.]

\textsuperscript{160} Cf. Note, supra note 127, at 527 (suggesting that sales of remainder interests are generally made by heirs to large fortunes).

\textsuperscript{161} See supra note 140 and accompanying text.

IV. INVESTMENT

Encouraging transferability and risk are two reasons for the capital gains preference. The third is encouraging significant personal investment. The investment criterion has intuitive appeal and a basis in history. Examples of capital assets in early legislative history presupposed taxpayer investment, and subsequent rules permitting capital gains treatment of the sale of business property suggest that investment is a necessary condition for the preference.163 Stock, the modern paradigm of a capital asset, also requires investment. Yet the case for the investment criterion rests on more than history and intuitive appeal; it has been used by the courts to develop doctrine defining capital assets.

The most important cases in which the presence or absence of

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163. See supra notes 40-43 and accompanying text. Not all investments necessarily deserve preferential treatment. Business assets, for example, have a confused history. Before 1942, gain on corporate-owned business assets was denied preferential treatment. Capital gains treatment was not imperative for corporations, however, because ordinary rates on corporate income and capital gains rates on individual income were almost identical until 1933. Sutherland, A Brief Description of Federal Taxes on Corporations Since 1881, 7 LAW & CONTEM. PROBS. 266, 280 (1940). See also Statement of Dr. T.S. Adams, supra note 23, at 37. After 1933, during the Depression, the treatment of losses, not gains, was the focus of attention. See TREASURY STUDY, supra note 12, at 36-38, 40. Nonetheless, when business assets, particularly corporate gains, were scrutinized during World War II, only real and depreciable business property were targeted for preferential capital gains treatment. See A.L.I., supra note 4, at 353-54. See generally Chirelstein, supra note 24, at 36-43 (discussing capital gains treatment of business-related securities and terminated contracts); A.L.I., supra note 4, at 2-4, 59-65, 347-63 (capital gains treatment of business property).

Uncertainty about the proper treatment of business assets is illustrated by cases dealing with whether investment assets such as stocks and bonds are ordinary assets when acquired to ensure a source of supply or a market for the taxpayer's goods. In W.W. Windle Co. v. Commissioner, 65 T.C. 694, 708-10 (1976), appeal dismissed, 550 F.2d 43 (1st Cir.), cert. denied, 431 U.S. 966 (1977), the tax court reviewed 17 prior cases, all but 4 of which held that these intangible investments were not capital assets. The tax treatment of such assets may have been determined more by the fact that the cases usually involve deductibility of losses, than by any theory regarding the status of business assets as ordinary or capital. Only one of the cases cited in Windle (Agway Inc. v. United States, 524 F.2d 1194 (Ct. Cl. 1975)) involved gain. That the cases usually involve losses is relevant—there is little reason to limit capital loss deductions absent a serious risk of taxpayer manipulation such as attempts to realize gain in low tax bracket years and loss in high bracket years. See TREASURY STUDY, supra note 12, at 61-63; L. SELTZER, supra note 20, at 187-88. If a court finds minimal opportunity for manipulation where a taxpayer incurs a loss on an investment intended to ensure a source of supply or a market, and losses rather than gains are expected to predominate, allowing ordinary loss treatment through the only technique available to the court—the denial of capital asset status—is reasonable. On the other hand, if the court were to assume that most such losses are the result of taxpayers concealing ordinary gain, it might find capital asset status, thereby invoking the capital loss limitations. See W.W. Windle Co., 65 T.C. at 712-13, Rev. Rul. 78-94, 1978-1 C.B. 58, 58; Note, A Spreading of Receipts Formula, supra note 24, at 734-35.
an investment has been significant in defining capital assets involve the sale of a contract right. These cases involve the taxpayer's right to earn money by performing personal services as an employee or independent contractor, or by selling or buying business property. The absence of an investment usually justifies denying the capital gains preference, but in rare con-

164. See generally, Chirelstein, supra note 24 (analyzing tax consequences of premature termination of business contracts); Eustice, supra note 139 (discussing Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962)); A.L.I., supra note 4, at 195-225, 292-95 (reviewing capital gains treatment of contract rights transfers).


