



SEVENTEEN CULLS FROM CAPITAL GAINS

by Calvin H. Johnson

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In this article, Johnson assumes that a preference will be restored for long term capital gains. But he argues that Congress needs to clean up the old definitions of capital gains to get rid of the anomalies and errors. Otherwise, the rate reductions will extend beyond what legislators are thinking of as real capital gains and into areas where there is no reason for a preferential rate. For some capital gains, for instance, a cut in the tax rate cannot rationally be expected to yield a revenue gain to the government. He proposes 17 cases where capital gain treatment should be denied. Capital gains, for instance, should be denied to income earned by personal services, even when the gain is received by sale of self-produced assets or a patent. He is also concerned about negative taxes—rates less than zero. Congress is thinking of capital gains as a reduction in tax rates, not as a subsidy as measured from zero tax rates. He would thus dramatically expand the recapture concept and deny the off-budget subsidies to industries such as farming, coal, and iron ore mining.

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In connection with the proposed rate reductions for capital gains, Congress needs to simplify the law of capital gains to clean out some of the deadwood. The common understanding of "capital gain" is that it represents appreciation over time of investment property, such as land or corporate stock. But there are receipts that would qualify as capital gains, if the pre-1986 definitions of "capital asset" and "sale or exchange" are reused, that bear little if any resemblance to the common understanding of investment appreciation. The existing law of capital gains has anomalies and complexities unrelated to any policy for giving special rates to capital gains.

In the compromises that will inevitably occur, members of Congress on both sides of the aisle need to support work that rationalizes and recodifies the law to strike the most glaring anomalies. Decision-makers should avoid misunderstanding what "capital gains" means when they vote and should keep decisions reached under one set of policies from governing where the policies do not rationally apply. In the current debate, for instance, the budget

deficit means that there is little room for Congress to give away tax revenue. It is assumed that if the capital gains rates are lowered, taxpayers will increase their realizations of economic appreciation by enough to offset the lower rate, so that government revenue will rise or at least not fall much. Economic studies are trying to find the optimal rate that will maximize revenue from capital assets. But many of the items qualifying as capital gain under pre-1986 law are not under taxpayer control to realize or not and without taxpayer control, realizations cannot be expected to rise by enough to yield a revenue gain. Such items do not fall into the model of voluntary realizations that decision-makers are using. When the herd is crossed over the river to the land of low rate capital gains, there are some things that need to be culled from the herd.

Following are seventeen reforms that need to be made to the law of capital gain, on the assumption that preferentially lower rates for capital gain will return. Each proposal is explained so it can stand on its own as a separate document, which means that there is some repetition of

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arguments. None of the proposals is intended to enclose preferential rates for capital gains nor to imply one case for any preference has been made.

While the specific proposals or their articulation are my work, they draw upon a long tradition of critical analysis of capital gains. Some of the proposals have important revenue impact; some just foreclose future abuses or achieve academic neatness. But for almost all, if not all, of the proposals, there is or would be a strong consensus within the academic community that these items should be culled from the definition of capital gains. The list is not, however, exhaustive.

There are recurring patterns in the culls. The statute, first, needs to do a better job of articulating what is meant by capital gains in general. Section 1221, defining "capital asset" literally says that any "property" qualifies for capital gain, unless there is a special exception, but many things like salary, rents and interest that are clearly supposed to be ordinary can be shoehorned by tax planning into a sale of something that is literally property. The courts have had to be extraordinarily active in restricting the tax meaning of capital gains, to prevent the lower rates intended for capital gain from absorbing all income from whatever source derived. It is far better form for Congress to include in the statute the common understandings of what capital gain is about.

There are recurring patterns in the culls.

Capital gain is understood not to include compensation given for services. Lower tax rates on some kinds of compensation received by some kinds of taxpayers create a special caste or status system inconsistent with the equality of all people before the law. Incentives for services should come from the pretax free market. Thus, the proposals exclude from the definition of "capital assets," property created or substantially improved by the taxpayer. (Proposal 1.) (See also Proposal 12, repealing incentive stock options, and Proposal 13, repealing section 1235 for inventors.)

