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Gain from the Sale of an Income Interest in a Trust

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GAIN FROM THE SALE OF AN INCOME INTEREST IN A TRUST

Douglas A. Kahn

A tax doctrine that is related to the anticipatory assignment of income doctrine, but yet different from that doctrine is variously referred to as the “substitute for ordinary income doctrine” or the “anticipation of income doctrine.” This latter doctrine arises on the sale of an item. The test often utilized to determine whether that latter doctrine applies is whether the sale of an item substantively represents the receipt of a substitute for future income — i.e., are the proceeds of the sale given “in lieu of” ordinary income that the seller would have otherwise received at a later date. The “substitute for ordinary income” concept is not only used to characterize the doctrine itself but also is used to describe the test used to determine whether the doctrine applies. One of the points made in this article is that the “substitute for ordinary income” concept is useless as a test. Courts that have purported to apply that concept recently have recognized that the concept is too broad, and so they have fashioned standards to be applied to distinguish when the doctrine is applicable from when it is not. The article points out that it is the standards themselves that are the tests, and the “substitute for ordinary income” concept plays no role and is a distraction. Several of the standards are discussed — especially the retention of a residual interest standard.

There is established authority that the doctrine does not apply to the sale of a term interest in a trust when the seller does not retain any interest in the trust; and therefore the seller will receive capital gain treatment on such sales. Several courts have questioned that holding recently; one of which suggested that the holding was no longer valid. In this article, the author concludes that the holding is still valid and so the gain from such sales is a capital gain. The author also defends capital gain treatment for such sales of a term interest in a trust as

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proper under tax policy considerations.

TABLE OF CONTENTS

I. INTRODUCTION ................................................................. 446

II. SALE OF INCOME — PRODUCING PROPERTY ......................... 447

III. RETENTION OF A RESIDUAL INTEREST ............................... 448

IV. "SUBSTITUTE FOR ORDINARY INCOME" DOCTRINE OR "IN LIEU OF INCOME" TEST .............................. 450

V. SALE OF AN UNDIVIDED FRACTIONAL INTEREST ..................... 451

VI. SALE OF AN INCOME INTEREST WHERE NO RESIDUAL INTEREST IS RETAINED ..................................... 452

VII. THE LATTERA DECISION .................................................... 454

VIII. POLICY CONSIDERATIONS FOR TREATMENT OF GAIN FROM THE SALE OF AN INCOME INTEREST IN A TRUST ....... 457

IX. CONCLUSION ..................................................................... 464

I. INTRODUCTION

Instead of assigning income to another person in the hope that the income will be taxed to the assignee, a taxpayer might sell the right to income in an attempt to convert ordinary income to capital gains and to utilize his basis in the underlying property to offset some of the amount realized. The doctrine that has been employed to prevent that abuse has been given various names, one of which is the "substitute for ordinary income" doctrine.¹ For reasons noted below, I prefer to designate that doctrine as the "anticipation of income" doctrine; and I will refer to the doctrine by that name throughout this article.

This article will focus on the question of whether gain recognized on the sale of an income interest in a trust will qualify for capital gain

¹ See, e.g., United States v. Maginnis, 356 F.3d 1129 (9th Cir. 2004).
treatment when the transferor does not retain a residual interest in the transferred property. The principal obstacle to capital gain treatment for such sales is the anticipation of income rule, and so a discussion of that topic comprises a significant part of the article. In addition to concluding that the sale of an income interest in a trust generally will produce capital gain when the residual interest rule does not apply, the article will address the question of whether capital gain treatment for such sales conforms to the tax policy for allowing capital gain treatment.

In determining whether the anticipation of income rule applies to a specific circumstance, courts often purport to apply a “substitute for ordinary income” test, which was advanced by the Supreme Court in 1941.\(^2\) It is the position of the author that that test serves no useful purpose. Perhaps, the substitute for ordinary income doctrine should be considered merely a synonym for the anticipation of income rule. That is, it is a term to describe a consequence rather than a term for a test or standard for determining when that consequence takes place.

II. SALE OF INCOME-PRODUCING PROPERTY

Any item of property is capable of producing income. If the sale of all income-producing property were to constitute an anticipation of income and thereby cause ordinary income treatment, it would extend the rule too far and would virtually eliminate capital gain treatment. Consequently, the sale of all of the rights to an item of property will not be subject to that rule in most cases.

One circumstance in which the anticipation of income rule will apply is when the sale of an item of property includes the right to receive income that had already been earned.\(^3\) In such circumstances, part of the purchase price will be treated as having paid for that earned income and so will be separated and treated as ordinary income to the seller.\(^4\) Even in that latter case, the anticipation of income doctrine will not always apply. The income earned on the property generally has to have achieved an advanced stage for the rule to apply.