166. See Furrer v. Commissioner, 566 F.2d 1115, 1117 (9th Cir. 1977) (agency contract with insurance company produced ordinary income), cert. denied, 437 U.S. 903 (1978); Flower v. Commissioner, 61 T.C. 140, 149 (1973) (promotion and sales representation contract produced ordinary income), aff'd mem., 505 F.2d 1302 (5th Cir. 1974); Vaaler v. United States, 454 F.2d 1120, 1122-23 (8th Cir. 1972) (agency contract with insurance company produced ordinary income); Elliott v. United States, 431 F.2d 1149, 1154-57 (10th Cir. 1970) (same); Bankers Guar. Title & Trust Co. v. United States, 418 F.2d 1084, 1085-86 (6th Cir. 1969) (mortgage service contract produced ordinary income); General Guar. Mortgage Co. v. Tomlinson, 335 F.2d 518, 520-21 (5th Cir. 1964) (same); United States v. Woolsey, 326 F.2d 287, 291-92 (5th Cir. 1963) (agency contract with insurance company produced ordinary income); Hyatt v. Commissioner, 325 F.2d 715, 716 (5th Cir. 1963) (same), cert. denied, 379 U.S. 832 (1964); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929, 932-35 (5th Cir. 1963) (mortgage servicing contract produced ordinary income); United States v. Eidson, 310 F.2d 111, 115-17 (5th Cir. 1962) (agency contract with insurance company produced ordinary income), modified, 312 F.2d 744 (5th Cir. 1963); Holt v. Commissioner, 303 F.2d 687, 691 (9th Cir. 1962) (motion picture producer's share of profits for producing films deemed ordinary income); General Artists Corp. v. Commissioner, 205 F.2d 360, 361 (2d Cir.) (exclusive booking agency produced ordinary income), cert. denied, 346 U.S. 866 (1953); Kathman v. Commissioner, 50 T.C. 125, 129 (1968) (right to future sales commissions deemed as ordinary income); King Broadcasting Co. v. Commissioner, 48 T.C. 542, 552 (1967) (contract to transmit recorded music produced ordinary income); Paul Small Artists, Ltd. v. Commissioner, 37 T.C. 223, 227-28 (1961) (theatrical agency contract produced ordinary income). But cf. Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897, 901 (5th Cir. 1972) (mortgage servicing contract produced capital gain); Jones v. Corby, 186 F.2d 450, 452 (10th Cir. 1950) (insurance agency contract produced capital gain). Moreover, good will created by personal services is "property" eligible for capital gains. See infra note 195 and accompanying text.

167. See Commissioner v. Starr Bros., 204 F.2d 673, 674 (2d Cir. 1953) (payment received by wholesaler for releasing rights to exclusive distributorship taxed as ordinary income); Spray Water Power & Land Co. v. Commissioner, 30 T.C.M. (P-H) 376, 381 (1961) (payment to seller of water in exchange for release from obligation to buy taxed as ordinary income).


169. Norton v. United States, 551 F.2d at 826-27; see Holt v. Commissioner, 303 F.2d
tract right cases where investment has been proven, the capital gains preference was allowed. The investment criterion also explains the Supreme Court's decision that a landlord was ineligible for the capital gains preference on payment made by a tenant in exchange for release from a rental agreement after market rentals had plunged during the Depression. Although the Court stressed that the payment was a substitute for future income, the decision is best explained by the fact that the landlord had no investment in the premium lease itself. The absence of investment also explains the denial of the capital gains preference to the taxpayer selling blood or a right of privacy.

Practical application of the investment criterion may be difficult. While the contract itself may not involve an investment, the taxpayer may have made other investments to enable him to engage in the business that has generated the contract. For example, if investment in a distributorship entitles the taxpayer to capital gains, why should the investment in an underlying business not...

687, 691 (9th Cir. 1962); Commissioner v. Pittston Co., 252 F.2d at 348; Spray Water Power & Land Co. v. Commissioner, 30 T.C.M. (P-H) at 380–81; A.L.I., supra note 4, at 53, 190, 214.

170. See Martin v. Commissioner, 50 T.C. 341, 362 (1968); I.R.C. § 1241 (1976); see also Commissioner v. Goff, 212 F.2d 875, 876 (3d Cir.) (taxpayer invested in machines and contracted for percentage of profits from their use; sale of profit right produced capital gains), aff'd, 348 U.S. 829 (1954).

