



Volume 13 (2016) | ISSN 1932-1821 (print) 1932-1996 (online)
DOI 10.5195/taxreview.2016.46 | <http://taxreview.law.pitt.edu>

ARTICLES

THE *LONG* (v. *COMMISSIONER*) AND SHORT OF THE SUBSTITUTE
FOR ORDINARY INCOME DOCTRINE

Philip G. Cohen



This work is licensed under a Creative Commons Attribution-NonCommercial-No Derivative Works 3.0 United States License.



This journal is published by the [University Library System](#) of the [University of Pittsburgh](#) as part of its [D-Scribe Digital Publishing Program](#), and is cosponsored by the [University of Pittsburgh Press](#).

ARTICLES

THE *LONG* (v. *COMMISSIONER*) AND SHORT OF THE SUBSTITUTE FOR ORDINARY INCOME DOCTRINE

*Philip G. Cohen**

Abstract

In Long v. Commissioner, the Eleventh Circuit determined that the substitute for ordinary income doctrine was inapplicable to a situation wherein the taxpayer had assigned his plaintiff position in a lawsuit which was being appealed following the plaintiff's victory at trial. The article examines the methodologies advanced for determining when the doctrine should be utilized and evaluates the decision in Long in light of these theories.

The Eleventh Circuit correctly rejected the application of the doctrine in Long (discussed and further explained in this article). The taxpayer had transferred a vertical slice of his property, i.e., he did not retain a temporal interest in it. The right transferred was an appreciated equitable interest in property. Furthermore, he had not sold "the future right to earned income" but rather "the future right to earn income." By any reasonable methodology for determining if the substitute for ordinary income doctrine should apply, it is clear that in Long it should not.

In general, the substitute for ordinary income doctrine should not be utilized in circumstances where there has been a transfer involving a vertical

* Associate Professor of Taxation, Pace University Lubin School of Business; Retired Vice President-Tax & General Tax Counsel, Unilever United States, Inc.; New York University, B.A., 1971; Duke University School of Law, J.D., 1974; New York University School of Law, LL.M. (Labor Law), 1975; LL.M. (Taxation), 1982; George Washington University, M.B.A., 1979. The author would like to thank Michael Schler, Professor Richard Kraus, Professor Martin McMahon for their helpful comments on an earlier draft and his graduate teaching assistant, Jianan (Cleo) Guo for her assistance with the article. All errors or omissions are his own.

slice (in contrast with a horizontal slice) of an appreciated equitable interest in property conferring a future right to earn income (and not a future right to earned income). Where it is clear that the above criteria have been met, as was the case in Long, the government should generally eschew arguing for the doctrine's application.

I. INTRODUCTION

The substitute for ordinary income doctrine often serves as an additional, judicially formulated limitation beyond the explicit statutory exceptions set forth in § 1221 to capital asset status. It is therefore an impediment on what has been colorfully described as “the golden road to capital gain treatment.”¹ The substitute for ordinary income doctrine essentially provides that in certain, but not all, cases the “right to receive payments that would be ordinary income if received in due course is taxed on the substitute payment as ordinary income rather than as capital gain.”² Determining when the doctrine should apply has proven at times difficult to discern.

Professors Boris Bittker and Lawrence Lokken have opined that “[u]nless and until Congress establishes an arbitrary line on the otherwise seamless spectrum between [substitute for ordinary income] . . . transactions and conventional capital gain transactions, the courts must locate the boundary case by case. . . .”³ There have, however, been analytical guidelines provided by some courts and scholars to aid this endeavor, which this article will consider.⁴

In *Long v. Commissioner*,⁵ the Eleventh Circuit rejected the government’s attempt to apply the substitute for ordinary income doctrine to the sale of plaintiff’s rights in a civil action. Long was a condominium developer who was scheduled to close on the purchase of land. When the seller unilaterally attempted to terminate the agreement, Long brought an action for specific performance and other damages. He won at trial court, but the seller appealed. Prior to the appeal being decided, Long transferred his

¹ James S. Eustice, *Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case*, 20 TAX L. REV. 1, 2 (1964).

² BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 47.9.5, 2d/3d eds. 1993–2014, updated Mar. 2015 (footnote omitted).

³ *Id.* (footnote omitted).

⁴ At least one leading scholar, however, expressed doubts about the wisdom of a substitute for ordinary income test. Professor Douglas Kahn concluded that the “‘substitute for ordinary income test’ . . . serves no useful purpose. . . . [I]t is a term to describe a consequence rather than a term for a test or standard for determining when that consequence takes place.” Douglas A. Kahn, *Gain from the Sale of an Income Interest in a Trust*, 30 VA. TAX REV. 445, 447 (2010).

⁵ *Long v. Comm’r*, 772 F.3d 670 (11th Cir. 2014), *aff’g and rev’g* T.C. Memo. 2013-233.

rights to a third party for a lump-sum payment, which the government asserted should be treated as ordinary income pursuant to the substitute for ordinary income doctrine. As explained below, the Eleventh Circuit was correct in denying the government's arguments for employing the doctrine to this fact-pattern. *Long* serves as an avenue for examining under what circumstances should the substitute for ordinary income doctrine apply. The objective of this article is to analyze some key methodologies advanced for determining when the doctrine should and should not be utilized, and then to evaluate the decision in *Long* in light of these approaches. Because of the voluminous amount of decisions and other sources on this subject, coverage is somewhat limited.

II. CAPITAL GAIN TREATMENT

For individual taxpayers, characterizing a transaction as generating long-term capital gain instead of ordinary income can produce a major tax benefit. For example, an individual in the highest bracket faces a top federal tax rate generally on "net capital gain"⁶ of twenty percent instead of 39.6% for ordinary income.⁷ In order to obtain the favorable tax treatment, there must be: (1) a sale or exchange, (2) of a capital asset, (3) that was held for more than one year.⁸

A capital asset is defined indirectly in § 1221 as "property held by the taxpayer (whether or not connected with his trade or business), but does not include . . ." eight specified types of assets delineated in § 1221(a)(1)–(8). In terms of what constitutes "property" for purposes of § 1221, the Supreme Court has construed the word "property" in the statute "narrowly."⁹

⁶ As defined in I.R.C. § 1222(11).

⁷ It should be noted, however, that there is an additional potential 3.8% tax on net investment income under § 1411. Furthermore, taxpayers are subject to higher rates with respect two categories of capital gain: "unrecaptured section 1250 gain," as defined in § 1(h)(6), and "collectibles gain," as defined in § 1(h)(5).

⁸ I.R.C. §§ 1222(3), (11), 1(h)(1).

⁹ *See, e.g.,* *Corn Prods. Ref. Co. v. Comm'r*, 350 U.S. 46, 52 (1955) (stating that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose.").

Professor Stanley S. Surrey explained the reason for the need for a limited reading of the word “property” as used in the statutory definition of capital asset. He wrote that:

in one sense everything that the taxpayer holds is “property” and hence will be a capital asset, at this point it would seem to follow that all income could well be “capital gain” . . . unless a particular item of property is covered by an exclusion . . . the courts have in some cases attempted to produce a more reasonable situation by refusing to consider the term “property” as being here used by Congress in the normal, all-inclusive sense in which it is used elsewhere in the Code.¹⁰

*Miller v. Commissioner*¹¹ is illustrative of the word “property” being applied narrowly by the courts in the definition of a capital asset. There, the Second Circuit commented “that not everything people pay for is property.”¹² In *Miller*, the widow of Glenn Miller, the world famed band leader, had received from Universal Pictures Company, Inc. a little over \$409,000 in connection with the production of a film about her late husband, “The Glenn Miller Story,” which she contended was entitled to capital gain treatment. The Second Circuit held that the income should be treated as ordinary income because the taxpayer did not transfer “property.” The court defined “‘property’ as a bundle of rights, protected from interference by legal sanctions.”¹³ The Second Circuit indicated that even if hypothetically Miller had a right of privacy or public image, this right couldn’t be passed to the beneficiaries of his estate. The court reasoned that:

the “thing” bought, or more appropriately “bought off,” seems to have been the chance that a new theory of “property” might be advanced, and that a lawsuit predicated on it might be successful. It was a purchase . . . for . . . freedom from the danger that at a future date a defensible right constituting “property” would be found to exist. But it didn’t pay for “property.”¹⁴

While only of academic interest, there was disagreement as to whether the substitute for ordinary income doctrine was intended as a stand-alone

¹⁰ Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 988 (1956).

¹¹ *Miller v. Comm’r*, 299 F.2d 706 (2d Cir. 1962), *cert. denied*, 370 U.S. 923 (1962).

¹² *Id.* at 710.

¹³ *Id.* at 708.

¹⁴ *Id.* at 710 (footnote omitted).

principle rather than a restriction as to what is considered “property” in the definition of a capital asset.¹⁵ For example, as discussed below, the Supreme Court in *Hort v. Commissioner*,¹⁶ a leading decision in this area, implied that it was a stand-alone doctrine when it denied capital asset status to a lease that it determined was indeed “property.” In any event, the issue of whether the doctrine should be viewed as a type of constraint on what is property under § 1221 was specifically addressed in a footnote by a more recent Supreme Court decision. In footnote five to its decision in *Arkansas Best Corp. v. Commissioner*,¹⁷ the Supreme Court observed that the substitute for ordinary income doctrine is “based on the premise that § 1221 ‘property’ does not include claims or rights to ordinary income. . . .”¹⁸ This conclusion has been further supported in other decisions subsequent to *Arkansas Best*. For example in *Womack v. Commissioner*,¹⁹ a case discussed at length below, the Eleventh Circuit noted that “in deciding that the substitute for ordinary income doctrine applies, we necessarily find that Lottery Rights do not constitute ‘property’ as that term is used in Section 1221.”²⁰

For many years, prior to the Supreme Court’s decision in *Arkansas Best*,²¹ there was also considerable controversy as to whether the Court in *Corn Products Refining Co. v. Commissioner*²² intended to create another judicially fashioned exception to capital gain treatment, i.e., to deny capital

¹⁵ One treatise notes in this regard that

[i]n most of the cases considering the issue of whether the proceeds from the sale of a contract are capital gains or ordinary income, there is little or no explicit reference to the issue of whether the contract was “property” within the meaning of § 1221. Instead, these cases have addressed the question of whether or not the proceeds should be considered a substitute for what would have been income to the seller.

Howard J. Rothman et al., *Capital Assets—Related Issues*, 562 TAX MGMT. PORT. (BNA) ¶ II.B.2.a.

¹⁶ *Hort v. Comm’r*, 313 U.S. 28 (1941).

¹⁷ *Arkansas Best Corp. v. Comm’r*, 485 U.S. 212 (1988).

¹⁸ *Id.* at 217 n.5.

¹⁹ *Womack v. Comm’r*, 510 F.3d 1295 (11th Cir. 2007).

²⁰ *Id.* at 1304.

²¹ *Arkansas Best*, 485 U.S. 212.

²² 350 U.S. 46.

asset status if the asset was held for a business purpose.²³ In *Arkansas Best*, however, the Court cleared up this confusion by stating “that Corn Products is properly interpreted as involving an application of § 1221’s inventory exception”²⁴ and then concluding that “a taxpayer’s motivation in purchasing an asset is irrelevant to the question whether the asset is ‘property held by a taxpayer (whether or not connected with his business)’ and is thus within § 1221’s general definition of ‘capital asset.’”²⁵

In sum, the substitute for ordinary income doctrine is a canon created by the courts which serves to limit the scope of the word “property” in § 1221, and thus, where appropriate, to deny capital gain treatment on the sale or exchange of certain assets even though such assets are not encompassed within any of the statutory exclusions listed in § 1221(a)(1)–(8). It is not, however, the only restraint placed on the term “property” to restrict the scope of capital asset status, as exemplified by the Second Circuit’s decision in *Miller*.²⁶

III. SUBSTITUTE FOR ORDINARY INCOME DOCTRINE

A. The Supreme Court Roots of the Substitute for Ordinary Income Doctrine

While its derivation can perhaps be traced to *Burnet v. Harmel*²⁷ and other early Supreme Court cases, the first landmark substitute for ordinary income case before the Court was *Hort v. Commissioner*.²⁸ In *Hort*, the taxpayer inherited from his father a lot and ten-story office building, part of which was leased to a bank, the Irving Trust Co. In 1933, Irving Trust Co., having found it unprofitable to maintain a branch in the taxpayer’s building

²³ For a more detailed discussion of this topic, see BITTKER & LOKKEN, *supra* note 2, at ¶ 47.9.3.

