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TAXATION-FEDERAL INCOME TAX-PAYMENT TO LESSEE FOR SURRENDER OF LEASE TAXABLE AS CAPITAL GAIN

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TAXATION—FEDERAL INCOME TAX—PAYMENT TO LESSEE FOR SURRENDER OF LEASE TAXABLE AS CAPITAL GAIN—Taxpayer, a tenant in possession of premises under a lease, received a payment from the lessor to vacate and surrender the premises before the lease expired. The Tax Court decided that the payment was taxable only as a capital gain. On appeal, *held,* affirmed. Since the leasehold interest constituted property, its transfer by the lessee to the lessor was a sale of a capital asset under I.R.C., §117. *Commissioner v. Golonsky,* (3d Cir. 1952) 200 F. (2d) 72.

Income may be treated as a capital gain only where it is derived from the sale or exchange of a capital asset.[1] Each transaction thus presents two[2] issues: (1) Is the subject matter a capital asset? and (2) Is the transaction a sale or exchange? A capital asset is defined, with specific exceptions not here material, as property held by the taxpayer.[3] Despite the breadth of this definition, the courts have refused to treat as a capital asset every right, contractual or otherwise, to obtain income, even though the right would ordinarily be regarded as property. Instead, the determination turns largely on the nature of the income which would normally result from the exercise of the right or the fulfillment of the contract.[4] If such income would be taxable as ordinary income, the right is generally not a capital asset. The courts have thus excluded from the category of capital assets a contract of employment,[5] a claim based on the rendition of personal services,[6] an agreement not to compete,[7] and a right to receive dividends[8] or rental payments.[9] Consequently, consideration received for giving up such rights is taxed as ordinary income, on the theory that it is a substitute present payment of anticipated future income.[10] On the other hand, a life tenancy in a trust, which is regarded as an equitable estate in the corpus rather than merely a right to receive income therefrom,[11] is a capital asset that may be sold even to the remainderman.[12] The Internal Revenue Code does not define "sale or exchange." In formulating judicial definitions, the courts have emphasized the fact that the essential element of a sale or exchange is the acquisition of property by the transferee.[13] Where a capital asset consists of an obligation owed the holder, its cancellation is not a sale or exchange since the obligation is extinguished and the obligor receives no property right. Capital gains treatment has therefore

[1] I.R.C., §117(b).

[2] Though logically distinct, the two questions may become inseparably interwoven in actual practice. See 3 MERTENS, FEDERAL INCOME TAXATION §§22.11–22.12 (1942).

[3] I.R.C., §117(a)(1).

[4] Shumlin v. Commissioner, 16 T.C. 407 (1951); see Starr Bros. v. Commissioner, 18 T.C. 149 (1952).

[5] McFall v. Commissioner, 34 B.T.A. 108 (1936); Gann v. Commissioner, 41 B.T.A. 388 (1940).

[6] Shumlin v. Commissioner, supra note 4; General Artists Corp. v. Commissioner, 17 T.C. 1517 (1952); cf. Doyle v. Commissioner, (4th Cir. 1939) 102 F. (2d) 86 (partnership earnings). But capital assets were found in Jones v. Corbyn, (10th Cir. 1950) 186 F. (2d) 450 (exclusive insurance agency), and in Starr Bros. v. Commissioner, supra note 4 (exclusive sales franchise).

[7] Beals' Estate v. Commissioner, (2d Cir. 1936) 82 F. (2d) 268.

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

[9] Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757 (1941).

[10] Ibid.

[11] Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330 (1937). See Harrison v. Schaffner, 312 U.S. 579, 61 S.Ct. 759 (1941).

[12] Bell's Estate v. Commissioner, (8th Cir. 1943) 137 F. (2d) 454; McAllister v. Commissioner, (2d Cir. 1946) 157 F. (2d) 235, cert. den. 330 U.S. 826, 67 S.Ct. 864 (1947); Allen v. First National Bank & Trust Co. in Macon, (5th Cir. 1946) 157 F. (2d) 592, cert. den. 330 U.S. 828, 67 S.Ct. 868 (1947).