The conversion of future personal service income into capital gains through the use of corporate stock is inconsistent with contract right cases denying capital gains. See Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv. L. Rev. 985, 1003 (1956). When stock received for personal services is included in taxable income, however, the taxpayer has in effect received taxable cash and invested it in stock. The stock is then properly considered a capital asset. Cf. I.R.C. § 83(b) (1976) (election to include stock as ordinary income prior to statutory time limit results in capital gain on future stock appreciation).


172. Cf. Commissioner v. Gillette Motor Transp., 364 U.S. 130, 135 (1960) ("the right to use is not a capital asset, but is simply an incident of the underlying physical property").

173. See United States v. Garber, 589 F.2d 843, 847–48 (5th Cir. 1979). The dissent would have allowed the capital gains preference if the taxpayer could have proven an investment. See id. at 850 (Clark, J., dissenting). On rehearing en banc, 607 F.2d 92, 97 (5th Cir. 1979), Judge Clark wrote for the majority that basis may necessarily have equalled value. The dissent correctly pointed out that this statement was transparently erroneous. See id. at 103–04; see also A.L.I., supra note 4, at 126–27 (recommending that income from disposition of patents and copyrights be treated as ordinary income); Note, A Spreading of Receipts Formula, supra note 24, at 744.


be attributable to an exclusive purchase contract?\textsuperscript{176} Furthermore, why should the taxpayer's investment in education not be attributable to personal service contracts? The explanation may lie in the investment criterion's purpose of encouraging out-of-pocket investment.\textsuperscript{177} When there has been no investment in the contract itself, preferential treatment upon disposition of a favorable contract incidental to the underlying investment should depend on a demonstration that the prospect of such preferential treatment influenced the original investment. Since such a generalization would be difficult to sustain, preferential capital gains treatment might only be allowed when the taxpayer sells the underlying investment along with the contract,\textsuperscript{178} because denying capital gains on such a liquidating disposition might deter the initial investment.\textsuperscript{179}

Whether the investment criterion successfully explains the results in contract right cases depends on determining that no other explanation works as well. Consider as alternative explanations

\textsuperscript{176} See A.L.I., \textit{supra} note 4, at 59–60 (this should be done "on the view that the particular asset need not qualify as an 'investment-type' asset since the business as a whole represents an investment"); cf. Michaels v. Commissioner, 12 T.C. 17, 19 (1949) (covenants not to compete are capital assets if incidental to transfer of good will).

\textsuperscript{177} See \textit{supra} notes 40–42 and accompanying text.

\textsuperscript{178} But cf. King Broadcasting Co. v. Commissioner, 48 T.C. 542, 547–50 (1967) (sale of personal service contract produced ordinary income because it was not ancillary to simultaneous sale of franchise which was a capital asset).


Other hints of a distinction between liquidating and nonliquidating dispositions of business assets support the view that nonliquidating sales produce ordinary gain. First, only liquidating bulk sales of inventory are eligible for favorable treatment under I.R.C. § 337(b)(2) (1976). Second, nonliquidating dividends of inventory may be taxed to the distributing corporation. United States v. Lynch, 192 F.2d 718, 721–22 (9th Cir. 1951), \textit{cert. denied}, 343 U.S. 934 (1952). Third, the liquidation-nonliquidation distinction appeared in some early cases involving net operating loss carryovers; these cases included nonliquidating, but not liquidating, losses on business assets in the definition of preferentially treated net operating losses. \textit{See}, e.g., Independent Brick Co. v. Commissioner, 11 B.T.A. 862, 868–69 (1928); Phillip Kobbe Co. v. Commissioner, 4 B.T.A. 663, 664 (1926). However, the government objected to treating either type as net operating losses, I.T. 1943, 3-1 C.B. 65, 66–67 (1924), and courts interpreting a later statute agreed. \textit{See}, e.g., Ford v. Commissioner, 31 T.C. 119, 123 (1958).
the transferability and risk criteria. The courts' refusal to treat contract rights as capital assets might be based as much on the transferability criterion as on the lack of investment. In most of these cases, the future income period under the contract is so short that no lock-in effect occurs;\textsuperscript{180} on the other hand, in a case involving a contract right to perform personal services which extended for the life of a surviving partner in the personal service business, the court found capital gains on disposition of the right.\textsuperscript{181} Likewise, the sale or exchange requirement, which is frequently invoked to deny capital gains when a contract right is released to another party to the contract,\textsuperscript{182} might be explained by the transferability criterion. This explanation flows from the premise that the release indicates the right is not easily transferable, so that the capital gains preference, intended to overcome obstacles to transferability, becomes unnecessary.\textsuperscript{183} The difficulty with the transferability explanation for sale of contract rights