²⁴ *Arkansas Best*, 485 U.S. at 220.

²⁵ *Id.* at 223.

²⁶ *Miller v. Comm’r*, 299 F.2d 706 (2d Cir. 1962), *cert. denied*, 370 U.S. 923 (1962).

²⁷ *Burnet v. Harmel*, 287 U.S. 103 (1932) (holding that the cash bonus the lessor received upon executing an oil and gas lease was not taxed as gain from the sale of capital assets, but ordinary income equivalent to advanced rent).

²⁸ 313 U.S. 28. *Hort*, however, does not cite *Burnet*.

in the Depression environment, paid him \$140,000 to cancel the lease. The taxpayer had argued that the payment “was capital rather than ordinary income. . . .”²⁹

The Court, in *Hort*, held the entire payment should be treated as ordinary income. The Court stated that “[t]he consideration received for cancellation of the lease was not a return of capital.”³⁰ It noted that: “the lease was ‘property,’ whatever that signifies abstractly . . . but that [p]resumably the bond in *Helvering v. Horst*³¹ . . . and the lease in *Helvering v. Brunn*³² . . . were also ‘property,’ but the interest coupon in *Horst* and the building in *Brunn* nevertheless were held to constitute items of gross income.”³³

The Court reasoned that “[t]he cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises.”³⁴

Professors Marvin A. Chirelstein and Lawrence Zelenak have commented that the Court’s intention in *Hort* was:

to deny (a) capital treatment and (b) an offsetting basis, to one who disposes of a right to future income which has been carved out of a larger estate. In effect, the sale of an income right, unaccompanied by a disposition of the underlying property, results in ordinary income to the seller equal in amount to the entire proceeds of the sale.³⁵

²⁹ *Id.* at 30. The taxpayer actually reported a loss on the transaction. The taxpayer’s “theory [was] that the amount he received as consideration for the cancellation was \$21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease.” *Id.* at 29.

³⁰ *Id.* at 31.

³¹ *Helvering v. Horst*, 311 U.S. 112 (1940). *Horst*, a prominent assignment of income case, is also cited and examined by the Supreme Court in *Commissioner v. P.G. Lake*, 356 U.S. 260 (1958), discussed below. In *P.G. Lake*, the Court described the *Horst* fact pattern as follows: “the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father.” 356 U.S. at 267.

³² *Helvering v. Bruun*, 309 U.S. 461 (1940).

³³ *Hort*, 313 U.S. at 31.

³⁴ *Id.* at 32.

³⁵ MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION: A LAW STUDENT’S GUIDE TO LEADING CASES AND CONCEPTS 434 (13th ed. 2015).

They observed further that “[t]he ‘substitute’ language [in *Hort*], in the view of most commentators, was merely a short-hand way of asserting that carved-out interests do not qualify as capital assets and do not absorb any portion of the taxpayer’s property basis.”³⁶

Professors Richard L. Doernberg and Thomas D. Hall opined in a similar vein that “the underlying reasoning [of *Hort*] was inescapable: the tenant had purchased nothing but the freedom from its obligation under the lease . . . the freedom from the lease obligation has no value once separated from the underlying property, the lease.”³⁷

The next important Supreme Court case that utilized the substitute for ordinary income doctrine to deny capital gain treatment was *Commissioner v. P.G. Lake*.³⁸ The decision involved five cases that were consolidated for argument, which entailed an identical question of law. The legal issue in *P.G. Lake* was whether consideration received by the taxpayer in return for the assignment of oil payment rights, or in one case sulfur payment rights, was taxable as ordinary income or capital gain.

The facts of the namesake case in *P.G. Lake* were as follows: the taxpayer was a corporation engaged in the business of producing oil and gas that had a seven-eighths working interest in two commercial oil and gas leases. In satisfaction of a debt owed to the taxpayer’s president, the taxpayer “assigned him an oil payment right in an amount of \$600,000 plus an amount equal to interest at three percent a year on the unpaid balance. . . .”³⁹ The taxpayer treated the transfer of this oil payment right as a sale of property

³⁶ *Id.* at 423–24; Thomas G. Sinclair suggested that

[t]he [*Hort*] decision could have narrowed the substitute-for-ordinary income doctrine at its inception by limiting its application to carved-out interests. If the owner of the asset retained some interest in it, he would receive ordinary income; but, if he completely disposed of the asset, then he would avoid the doctrine.

Thomas G. Sinclair, Note, *Limiting the Substitute-for-Ordinary Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights*, 56 S.C. L. REV. 387, 396 (2004) (footnote omitted).

³⁷ Richard L. Doernberg & Thomas D. Hall, *The Tax Treatment of Going-Concern Value*, 52 GEO. WASH. L. REV. 353, 382–83 (1984) (footnotes omitted).

³⁸ 356 U.S. 260.

³⁹ *Id.* at 262.

resulting in capital gain. In a unanimous opinion, the Supreme Court, however, accorded ordinary income treatment referring to the arrangements as “transparent devices.”⁴⁰

The Court reasoned that “[t]he payout of these particular assigned oil payment rights could be ascertained with considerable accuracy.”⁴¹ The transferee was obtaining a fairly risk-free asset. Furthermore, “[o]nly a fraction of the oil . . . rights were transferred, the balance being retained.”⁴² That is, this was a transfer of a carved out interest, like *Hort*, albeit to a third party. Professors Chirelstein and Zelenak observed that “capital gain treatment would presumably have been sustained if the life of the oil-payment and the life of the working-interest had been coterminous, since then the fatal element of carving-out would have been absent.”⁴³

The Court in *P.G. Lake* concluded that “[t]he substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.”⁴⁴

In their leading article regarding the *P.G. Lake* decision, Professors Charles S. Lyon and James S. Eustice observed that “*Lake* represents a powerful and pervasive influence, already apparent in several recent lower court decisions, against the attempt to convert future rights to ordinary

⁴⁰ *Id.* at 266.

⁴¹ *Id.* at 265.

⁴² *Id.* (footnote omitted).

⁴³ CHIRELSTEIN & ZELENAK, *supra* note 35, at 435.

⁴⁴ *P.G. Lake*, 356 U.S. at 266. The results of *Lake* were, however, impacted by § 636, enacted in 1969, after *Lake* was decided. Michael Graetz and Deborah Schenk point out that pursuant to § 636,

[t]he sale of a carved-out production payment is treated as a loan. The seller remains taxable on the income from the oil produced and is entitled to deductions for depletion. He can deduct the interest element of the payments. The purchaser of the payment is taxable only on the interest and cannot deduct depletion. An owner who sells a well and retains a production payment is treated as having made a sale subject to a mortgage. The purchaser is taxable on the proceeds of production and is entitled to depletion deductions.

MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 548 (7th ed. 2013).

income into present capital gain through the device of a sale of these rights.”⁴⁵ The decision has been viewed by some courts and commentators as having embraced the Service’s position that, as described by Professor Louis A. Del Cotto: “[an] assignment of an oil payment right, no matter how long or short lived it may be, which extends over a period less than the life of the property interest retained by the transferor is an assignment of future ordinary income and will not receive capital gain treatment.”⁴⁶

Using Justice Holmes’ renowned fruit-tree metaphor from *Lucas v. Earl*,⁴⁷ Professor Del Cotto stated that the Court in *P.G. Lake* considered “the interest sold as ‘fruit’ rather than ‘tree’ and therefore, not a capital asset.”⁴⁸ The theory is that horizontal slices, i.e., situations in which “temporal divisions [are made] in a property interest in which the person owning the interest disposes of part of his interest but also retains a portion of it,”⁴⁹ like the ones in *P.G. Lake*, are simply not “property” as the term was intended to be used by Congress in § 1221 and its predecessors.

Professor Del Cotto was of the opinion that in contrast to a horizontal slice, with “a so-called ‘vertical slice’—that is, the entire interest of the assignor in the property or a fraction of his interest, extending over the entire life of the property—then a capital asset—the ‘tree,’ or a fractional part of it—will have been transferred.”⁵⁰ As discussed below, well-thought-through judicial reasoning since then challenges this conclusion, i.e., vertical slices do not necessarily escape the substitute for ordinary income doctrine. That is, as illustrated by some of the lottery winnings assignment cases discussed

⁴⁵ Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 303–04 (1962).

⁴⁶ Louis A. Del Cotto, “Property” in the Capital Asset Definition: Influence of “Fruit and Tree,” 15 BUFF. L. REV. 1, 18 (1965).

⁴⁷ *Lucas v. Earl*, 281 U.S. 111 (1930). In *Lucas*, the Supreme Court held that a husband was not permitted to shift his income to his wife through the use of a contract. *Id.* The Court would not uphold an “arrangement by which fruits are attributed to a different tree from that on which they grew.” *Id.* at 115. This analogy was also famously embraced by Lyon & Eustice, *supra* note 45, at 303–04.

⁴⁸ Del Cotto, *supra* note 46, at 18.

⁴⁹ *Lattera v. Comm’r*, 437 F.3d 399, 407 (3d Cir. 2006) (alteration in original) (quoting *Sinclair*, *supra* note 36, at 401).

⁵⁰ Del Cotto, *supra* note 46, at 18.

below, the lack of retention of “an interest in the underlying income-producing property”⁵¹ by the seller should not always make the doctrine inapplicable.

Query whether *P.G. Lake* would have come out differently if there had been real risk in the assignees’ interests? Professor Del Cotto commented that in *P.G. Lake*, “[t]he Court stressed that the pay out of the assigned oil payment rights could be ascertained with considerable accuracy. . . .”⁵² He referred to the Fifth Circuit decision *United States v. Foster*,⁵³ a fact-pattern involving a horizontal slice. The court determined that that the risk factor “must be taken into consideration and capital gains will result on the sale of a carved-out payment if the pay out of the oil payment cannot be predicted with reasonable accuracy.”⁵⁴ As discussed below, this position has been undercut by other cases and the substitute for ordinary income doctrine can apply to situations where taxpayer’s rights being transferred are not fixed. Horizontal slices should invariably result in ordinary income treatment even where the transferee assumes risks.

Professor Del Cotto also asserted that the Court in *P.G. Lake* could have, as an alternative to lack of capital asset status, denied capital gain treatment on the basis of an absence of a “sale or exchange.”⁵⁵ He points out that this was implied by the Court when it stated twice that “there had been no conversion of a capital investment.”⁵⁶

⁵¹ Sinclair, *supra* note 36, at 405.

⁵² Del Cotto, *supra* note 46, at 20.

⁵³ *United States v. Foster*, 324 F.2d 702 (5th Cir. 1963).

⁵⁴ Del Cotto, *supra* note 46, at 21. The importance of the lack of risk transferred to the assignee in *P.G. Lake* was stressed by the Tax Court in *Guggenheim v. Comm’r*, 46 T.C. 559 (1966). In *Guggenheim* the Tax Court stated that

[t]he transferee [in *P.G. Lake*] assumed few of the risks identified with the holding of a capital asset; he assumed only a nominal risk of his oil payment right decreasing in value and none of the possibility of the oil payment right increasing in value. On the other hand, the taxpayer, after the transfer, retained essentially all of the investment risks involved in his greater interest to the same extent as before the transfer.

Id. at 569.

⁵⁵ Del Cotto, *supra* note 46, at 19.

⁵⁶ *Id.* (citing *P.G. Lake*, 356 U.S. at 265, 268).