[13] Bingham v. Commissioner, (2d Cir. 1939) 105 F. (2d) 971; Hale v. Helvering, (D.C. Cir. 1936) 85 F. (2d) 819; Milliken v. Commissioner, 15 T.C. 243 (1950).

been denied to transactions involving the compromise of promissory notes,[14] the redemption of bonds before maturity,[15] and the surrender of insurance contracts[16] and stock options.[17] In the principal case the court was careful to resolve the first of the two issues presented in this type of case by showing that a leasehold is property, although the Commissioner had made this unnecessary by conceding that the lease was to be treated as a capital asset in the tenant's hands.[18] The court then proceeded from the fact that intangible property may be the subject of a sale[19] to the conclusion that the transfer of a leasehold to the lessor is a sale within the meaning of the Revenue Code. Only in the use of the word "transfer" was there an allusion to the crucial problem raised by the second issue: Was property received by the lessor? In relying on a decision that capital gains are realized when a tenant transfers his lease to a third party,[20] the court failed to consider holdings that capital gains are similarly realized when bonds are transferred to a third person,[21] but not when they are redeemed by the issuing corporation.[22] Despite this sketchy treatment, however, the result appears to be in accordance with reason and authority. Unlike the issuer of a bond or the maker of a note, the lessor seemingly does receive a valuable property right— the right to possession for the unexpired term of the lease.[23] A holding contrary to the principal case has been reached under the District of Columbia revenue act, chiefly on the ground that a cancellation of a lease is not commonly thought of as a sale or exchange.[24] But such a literal approach is not the present trend of the Tax Court,[25] which apparently feels that this is

[14] Bingham v. Commissioner, supra note 13; Commissioner v. Spreckels, (9th Cir. 1941) 120 F. (2d) 517; Hale v. Helvering, supra note 13.

[15] Fairbanks v. United States, 306 U.S. 436, 59 S.Ct. 607 (1939); Felin v. Kyle, (3d Cir. 1939) 102 F. (2d) 349. This rule has been changed by I.R.C., §117(f).

[16] Bodine v. Commissioner, (3d Cir. 1939) 103 F. (2d) 982, cert. den. 308 U.S. 576, 60 S.Ct. 92 (1940).

[17] Milliken v. Commissioner, supra note 13.

[18] Petitioner's brief at 8. See Sutliff v. Commissioner, 46 B.T.A. 446 (1942); cf. note 23 infra.

[19] 1 WILLISTON, SALES, rev. ed., §145 (1948); see note in 50 MICH. L. REV. 953 (1952).

[20] Sutliff v. Commissioner, supra note 18.

[21] McKee v. Commissioner, 35 B.T.A. 239 (1937).

[22] See note 15 supra.

[23] This was the basis of the Tax Court's decision in the principal case. 16 T.C. 1450 at 1451 (1951). Thus also, an amount paid by a lessor to secure the surrender of a leasehold is a capital expenditure, and is not deductible as an ordinary business expense. Miller v. Commissioner, 10 B.T.A. 383 (1928); Bretzfelder v. Commissioner, 21 B.T.A. 789 (1930); Borland v. Commissioner, 27 B.T.A. 538 (1933). Cf. note 12 supra. The Commissioner could cite no tax cases to support his contention that any transfer of the lease to the lessor would result in its destruction by merger.

[24] United Cigar-Whelan Stores Corp. v. District of Columbia, (D.C. Cir. 1949) 176 F. (2d) 952, interpreting D.C. Code (1940) §47-1506. Cf. Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 61 S.Ct. 878 (1941).

[25] The principal case has been followed in Ray v. Commissioner, 18 T.C. 438 (1952) (release of restrictive covenant), and McCue Bros. & Drummond v. Commissioner, 19 T.C. No. 84 (1953).

one situation where greater realism is achieved by recourse to technicalities rather than to common parlance.[26]

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[26] The ultimate extent of capital gains treatment may be decided on policy considerations, not technicalities. Congress has already applied it to situations not logically within the courts' concept of sale or exchange. See, e.g., I.R.C., §117(f) and (g).