\textsuperscript{180} See, e.g., Vaaler v. United States, 454 F.2d 1120, 1121 (8th Cir. 1972) (contract terminable at will upon 60 days' notice); Elliott v. United States, 431 F.2d 1149, 1150 (10th Cir. 1970) (contract terminable at will on 30 days' notice); Bankers Guar. Title & Trust Co. v. United States, 418 F.2d 1084, 1085 (6th Cir. 1969) (at will); United States v. Eidson, 310 F.2d 111, 112 (5th Cir. 1962) (6½ years); Leh v. Commissioner, 260 F.2d 489, 490–92 n.3 (9th Cir. 1958) (½ year); Commissioner v. Pittston Co., 252 F.2d 344, 345–46 (2d Cir. 1958) (4½ years); Commercial Solvents Corp. v. United States, 427 F.2d 749, 751 (Ct. Cl. 1970) (8 years); Foxe v. Commissioner, 53 T.C. 22, 22–24 (1969) (2½ years); Paul Small Artists, Ltd. v. Commissioner, 37 T.C. 223, 224–26 (1961) (2 years); Jessop v. Commissioner, 16 T.C. 491, 493 (1951) (3½ years); Gann v. Commissioner, 41 B.T.A. 388, 392–93 (1940) (7½ years); McFall v. Commissioner, 34 B.T.A. 108, 109 (1936) (2½ years); see also Chirelstein, supra note 24, at 33.

\textsuperscript{181} See Jones v. Corby, 186 F.2d 450, 451 (10th Cir. 1950). This case is generally considered an aberration. See Commissioner v. Ferrer, 304 F.2d 125, 130 (2d Cir. 1962).

\textsuperscript{182} See Leh v. Commissioner, 260 F.2d at 494 (purchase contract); General Artists Corp. v. Commissioner, 205 F.2d 360, 361 (2d Cir. 1953) (exclusive agent); Commissioner v. Starr Bros., Inc., 204 F.2d 673, 674 (2d Cir. 1953) (same); Paul Small Artists, Ltd. v. Commissioner, 37 T.C. at 228 (same); see also A.L.I., supra note 4, at 196, 199, 201, 207; Chirelstein, supra note 24, at 11; Eustice, supra note 139, at 3–4.

\textsuperscript{183} Merely because a contract right is released does not mean that it is not transferable. Criticism of mechanical applications of the sale or exchange criterion is therefore justified, see Commissioner v. Ferrer, 304 F.2d at 131; A.L.I., supra note 4, at 292–95; Chirelstein, supra note 24, at 32–33; Eustice, supra note 139, at 6–7 n.17, 19–20 n.49, because the choice between sale and release of transferable assets should not be distorted by tax law, cf. I.R.C. § 165(g)(1) (1976) (providing for capital loss treatment when capital asset securities become worthless). Many personal service contracts and rights to distributorships may not be assignable, at least not without the consent of the other party, and some of the cases involve such contracts. See, e.g., United States v. Eidson, 310 F.2d 111, 112–13 (5th Cir. 1962) (consent needed for assignment of agency contract; ordinary income); see also Elliott v. United States, 431 F.2d at 1150 (same); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929, 931 (5th Cir. 1963) (mortgage servicing contract nonassignable but assignment customarily allowed; ordinary income); cf. Gann v. Commissioner, 41 B.T.A. at 396–97 (contract for personal services cannot be sold). But see Nelson Weaver Realty Co.
cases is that the capital gains preference is usually disallowed when the income period is long and the lock-in effect therefore serious.\textsuperscript{184} Moreover, the sparse case law on the relevance of contract length to capital gains treatment has been contradictory.\textsuperscript{185}