Another application of the anticipation of income doctrine arises when a taxpayer ("TP") sells an income interest in property and retains a residual interest in it. The amount received in that situation

\(^3\) See Helvering v. Eubank, 311 U.S. 122 (1940).
\(^4\) See, e.g., Storz v. Commissioner, 583 F.2d 972 (8th Cir. 1978).
will be treated as ordinary income.\(^5\)

III. RETENTION OF A RESIDUAL INTEREST

The residual interest principle refers to a situation where a TP carves out and sells an income interest in property from a larger property interest that the TP retains. For the principle to apply, the TP must have retained a right to enjoy the interest from which the sold portion was carved once that portion expires. Consequently, not every carved out interest triggers the anticipation of income rule. Only when the seller retains a residual interest in the very interest he sold does the rule apply.\(^6\)

A sale of a right to income from property in which the seller reserves a residual interest, no matter how small that interest might be, will be subject to the anticipation of income rule. The amount that the seller receives from the sale will be treated as ordinary income; the seller will not be permitted to use any of his basis in the property to treat part of the purchase price as a recovery of capital.\(^7\)

For example, if G owns stock in X Corporation, and if G sold to L the right to dividends from the stock for the next fifteen years, the entire amount that G received from L as payment for the right to the dividends will be ordinary income to G. G’s basis in the stock cannot be used to reduce the amount of his gain on that sale, and G’s basis in the stock will not be changed by the sale.

In this example, G retained two residual interests in the income interest that he sold to L, and either one would have been sufficient to trigger the anticipation of income rule. Once the fifteen-year period in which L is entitled to dividends from the stock expires, the subsequent dividends from the stock will be paid to G. That right to the subsequent income constitutes a retained residual interest in the income interest that G sold to L. In addition, G retained the right to receive the principle of the stock on its sale or redemption.

The landmark case for the residual interest rule is the Supreme Court’s decision in Lake.\(^8\) Let us examine that decision.

Lake involved five consolidated cases. The facts of one of those cases are typical. The principal issue in that case concerned a transfer of an oil payment right to an officer of the transferor to compensate

\(^6\) See id.
\(^7\) Id.
\(^8\) Id.
the officer for his services. This constituted a sale of the oil payment right to the officer. An oil payment right is the right to a specified amount of money to be paid out of a specified percentage of the oil produced or the proceeds from the sale of that oil. In Lake, the oil payment right was a stated amount to be paid out of 25% of the oil attributable to the TP’s interest. At the time of assignment, it could be estimated with reasonable accuracy that the amount of the oil payment right would be paid out in approximately three years, and it actually was completed in a little more than three years. The transferor retained the right to the oil produced from all of its interest after the transferee had received the full amount of his oil payment right.

While the opinion in Lake refers to the substitute for ordinary income doctrine in concluding that the transferor recognized ordinary income on the sale, the key to the decision in that case is that the seller retained a residual interest in the property it transferred to the officer. In footnote 5 of the Court’s opinion, the Court quoted, with apparent approval, a 1950 ruling of the Commissioner which concluded that the sale of an oil payment right that extends over a period that is less than the life of the depletable interest from which it was carved will cause ordinary income to the seller; but the sale of an oil payment right that constitutes the entire depletable interest of the seller will cause capital gain to the seller. In other words, if the seller retains a residual interest, he will have ordinary income, but if he retains no residual interest he will have capital gain. This residual interest rule is sometimes referred to as the “carved out interest” rule; but the residual interest rule is a more precise designation.

Eleven years after Lake was decided, Congress changed the tax treatment of the “sale” of a right to a production payment. Congress concluded that the purported sale of such rights substantively was not actually a sale but rather was the obtaining of a nonrecourse loan secured by the mineral rights. Congress added section 636 to the Internal Revenue Code (“Code”) in 1969 to treat such transactions as nonrecourse loans. As the Service has acknowledged, however, the principles of the Lake decision remain applicable to other

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9 Id. at 261.
10 Id. at 262.
12 Id. at 264.
13 Id. at 266.
14 I.R.C. § 636.
circumstances in which the anticipation of income doctrine arises.\textsuperscript{15}

IV. "\textsc{Substitute for Ordinary Income}" \textsc{Doctrine} or "\textsc{In Lieu of Income}" \textsc{Test}

Some courts have utilized a so-called "in lieu of" test or a "substitute for ordinary income" doctrine for applying the anticipation of income rule. The landmark case that adopted that doctrine is \textit{Hort v. Commissioner}.\textsuperscript{16} The doctrine purports to provide a standard for determining whether all or part of the amount received on a sale of a property interest is actually a substitute for all or some of the income that the underlying property will produce.\textsuperscript{17} To the extent that the payment received is deemed a substitute for ordinary income to be produced by the property, it will be taxed as ordinary income under the anticipation of income rule.\textsuperscript{18}

