Michigan Law Review

Volume 56 | Issue 8

1958

Taxation - Federal Income Tax - Proceeds from Cancellation of Contract Treated as Ordinary Income

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TAXATION—FEDERAL INCOME TAX—PROCEEDS FROM CANCELLATION OF CONTRACT TREATED AS ORDINARY INCOME—Taxpayer had the exclusive right for a period of ten years to purchase all the coal mined by the operator of certain mines. In 1949 the operator paid taxpayer $500,000 as consideration for the complete acquisition of taxpayer's right and interest in the purchase agreement. Taxpayer reported this sum as a long-term capital gain. The Commissioner claimed that the amount received was ordinary income. The Tax Court upheld taxpayer's contention,[1] indicating that the transaction had resulted in the sale or exchange of a capital asset. On appeal by the Commissioner, *held,* reversed, one justice dissenting. This transaction was more in the nature of an extinguishment of taxpayer's right than of its sale or transfer. The amount received was thus ordinary income and not capital gain. *Commissioner v. Pittston Co.,* (2d Cir. 1958) 252 F. (2d) 344.

The benefits of capital gain treatment are available to taxpayers deriving income through the *"sale or exchange"* of a *"capital asset."* The pivotal issue in the principal case was whether the transaction constituted a "sale or exchange," as the Commissioner conceded that the contract right held by taxpayer was a "capital asset." With specific exceptions not

[1] Pittston Co., 26 T.C. 967 (1956).

here material, a capital asset is defined generally as "property held by the taxpayer."[2] The courts have recognized the existence of a capital asset where a contract right represents something more than the naked right to receive income.[3] In the instant case, since taxpayer's right was to purchase coal and not to receive income, there can be little question that it was a capital asset. On the other hand, where the mere fulfillment of the contract will result in ordinary income to the taxpayer, the right held will not so qualify. It is reasoned that the consideration received on the disposition of rights of this type is a substitute payment for the ordinary income which would have been realized by the taxpayer and accordingly must be taxed at ordinary income rates. Thus a contract of employment,[4] a claim based on the rendition of personal services,[5] and a right to receive dividends[6] or rental payments[7] have been excluded from the capital asset category.

Establishing occurrence of a "sale or exchange" presents greater difficulty. While courts have frequently stated the test to be whether rights owned by the taxpayer survive the transaction in the hands of the transferee,[8] the cases evidence little consistency in result. Illustratively, the absence of rights which survive the transaction has been relied upon to deny capital gain or loss treatment in situations involving a creditor's loss on the cancellation of indebtedness for a valuable consideration,[9] a payee's loss on the compromise of promissory notes with the maker,[10] gain from the release of a right to serve as an exclusive selling agent,[11]

2 I.R.C. (1954), §1221; I.R.C. (1939), §117(a)(1).

3 Contract rights have been considered sufficiently "substantial" to qualify as capital assets in the following cases: Commissioner v. Goff, (3d Cir. 1954) 212 F. (2d) 875, cert. den. 348 U.S. 829 (1954) (exclusive right to the output of certain machines); Commissioner v. Ray, (5th Cir. 1954) 210 F. (2d) 390, cert. den. 348 U.S. 829 (1954) (covenant prohibiting the making of a lease with a competitor); Commissioner v. Golonsky, (3d Cir. 1952) 200 F. (2d) 72, cert. den. 345 U.S. 939 (1953) (right to possession of property); Commissioner v. Starr Bros., Inc., (2d Cir. 1953) 204 F. (2d) 673 (right to serve as exclusive selling agent); Jones v. Corbyn, (10th Cir. 1950) 186 F. (2d) 450 (exclusive insurance agency). See also McAllister v. Commissioner, (2d Cir. 1946) 157 F. (2d) 235 (life tenant's interest in trust held to be a sufficiently substantial property right to qualify as a capital asset).

4 Thurlow E. McFall, 34 B.T.A. 108 (1936).

5 Herman Shumlin, 16 T.C. 407 (1951).

6 Rhodes' Estate v. Commissioner, (6th Cir. 1942) 131 F. (2d) 50.

7 Hort v. Commissioner, 313 U.S. 28 (1941).

8 See 53 COL. L. REV. 976 at 988 (1953).

9 Bingham v. Commissioner, (2d Cir. 1939) 105 F. (2d) 971.

10 Hale v. Helvering, (D.C. Cir. 1936) 85 F. (2d) 819.

11 Commissioner v. Starr Bros., Inc., note 3 supra. I.R.C. §1241 provides that amounts received by a lessee or a distributor of goods for the cancellation of a lease or distributor's agreement shall be considered as received in exchange for such lease or agreement, if the distributor has a substantial capital investment in the distributorship. This provision was enacted as a result of the decision in the Starr Bros. case, but it was made clear that the section is limited in scope and "does not constitute a reexamination of present law relating to contracts to which the section does not specifically apply." S. Rep. 1622, 83d Cong., 2d sess., pp. 115, 444 (1954).