While there should be little doubt that *Hort* and *P.G. Lake* were correctly decided, they do not provide a clear roadmap as to when the doctrine should serve to deny capital gain treatment. Bittker and Lokken have observed that “the holdings of *Hort* and *Lake* are . . . that a present receipt substituting for one or more future receipts has the same character as the future receipts would have had it received in the ordinary course.”⁵⁷ The utilization of that interpretation of the doctrine they believe, however, is “too broad.”⁵⁸

Professor David F. Shores wrote that the substitute for ordinary income doctrine should be applicable when a capital gain “result is deemed incompatible with the congressional intent of taxing an item as ordinary income.”⁵⁹ One still needs to grapple with the question as to under what circumstances would capital gain treatment be in conflict with congressional objectives. The challenge is to develop and apply a fairly consistent methodology for determining when the doctrine should be employed. Some frameworks have been offered by the courts and commenters which are discussed below.

Expansive interpretation by the courts of the substitute for ordinary income can lead to denying capital gain treatment in inappropriate circumstances. One commentator observed that “[t]he problem with the [substitute for ordinary income] doctrine is that every capital asset is a substitute for ordinary income; read literally, the doctrine would completely swallow the concept of capital gains.”⁶⁰ For example, if “the taxpayer in *Hort* had sold the building, consideration received would include the value for the favorable lease . . . but it is clear that . . . *Hort* [was not] . . . intended to deny capital gain treatment in these situations.”⁶¹ Some courts, however, have

⁵⁷ BITTKER & LOKKEN, *supra* note 2, at ¶ 47.9.5.

⁵⁸ *Id.* They opined that “[i]t is most persuasive when the taxpayer sells a right to receive income items that will accrue in the near future.” *Id.*

⁵⁹ David F. Shores, *Reexamining the Relationship Between Capital Gain and the Assignment of Income*, 13 IND. L. REV. 463, 467 (1980).

⁶⁰ Matthew S. Levine, Case Comment, *Lottery Winnings as Capital Gains*, 114 YALE L.J. 195, 196 (2004). In accord with this is Bittker & Lokken’s observation that “[u]nless restrained, the substitute-for-ordinary income theory . . . threatens even the most familiar capital gain transactions.” BITTKER & LOKKEN, *supra* note 2, at ¶ 47.9.5.

⁶¹ BITTKER & LOKKEN, *supra* note 2, at ¶ 47.9.55.

unfortunately interpreted *Hort* and *P.G. Lake* in a way that ignores commonsense limitations. The well-reasoned decision of the Fifth Circuit in *United States v. Dresser Industries, Inc.*,⁶² discussed below, was critical of an earlier Fifth Circuit decision, *United States v. Eidson*,⁶³ for its failure to put reasonable boundaries on the doctrine's reach. In *Eidson*, the Fifth Circuit reversed a trial court that had held that amounts received by taxpayers in consideration for the assignment of their rights under a management contract that they had with an insurance company was capital gain. *Eidson* held that the right to receive a percentage of the net profits from the operations of the business for the remainder of the contract was ordinary income.

In *Dresser*, the court observed that *Eidson* had illogically literally applied *P.G. Lake*'s generalized language "to mean that any money paid which represents the present value of future income to be earned is always taxed as ordinary gains."⁶⁴ The Fifth Circuit, in *Dresser*, reasoned that the court in *Eidson* failed to appreciate the fact "[t]he only commercial value of any property is the present worth of future earnings or usefulness . . . [t]he value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income."⁶⁵ The approach *Dresser* utilized for determining when the doctrine should be applied is discussed below.

⁶² *United States v. Dresser Indus.*, 324 F.2d 56 (5th Cir. 1963).

⁶³ *United States v. Eidson*, 310 F.2d 111 (5th Cir. 1962).

⁶⁴ *Dresser*, 324 F.2d 59.

⁶⁵ *Id.* The importance of limiting the reach of the doctrine, because most assets generate ordinary income, was echoed by another academic, William A. Klein. Klein was quoted by the Third Circuit in *Lattera*, discussed below, that "[a] fundamental principle of economics is that the value an asset is equal to the present discounted value of all the expected net receipts from that asset over its life." *Lattera*, 437 F.3d at 404 (citing WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 786 (12th ed. 2000)). Similarly, Professor Douglas Kahn writes:

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.

Kahn, *supra* note 4, at 450.

The next important Supreme Court case in this area was *Commissioner v. Gillette Motor Transport, Inc.*⁶⁶ The question the Court decided in *Gillette Motor* was whether compensation received by the taxpayer “for the temporary taking by the government of its business facilities during World War II”⁶⁷ should be treated as ordinary income or capital gain. The Court held the payment to be ordinary income.

The Court acknowledged that the taxpayer “had been deprived of *property* . . . compensable under the Fifth Amendment. . . .”⁶⁸ The Court, however, then declared that “not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset.”⁶⁹ The Court distinguished the taxpayer’s right to compensation for the use of its facilities from the facilities themselves. The Supreme Court stated that this “right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves.”⁷⁰ The Court found that “[i]n short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent.”⁷¹ This case was undoubtedly correctly decided, too. The taxpayer assigned a horizontal slice retaining the underlying property. The taxpayer’s income was the equivalent of rent for the limited use of the taxpayer’s business facilities and should be taxed as such.

The fourth major Supreme Court case concerning this subject matter was *United States v. Midland-Ross Corp.*⁷² In *Midland-Ross*, the taxpayer bought noninterest-bearing promissory notes discounted below the face amounts and then sold them after holding the notes for more than the six months statutory requirement for long-term capital gain treatment. The sales, which occurred before the notes maturity, were for more than their issue price

⁶⁶ *Comm’r v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960).

⁶⁷ *Id.* at 130.

⁶⁸ *Id.* at 133 (emphasis in original).

⁶⁹ *Id.* at 134.

⁷⁰ *Id.* at 135.

⁷¹ *Id.*

⁷² *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965).

but less than their face amount.⁷³ The Court held the gain to be ordinary income and not capital gain.

The Court, in *Midland-Ross*, cited approvingly its observation from *Gillette Motor* that “not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset.”⁷⁴ The Supreme Court further reasoned that “this Court has consistently construed ‘capital asset’ to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income.”⁷⁵ The Court noted that “[e]arned original issue discount serves the same function as stated interest . . . it is simply ‘compensation for the use or forbearance of money.’”⁷⁶ The Supreme Court stressed that “[u]nlike the typical case of capital appreciation, the earning of discount to maturity is predictable and measurable, and is ‘essentially a substitute for . . . payments which [the statute] expressly characterizes as gross income [; thus] it must be regarded as ordinary income. . . .’”⁷⁷

This decision was certainly properly decided also. The income clearly represented interest for the use of money and should be taxed as such, i.e., ordinary income. While courts and scholars often cite *Midland-Ross* along with *Hort*, *Lake* and *Gillette Motor* as the significant foundational cases for the doctrine, there were key distinctions between *Midland-Ross* from the other cases.⁷⁸

While these four Supreme Court decisions are certainly essential for understanding the substitute for ordinary income doctrine, lower court decisions and other observations by commentators, discussed below, are critical for analyzing both when to apply the principle and whether the

⁷³ The case was decided under the Internal Revenue Code of 1939, before the enactment of the current statutory treatment of original issue discount, as set forth in § 1271.

⁷⁴ *Midland-Ross*, 381 U.S. at 56 (quoting *Gillette Motor*, 364 U.S. at 134).

⁷⁵ *Id.*

⁷⁶ *Id.* at 57 (quoting *Deputy v. du Pont*, 308 U.S. 488, 498 (1940)).

⁷⁷ *Id.* (alteration in original) (quoting *Hort*, 313 U.S. at 31).

⁷⁸ Professor Del Cotto observed that in *Midland-Ross* “there is no sale of ‘future income’ and a retention of the ‘property’ since the transferor has parted with his entire interest in the property.” Del Cotto, *supra* note 46, at 25.

Eleventh Circuit was correct in rejecting its application in *Long v. Commissioner*.

B. Some Other Notable Decisions Serving to Clarify the Scope of the Doctrine

While the Second Circuit decision *Commissioner v. Ferrer*⁷⁹ did not refer to the substitute for ordinary income doctrine per se, it remains a very notable case in understanding when to employ the doctrine. This is because of Judge Friendly’s noteworthy analysis in distinguishing circumstances in which a taxpayer was and was not entitled to capital gain treatment upon the surrender of contract rights.⁸⁰ In *Ferrer*, the taxpayer, actor Jose Ferrer, received certain payments with respect to the motion picture “Moulin Rouge” about the artist Henri de Toulouse-Lautrec. The court examined the nature of the rights released and determined that while the transfer of two rights resulted in capital gain treatment, a third right conveyed should be treated as ordinary income.

Ferrer had entered into a contract with Pierre LaMure, the author of both the novel “Moulin Rouge” and the play “Monsieur Toulouse,” based on the novel. Pursuant to the contract, Ferrer obtained three key rights with respect to the novel and play that were relevant to the case: (1) “‘the sole and exclusive right’ to produce and present . . .”⁸¹ the play in the United States and Canada with some production privileges elsewhere; (2) the “power . . .

⁷⁹ *Comm’r v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).

⁸⁰ The decision, however, is not devoid of scholarly criticism. For example, Professors Chirelstein and Zelenak wrote that

Judge Friendly’s opinion in *Ferrer* is skillfully devised and plausible. Even so, one can question whether it was truly appropriate to treat each of the taxpayer’s contract rights as a separate unit, instead of viewing the contract, as the Tax Court had, as one single economic interest . . . It is [also] difficult to see [] why right (3) should have been carved out of the basic contract and treated as if disposed of for a separate consideration when that was simply not the case . . . Actually, the simplest, and probably the most nearly accurate view of the facts in *Ferrer* was that the entire percentage payment represented a reward for Ferrer’s services as an actor . . . and quite probably all of it should have been lumped together with Ferrer’s salary and found to be ordinary in the first instance.

CHIRSTELSTEIN & ZELENAK, *supra* note 35, at 444–45.

⁸¹ *Ferrer*, 304 F.2d at 127.

to prevent any disposition of the motion picture rights until June 1, 1952 . . .”⁸² or longer, if he satisfied certain conditions, as well as the power “to prevent disposition of radio and television rights . . .”⁸³ and (3) the entitlement to “forty percent share of the proceeds of the motion picture and other rights if he produced the play.”⁸⁴ Accordingly, Ferrer’s contractual rights “consisted of his lease of the play, his ‘encumbrance’ or restriction of the author’s power to transfer the retained film rights, and a contingent royalty interest in the consideration received by the author if the film rights were sold with Ferrer’s consent.”⁸⁵

Shortly after having signed the agreement with LaMure, the renowned director John Huston contacted Ferrer and inquired if he was interested in playing Toulouse-Lautrec in a picture based upon “Moulin Rouge.” Contracts were entered into with Huston’s company, Moulin Productions, Inc. by Ferrer and LaMure. A letter agreement was also reached between Ferrer and LaMure. Pursuant to these agreements, LaMure sold the author’s film and television rights to “Moulin Rouge” to Moulin Productions, with Ferrer simultaneously signing a letter of agreement cancelling and terminating his contract with LaMure. In addition to his salary as an actor in the film, Ferrer received about \$179,000 in 1953 as stipulated percentages of net profits for which Ferrer provided evidence was for the sale of dramatic rights he had with LaMure that were relinquished. The question before the Second Circuit in *Ferrer* was how much of the amount paid for these rights was entitled to capital gain treatment.

The court observed that

[o]ne common characteristic of the group [of cases] held to come within the capital gain provision is that the taxpayer had either what might be called an “estate” in . . . or an “encumbrance” on . . . or an option to acquire an interest in . . . property which, if itself held, would be a capital asset.⁸⁶

⁸² *Id.* at 131.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Eustice, *supra* note 1, at 5.

⁸⁶ *Ferrer*, 304 F.2d at 130.