Alternatively, the risk criterion might better explain sale of contract right cases than the investment criterion. The gain upon disposition of a contract right is usually the gain accruing to the taxpayer's risk upon entering the contract.\textsuperscript{186} However, sale proceeds may not always be a reward for economic risk. Where sellers can enter many contracts based on the same underlying property or services, the price for foregoing an advantageous contract right will be based not only on the difference between the high contract price and the lower market value of the contract's subject matter, but also on the market value of the subject matter itself.\textsuperscript{187}

In the context of a family corporation, payments made upon retirement of a controlling employee would not be limited to gain on the employment contract but might include some of the salary which he could earn by working elsewhere. Moreover, parties to a contract might have made commitments which they cannot avoid when they give up their contract or property rights.\textsuperscript{188} For example, a seller might be locked into a contract to purchase raw materials even though he has sold his long term contract to supply goods made from the raw materials. Since such unavoidable expenses may later be deducted as ordinary deductions, the proceeds of the sale of contract rights do not equal the taxpayer's gain on investment, but should instead be taxed as ordinary income to the extent necessary to offset ordinary deductions.\textsuperscript{189}

\textsuperscript{184} See United States v. Woolsey, 326 F.2d 287, 289 (5th Cir. 1963) (capital gains preference disallowed upon disposition of contract rights on 19-year contract); Flower v. Commissioner, 61 T.C. 140, 145-49 (1973) (same), aff'd mem., 505 F.2d 1302 (5th Cir. 1974); Spray Water Power & Land Co. v. Commissioner, 20 T.C.M. (CCH) 353, 355 (1961) (no preference when contract period was over 900 years). \textit{But see} Jones v. Corby, 186 F.2d at 452.


\textsuperscript{186} See A.L.I., supra note 4, at 209-10 n.19; Chirelstein, supra note 24, at 26-32.

\textsuperscript{187} J. CALAMARI & J. PERILLO, CONTRACTS 541-42 (2d ed. 1977).

\textsuperscript{188} This may well have been the case in Metropolitan Bldg. Co. v. Commissioner, 31 T.C. 971, 973-74 (1959), \textit{rev'd}, 282 F.2d 592 (9th Cir. 1960), where a portion of the sale proceeds seems to have been compensation for unavoidable expenses.

\textsuperscript{189} The proceeds are analogous to prepaid income, to be offset by future deductible expenses. The taxpayer can only hope to defer tax on the prepayment. \textit{Cf.} Treas. Reg.
The situations where sale proceeds are not rewards for economic risk are too uncommon, however, to explain the denial of the capital gains preference in most contract right cases. Certainly, courts have never based their decisions on such narrow grounds. Thus, the investment criterion theory—not transferability or risk—must be seriously considered as the best explanation for the ordinary income treatment of contract right sales.

The most serious problem with accepting the investment criterion is that while it is a factor in contract right sales, it virtually vanishes where property rights are sold. The sale of traditional property rights such as landlords' or tenants' rights under a lease, the right to use a patent, or the option to acquire property which is itself a capital asset, results in capital gains, apparently without regard to the investment criterion. Even the good will of a personal service business is a capital asset. To be sure, the investment criterion is occasionally relevant in property right

§ 1.451-5(b), (c) (1976) (prepayment for goods and long term contracts); Rev. Proc. 71-21, 1971-1 C.B. 549, 549 (prepayment for services).

190. A few of the cases denying capital gains treatment may be explained by the fact that they involved unspecified mixtures of accrued ordinary income and future income rights. See, e.g., United States v. Eidson, 310 F.2d at 116; Holt v. Commissioner, 303 F.2d 687, 689 (9th Cir. 1962); General Artists Corp. v. Commissioner, 205 F.2d at 361; Paul Small Artists, Ltd. v. Commissioner, 37 T.C. at 227; see also Chirelstein, supra note 24, at 26. The taxpayer's failure to separate out any capital asset element should justify taxing the entire gain as ordinary income. None of these cases, however, suggest a willingness to permit the taxpayer to allocate.

191. See Metropolitan Bldg. Co. v. Commissioner, 282 F.2d at 594 (lessor's release of entire interest to lesee qualifies for capital gains preference); Miller v. Commissioner, 48 T.C. 649, 655 (1967) (same).