and a promisee's gain from the release to a third party and subsequent cancellation by the promisor of exclusive booking agency contracts.[12] Where, however, the transaction has involved the agent's gain on cancellation of an exclusive agency franchise,[13] the surrender by a tenant to the landlord of possessory rights under a lease,[14] the relinquishment by a tenant of a covenant in a lease restricting the use of the real estate by the landlord,[15] and the release of the exclusive right to purchase the output of certain machines,[16] a "sale or exchange" has been found. The basis for decision in the principal case was a conclusion by the majority that the contract rights held by taxpayer had merely vanished, and did not survive the transaction.[17] Analytically the position of the Second Circuit is justifiable. Under the agreement taxpayer held the exclusive right to purchase the operator's entire output. Cancellation of the contract extinguished this right, and did not have the effect of preserving it in the hands of the operator. It is also clear that there could be no transfer of the right to deal with others, as taxpayer did not hold this right under the contract. A literal application of the "sale or exchange" requirement thus precludes capital gain treatment. Arguably, this result contravenes the policy considerations underlying the enactment of the capital gains provisions. This tax benefit was conferred for the general purpose of removing the tax obstacle in dispositions of appreciated property. Since legislative history fails to explain the limitation of capital gains treatment to a "sale or exchange,"[18] the function of the courts is to give effect to the policy underlying capital gains treatment in inter-

12 General Artists Corp. v. Commissioner, (2d Cir. 1953) 205 F. (2d) 360.

13 Jones v. Corbyn, note 3 supra. It is not clear from the pre-enactment material whether I.R.C., §1241 is intended to overrule the Corbyn case. See S. Rep. 1622, 83d Cong., 2d sess., p. 444 (1954).

14 Commissioner v. Golonsky, note 3 supra. See also Commissioner v. McCue Bros. & Drummond, Inc., (2d Cir. 1954) 210 F. (2d) 752, cert. den. 348 U.S. 829 (1954), where the surrender of a statutory right to possession was held to constitute the sale or exchange of a capital asset. The Second Circuit in McCue distinguished Starr Bros. and General Artists on the ground that the rights involved in those cases were less "substantial."

15 Commissioner v. Ray, note 3 supra, strongly criticized in 10 TAX L. REV. 257 at 262 (1954). The Internal Revenue Service announced its acquiescence in the Ray, Golonsky and McCue cases in Rev. Rul. 56-531, 1956-2 Cum. Bul. 983, but also indicated that it would continue to regard the relinquishment of "simple contract rights" as *not* involving the sale or exchange of a capital asset. Reference was made in support of this position to the General Artists, Starr Bros. and Bingham cases, as well as to Roscoe v. Commissioner, (5th Cir. 1954) 215 F. (2d) 478 (dictum to the effect that cancellation of an exclusive agency contract would result in ordinary income to agents).

16 Commissioner v. Goff, note 3 supra.

17 This was the rationale applied by the Second Circuit in the Starr Bros. and General Artists cases.

18 See H. Rep. 350, 67th Cong., 1st sess., p. 10 (1921), and S. Rep. 275, 67th Cong., 1st sess., p. 12 (1921). Compare the broad interpretation given the phrase "sale or exchange" in Henry P. Werner, 15 B.T.A. 482 (1929), apparently the first case interpreting the provision, with the literal interpretation applied in John H. Watson, 27 B.T.A. 463 (1932), which overruled the Werner case.

preting this phrase without doing violence to statutory language. Thus it seems unnecessarily restrictive to limit capital gains benefits to situations where the surrendered contract rights survive the transaction. Whenever the transaction has the effect of creating in both parties a *new* right or interest, the "sale or exchange" requirement should be satisfied. This approach best comports with the policy against discouraging dispositions, since capital gain or loss treatment will not be extended to cases comparable to those where a creditor incurs loss on the cancellation or compromise of indebtedness.[19] In the principal case it was only through cancellation of the contract that the operator could have acquired the right to deal with others prior to its expiration. This new right was created as the direct result of the relinquishment of the rights held by taxpayer. While the majority in the instant case was reluctant to extend the "sale or exchange" concept without specific legislative authorization,[20] the Tax Court has consistently favored application of the "new rights" test.[21] Similarly, the Third Circuit had no difficulty in finding a "sale or exchange" in *Commissioner v. Goff*,[22] involving a release of the right to purchase the entire output of certain machines. This liberal interpretation of the "sale or exchange" requirement would eliminate any doubt which might tend to hinder negotiations for the release of contractual obligations, and serve to advance the legislative policy underlying capital gains treatment. It seems likely, however, that uncertainty in the area will continue in the absence of a more definitive legislative or judicial declaration.

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19 Bingham v. Commissioner, note 9 supra, and Hale v. Helvering, note 10 supra. In situations of this type there is only an extinguishment of the debtor's liability as a result of the cancellation or compromise, but no corresponding increase in his rights.

20 Principal case at 348. As previously indicated, I.R.C., §1241 applies to cancellation of a distributor's agreement if the distributor has a substantial capital investment in the distributorship. This provision would not now extend to the arrangement present in this case.

21 Pittston Co., note 1 supra, at 970 (1956). See also Henrietta B. Goff, 20 T.C. 561 (1953), and Marc D. Leh, 27 T.C. 892 (1957). Government acquiescence in Commissioner v. Ray, note 3 supra, involving the relinquishment of a restrictive covenant in a lease, seems to indicate that the Internal Revenue Service may not adhere to a strictly analytical approach in every case of this type.

22 (3d Cir. 1954) 212 F. (2d) 875, cert. den. 348 U.S. 829 (1954), affirming 20 T.C. 561 (1953).