The Second Circuit commented that “[i]n all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another . . . or by rendering services . . . or by virtue of ownership of a larger ‘estate.’”⁸⁷

While not germane to the applicability of whether the assets transferred should have been treated as capital assets, the Second Circuit in *Ferrer* rejected some prior case law that distinguished between a sale to a third person and a release to the grantor in determining whether the “sale or exchange” requirement of § 1222 was satisfied. In this regard, the court asserted that “we can see no sensible business basis for drawing a line between a release of Ferrer’s rights to LaMure for a consideration paid by Moulin, and a sale of them, with LaMure’s consent, to Moulin or to a stranger who would then release them.”⁸⁸ The court further observed that the “[t]ax law is concerned with the substance, here the voluntary passing of ‘property’ rights allegedly constituting ‘capital assets,’ not with whether they are passed to a stranger or to a person already having a larger ‘estate.’”⁸⁹

The Second Circuit next analyzed the three important rights Ferrer ceded and determined that the first two transfers were each entitled to capital gain treatment, but that relinquishment of the 40% share of proceeds of the motion picture predicated on the production of the play was ordinary income. As to the first right, the surrender of Ferrer’s lease of the play, the court, without using the phrase “substitute for ordinary income,” explained its lack of relevance. The Second Circuit opined that “[w]e see no basis for holding that amounts paid Ferrer for surrender of his lease of the play are excluded from capital gain treatment because receipts from the play would have been ordinary income.”⁹⁰ In this regard, the court equated the *Ferrer* fact-pattern with a lessee who received payment for terminating its lease, which property it had either subleased (and thus received rental income) or received business income from its use. In these situations, the termination of the lease should

⁸⁷ *Id.*

⁸⁸ *Id.* at 131.

⁸⁹ *Id.*

⁹⁰ *Id.* at 132.

not result in ordinary income.⁹¹ As Professor Eustice observed, “Ferrer’s exclusive use of the dramatic rights was a speculative property interest in a copyright . . . [and] Ferrer sold his *entire* interest in the transferred property, so the ‘carving out’ problem in the *Lake* and *Hort* cases was absent here.”⁹² Thus, the transfer of the first right can be viewed as that of a vertical slice.

As to the second right that Ferrer surrendered, his negative power to prevent disposition of the of motion picture, television and radio rights, the Second Circuit again found capital gain treatment appropriate. The court characterized this right as an “‘equitable interest’ in [a] portion of the copyright.”⁹³ The court, in its determination that capital gain treatment was appropriate, again analogized to a lessor/lessee fact-pattern. The Second Circuit stated that a “tenant’s relinquishment of a right to prevent his landlord from leasing to another tenant in the same business . . . [was] held to be the sale or exchange of a capital asset.”⁹⁴ The court also emphasized the presence of an equitable remedy to enforce this right.

⁹¹ *Id.* There is thus a distinction between payments a lessor receives for lease termination as in *Hort*, and payments made to a lessee upon this event. Professors Chirelstein and Zelenak comment that some authorities have argued that the distinction is that “[i]n the lessee’s hands, it is said, the leasehold is a substantial interest in real estate, not merely a claim to future income.” CHIRELSTEIN & ZELENAK, *supra* note 35, at 440. They believe, however, that

the best . . . reason for [distinguishing between the lessor and lessee upon a lease termination] resides in the presence (in one case) and the absence (in the other case) of the familiar carving out. Once again, a lessor who disposes of his interest in a lease *still* owns the underlying income-producing property—land or building—after the disposition. He therefore retains the ability, on the expiration of the lease, to *repeat* the process, on making an advance disposition of his right to future rentals. If such advance dispositions were accorded capital gain treatment, then all of the property-owner’s rental income could be converted into capital gain.

Id. (emphasis in original).

⁹² Eustice, *supra* note 1, at 8 (emphasis in original) (footnote omitted).

⁹³ *Ferrer*, 304 F.2d at 133.

⁹⁴ *Id.* The scope of *Ferrer* in according capital gain treatment to the relinquishment of contract rights was substantially limited by the Tax Court in *Bellamy v. Commissioner*, 43 T.C. 487 (1965). In that case, the actor, Ralph Bellamy, claimed capital gain treatment on the sale of his rights under a contract to prevent the distribution and showing of certain films. The court stated that

[w]hile the right which the petitioner granted to Revue to distribute and show the films might, in the ordinary sense, be characterized as a property right, he had no investment therein, aside from the services which he had performed in connection with the making of the films, and hence such right had no cost basis in his hands.

With respect to the third right given up by Ferrer, 40% of the motion picture proceeds if he produced “Monsieur Toulouse,” the Second Circuit determined that ordinary income treatment was proper. The court noted that with respect to this claim, “Ferrer was to ‘have no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive the Manager’s share of the proceeds’ . . . he was to have ‘no recourse, in law or in equity’ . . . but only a right to arbitration against the Author.”⁹⁵ In short, Ferrer lacked “an affirmative equitable interest in the motion picture or other rights, as distinguished from his temporary negative ‘encumbrance’ on them.”⁹⁶ The Second Circuit referred to *Hort* to “point to what would seem the inevitable corollary that if, on the same facts, Ferrer had then sold his rights to a percentage of the profits for a lump sum, that, too, would have been ordinary income. . . .”⁹⁷ Professor Eustice commented that “[w]hat Ferrer received from Moulin to cancel these rights still retained its stigma as a substitute for future ordinary income.”⁹⁸

There was, however, risk and opportunity with respect to this third right. In this respect it differs from e.g., the lottery winning installment transfer cases discussed below, where the amount to be received in the form of an annuity is known in advance and the only risk is that of being a creditor of the payer. That is, in *Ferrer*, “the amount of such income [from the third right Ferrer could have earned had it not been released] was subject to a future contingency that the third person would and could profitably exploit his

Id. at 498. The court further stated that

the facts in the *Ferrer* case are substantially different from those obtaining here. There the right which was transferred was incidental to a property interest, namely, the “lease” of the play, in which the taxpayer had an investment, and was not a right stemming from a contract of employment. Clearly the amount in question in the instant case did not represent, to any extent, consideration for the transfer of any property interest comparable to that involved in the *Ferrer* case.

Id. at 499–500.

⁹⁵ *Ferrer*, 304 F.2d at 134.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ Eustice, *supra* note 1, at 9.

property.”⁹⁹ Thus, while the substitute for ordinary income doctrine can apply to transfers for consideration representing the present value of a fixed payments to be received in the future, such as the lottery winnings installment sales cases discussed below, it can also apply when the future payment is contingent. For example, if one sells his ticket in a horse race, halfway through the race when his horse is ahead for a fixed amount the payment should be ordinary income, i.e., the doctrine should apply.

As with the lottery winnings cases, with respect to this third right in *Ferrer*, “all events had been performed by Ferrer which were necessary for him to ‘earn’ the basic right to his income. . . .”¹⁰⁰ This distinction was expanded upon and reinforced by the Fifth Circuit in *United States v. Dresser Industries, Inc.*¹⁰¹

In *Dresser*, the Fifth Circuit rejected the government’s attempt to apply the substitute for ordinary income doctrine. In that case, the taxpayer had entered into an agreement with Well-Surveys, Inc., which granted the taxpayer a license to utilize its patent for work the taxpayer did for third parties. Several years later, a taxpayer and Well-Surveys, Inc. entered into a new agreement pursuant to which the taxpayer relinquished its exclusivity rights under the original contract and received in return \$500,000 “to be paid out of one quarter of the fees earned by practice of the patent to third parties.”¹⁰² In its finding that the taxpayer was entitled to capital gain treatment, the Fifth Circuit stated that the “[t]axpayer had an asset, a right, a property which would produce income. The fact that the income, which could be earned would be ordinary income is immaterial; such would be true of the sale of all income-producing property.”¹⁰³

The court in *Dresser* initially observed that the case was not a horizontal slice wherein the taxpayer continued to retain rights to the property transferred. The court stated “[t]he taxpayer here is cutting off a ‘vertical slice’ of its rights, rather than carving out an interest from the totality of its

⁹⁹ *Id.* at 16.

¹⁰⁰ *Id.*

¹⁰¹ *United States v. Dresser Indus.*, 324 F.2d 56 (5th Cir. 1963).

¹⁰² *Id.* at 57.

¹⁰³ *Id.* at 59.

rights under the grant. . . . The tree was sold, along with the fruit, at least insofar as that branch was concerned.”¹⁰⁴

Very importantly, the court in *Dresser* enunciated a major demarcation as to when and when not to apply the substitute for ordinary income doctrine. The Fifth Circuit stated that “[t]here is, in law and fact, a vast difference between the present sale of the future right to earn income and the present sale of the future right to earned income.”¹⁰⁵ The *Dresser* fact-pattern was one in which there was both a vertical slice and a “future right to earn income.”¹⁰⁶ Under these circumstances, the court appropriately concluded the doctrine was inapplicable. As discussed below, however, there are decisions where the doctrine was held to apply even where the taxpayer met the criteria of both selling “the future right to earn income” and at least arguably having transferred a vertical slice.¹⁰⁷ It would seem, however, that the better answer is the doctrine should generally be inapplicable in circumstances where the foregoing criteria are met and is coupled with the taxpayer having transferred an appreciated equitable interest in property.

¹⁰⁴ *Id.* at 58.

¹⁰⁵ *Id.* at 59 (footnote omitted). The following language in Judge Brown’s concurring opinion in *Dresser* is also worth noting:

But although this sales price is determined by future earnings, and to the seller it takes the place of what he would have received had he continued his ownership, under no stretch of the imagination is it “ordinary income” either in the business world or in the sometimes more weird, tax world. Were this so, then every such sale for a price in excess of cost would entail this analysis and this tax consequence.

Id. at 61.

¹⁰⁶ *Id.* at 59.

¹⁰⁷ *Id.*; see, e.g., *Foot v. Comm’r*, 81 T.C. 930 (1983) (wherein a professor’s relinquishment of tenure rights was treated as a substitute for ordinary income despite the fact that a vertical slice had been transferred because tenure only gave him the right to earn income in the future). As to the latter point, the case applied to years before § 1234A became effective. Section 1234A provides, in pertinent part, that

[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of—
(1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.

A recent case concerning whether the substitute for ordinary income doctrine should be employed is *Tempel v. Commissioner*.¹⁰⁸ In *Tempel*, the taxpayers argued that gains from the sale of their transferable Colorado income tax credits, obtained from the donation of a qualified conservation easement, were entitled to long-term capital gain treatment. One of the Service's arguments for its position that such benefits should be denied was that these sales had resulted in ordinary income pursuant to the substitute for ordinary income doctrine. The court held the doctrine inapplicable but the taxpayers' victory on this issue proved Pyrrhic because the Tax Court found the capital gain to be short-term.¹⁰⁹

The Tax Court, in its analysis as to whether capital gain treatment was proper, decided initially that the Colorado tax credits were not contract rights and should not be analyzed as such in determining whether capital gain treatment was appropriate.¹¹⁰ The court stated that "[t]here is nothing in the

¹⁰⁸ *Tempel v. Comm'r*, 136 T.C. 341 (2011), *aff'd sub nom.* *Esgar Corp. v. Comm'r*, 744 F.3d 648 (10th Cir. 2014).

¹⁰⁹ *See Tempel*, 136 T.C. 341. The court found the holding period of the credits to begin "at the time the credits were granted and ended when petitioners sold them." *Id.* at 355. The taxpayers had asserted that the holding period of the land upon which they donated the conservation easement should apply to the tax credits. The Tax Court also held the taxpayers had no basis in the tax credits sold. This latter holding was appealed but was affirmed by the Tenth Circuit. *Esgar*, 744 F.3d 648.