While many courts have purported to apply the substitute for ordinary income doctrine, it actually is completely useless in determining whether the anticipation of income rule is applicable to a specific set of facts. Consider the following illustration, which is drawn from the \textit{Hort} case.

\begin{quote}
\textit{X} owns an office building. \textit{Y} is the principal tenant under a lease expiring in ten years. \textit{Y} desires to cancel the lease. \textit{X} agrees to release \textit{Y} from the lease in consideration of \textit{Y}'s payment to \textit{X} of $50,000. The entire $50,000 is ordinary income to \textit{X}; it was received by \textit{X} in lieu of the rent that \textit{Y} otherwise would have had to pay.\textsuperscript{19}
\end{quote}

Why do I say that the in lieu of test is useless? The value of any property is the present value of the income stream that the property is deemed capable of producing. The outright sale of any property (for example, corporate stock) can be seen as the sale of the income stream that that property will produce. So the purchase price for any property is a substitute for the income that the property can produce. Obviously, the fact that the payment represents a substitute for the future income that the property can produce does not prevent the seller from qualifying for capital gain treatment and for utilizing his basis in the property. If that were not so, there could be virtually no circumstances that qualify for capital gains treatment. Recognizing that the in lieu of test is too broad to be applied without modification,

\textsuperscript{15} I.R.S. Field Service Advisory, 1996 WL 33320880 (July 1, 1996).
\textsuperscript{16} 313 U.S. 28 (1941).
\textsuperscript{17} See id. at 31.
\textsuperscript{18} Id. at 30–31.
\textsuperscript{19} See Treas. Reg. § 1.61-8(b) (1960); Hort, 313 U.S. at 31–32.
courts have applied standards to determine when the rule is to be applied.\textsuperscript{20}

The better reason for treating $X$ as having ordinary income on the $50,000 receipt in this illustration is that $X$ still owns the building and thus continues to own the residual interest that will produce the future income.

As we will see, if a life income beneficiary sells her entire life income interest to an unrelated party, any gain or loss she recognizes will be a capital gain or loss.\textsuperscript{21} The payment received clearly is given for the income that the trust will produce since that is the only interest that the seller has to sell. Nevertheless, since the seller did not retain any residual interest in the property, the anticipation of income rule does not apply. Consider another illustration.

$X$ owned an apartment building, which was leased to $Y$ for fifteen years. $X$ sold to $Z$ for $30,000 his rights to receive annual rents from $Y$ under the lease, but $X$ retained his residual interest in the building. $X$ recognized $30,000 in ordinary income from the "sale." The retention of any residual interest by a seller will be sufficient to prevent the seller from enjoying capital gains treatment or utilizing his basis.\textsuperscript{22}

V. SALE OF AN UNDIVIDED FRACTIONAL INTEREST

What if, instead of selling a right to income from property in which the seller retains a residual interest, the seller were to sell an undivided fraction of all of his interest in the property? In that case, the anticipation of income rule will not apply. The seller will not have retained a residual interest in the property that he sold to the purchaser. This distinction is sometimes described by referring to the sale with a retained residual interest as a sale of a horizontal slice of the seller's property, whereas the sale of an undivided fractional share of the property is described as a sale of a vertical slice of the seller's property. Consider the following illustration.

$F$ owns a commercial building, which is leased to $N$ for fifteen years. As noted above, if $F$ sold to $P$ the right to rents from the property for the remainder of the term of the lease, the anticipation of income rule would apply. Instead, $F$ sells to $P$ one-third of his interest in the property including one-third of his right to collect rent under the lease. The sale of that fractional interest is not substantively

\textsuperscript{20} See, e.g., Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006).
\textsuperscript{21} See infra Part VI.
different from the situation where F sells all of his interest in the property since, in both situations, F retains no residual interest in the portion of the property sold to P. Consequently, the anticipation of income rule is not applicable.

VI. SALE OF AN INCOME INTEREST WHERE NO RESIDUAL INTEREST IS RETAINED

If a TP sells his entire interest in an item of property, or a fractional share of his entire interest, even if the TP's only interest is an income interest, the anticipation of income rule ordinarily will not apply. One possible exception to that exclusion might arise if the income interest that the TP owns has only a very brief period remaining.

The landmark case for this proposition is McAllister v. Commissioner. In that case, the TP inherited a life income interest in a trust. The TP sold her life income interest to the remainderman of the trust. The case came to the Second Circuit to resolve two issues: (1) in determining her gain or loss from the sale, should the TP be allowed to use the basis she acquired in the life income interest under the antecedent to Code section 1014 when she inherited that interest, and (2) should the gain or loss that the TP recognized from the sale of her life income interest be treated as a capital gain or loss. In a majority opinion, the Second Circuit answered both questions in the affirmative. The court held that TP could use her basis in the interest to measure her gain or loss, and any gain or loss she had was a capital gain or loss.