192. See Commissioner v. McCue Bros. & Drummon, Inc., 210 F.2d 752, 753 (2d Cir.) (lessee surrendered lease to lessor; capital gain), cert. denied, 348 U.S. 829 (1954); Commissioner v. Ray, 210 F.2d 390, 391-92 (5th Cir.) (lessee released lessor from obligation under restrictive covenant; capital gain), cert. denied, 348 U.S. 829 (1954); Commissioner v. Golonsky, 200 F.2d 72, 73-74 (3d Cir. 1952) (lessee surrendered lease to lessor; capital gain), cert. denied, 345 U.S. 939 (1953); see also Kingsbury v. Commissioner, 65 T.C. 1068, 1083-87 (1976) (personal service arrangement interpreted as lease; capital gain); I.R.C. § 1241 (cancellation of lease treated as sale).

193. See United States v. Dresser Indus., 324 F.2d 56, 59-61 (5th Cir. 1963) (payment to licensee who surrendered license to licensor treated as capital gain).

194. See Dorman v. United States, 296 F.2d 27, 30-31 (9th Cir. 1961) (surrender of option to acquire partnership interest produced capital gain); Fraser v. Commissioner, 64 T.C. 41, 51 (1975) (same). But see Saunders v. United States, 450 F.2d 1047, 1049 (9th Cir. 1971) (sale of real estate option where coinvestors had buy-out rights produced ordinary income).

195. Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1967); Johnson v. Commissioner, 53 T.C. 414, 426 (1969); Kenney v. Commissioner, 37 T.C. 1161, 1173 (1962); Aitken v. Commissioner, 35 T.C. 227, 230 (1960); see also Nelson Weaver Realty Co. v. Commissioner, 307 F.2d at 901 (capital gains preference allowed on sale of mortgage service contract) (explained in United States v. Eidson, 310 F.2d 111, 116 (5th Cir. 1962), as
cases. Where the asset is the right to block another's use of property, the absence of investment may foreclose capital gains treatment.\textsuperscript{196} Similarly, the absence of investment in a premium lease led at least one court to decide that sale of the lease to a tenant produced ordinary income.\textsuperscript{197} Generally, however, investment is not a prerequisite for capital gains treatment of property rights.\textsuperscript{198}

One explanation for the pervasive capital gains treatment of property rights is that traditional property law concepts have been blindly imported into the tax law.\textsuperscript{199} Even if that is true, however, the role of property law in defining capital assets has been very limited—property law doctrine has frequently given way to tax doctrine.\textsuperscript{200} It may well be that no principled, rational reason exists for abandoning the investment criterion when property rights are sold. For those schooled in the common law tradition, however, this concession is difficult to make. Even doctrinal confusion—which often arises when an old principle has weakened prior to agreement on a new principle—may signify that a rational process is at work. Here, the old principle is that the capital gains preference requires both investment and risk; the new principle is that risk alone determines eligibility for the preference. Until the new principle supplants the old, however, courts might exploit weaknesses in the existing doctrine rather than discard it completely.

involving good will); Rev. Rul. 70-45, 1970-1 C.B. 17 (whether good will has been transferred is question of fact).


197. Hort v. Commissioner, 39 B.T.A. 922, 926 (1939), aff'd, 313 U.S. 28 (1941). The government's Supreme Court brief in this case argued that the lease was merely contractual and not a property right. Brief for Respondent at 10, \textit{Hort}.

198. Moreover, property rights are deemed capital assets notwithstanding the absence of a serious lock-in effect. See \textit{supra} notes 49–51 and accompanying text. One of the earliest cases involving the sale of a property right, Sutliff v. Commissioner, 46 B.T.A. 446, 447–48 (1942), may have involved a serious lock-in effect because the lease which was sold extended for the lessee's life. Cf. Jones v. Corbyn, 186 F.2d 450, 452 (10th Cir. 1950) (contract right extending for life of surviving partner is capital asset). However, courts subsequently have ignored the transferability criterion. See \textit{supra} note 49 and accompanying text.

199. The domination of property law over tax law seems especially strong in the area of life estates. See Estate of Camden v. Commissioner, 47 B.T.A. 926 (1942) (carved-out income interest in life estate is capital asset), aff'd \textit{per curiam}, 139 F.2d 697 (6th Cir. 1943).