¹¹⁰ *Tempel*, 136 T.C. at 349. In doing so, it rejected the Service's contention that it was appropriate to use a six-factor test for determining whether the assignment of contract rights qualified for capital gain treatment first enunciated by the Tax Court in *Foy v. Comm'r*, 84 T.C. 50 (1985), and then followed by the court in *Gladden v. Comm'r*, 112 T.C. 209 (1999), *rev'd on a different issue* 262 F.3d 851 (9th Cir. 2001). *Tempel*, 136 T.C. at 348 & nn.9–10. In *Foy*, the Tax Court observed that

in determining whether the taxpayer's contract rights that were transferred constituted a capital asset, courts generally consider all aspects of the bundle of rights and responsibilities of the taxpayer that were transferred, specifically including the following six factors: (1) How the contract rights originated; (2) How the contract rights were acquired; (3) Whether the contract rights represented an equitable interest in property which itself constituted a capital asset; (4) Whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income; (5) Whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and (6) Whether the contract rights primarily represented compensation for personal services.

Foy, 84 T.C. at 69–70.

Colorado statutes granting the tax credits that could be understood to create a contract.”¹¹¹

The court next opined that the substitute for ordinary income doctrine was inapplicable to the taxpayers’ situation. This was, the court reasoned, because the credits could only be utilized to obtain a refund if Colorado produced a budget surplus which it had not in 2004 (the year the credits were sold) or 2006–10.¹¹² Furthermore, the Tax Court observed that had the taxpayers themselves used the credits, this “reduction in a tax liability [would not be] . . . an accession to wealth,”¹¹³ and thus should not be treated as income. The credits “merely represented the right to reduce a taxpayer’s State tax liability.”¹¹⁴ The Tax Court concluded that the taxpayers “never possessed a right to income from the receipt of the credits. They did not sell a right either to earned income or to earn income.”¹¹⁵

Professors Martin J. McMahon, Jr., Ira B. Shepard, and Daniel L. Simmons are suitably critical of the court’s reasoning with respect to capital asset status in *Tempel*, commenting that “[t]he taxpayer in this case recognized [short-term] capital gain treatment with respect to an asset that had never appreciated over the time they held it. That is not the type of situation that should receive [assuming it had been held for more than one year] preferential treatment.”¹¹⁶ *Tempel*, however, was cited and followed in another Tax Court case involving the transfer of Colorado state tax credits, *McNeil v. Commissioner*.¹¹⁷

¹¹¹ *Tempel*, 136 T.C. at 348.

¹¹² *Id.* at 349. The Tax Court noted, however, that Colorado taxpayers were able to receive a refund for such credits in 2005. *Id.* at 349 n.13.

¹¹³ *Id.* at 351.

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 351–52.

¹¹⁶ Martin J. McMahon, Jr. et al., *Recent Developments in Federal Income Taxation: The Year 2011*, 12 FLA. TAX REV. 235, 298 (2012); see also Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 709, 810–12 (2012).

¹¹⁷ *McNeil v. Comm’r*, 101 T.C.M. (CCH) 1535, 2011 T.C.M. (RIA) ¶ 2011-109 (2011).

C. Lessons from the Lottery Decisions

There are a series of relatively recent cases that have treated the sale of lottery winning installment payments for a lump sum as ordinary income under the substitute for ordinary income doctrine. While the outcomes of these decisions appear obvious, there are useful insights drawn from some of the court opinions and commentary in this area, which provide considerable assistance in determining when the doctrine should be employed.

In *Womack v. Commissioner*,¹¹⁸ the taxpayer had won a portion of the Florida State Lottery (“Florida Lotto”) and collected annual installments for a few years until Florida changed its law permitting winners to assign their Florida Lotto rights. He reported the annual installments as ordinary income. In 2000, he sold his Florida Lotto rights to a third party for \$1.328 million. He reported this as long-term capital gain which was disallowed by the Service.

The Eleventh Circuit commented that “four Circuits have reviewed the precise legal question we face here under materially identical circumstances. Each Circuit has concluded that Lottery Rights are substitutes for ordinary income, but came to this conclusion in different ways.”¹¹⁹

As to its own reasoning and conclusion, the Eleventh Circuit in *Womack* stated that:

[w]e agree with our sister circuits that Lottery Rights are a clear case of a substitute for ordinary income. A lottery winner who has *not* sold the right to his winnings to a third party must report the winnings as ordinary income whether the state pays him in a lump sum or in installments.¹²⁰

The court further opined that “Congress did not intend for taxpayers to circumvent ordinary income tax treatment by packaging ordinary income payments and selling them to a third party.”¹²¹ The court observed that “any ‘gain’ from their sale reflects no change in the value of the asset. It is simply

¹¹⁸ *Womack v. Comm’r*, 510 F.3d 1295 (11th Cir. 2007). A comparable fact-pattern to that of *Womack* involving one Maria Spiridakos was also decided as part of the case. *Id.* at 1298.

¹¹⁹ *Id.* at 1300 (footnote omitted). The analysis provided by the other Circuit Courts of Appeals regarding this matter is discussed below. *See infra* part D.

¹²⁰ *Id.* at 1301.

¹²¹ *Id.*

the amount Taxpayers would have received eventually, discounted to present value.”¹²²

This fact-pattern contrasted with that in *Dresser*.¹²³ That is “when a lottery winner sells Lottery Rights, he transfers a right to income that is already earned, not a right to earn income in the future.”¹²⁴ These lottery cases, even those involving vertical slices, are the poster child for when the doctrine should be applied, i.e., an almost risk-free right involving income already earned with no upside potential for the transferee. The Fifth Circuit specifically distinguished *Dresser*, noting that “when a lottery winner sells Lottery Rights, he transfers a right to income that is already earned, not a right to earn income in the future.”¹²⁵ The Eleventh Circuit also observed that “income from a lottery payment is earned income despite the fact that it does not accrue until the scheduled annual payment date.”¹²⁶

The Eleventh Circuit in *Womack* joined a number of other courts in its rejection of the taxpayer’s contention that the substitute for ordinary income doctrine was significantly limited by the Supreme Court’s decision in *Arkansas Best*.¹²⁷ In its dismissal of the taxpayer’s interpretation of footnote five in *Arkansas Best* as support for its position, the court indicated that “[i]t in no way implies that the Court applied the *substitute for ordinary income doctrine* narrowly, nor hints that the Court would confine the doctrine to the facts of the cases it cites.”¹²⁸

The court in *Womack* also rebuffed the taxpayer’s argument for claiming capital gain treatment under the theory that lottery rights should constitute “property” under § 1221 because they “are property in the ordinary sense of

¹²² *Id.*

¹²³ *United States v. Dresser Indus.*, 324 F.2d 56, 57 (5th Cir. 1963).

¹²⁴ *Womack*, 510 F.3d at 1302.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* See *Lattera v. Comm’r*, 437 F.3d 399, 403–04 (3d Cir. 2006); *United States v. Maginnis*, 356 F.3d 1179, 1185 (9th Cir. 2004); *Davis v. Comm’r*, 119 T.C. 1, 6–7 (2002); *Gladden v. Comm’r*, 112 T.C. 209, 221 (1999); *FNMA v. Comm’r*, 100 T.C. 541, 573 & n.30 (1993).

¹²⁸ *Womack*, 510 F.3d at 1303.

the term and for purposes of other . . . laws.”¹²⁹ The Eleventh Circuit observed that “[t]he Court again recognized in *Arkansas Best* that a literal reading of the term ‘property’ is not appropriate where such a reading would include ordinary income and substitutes for ordinary income.”¹³⁰ The court noted that “Lottery Rights are property for most other purposes, but ‘property’ under Section 1221 is a narrower concept . . . [and that] some things that would normally be ‘property’ are not capital assets, even if no statutory exclusion covers them.”¹³¹

A year earlier, the Third Circuit decided another case involving the assignment of lottery winnings, *Lattera v. Commissioner*,¹³² which also held for the Service in its treatment of the assignment of lottery income rights as ordinary income. In 1991, the Latters had won close to ten million dollars in the Pennsylvania lottery and were required at that point to take the prize in 26 annual installments. Upon receiving the required court approval, in 1999 they sold their rights to the remaining seventeen lottery payments, which they reported as capital gain. The Service determined the proper treatment was ordinary income.

Just as in *Womack*, the court dismissed the taxpayer’s assertion that the substitute for ordinary income doctrine “did not survive *Arkansas Best*.”¹³³ The Third Circuit did, however, recognize the importance of not applying the doctrine broadly. It quoted one writer that “[r]ead literally, the [substitute-for-ordinary income] doctrine would completely swallow the concept of capital gains.”¹³⁴

The court in *Lattera* emphasized that it was utilizing a different methodology from some other lottery winnings transfer cases, especially an earlier decision by the Ninth Circuit in *United States v. Maginnis*,¹³⁵ discussed below. The Third Circuit, in *Lattera*, indicated that in determining

¹²⁹ *Id.* at 1304.

¹³⁰ *Id.* (alteration in original) (citing *Ark. Best Corp.*, 485 U.S. at 217 n.5).

¹³¹ *Id.* at 1304–05 (citing *Gillette*, 364 U.S. at 134).

¹³² *Lattera*, 437 F.3d at 410.

¹³³ *Id.* at 403.

¹³⁴ *Id.* at 404 (quoting Levine, *supra* note 60, at 196).

¹³⁵ *Id.* See *infra* nn.163–72.

whether the substitute for ordinary income doctrine applies to a particular fact-pattern, it was necessary to do a “case-by-case analysis . . . [and] that any rule we create could not account for every contemplated transactional variation.”¹³⁶ Nevertheless, it proceeded to “craft a rubric,”¹³⁷ which it adopted by analogy from a Second Circuit securities case,¹³⁸ based on a “family resemblance”¹³⁹ test. The court observed that there are “[s]everal types of assets we know to be capital: stocks, bonds, options and currency contracts for example.”¹⁴⁰ At the opposite end of the spectrum, the court pointed out “are several types of rights that we know to be ordinary income, e.g., rental income and interest income.”¹⁴¹ The Third Circuit asserted that in analyzing a particular circumstance to determine whether the doctrine should be applied, one should look as to whether there is a “family resemblance” to the aforementioned categories. The Third Circuit commented that “for example, we presume that stock, and things that look and act like stock, will receive capital-gains treatment.”¹⁴²

For cases lacking a “family resemblance,” the Third Circuit observed, “like contracts and payment rights, we use two factors to assist in our analysis: (1) type of ‘carve-out’ and (2) character of asset.”¹⁴³ With respect to the carve-out factor, the court reaffirmed the distinction between those done horizontally and vertically and explained that in “[a] horizontal carve-out [which] is one in which ‘temporal divisions [are made] in a property interest in which the person owning the interest disposes of part of his interest

¹³⁶ *Id.* at 405.

¹³⁷ *Id.*

¹³⁸ *Exch. Nat’l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976).

¹³⁹ *Lattera*, 437 F.3d at 406.

¹⁴⁰ *Id.* The court added to this category “physical assets like land and automobiles.” *Id.* For this purpose the court obviously ignored the carve-out from capital asset treatment contained in § 1221(a)(2), i.e., “property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.” I.R.C. § 1221(a)(2).

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.* (footnote omitted).

but also retains a portion of it.”¹⁴⁴ Horizontal carve-outs, like those in *Hort* and *P.G. Lake*, “typically lead to ordinary income treatment.”¹⁴⁵ The Third Circuit noted that horizontal carve-outs also occurred in some of the prior lottery cases where “the lottery winners sold some of their future lottery payment rights (*e.g.*, their 2006 and 2007 payments), but retained the rights to payments further in the future (*e.g.*, their 2008 and 2009 payments).”¹⁴⁶

With respect to vertical carve-outs, the court gave as examples situations in which “the lottery winners sold the rights to all their remaining lottery payments,”¹⁴⁷ which was the fact-pattern in *Lattera*. The Third Circuit pointed out that vertical carve-outs do not always generate capital gains as was illustrated *e.g.*, by *Womack* and other cases in which the taxpayer had assigned all his remaining lottery rights. The court stated that in vertical carve-out fact-patterns one must “proceed to the second factor—character of the asset—to determine whether the sale proceeds should be taxed as ordinary income or capital gain.”¹⁴⁸

As to “the character of the asset” test, the court in *Lattera* instructed that “[a]ssets that constitute a right to earn income merit capital-gains treatment, while those that are a right to earned income merit ordinary-income treatment.”¹⁴⁹ This was the lesson from *Dresser*, *i.e.*, “there is, in law and fact, a vast difference between the present sale of the future right to *earn* income and the present sale of the future right to *earned* income.”¹⁵⁰

The Third Circuit provided termination payments for personal service contracts as an example of circumstances where ordinary income treatment is proper. In those circumstances, the “employee still possesses the asset (the right to provide certain personal services) and the money (the termination

¹⁴⁴ *Id.* at 407 (quoting *Sinclair*, *supra* note 36, at 401).