Congress subsequently amended the Code to override the court's determination that a TP could use her basis in determining gain or loss on such sales. Subject to one exception, section 1001(e) disallows the use of basis on the sale of a term interest if the basis was acquired in accordance with section 1014, 1015, or 1041 (i.e. acquired from a decedent, or by gift, or from a spouse). The one exception to that rule is that the TP can use her basis if her sale of a term interest is part of a transaction in which the entire interest in the property is transferred to another person or persons.

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23 157 F.2d 235 (2d Cir. 1946).
24 Id.
25 Id.
26 Id. at 237.
27 I.R.C. §§ 1001(e), 1014, 1015, 1041.
28 I.R.C. § 1001(e)(3).
Significantly, Congress did not pass any legislation altering the Second Circuit's decision that the TP's gain or loss on the sale of a life income interest is a capital gain or loss if the TP retains no residual interest. Moreover, the Service has promulgated a Revenue Ruling adopting the McAllister view that the sale of a life income interest qualifies for capital gain treatment.\textsuperscript{29} Last, the congressional decision to overturn one of the two holdings of the McAllister court and to leave undisturbed the other holding of that decision constitutes an implicit approval of the second holding.

In a number of recent cases, courts have uniformly held that when the winner of a lottery that provides an annuity (i.e. the right to receive annual payments over a specified period of years) sells the right to subsequent annuity payments, the seller recognizes ordinary income.\textsuperscript{30} Those courts rested their decisions on the "substitute for ordinary income" doctrine. In some of those cases, the sellers retained a residual interest in the annuity, and in some they did not. As we will see, the sellers will recognize ordinary income from such sales regardless of whether they retain a residual interest.\textsuperscript{31}

Several of the courts that imposed ordinary income treatment on the sale of the right to annuity payments questioned the current vitality of the McAllister decision on capital gains on the ground that it preceded Supreme Court cases adopting the substitute for ordinary income test.\textsuperscript{32} That issue is discussed below in connection with the discussion of the Lattera decision. Note, however, that the substitute for ordinary income doctrine was first adopted by the Supreme Court in 1941 in Hort,\textsuperscript{33} which predates McAllister by some five years and indeed was cited by the Second Circuit in its opinion in McAllister.

One of the courts that dealt with the sale of the annuity payments, the Third Circuit, expressly suggested that McAllister was wrongly decided and is not good law today.\textsuperscript{34} The Lattera decision is worthy of some discussion.

\textsuperscript{29} Rev. Rul. 72-243, 1972-1 C.B. 233.
\textsuperscript{30} Prebola v. Commissioner, 482 F.3d 610, 611 (2d Cir. 2007); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006); Watkins v. Commissioner, 447 F.3d 1269 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004).
\textsuperscript{31} See infra Part VII.
\textsuperscript{32} See, e.g., Clopton v. Commissioner, 87 T.C.M. 1217 (2004).
\textsuperscript{33} Hort v. Commissioner, 313 U.S. 28, 29 (1941).
\textsuperscript{34} Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006).
VII. THE LATTERA DECISION

The facts of Lattera were that the taxpayers won a state lottery having a value of more than nine million dollars.\(^{35}\) The winnings were required to be paid in twenty-six annual installments. In other words, the taxpayers received an annuity payable over a period of twenty-six years.\(^{36}\) After receiving nine of the installments, the taxpayers sold their right to the remaining seventeen installments for a lump sum of over three million dollars.\(^{37}\) The taxpayers reported the sales price as a long-term capital gain, listing their basis in the right to the installment payments as zero.\(^{38}\) The Third Circuit sustained the Commissioner’s determination that the amount the taxpayers received was ordinary income.\(^{39}\) The result that the court reached is correct, but its reasoning is faulty.

While ostensibly relying on the substitute for ordinary income doctrine, the court correctly observed that the doctrine cannot be applied indiscriminately or it would preclude capital gain treatment in virtually all situations.\(^{40}\) The court said that other standards had to be employed to determine when the substitute for ordinary income doctrine applied and when it did not.\(^{41}\) One fault with the Third Circuit’s decision lies with its use of the substitute for ordinary income doctrine at all. Since, as the court acknowledged, virtually all sales involve a substitute for future income, the standards that the court says are to be used to distinguish when the doctrine applies are the only standards that matter. In other words, the substitute for ordinary income doctrine adds nothing to the analysis of the issue; the standards ostensibly used to determine whether that doctrine applies are the only standards to determine whether the anticipation of income rule applies. The substitute for ordinary income doctrine has no useful function and constitutes a distraction.

The Third Circuit said that it was not prepared to set forth an exclusive list of the standards to be employed in determining whether the substitute for ordinary income doctrine applied.\(^{42}\) It did, however, list three standards that can be used.