One technique is to incorporate property law concepts into tax law so that property rights are deemed capital assets regardless of the presence of investment. Another is to effect a compromise by allocating between capital gain and ordinary income, as courts have done where good will is sold with a contract right. A similar compromise was effected by the Ferrer court, which allocated proceeds from the sale of a play. The court afforded capital gains treatment to the sale of production rights and veto rights preventing the play's exploitation through other media, but treated as ordinary income that portion of the proceeds derived from the sale of future motion picture profit rights. The entrepreneurial nature of the taxpayer's dealings undoubtedly helped induce the Ferrer court's compromise. One conclusion to be drawn from the confusing array of approaches presented here is that the investment criterion, like the lock-in criterion, may be losing its significance in defining capital gains.

V. SOME CONCLUSIONS AND A LOOK AHEAD

The deep structure of the capital gains preference encourages transferability, risk, and investment. This much is apparent from the history and development of capital gains doctrine. Although the doctrine should mediate creatively between statutory language and structure, it has not done so. Serious lock-in ef-

201. See Bankers Guar. Title & Trust Co. v. United States, 418 F.2d 1084, 1086 (6th Cir. 1969); General Guar. Mortgage Co. v. Tomlinson, 335 F.2d 518, 521 (5th Cir. 1964); United States v. Woolsey, 326 F.2d 287, 292 (5th Cir. 1963); Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929, 934-35 (5th Cir. 1963); Realty Loan Corp. v. Commissioner, 54 T.C. 1083, 1093 (1970), aff'd on other grounds, 478 F.2d 1049 (9th Cir. 1973). But see Ferrer v. Commissioner, 566 F.2d 1115, 1117-18 (no good will in personal service contract), cert. denied, 437 U.S. 903 (1978); Vaaler v. United States, 454 F.2d 1120, 1123 (8th Cir. 1972) (same); Elliott v. United States, 431 F.2d 1149, 1154 (10th Cir. 1970) (same); Foxe v. Commissioner, 53 T.C. at 26 (ordinary income).

Perhaps the high water mark of permitting capital gains on the sale of a personal service contract was reached in Bankers Guar. Title & Trust Co. v. United States, 290 F. Supp. 522, 527 (N.D. Ohio), aff'd, 418 F.2d 1084 (6th Cir. 1969). The district court held that a contract terminable at will had value and was a capital asset because it had been frequently renewed. Renewal is evidence of good will but the contract itself cannot have value.


204. See supra notes 39-43 and accompanying text.
205. See supra text accompanying note 43.
fect has not been a prerequisite to capital gains treatment,\textsuperscript{206} and the retained income interest rules do little to require risk shifting.\textsuperscript{207} Giving ordinary income treatment to proceeds of a sale of a carved-out income interest correctly taxes some of the relatively riskless income accruing to the remainderman, but overtaxes the remainderman by accelerating the tax payment.\textsuperscript{208} Finally, judicial doctrine regarding the sale of a contract right is hopelessly confused. The courts appear to require an investment, but that requirement may be waived when the taxpayer sells an entire property interest, including property whose value derives from personal services.\textsuperscript{209}

Are these criticisms of the capital gains rules too harsh? After all, overbreadth and underbreadth are often the necessary price of workable rules. Is current doctrine the best alternative because a more precise meshing of doctrine and policy is too difficult? The case favoring the current rules would emphasize a wide variety of factors. For one, why should so much solicitousness be shown taxpayers selling carved-out income interests? These sales are too unlikely to serve useful economic goals to warrant the efforts involved in treating the transaction as a sale—allocating basis to the income interest, computing income accruing to the remainderman, and measuring the seriousness of obstacles to transferability. Furthermore, taxing the sale of a contract right as ordinary income is acceptable for two reasons: investment is usually lacking,\textsuperscript{210} and the lock-in effect is minimal.\textsuperscript{211} The underbreadth of the rules dealing with risk transfer, and the complete indifference to calculating the lock-in effect can also be justified by a combination of administrative and economic considerations; here the advantage lies with the taxpayer on the theory that the extra administrative effort might discourage economically useful transactions.\textsuperscript{212}

However, claims that administrative difficulty justifies a poor fit between legal rules and underlying policy should be suspect. Immense complexity is tolerated when it seems worthwhile.\textsuperscript{213} Moreover, it is too easy to assume that application of an adminis-