¹⁴⁵ *Id.* See *Lake*, 356 U.S. at 264; *Hort*, 313 U.S. at 32.

¹⁴⁶ *Lattera*, 437 F.3d at 407. See *Clopton*, 87 T.C.M. (CCH) at 1217–18; *Boehme v. Comm’r*, 85 T.C.M. (CCH) 1039, 2003 T.C.M. (RIA) ¶ 2003-081 (2003); *Davis*, 119 T.C. at 3.

¹⁴⁷ *Lattera*, 437 F.3d at 407. See *Watkins v. Comm’r*, 447 F.3d 1269 (10th Cir. 2006); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004). See also *Womack v. Comm’r*, 510 F.3d 1295 (11th Cir. 2007).

¹⁴⁸ *Lattera*, 437 F.3d at 407.

¹⁴⁹ *Id.* at 408.

¹⁵⁰ *Id.* at 407 (quoting *Dresser*, 324 F.2d at 59).

fee) has already been ‘earned’ and will simply be paid.”¹⁵¹ This is discussed further below. Another example the court gave as a “right to earned income” was the third right surrendered in *Ferrer*, discussed above, 40% of the motion picture proceeds etc. if Ferrer produced “Monsieur Toulouse.” This was “a right to earned income—thus ordinary-income treatment was indicated.”¹⁵²

The court in *Lattera* then applied its analytical framework to the case at bar, and concluded that ordinary treatment was proper. The court reasoned that:

the right to receive annual lottery payments does not bear a strong family resemblance to either the “capital assets” or the “income items” listed at the polar ends of the analytical spectrum. The Latteras sold their right to all their remaining lottery payments, so this is a vertical carve-out, which could indicate either capital-gains or ordinary-income treatment. But because a right to lottery payments is a right to earned income (*i.e.*, the payments will keep arriving due simply to ownership of the asset), the lump-sum payment received by the Latteras should receive ordinary-income treatment.¹⁵³

It should be noted that the court in *Lattera* commented in a footnote,¹⁵⁴ that in *McAllister v. Commissioner*¹⁵⁵ the taxpayer’s situation was a vertical carve-out of her right to earned income (not the right to earn income), yet the Second Circuit accorded her capital gain treatment. The court noted that the case “has been roundly criticized” and that “[w]e consider *McAllister* to be an aberration.”¹⁵⁶

With respect to *McAllister*, it should also be observed that a year after *Lattera* was rendered, the same Second Circuit that decided *McAllister*, in another case involving the sale of a taxpayer’s remaining lottery rights, *Prebola v. Commissioner*,¹⁵⁷ in effect rejected *McAllister* as valid precedent and held the gain to be taxed as ordinary income under the substitute for

¹⁵¹ *Id.* at 408.

¹⁵² *Id.* at 409.

¹⁵³ *Id.* at 409–10.

¹⁵⁴ *Lattera*, 437 F.3d at 410 n.5.

¹⁵⁵ *McAllister v. Comm’r*, 157 F.2d 235 (2d Cir. 1946).

¹⁵⁶ *Lattera*, 437 F.3d at 410 n.5.

¹⁵⁷ *Prebola v. Comm’r*, 482 F.3d 610 (2d Cir. 2007).

ordinary income doctrine. The *Prebola* court pointed out that *McAllister* “was decided before *P.G. Lake*.”¹⁵⁸ Professors Martin J. McMahon, Jr., Ira B. Sheppard, and Daniel L. Simmons concluded that *Prebola* resulted in “[c]onsigning *McAllister* to the dustbin of history.”¹⁵⁹

The *Lattera* decision is, as Susan Simmonds wrote, “an opinion destined for law school casebooks.”¹⁶⁰ *Lattera*’s framework for determining the application of the doctrine, while neither infallible nor immune to criticism,¹⁶¹ appears conceptually sound and should serve as a means for analyzing future cases. The methodology in *Lattera* is certainly, as Professor Timothy R. Koski observed, “a step in the right direction.”¹⁶²

As indicated above, the Third Circuit in *Lattera* was critical of the reasoning, but not the holding, of *Maginnis*. As with the fact-patterns in *Womack*, *Lattera* and *Prebola*, the taxpayer in *Maginnis* had won a lottery, started receiving annual payments, and then subsequently assigned his right to future income to a third party for a lump-sum payment. The Ninth Circuit in *Maginnis*, like the other courts, held the income to be ordinary income.

¹⁵⁸ *Id.* at 611.

¹⁵⁹ Martin J. McMahon, Jr. et al., *Recent Developments in Federal Income Taxation: The Year 2007*, 8 FLA. TAX REV. 715, 743 (2008).

¹⁶⁰ Susan Simmonds, *Third Circuit Adopts “Family” Approach to Asset Treatment*, 110 TAX NOTES 953 (2006).

¹⁶¹ While Professor Douglas Kahn agreed with the court’s conclusion, he rejected the Third Circuit’s analysis “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.” Kahn, *supra* note 4, at 455 (citing *Lattera*, 437 F.3d at 408). Professor Kahn observed that under the *Lattera* court’s reasoning

the sale of shares of stock would produce ordinary income [O]n 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.

Kahn, *supra* note 4, at 455–56. I believe Professor Kahn’s criticism in this regard is perhaps unwarranted. Stock would not fall under the character of the asset test the *Lattera* court framed because it would have been accorded capital gain treatment under the court’s initial “family resemblance” test. *Lattera* also observed that its standards might not have universal application, commenting that “we recognize that any rule we create could not account for every contemplated transactional variation.” *Lattera*, 437 F.3d at 405.

¹⁶² Timothy R. Koski, *A New Twist to the Substitute-for-Ordinary Income Doctrine: Third Circuit Adopts “Family Resemblance” Test to Characterize Sale of Lottery Proceeds as Ordinary Income*, 83 N.D. L. REV. 27, 53 (2007).

The court’s analysis, however, was different. The Ninth Circuit reasoned that ordinary income treatment was appropriate because “Maginnis (1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to any underlying asset Maginnis held.”¹⁶³ The court asserted that:

[b]ecause Maginnis did not make any capital investment in exchange for his lottery right—because there was no “cost” in the relevant sense to Maginnis for the right to receive accrued future payments from the Oregon lottery—the money he received for the sale of his right cannot plausibly be seen as reflecting an increase of value above the cost of any underlying capital asset . . . the sale of Maginnis’ lottery winning . . . lacks the requisite “realization of appreciation in value accrued over a substantial period of time” that is typically necessary for capital gains treatment.¹⁶⁴

The *Maginnis*’ analysis was criticized by the Third Circuit in *Lattera* and by some commentators. The court, in *Lattera*, opined that: “[t]he first factor—underlying investment of capital—would theoretically subject all inherited and gifted property (which involves no investment at all) to ordinary-income treatment.”¹⁶⁵ *Lattera* was also disparaging of the second factor offered by the court in *Maginnis*. The Third Circuit, in *Lattera*, stated that “[n]ot all capital assets experience an accretion in value over cost. For example, cars typically depreciate, but they are often capital assets. . . .”¹⁶⁶ On this one point, *Lattera*’s criticism may not be apposite. Was it the intention of Congress to bestow favorable tax treatment for a long-term capital gain in circumstances where taxpayer was not transferring an asset with an “appreciation in value?”¹⁶⁷ The consideration received by the *Maginnis*’ and the others for assigning their lottery payment rights was equal in value to what they gave up. There was no economic gain, unless one compares the cost of the lottery ticket with what was ultimately received.

¹⁶³ *Maginnis*, 356 F.3d at 1183.

¹⁶⁴ *Id.* at 1184.

¹⁶⁵ *Lattera*, 437 F.3d at 405 (citing *Levine*, *supra* note 60, at 198). Obviously, however, if amount realized is less than adjusted basis there would not be an ordinary or capital gain.

¹⁶⁶ *Id.* Cars used in a trade or business would not be a capital asset pursuant to I.R.C. § 1221(a)(2) but if held for more than one year might qualify for favorable capital gain treatment pursuant to I.R.C. § 1231.

¹⁶⁷ *Maginnis*, 356 F.3d at 1184.

This, however, would require the original yearly payments to qualify for capital gain treatment which, of course was not being asserted. In the case of a gift of property with built-in gain, there is appreciation in value of the possession even if the asset's worth does not increase further in the hands of the donee. *Maginnis* makes a valid assertion about the necessity of value appreciation for capital gain characterization. It is a *sine qua non* for this favorable tax treatment.

The Ninth Circuit in *Maginnis* also commented that an additional rationale for not according capital gain treatment to the assignment is that “treating the sale of *Maginnis*’ lottery right as a capital gain would reward lottery winners who elect to receive periodic payments in lieu of a direct lump sum payment from the state, and then sell that payment right to a third party.”¹⁶⁸ This too makes sense.

Maginnis, just as the courts did in *Womack* and *Lattera*, dispensed with the taxpayer’s argument that *Arkansas Best* “largely invalidated the substitute for ordinary income doctrine.”¹⁶⁹ The court, as had the Third Circuit in *Lattera*, rejected the taxpayer’s contention that vertical slices “automatically prevent[s] application of the substitute for ordinary income doctrine.”¹⁷⁰

The Tenth Circuit in *Watkins v. Commissioner* also employed the substitute for ordinary income doctrine to deny capital gain treatment for a taxpayer who had sold all his rights to future lottery payments.¹⁷¹ The court discussed the theories enunciated by sister circuits in *Lattera* and *Maginnis* but “decline[d] to enter the fray”¹⁷² and stated simply that “what Mr. Watkins exchanged for a lump sum payment was his future right to receive set amounts of income he had essentially already obtained as a result of his lottery success.”¹⁷³ The same conclusion was also reached in another, but

¹⁶⁸ *Id.* at 1184.

¹⁶⁹ *Id.* at 1185.

¹⁷⁰ *Id.*

¹⁷¹ *Watkins v. Comm’r*, 447 F.3d 1269 (10th Cir. 2006).

¹⁷² *Id.* at 1273.

¹⁷³ *Id.*

unpublished, Tenth Circuit decision, *Wolman v. Commissioner*,¹⁷⁴ in which the taxpayer sold his remaining lottery annual payments for two lump sum payments.

The identical right result was reached by the Tax Court, in *Clopton v. Commissioner*,¹⁷⁵ where the taxpayer transferred some, but not all, lottery installment rights contained in a trust, thus creating a horizontal slice situation, in which part of the property rights were retained. From the court's reasoning, however, it appears that the taxpayer would and should have had ordinary income treatment, even if there had been a vertical slice.

The court decisions holding that a transfer of all or part of a taxpayer's right to future lottery winning installment payments should be denied capital gain treatment under the substitute for ordinary income doctrine were undoubtedly correct. They all fell under the ordinary income wing of the *Dresser* delineation as "the present sale of the future right to earned income" instead of the "present sale of the future right to earn income."¹⁷⁶ There was not an appreciation in value, i.e., the transfer price represented the present value of what the assignees would have received in the future had they kept their rights, less the assignees' profit. Finally, while certainly not dispositive of the treatment, the amount of income the assignee was to receive was known and its only risk was a potentially unlikely default by the payer of the lottery installments and the transferee had no possibility of an upside to its purchase.

The reasoning of some of the decisions in this area, notably *Lattera*, provides useful guidance about the scope of the doctrine in other settings.