\(^{35}\) Id. at 401.
\(^{36}\) Id.
\(^{37}\) Id.
\(^{38}\) Id.
\(^{39}\) Id. at 410.
\(^{40}\) Lattera, 437 F.3d at 406.
\(^{41}\) Id.
\(^{42}\) Id. at 405.
The first of the three standards that the court adopted is a resemblance test. The court listed a number of items that have been treated as capital assets and a number that have not to see if the right to the installment payments looked more like one of the lists than the other. The court concluded that the resemblance test was of no help in that case because the right to the lottery installment payments does not resemble items on either list.

The second standard is the well-established principle that if the seller of a right to future income (a carved out interest) retains a residual interest in that income or in the property that produces the income, the seller will recognize ordinary income on the sale. Since the taxpayers in Lattera had sold all of the interest they had in the property, the residual interest rule did not apply. The court therefore turned to a third standard.

The third standard, like the resemblance test, requires an examination of the character of the property that was sold to determine whether it qualifies as a capital asset. This third standard, on which the court based its decision, rests on a distinction between “earned income” and the right to earn income. While an earned income distinction is proper if construed correctly, the court’s construction and use of that standard makes no sense.

The court concluded that only if the transferee of the right to the income must do something further to earn the income can the seller have capital gain treatment. The court determined that if the mere ownership of property gives the owner the right to future income, then the sale of the right to that income will be treated as a sale of earned income and so be taxed as ordinary income. The court said that the right to the installments was earned by the taxpayers when they won the lottery; nothing further needed to be done; and so their sale of that right produced ordinary income.

The problem with the court’s opinion is its construction of “earned income” for purposes of this issue. If the court’s construction were adopted, the sale of shares of stock would produce ordinary income.

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43 Id. at 406.
44 Id.
45 Id. at 406–07.
46 Lattera, 437 F.3d at 409–10.
47 Id. at 407–08.
48 Id. at 408.
49 Id.
50 Id.
income. As the court itself noted, a sale of stock typically produces a capital gain. The court also noted that “a stock’s value is the present discounted value of the company’s future profits.”\textsuperscript{51} Yet, on the sale of stock, the purchaser obtains the right to future income (dividends) solely by virtue of owning the stock; he need do nothing further to obtain the dividends. The tax treatment of the sale of stock cannot be reconciled with the construction of earned income that the court adopted.

Moreover, the court concluded that its application of the earned income distinction conflicts with the decision of the Second Circuit in the \textit{McAllister} case on the capital gain issue. The court dismissed that decision in the following language: “We consider \textit{McAllister} to be an aberration, and we do not find it persuasive in our decision in this case.”\textsuperscript{52} The court ignored the significance of the fact that Congress changed the basis rule of the \textit{McAllister} decision, but left unimpeded the part of that decision that adopted the capital gain rule. The court also ignored that the Service has promulgated a Revenue Ruling adopting the \textit{McAllister} view that such a sale produces capital gains.\textsuperscript{53} Moreover, if the court had construed the “earned income” distinction correctly, there would have been no conflict with the \textit{McAllister} decision, and the court would not have had to try to repudiate that case.

The court’s conclusion that the amount received for the sale of the right to the installment payments was ordinary income to the taxpayers is correct. The reason, however, is different from the rationale adopted by the court.

When the taxpayers won the lottery, they received a property right that had value. Why were they not taxed in that year for the present value of the right to those payments? The apparent answer is that the taxpayers likely are on the cash receipts and disbursements method of accounting, as most individuals are. While there are exceptions, an unfunded, nonnegotiable promise to make payments generally does not qualify as cash or its equivalent. The taxpayers’ right to the installment payments was not taken into income in the year they won because of the accounting system they use. Their right to those annuity payments represented a kind of deferred income. As one student commentator put it, the transaction effectively was kept

\textsuperscript{51} \textit{Id.} at 404.
\textsuperscript{52} \textit{Lattera}, 437 F.3d at 409.
open until the payments were received.\textsuperscript{54} The right to already earned but deferred income is not a capital asset, and so the sale of that right does not produce capital gain.\textsuperscript{55}

In applying the earned income test, the court should not have made its decision turn on the fact that the purchaser did not have to do anything to have the right to the future installment payments. Mere ownership of property is not an obstacle to capital gain treatment when the property itself will earn the income. A bond will produce income because it represents a debt on which interest is payable. A share of stock represents ownership in a corporation that can produce income through the management of its business. The owner of the bond or stock does not have to do anything to receive that income, but that fact does not influence the tax treatment of a sale of those items.