\textsuperscript{206} See \textit{supra} notes 44–64, 83–84, and accompanying text.
\textsuperscript{207} See \textit{supra} notes 70–82 and accompanying text.
\textsuperscript{208} See \textit{supra} text accompanying note 143.
\textsuperscript{209} See \textit{supra} notes 191–98 and accompanying text.
\textsuperscript{210} See \textit{supra} notes 164–74.
\textsuperscript{211} See \textit{supra} notes 180–85 and accompanying text.
\textsuperscript{212} See \textit{supra} notes 77–82, 159–62, and accompanying text.
trative solution is as complicated as the analytical route by which the solution is reached. This Article has sought to show that, with a few simple but acceptable assumptions, the remainderman's income and the period of income flow creating excessive lock-in effects can indeed be computed.\textsuperscript{214} Therefore, factors other than avoiding complexity must explain the mismatch between doctrine and structure.

First, the necessary computations are unfamiliar to lawyers and judges. They depend to a large extent on discounting future income to account for the time value of money—a consideration that has been difficult to incorporate into tax policy analysis. Despite growing attention to such computations in the basic law school tax course,\textsuperscript{215} many students remain uncomfortable with such reasoning.\textsuperscript{216} Of at least equal importance is the fact that basing rules on such computations may so mystify the affected public as to deprive the rules of acceptability, despite the efforts of those who strive to overcome these difficulties.\textsuperscript{217}

Second, there are institutional obstacles to adopting the rules proposed in this Article. The rules are based on bright-line distinctions that must vary over time, and thus would be difficult for courts to embrace on their own. The measurement of income accruing to a remainderman and lock-in effect varies with discount rates; both must be periodically identified by an administering agency. Courts disposed to undertaking the lock-in analysis presented in this Article, for example, could do little more than identify extreme cases of the presence or absence of lock-in effect,\textsuperscript{218} decide how to treat these extreme cases, and place the rest on the other side of the line. The computation of income accruing to the remainder interest would also be an unfamiliar judicial task, being essentially an accounting problem usually left to the

\textsuperscript{214} See supra notes 64, 159.


\textsuperscript{216} Cf. Note, supra note 24, at 755 (commenting on lawyers' unfamiliarity with mathematics).

\textsuperscript{217} Several Regulations make use of such computations. See, e.g., Treas. Reg. § 1.170A-12(e)(2) (1975); § 1.483-1(c)(3) (1980); § 1.1232-3(b)(2)(ii)(d) (1981).

\textsuperscript{218} Such would be the case when very long or very short periods of income are sold.
Internal Revenue Service.\textsuperscript{219}

Third, judges seem reluctant to incorporate an economic justification for capital gains into their analysis, and instead argue that the preference is justified on fairness considerations stemming from income bunching.\textsuperscript{220} Perhaps courts are compelled for institutional reasons to rationalize results on fairness instead of economic grounds. Whatever the judicial tendencies might be, however, the development of tax expenditure analysis has established economic policy as part of the tax law's fabric from which courts can reason in interpreting the law.\textsuperscript{221}

Finally, the growth of capital gains doctrine may be evaluated from a different perspective—instead of basing the mismatch between doctrine and structure on institutional considerations affecting courts, administrators, and the tax bar, one might accept the unfolding of substantive rules at face value and try to understand them as the result of a creative dialogue between the legislature and the courts. The initial legislative emphasis on transferability and out-of-pocket investment has been weakened on its way through the adjudicative process so that these criteria are now only sporadically applied, but the vitality of the risk factor continues unabated.\textsuperscript{222} The absence of risk is the core of the sale of a carved-out income interest doctrine,\textsuperscript{223} which is otherwise inexplicable; the presence of risk explains the curious extension of capital gains treatment to property interest transactions lacking out-of-pocket investment, as well as the willingness of some courts to find part capital gain, part ordinary income when a personal service business disposes of a valuable right to future income.\textsuperscript{224} What the courts may really be saying is that risk may be taken in many forms, so that selectively excluding some of them from the capital gains preference would be unfair, and that courts have a role in the dialogue from which the deep structure of the capital gains preference evolves.


\textsuperscript{220} See supra note 12 and accompanying text.


\textsuperscript{222} See supra notes 85–92 and accompanying text.

\textsuperscript{223} See supra notes 127–29 and accompanying text.

\textsuperscript{224} See supra text accompanying note 201.