¹⁷⁴ *Wolman v. Comm'r*, 180 F. App'x 830 (10th Cir. 2006).

¹⁷⁵ *Clopton v. Comm'r*, 87 T.C.M. (CCH) 1217, 2004 T.C.M. (RIA) ¶ 2004-095 (2004).

¹⁷⁶ *United States v. Dresser Indus.*, 324 F.2d 56, 59 (5th Cir. 1963).

D. Personal Service Contracts

The substitute for ordinary income doctrine has been widely applied by the courts to payments made to terminate a contract for personal services.¹⁷⁷ As noted, the Tax Court explicitly referenced as one of the six factors to focus on in determining whether transfers of contract rights were capital assets, “[w]hether the contract rights primarily represented compensation for personal services.”¹⁷⁸

*Flower v. Commissioner*¹⁷⁹ is illustrative of the treatment by the courts in this area. In that case, the taxpayer, acting as an independent contractor, served as a promotional and sales representative for a pharmaceutical company, Rowell Laboratories, Inc. He had a long-term contract to represent the company in certain specified territories. An agreement was reached between the parties to terminate the agreement pursuant to which \$216,000 was to be paid in monthly installments of \$1,500 to the taxpayer. In the years at issue, 1965–67, the taxpayer treated the \$18,000 received as capital gain. The Tax Court agreed with the Service that the amounts should be treated as ordinary income. The court stated that the taxpayer:

simply released to Rowell the right to represent Rowell in a given territory and to receive commissions on the sales of Rowell’s products within that territory. Those commissions would have been taxable to petitioner as ordinary income. The payments petitioner did receive under the termination agreement were simply a substitute for the income he would have received for performing personal services under the contract and the fact that under the termination agreement petitioner did not have to perform services does not convert the personal services contract which petitioner relinquished into a capital asset.¹⁸⁰

In *Holt v. Commissioner*,¹⁸¹ the taxpayer had entered into a contract with Paramount Pictures to produce motion pictures in return for a production fee plus a percentage of the gross receipts. The contract was terminated when

¹⁷⁷ See also Rev. Rul. 2004-110, 2004-2 C.B. 960 (holding that “[A]n amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income . . .”).

¹⁷⁸ *Foy v. Comm’r*, 84 T.C. 50, 70 (1985).

¹⁷⁹ *Flower v. Comm’r*, 61 T.C. 140 (1973), *aff’d*, 505 F.2d 1302 (5th Cir. 1974).

¹⁸⁰ *Id.* at 151.

¹⁸¹ *Holt v. Comm’r*, 303 F.2d 687, 688 (9th Cir. 1962).

during the course of the agreement it became apparent to Paramount that the market for the type of movies taxpayer produced was falling. Under the termination agreement, no more motion pictures were to be produced, and the taxpayer's partnership received a lump sum payment of \$153,000, which the taxpayer had argued was entitled to capital gain treatment. The Ninth Circuit, in its rejection of the taxpayer's position, stated that: "[i]t is well settled that a right to receive future income which is commuted into a lump sum payment results in ordinary income just as the income if actually received in the future in several payments would be ordinary income."¹⁸²

Similarly, in *Vaaler v. United States*,¹⁸³ the Eighth Circuit denied capital asset status to "claims, interests and rights in policies in force in his territory . . . and any renewals thereof"¹⁸⁴ conveyed to an insurance company by an insurance agent upon his termination. The Eighth Circuit observed that the "courts have quite uniformly held that contracts for the performance of personal services are not capital assets and that the proceeds from their transfer or termination will not be accorded capital gains treatment. . . ."¹⁸⁵

In *Trantina v. United States*, the Ninth Circuit decided against the taxpayer's claim for capital gain treatment in another case that involved termination payments made under a personal services contract to an insurance broker.¹⁸⁶ In its analysis, the court did not specifically refer to the application of the substitute for ordinary income doctrine. Instead, the court determined that the contract the taxpayer's company had with the insurance company gave the brokerage "no property that could be sold or exchanged."¹⁸⁷ The Ninth Circuit also rebuffed the taxpayer's assertion that capital gain treatment was apposite "because he made a 'substantial economic investment in the Agreement' that 'increased over the years.'"¹⁸⁸ The taxpayer's investment, he had asserted, was "the economic opportunity

¹⁸² *Id.* at 690–91.

¹⁸³ *Vaaler v. United States*, 454 F.2d 1120, 1121 (8th Cir. 1972).

¹⁸⁴ *Id.* at 1121.

¹⁸⁵ *Id.* at 1122.

¹⁸⁶ *Trantina v. United States*, 512 F.3d 567 (9th Cir. 2008).

¹⁸⁷ *Id.* at 573.

¹⁸⁸ *Id.* at 575.

cost that he incurred when he decided to pursue a career as an insurance agent instead of something else.”¹⁸⁹ The court appropriately indicated that if the taxpayer’s theory was adopted, “it would render not only every employment contract, but also every economic exchange, a capital asset.”¹⁹⁰

In *Foote v. Commissioner*,¹⁹¹ the Tax Court denied a taxpayer capital gain treatment for payments received by a professor for his resignation of his tenured appointment. The Tax Court indicated that tenure should not be accorded capital asset status because Professor Foote’s “payment received [was] . . . essentially a substitute for ordinary income which would have been earned in the future . . . [and that] his rights were not substantially different than the rights under any long-term employment or agency agreement.”¹⁹²

The court indicated that Professor Foote’s relinquishment of his tenure resulted in his loss of “the opportunity to receive future ordinary income . . . [and that] [w]hat he received was not paid for any increase in the value of his tenure over a long period of time, which is the basis for the favored tax treatment given capital gains.”¹⁹³

In personal service contract cases, like *Foote*, in which the taxpayer relinquished his right to earn income in the future, perhaps a valid basis for applying the doctrine is that there has not been a vertical slice. As discussed below, this is predicated on viewing the transaction as a bifurcation of the transferor’s property rights, whereby Professor Foote and similarly situated taxpayers are seen as retaining rights to provide comparable services to others in the future.

Professors Marvin Chirelstein and Lawrence Zelenak reflected as to why the courts have consistently treated payments made for the surrender of personal service contracts as ordinary income, even in situations where they meet at least some of the criteria used in other circumstances to find capital

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Foote v. Comm’r*, 81 T.C. 930 (1983).

¹⁹² *Id.* at 935.

¹⁹³ *Id.*

asset status was met.¹⁹⁴ They observed that “it seems likely that the courts have been influenced chiefly by the feeling that employment and personal service is simply not an appropriate context for capital gain.”¹⁹⁵ This is somewhat analogous to the *Lattera* “family resemblance” test, i.e., anything related to compensation should be characterized as ordinary income.

Another reason Professors Chirelstein and Zelenak offered was that the service provider upon contract termination is now “free to accept similar employment elsewhere.”¹⁹⁶ If considered as such, there has not been a vertical slice, because the taxpayer has preserved a temporal right in the property. They analogized the service provider to the lessor in *Hort*. They commented that: “[i]f ordinary income was required to be recognized in *Hort* (for reasons relating generally to the carved-out interest limitation), perhaps the same principle justifies ordinary treatment for employees (i.e., lessors of services) when an employment contract is terminated.”¹⁹⁷

Professor David F. Shores expressed dissatisfaction with some of case law that applied the doctrine in certain circumstances to the termination of personal service contracts.¹⁹⁸ He maintained that:

the *Lake* rationale clearly should not control the cancellation of an employment contract which involves a complete termination of all economic interests in the contract. Under such circumstances, even-handed treatment of wage earners and property owners demands capital gain treatment for the termination payment except to the extent that it constitutes payment for past services.¹⁹⁹

Thomas G. Sinclair shared Professor Shores’ discomfort with what they both view as expansive treatment of the doctrine to personal services

¹⁹⁴ There is an exception to ordinary income treatment in this area in circumstances where taxpayer’s “business activities enable them to create entitlements going beyond the right to be paid for past or future services.” BITTKER & LOKKEN, *supra* note 2, at ¶ 47.9.4 (footnote omitted). That is, the taxpayer has created an asset such as personal goodwill that he is conveying.

¹⁹⁵ CHIRELSTEIN & ZELENAK, *supra* note 35 at 441.

¹⁹⁶ *Id.* at 442.

¹⁹⁷ *Id.*

¹⁹⁸ Shores, *supra* note 59, at 495.

¹⁹⁹ *Id.*

contracts.²⁰⁰ Sinclair asserted that “the right to terminate or sell a contract has a separate value subject to appreciation.”²⁰¹ That is, personal services contracts “have an inherent value that is subject to market appreciation.”²⁰² For example, locking in a pharmaceutical representative like Flowers to a long-term arrangement could certainly benefit the company if the cost for comparable services were to go up in the marketplace. Sinclair was especially critical of the courts not distinguishing between the right to earned income and the right to earn income in this area.

In summary, the arguments for ordinary income treatment in this area seem to be based on: (1) the absence of a vertical slice, (2) the inappropriateness of according capital gain treatment to anything in the compensation family sphere, and (3) lack of economic appreciation of the asset, e.g., the tenure rights in *Footie*. While the position espoused by Shores and Sinclair is certainly not without merit, there are compelling reasons to support the courts’ characterization of such income as ordinary.

IV. *LONG V. COMMISSIONER*

Philip Long, the taxpayer who acted pro se in *Long v. Commissioner*, was a condominium developer in the Fort Lauderdale, Florida area. His apparent lack of organization and straight forwardness in his tax returns and court filings do not cast him as a very sympathetic figure. He also failed to file appellate briefs in support of his positions.

Nevertheless, the Eleventh Circuit, in a *per curiam* opinion, reversed the Tax Court²⁰³ in part. The Court of Appeals held that a payment received in 2006 from the assignment of his position as a plaintiff in a lawsuit that he had won at trial, but was being appealed, should be treated as capital gain, not ordinary income.²⁰⁴ The suit was for specific performance and other

²⁰⁰ Sinclair, *supra* note 36, at 407–09.

²⁰¹ *Id.* at 407.

²⁰² *Id.* at 408.

²⁰³ Long v. Comm’r, 106 T.C.M. (CCH) 409, 2013 T.C.M. (RIA) ¶ 2013-233 (2013).

²⁰⁴ Long v. Comm’r, 772 F.3d 670 (11th Cir. 2014). With respect to other issues on appeal before the Eleventh Circuit, however, the taxpayer was not successful. The court affirmed the Tax Court’s decision that denied a \$600,000 deduction to Steelervest, Inc., an entity with which the Taxpayer had

damages in connection with a contract to purchase land. The Eleventh Circuit specifically rejected the government's argument to apply the substitute for ordinary income doctrine to this matter.

The key facts were as follows: Long had formed Las Olas Tower Company, Inc. ("LOTC") in 1994 to design and build a luxury high-rise condominium called the Las Olas Tower in Fort Lauderdale, Florida. He was LOTC's president and sole shareholder. LOTC had never filed a corporate tax return, nor had a valid employer identification number, and its income was reported on Long's individual tax return in Schedule C.²⁰⁵ The condominium was to be built on land to be purchased from Las Olas Riverside Hotel ("LOR").

In 1995, Steelervest, Inc. agreed to loan LOTC a total of \$300,000 for the project. Long signed an agreement with Steelervest, both as president of LOTC and individually. At some point, Steelervest made other loans to LOTC, and by 2001, the balances totaled \$748,000. In 2001, Steelervest purchased Long's interest in another Fort Lauderdale condominium project, Alhambra Joint Ventures ("2001 Steelervest Agreement"), and as part of the transaction, Steelervest forgave the loans to LOTC. Further, as part of the 2001 Steelervest Agreement, Long agreed to pay Steelervest \$600,000 in the event that Long sold his interest in the Los Olas Tower project, or twenty percent of the net profit resulting from this endeavor.