The earned income concept properly refers to a sale of the right to income that had already been earned (i.e. produced) but had not yet been taxable to the seller. It does not properly refer to income that will be earned in the future that will be produced by the corpus itself rather than by the efforts of the owner of the corpus. \textit{Lattera} involved the former situation so that the gain on the sale in that case properly was treated as ordinary income.\textsuperscript{56} On the other hand, \textit{McAllister} involved the second situation; and so the Second Circuit’s holding in that case is not in conflict with the result reached in \textit{Lattera}.\textsuperscript{57}

\textbf{VIII. POLICY CONSIDERATIONS FOR TREATMENT OF GAIN FROM THE SALE OF AN INCOME INTEREST IN A TRUST}

There are several rationales suggested for having preferential tax treatment of net capital gains. Some commentators do not accept any of those rationales, and so there is controversy as to whether the current treatment is justified. Rather than to engage in that debate, I will accept capital gains rates as a given and consider the question of whether the sale of an income interest in a trust should qualify for that treatment. Whatever the reason for preferential treatment might be, the question arises whether the gain from the sale of an income interest in a trust satisfies that purpose.

\textsuperscript{55} See, e.g., Treas. Reg. § 1.61-7(d) (1966); Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962).
\textsuperscript{56} Levine, \textit{supra} note 54, at 201.
\textsuperscript{57} McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946).
There is general agreement that capital gains treatment should be reserved for recognized income that is attributable to the appreciation of a capital asset. One argument raised against allowing capital gain treatment for the sale of an income interest in a trust is that the taxpayer’s gain does not satisfy that condition. Let us examine that contention.

Initially, consider the circumstance when an asset that is universally accepted as a capital asset is sold for a gain. In Year One, X buys one share of corporate stock for $100, and that is his basis. In Year Six, X sells the stock for $1,000 and reports $900 long-term capital gain. To what is the $900 appreciation attributable? The appreciation in value of the stock is attributable to the belief in the market that the stock will produce much greater dividend income than was anticipated in Year One when the stock was purchased. X’s $900 gain represents the present value of the additional future income stream that the stock will produce. Yet, there is no question that X is entitled to capital gain tax treatment.

Now, consider the sale of a term interest in a trust. Let us first examine the sale of a term interest, which the seller had acquired by a prior purchase.

L has a life income interest in a trust whose corpus has a value of $1,000,000. The remainder interest is held by R. In Year One, the value of L’s life income interest is $400,000. In that year, B pays L $400,000 to purchase her interest. B is not related to R. I will consider the tax treatment of L later. For now, we will focus on the tax treatment of B when subsequently, in Year Three, B sells the life income interest to a third party for $450,000.

B’s original basis in the life income interest (an interest for the life of L) was $400,000. For the several years that B held the interest, B would recognize income for the amount distributed to him from the trust, and B would have taken a depreciation deduction for a portion of his $400,000 basis. Note that B is not prevented by section 167(e) or section 273 from taking a depreciation deduction since B is not related to R and since B purchased the term interest. B’s $400,000 basis in the term interest will be reduced by the depreciation that was allowable or allowed to B. B will report a gain equal to the excess of the amount received over his basis in the term interest. The portion of that gain equal to the depreciation deductions allowed to B will

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58 See I.R.C. § 1012.
59 I.R.C. §§ 167(e), 273.
60 I.R.C. § 1001.
constitute ordinary income under the recapture of depreciation rules.\(^\text{61}\) The balance of B's gain, $50,000 here, will be a long-term capital gain.

To what is the appreciation in the value of B's life income interest attributable? It represents the belief that the trust will produce more income than was anticipated when B purchased the interest in Year One. The anticipation of more income will also cause an increase in the value of the assets held in the trust (i.e. the trust's assets have a greater value because they are expected to produce more income). In other words, the value of the trust's assets will have increased, and consequentially the value of both the life income interest in the trust and the remainder interest will increase. There will also be a reduction of the value of the life income interest due to the exhaustion of two years of L's life expectancy, but the size of the price paid for the life income interest in Year Three shows that the increase in the value of the trust's assets more than offset that decline in value. So, the appreciation of B's interest in the trust is no different from the appreciation of the stock that was examined above. Like the stock, the income interest in the trust appreciated in value because of the anticipation that the assets in the trust will produce more income.

There is no reason that the gain that B recognized on the sale of that income interest, other than the recapture of depreciation element, will not receive capital gain treatment.\(^\text{62}\) Note that two of the courts that held ordinary income for the gain from the sale by lottery winners of the right to installment payments explicitly declined to express an opinion as to the tax treatment that should be accorded if the purchaser of those rights to installment payments subsequently sold them to a third party.\(^\text{63}\)

Any suggestion that gain from the sale of the entirety of a term interest in a trust should be ordinary income because it is a sale of the right to income is too broad. Even if the sale of some such term interests should be so treated (and the author contends otherwise), it is clear that there are term interests whose sale should produce capital gain.

Next, let us consider the circumstance where a taxpayer inherits a life income interest in a trust or receives a gift of such an interest.\(^\text{64}\)

\(^{61}\) I.R.C. § 1245.


\(^{63}\) United States v. Maginnis, 356 F.3d 1179, 1183 n.4 (9th Cir. 2004); Clopton v. Commissioner, 87 T.C.M. 1217, 1218 n.4 (2004).

\(^{64}\) McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946).
Since the considerations are the same whether the income interest is inherited or obtained as a gift, I will focus on an inheritance.

In Year One, D dies and leaves property having a value of $1,000,000 in trust, the income of which is payable to L for life and the corpus is to be distributed on L's death to R. None of the assets in the trust are depreciable. L is the life income beneficiary, and R is the remainderman. L and R are not related. Under section 1014 of the Code, the basis of the property owned by the trust is $1,000,000 (the value of that property at D's death).65 To determine the basis that L and R have in their interests in the trust, the $1,000,000 basis of the trust's corpus is allocated between L and R according to their respective actuarial interests.66 Let us assume that the basis of L is $400,000, and the basis of R in her remainder interest is $600,000. If the trust's basis in its assets remains constant at $1,000,000, the basis that L and R have in their interests will change each year as their actuarial interest in the trust changes. So, L's basis will be reduced each year, and R's basis will be increased. Section 273 will prevent L from taking a depreciation deduction for her basis in her life income interest.

Consider two alternative circumstances. In one, L and R sell their interests in the trust to C. Secondly, consider the circumstance where only L sells her income interest and R retains her remainder interest.

In Year Three, L sells her life income interest in the trust to C for $450,000, and at the same time, R sells her remainder interest to C for its value. Assume that L's basis in her life income interest at that time was $360,000. This reduction of L's basis is not the result of depreciation deductions since section 273 prevented L from deducting any depreciation. The $40,000 reduction of her basis reflects the reduction of her life expectancy and loosely represents the distributions that L received from the trust in the intervening years. Section 1001(e) does not prevent L from using her $360,000 basis in measuring her gain from the sale because R sold her interest as part of the same transaction.67 So, L will report a gain of $90,000. How should that gain be characterized?

The $90,000 gain represents two elements. Fifty thousand dollars of that gain is attributable to the income interest's share of the increase in value of the assets held by the trust (in turn, the increase in the value of the trust's assets represents the increase in income that it

65 I.R.C. § 1014.
67 I.R.C. § 1001(e)(3).
is expected that those assets will produce. That portion of the gain is no different from the gain recognized on the sale of shares of stock and is just as entitled to capital gain treatment.

What about the gain that is attributable to the $40,000 of decline in L’s basis in her interest? That gain also reflects an appreciation in the value of the trust’s assets since the value of her right to income for life declined because of her having a shorter life expectancy as each year expired. The fact that the overall value of L’s interest did not decline shows that the value of the trust’s assets increased to make up for the actuarial reduction.

Again, there is no policy reason to treat the $90,000 gain that L recognized on her sale as anything other than a capital gain. There is no recapture of depreciation in that sale since L was not allowed to take any depreciation deductions.

Finally, consider the tax treatment when L sells her life income interest to C in Year Three for $450,000, and R retains her interest. The only change in facts from the example above is that R did not sell her remainder interest. In that situation, since L’s interest is a term interest, section 273 prevents L from taking a depreciation deduction, and section 1001(e) prohibits L from using any of her basis in determining her gain. Consequently, the entire $450,000 will be a gain to L. How should that $450,000 gain be characterized?

You will recall from the example above that $90,000 of L’s gain is attributable to appreciation in the value of the trust’s assets. Just as L’s $90,000 gain in the example above qualified as capital gain income, so should $90,000 of L’s gain qualify in this circumstance. In both situations, $90,000 of L’s gain represents appreciation of the value of her interest in the trust and should qualify for capital gain treatment. There is no policy justification for denying capital gain treatment to that portion of L’s gain.

What about the remaining $360,000 of L’s gain? How should that be characterized? That amount does not represent appreciation of L’s interest. To the contrary, it represents her basis, which she is prohibited from using. Should that $360,000 of gain therefore be treated as ordinary income? While the author concludes that capital gain treatment is appropriate, this $360,000 item is the only one about which there can be a serious issue.