In 2002, LOR agreed to sell the land to LOTC to construct the condominium for \$8,282,800, to be closed on December 31, 2004, subject to certain contingencies. Before the December 31, 2004 scheduled closing date, the president of LOR died and his heirs did not want to proceed with the sale. They terminated the agreement in February 2004. Jasper Cummings commented that "[i]t seem[ed] . . . likely that the land appreciated sharply in

dealing. *Id.* Furthermore, the Eleventh Circuit also upheld the Tax Court's decision that Long's evidence regarding a deduction for unaccounted legal fees was insufficient. *Id.*

²⁰⁵ The government in its brief to the Eleventh Circuit noted that while there was no evidence that Long has elected S corporation status, since the Commissioner did not challenge Long's treatment of LOTC as an unincorporated business on his return he had "thus implicitly allowed an S election." Brief for the Appellee at 39, *Long v. Comm'r*, 772 F.3d 670 (11th Cir 2014) (No. 14-10288).

value [between 2002 and 2004] . . . and that the sellers did not want to voluntarily let it go for the original price.”²⁰⁶

In March 2004, LOTC brought action in a Florida state court against LOR for specific performance and other damages. By that point, Long indicated he “had decided that instead of constructing the condominium building, [LOTC] . . . would sell the land, ready for construction, to a purchaser.”²⁰⁷ LOTC won at trial, but the case was appealed by LOR. In 2006, Long also agreed that LOTC would pay Steelervest 50% of the proceeds of the first \$1.75 million of any moneys LOTC received as a result of its lawsuit against LOR or the development of the condominium.

In September 2006, Long entered into an agreement with one Louis Ferris, Jr., whereby LOTC/Long sold its position as plaintiff in the litigation with LOR for \$5,750,000 and Ferris was substituted as plaintiff.²⁰⁸ In his 2006 U.S. Individual Income Tax Return, Long reported tax liability for the year of zero, including \$1,896,824 of the \$5.75 million payment as ordinary income, and did not report the remaining \$3,853,176.

The Tax Court held that the 2001 Steelervest Agreement did not create a joint venture between Steelervest and LOTC, and therefore, the entire \$5.75 million payment made by Ferris was taxable income to Long.²⁰⁹ At trial, Long asserted that the character of any income from the \$5.75 million payment was capital gain and not ordinary income.

²⁰⁶ Jasper L. Cummings, Jr., *Reexamining Capital Gains for Real Estate*, 146 TAX NOTES 1409, 1416 (2015).

²⁰⁷ *Long*, 106 T.C.M. (CCH) 409, 2013 T.C.M. (RIA) ¶ 2013-233, at *7. Although this point was accepted as fact by the Tax Court, the government argued in its brief to the Eleventh Circuit that

Long was judicially estopped by the Florida court’s judgment from seeking relief here on that theory, because the judgment awarded by the Florida court . . . was based on the court’s finding that . . . [LOTC] was “ready, willing and able” to proceed with the purchase of land from [LOR] . . . and the development of Las Olas Tower.

Brief for the Appellee at 51, *Long v. Comm’r*, 772 F.3d 670 (11th Cir 2014) (No. 14-10288).

²⁰⁸ *Long*, 722 F.3d at 673. Cummings indicated that “[i]t is possible that the buyer [Ferris] of the claim was acting as agent for the defendant because the defendant dropped the appeal, and the judgment was canceled. If so, Taxpayer in effect settled his lawsuit for the cash payment.” Cummings, *supra* note 206, at 416.

²⁰⁹ *Long*, 106 T.C.M. (CCH) 409, 2013 T.C.M. (RIA) ¶ 2013-233. The finding was not appealed. *Long*, 772 F.3d at 675.

The Tax Court rejected Long’s claim for capital gain characterization. The court stated that “[a]lthough Long changed his plans and decided to sell the land ready for construction of a building—and not the building units—this does not alter our view that Long held the land primarily for sale to customers in the ordinary course of business.”²¹⁰ The Tax Court reasoned that “[t]he profit would have been from Long’s efforts to develop the land, not from the mere passage of time.”²¹¹

The government argued in its appeal that “[t]he \$5.75 million from the sale of the lawsuit to Ferris clearly was a substitute for ordinary income. . . .”²¹² Furthermore, the government contended that “[t]he judgment clearly was not a substitute for accretion to value of a passive investment arising from external market forces. Rather, it was a substitute for the proceeds of . . . LOTC’s real estate development business.”²¹³ The government stressed that it was “significant” that neither LOTC “nor Long individually ever owned the land upon which . . . [the project] was to be constructed.”²¹⁴ It finally argued that the “‘income’ is not ‘property’ within the meaning of [§ 1221] and, therefore, cannot be a capital asset. . . .”²¹⁵

The government alternatively contended that any capital gain would be short-term, not long-term, since it did not meet the more than one year holding period required by § 1222(3) on the theory that the judgment was entered on November 21, 2005 and that LOTC sold its rights to Ferris on September 13, 2006. This latter point was summarily dismissed by the Eleventh Circuit.²¹⁶

²¹⁰ *Long*, 106 T.C.M. (CCH) 409, 2013 T.C.M. (RIA) ¶ 2013-233, at *23–*24.

²¹¹ *Id.* at *24.

²¹² Brief for the Appellee at 47, *Long v. Comm’r*, 772 F.3d 670 (11th Cir. 2014) (No. 14-10288).

²¹³ *Id.* at 49–50.

²¹⁴ *Id.* at 58.

²¹⁵ *Id.* Presumably by “income” the government is referring to the Florida judgment.

²¹⁶ In its rejection of this position, the Eleventh Circuit stated that

If the asset subject to capital gains treatment was an assignment of litigation rights, then Long acquired the asset when he filed suit in March of 2004, not when he obtained the judgment. Additionally, the real asset at issue was Long’s exclusive right to purchase the

With respect to the character of the income, the Eleventh Circuit observed at the beginning of its analysis that “the substitute for ordinary income doctrine is the only recognized judicial limit to the broad terms of [§] 1221.”²¹⁷ In its rejection of the applicability of the substitute for ordinary income to *Long*, the Eleventh Circuit reasoned that:

[i]t cannot be said that the profit Long received from selling the right to *attempt* to finish developing a large residential project that was far from complete was a substitute for what he would have received had he completed the project himself. Long did not have a future right to income that he already earned.²¹⁸

The Eleventh Circuit emphasized “that Long possessed a ‘bundle of rights [that] reflected something more than an opportunity . . . to obtain periodic receipts of income.’”²¹⁹ The court stressed that “Long’s profit was not ‘simply the amount [he] would have received eventually, discounted to present value.’”²²⁰ The Eleventh Circuit also emphasized that “Long’s rights in the . . . property represented the potential to earn income in the future based on the owner’s actions in using it, not entitlements to income *merely by owning the property*.”²²¹ The court concluded that under the *Dresser*

land, which he obtained pursuant to his execution of the Riverside Agreement in 2002, well over the one-year period required for long-term capital gains treatment.

Long, 772 F.3d at 676. A noted tax law professor commented to the author that he thought the government’s position on this point was meritorious. It would seem, however, that the judgment could be properly viewed as an embellishment of the litigation rights that serves to enhance its value, rather than the creation of a new asset and as such should not give rise to the start of a new holding period.

²¹⁷ *Id.* (quoting *Tempel v. Commissioner*, 136 T.C. 341, 347 (2011)).

²¹⁸ *Id.* at 677.

²¹⁹ *Id.* (quoting *Ferrer v. Comm’r*, 304 F.2d 125, 130 (2d Cir. 1962)).

²²⁰ *Id.* (quoting *Womack v. Comm’r*, 510 F.3d 1295, 1301 (11th Cir. 2007)).

²²¹ *Long*, 772 F.3d at 677 (citing *Womack*, 510 F.3d at 1302). In this and other areas, albeit not the inapplicability of the substitute for ordinary income doctrine, Jasper Cummings is critical of the Eleventh Circuit opinion in *Long*. For example, he writes

[t]he Tax Court correctly intuited the principle that the sale of a right to property should have the same character as a sale of the underlying property would have had. The circuit court rejected that principle without even examining it. Instead, it stopped its analysis with the obvious fact that a contract right to buy property is different from owning the property, which it thought meant that it could separate the treatment of the right from the treatment of the land that Long would have bought.

Cummings, *supra* note 206, at 1410. This article generally confines itself to analyzing *Long* only with respect to the inapplicability of the substitute for ordinary income doctrine.

rationale, the taxpayer was entitled to capital gain treatment, since he was “selling a right to *earn* future undetermined income, as opposed to selling a right to *earned* income.”²²² Finally, the court observed that “[t]he fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial.”²²³

While not cited by the Eleventh Circuit, the Tax Court in *Hudson v. Commissioner*²²⁴ recognized that a court “judgment . . . was property and a capital asset.”²²⁵ Another case not cited by the Eleventh Circuit, *Nahey v. Commissioner*,²²⁶ concluded that a lawsuit was a capital asset, but like *Hudson*, denied the taxpayer capital gain treatment because there was no assignment of the property.²²⁷ Obviously, meeting the § 1222 “sale or exchange” requirement was not an issue in *Long*, i.e., the plaintiff’s rights on the lawsuit/judgment was sold to a third party.²²⁸

The Eleventh Circuit was spot-on in its decision not to apply the substitute for ordinary income doctrine in *Long*. Long’s transfer was a vertical slice. That is, he didn’t retain any temporal rights in the property. What he owned was assigned to Ferris.

Moreover he had not sold “the future right to earned income” but rather “the future right to earn income.”²²⁹ As such, it met capital gain treatment under *Lattera*’s “character of the asset”²³⁰ test. Furthermore, Long clearly transferred an asset that to him had appreciated in value.

²²² *Long*, 772 F.3d at 677 (citing *United States v. Dresser Indus.*, 324 F.2d 56, 59 (5th Cir. 1963)).

²²³ *Id.*

²²⁴ *Hudson v. Commissioner*, 20 T.C. 734 (1953).

²²⁵ *Id.* at 736.

²²⁶ *Nahey v. Commissioner*, 196 F.3d 866 (7th Cir. 1999).

²²⁷ In *Nahey*, the court denied taxpayer capital gain treatment because he “did not sell the suit; he prosecuted it to settlement himself.” *Id.* at 868.

²²⁸ As noted above, Jasper Cummings speculated that the purchaser of the judgment, was an agent of the defendant. Cummings, *supra* note 206, at 1416. In any event, Cummings recognized that “in form, Taxpayer did consummate a sale or exchange of property.” *Id.* at 1417.

²²⁹ *United States v. Dresser Indus.*, 324 F.2d 56, 59 (5th Cir. 1963).

²³⁰ *Lattera v. Comm’r*, 437 F.3d 399, 405–08 (3d Cir. 2006).

While the presence of risk and opportunity in the assignment is certainly not dispositive of whether the doctrine applies, as noted above, the Tax Court has indicated that in deciding if transferred contract rights were capital assets one needs to consider “[w]hether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer.”²³¹ In *Long*, the rights purchased were certainly not devoid of risk or opportunity. If the appeal had not been subsequently dropped, there could well have been a reversal, and if so, Ferris’ \$5.75 million investment might become worthless. On the other hand, by virtue of the purchase, Ferris might have hit the lottery. He could have developed the project or sold the rights to another party and in either event potentially earn significantly more than what he paid Long.

By any reasonable methodology for determining if the substitute for ordinary income doctrine should apply, it is clear in *Long* that it should not. The government should have refrained from asserting the application of the doctrine in this case. Especially in circumstances where the taxpayer acts pro se, steering the court to correctly interpret the law should have taken precedence for the government over winning.

V. CONCLUSION

In general, the substitute for ordinary income doctrine should not be utilized in circumstances where there has been a transfer involving a vertical slice (in contrast with a horizontal slice) of an appreciated equitable interest in property conferring a future right to earn income (and not a future right to earned income). Where it is clear that the above criteria have been met, as was the case with *Long*, the government should generally eschew arguing for the doctrine’s application.

²³¹ *Foy v. Comm’r*, 84 T.C. 50, 70 (1985); *Gladden v. Comm’r*, 112 T.C. 209, 221 (1999).