Before examining that question, it is necessary to consider why Congress decided not to allow L to use her basis. You will recall that under the uniform basis rule that the tax law utilizes, the trust’s basis

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68 I.R.C. §§ 273, 1001(e).
in its assets is allocated between the income beneficiary and the remainderman according to their actuarial interests, which change each year as the life expectancy of the life income beneficiary declines.69 Eventually, the remainderman, R in our facts, will have 100% of the trust's basis. So, if L were allowed to use her basis when she sold her interest, and since R would eventually obtain that same amount of basis for herself, it could be said that the same basis would be made available twice — once to the life income beneficiary and again to the remainderman. That problem does not occur if the life income beneficiary and the remainderman transfer their interests at the same time since then the basis used by the life income beneficiary will never end up in the hands of the remainderman or anyone else. To cure this problem, Congress adopted section 1001(e), which prohibits L from using her basis on the sale of her interest unless the remainderman transfers her interest at the same time.70

Congress could have solved this problem differently. They could have barred any increase in the remainderman's basis for actuarial changes that take place after the life income beneficiary sells her interest. Instead, they chose to prevent the beneficiary of a term interest from using her basis.71 Was that fair?

The division of a trust's income between a current beneficiary and a remainderman rests on a distinction between capital and the income it produces. The distinction between capital and income has artificial aspects to it. Take, for example, the treatment of a current beneficiary of a trust. One way of characterizing the distributions from a trust to a current beneficiary is to treat all distributions as coming from the income produced by the trust's assets that year to the extent thereof. The tax law adopts that view in that all the income earned by the trust in a year is allocated to the distributions made to beneficiaries that year.72 The balance of the trust's income (if any) is taxed to the trust. There are practical benefits to allocating the trust's income in that manner. But the situation can be viewed quite differently.

Another reasonable view is that the several interests in the trust can be seen as undivided interests in the trust's assets. The income produced by those assets therefore belongs partly to the current beneficiary and partly to the remainderman. When distributions are

70 I.R.C. § 1001(e).
71 See id.
72 See I.R.C. §§ 651, 661.
made to the current beneficiary, the distribution consists partly of that beneficiary’s share of the trust’s income and partly of a portion of the trust’s corpus. The portion that represents the trust’s corpus would not be taxable to the current beneficiary, but would reduce her basis. The trust’s income that is not distributed to the current beneficiary is added to the trust’s corpus and thereby increases the amount to be distributed to the remainderman when the current beneficiary’s interest terminates. The income added to the trust’s corpus would be taxed to the trust. This approach is based on a concept that while the amount to be distributed to the current beneficiary is equal to the amount of the trust’s income for that period, the characterization of what was distributed is made up of both income and principle of the trust.

Since that treatment has theoretical support, why is it not used by the tax law in its treatment of an income interest in a trust? There likely are two reasons for the tax law not to have adopted that approach.

One reason is administrative simplicity. It is much easier to calculate the income of the several parties if all of the trust’s income is allocated to the current beneficiaries.

A second reason for the current treatment of trust distributions is that it conforms to the general public’s conception of what is taking place. If a settlor of a trust provides that the income produced by the trust is to be distributed to a current beneficiary, he probably contemplates that the distribution received by the beneficiary is the actual income produced by the trust.

Return now to the example of L who has $360,000 of income that is attributable to not being allowed to use her basis. One could conclude that to tax L on that $360,000 is harsh in that it actually represents her capital, and so treating it as capital gain is a small mitigation of the harshness of taxing her. After all, if R had transferred her remainder interest at the same time that L made the sale, L would not have recognized any gain for the $360,000 of the payment she received. Taxing that amount as ordinary income to L because R did not transfer her interest would compound that harshness.

The reason that L recognizes $360,000 of her receipt from the sale as a gain is that Congress made a choice in its decision to prevent an abuse. It chose to deny L the use of her basis rather than to prevent

\footnote{Congress essentially adopted this approach in the treatment provided to the sale of a so-called stripped coupon. I.R.C. § 1286.}
additions to R's basis for subsequent changes in actuarial interests. It is simpler to deny L her basis in that circumstance, and that may explain why Congress made that choice. While achievement of administrative simplicity may justify the tax treatment of L, it is reasonable to allow some mitigation of the detriment she suffers because of that treatment.

Another approach is to accept as reasonable the construction that the beneficiaries have undivided interests in the trust. Then, a portion of distributions that L would have received from the trust can be seen as actually representing capital recovery even though it would have been taxed to her as income. Taxing her on all of the gain from her sale of her interest reinforces the failure to permit her to recover her capital interest. Capital gain treatment for her sale provides some mitigation.

IX. CONCLUSION

Capital gain treatment for the gain recognized on the sale of a term interest is clearly appropriate in every situation with a possible exception for the situation when the seller of the interest is precluded from using her basis in measuring the gain. Even in that latter situation, it is only as to that part of the seller's gain that is attributable to the denial of the use of the seller's basis that there can be a policy issue. That part of the seller's gain that is attributable to anticipated appreciation of future income clearly conforms to the policy reasons for allowing capital gain treatment. As to the amount of gain attributable to the denial of the use of the seller's basis, in the view of the author, capital gain treatment is an appropriate mitigation of the harshness of treating that amount as a gain.