Since capital gain is understood to mean appreciation of capital investment, the proposals would require that the taxpayer (or a predecessor whose basis carries over) had acquired the property for some substantial capital investment. (Proposal 2.) Consistently, the proposals would exclude from the capital gain privilege, an individual's proceeds from allowing use of his or her likeness, name, voice or private or autobiographical facts. (Proposal 3.)

Congress debates capital gains rates on the assumption that the reduction is a reduction to some lower positive tax rate. But there are accounting mistakes, mismatching ordinary deductions for the inputs into an investment with capital gains for the revenue from the investment, which means that the transaction is treated better than having no tax at all. The negative tax encourages the taxpayer to create or accept real economic losses. The proposals attack such negative taxes by requiring that assets expensed when acquired are not capital assets (Proposal 4), by recapturing the S corporation losses on sale of the S corporation stock (Proposal 5) and by recapturing many previously deducted expenses recovered in a sale because they were necessary to acquisition of the gain (Proposal 6). The proposals also would

deny capital gain on sale of patents created by expensed research and development (Proposal 12). The proposals would repeal the special capital gain on sale of timber (Proposal 13), coal and iron ore (Proposal 14) and livestock (Proposal 15) in part in order to prevent negative tax. The proposals would also prevent the taxpayer from transforming an ordinary asset into a capital asset, by giving the asset to a family member or related entity in whose hands the asset would be a capital asset. (Proposal 7.)

The proposals also repeal double dipping that would reduce effective (though positive) tax rates by too much. Congress will attempt to locate the optimal tax rate for capital gains that will increase voluntary realizations so as to maximize government revenue. But when capital gains reductions are combined with tax deferrals available from installment sales or the open transaction doctrine, then the effective rate of tax will drop below the optimal point. Thus, the proposals would prevent the use of both capital gains and either installment sales (Proposal 8) or open transaction reporting (Proposal 9).

In some cases, capital gain status arises from legal decisions, reached under the normal legal process of analogy or distinction, which have never been reviewed for tax policy. Thus, the proposals would limit the amount of capital gain in a sale to the fair market value of the capital asset sold, partially reversing *Tufts v. Commissioner*, 461 U.S. 300 (1983) *reh. den.* 463 U.S. 1215 (Proposal 10). Similarly, the proposals would reverse *Allan v. Commissioner*, 856 F.2d 1169 (8th Cir. 1988) to recapture a taxpayer's recovery of expenses deducted from ordinary income (Proposal 6). Executive stock options, moreover, repealed by Proposal 12, also originated from a doctrinal argument that a bargain purchase of an asset, even by an employee, was not a realization event. Somewhat analogously, the proposals would reverse results that arise solely from the feudal concepts of "corpus" or "income" that have very little to do with modern tax thinking. Thus the proposals would repeal section 301(c)(3) of the Code, so that distributions from a corporation would be ordinary income or gain, unless they are in liquidation or in a redemption that meaningfully reduces the shareholder's interest (Proposal 11).

The proposals also plead that OMB, Treasury and the Hill Budget and Tax Committees take government costs more seriously.

The proposals also plead that OMB, Treasury and the Hill Budget and Tax Committees take government costs more seriously. Special departures for some industries or some transactions, and especially negative taxes for some industry transactions, are not justified by tax considerations. The costs of the favors never seem to get considered in the debate and the decision-makers act as if tax favors were free lunches. Special favors exacerbate the deficit crisis while worsening the use of resources and the economic health of the country. Moreover, in a democracy, the hidden, off-budget subsidies accomplished through the tax system are not legitimated by the legislative process, because the true costs of the subsidies are not budgeted nor otherwise understood by voters or their representatives. Thus the proposals repeal "incentive

stock options" (Proposal 12) and special capital gains for sales of patents (Proposal 13). In the name of economic efficiency and productivity, the proposals would withhold capital gain from the timber industry (Proposal 14), coal and iron ore mining (Proposal 15) and the sale of livestock (Proposal 16).

Finally, the proposal would repeal section 1231 (Proposal 17) to simplify the law (getting rid of a whole form) because the political compromises that lead to its enactment in 1942 do not now look like sound tax policy.

Proposal 1: Self-Produced Assets.

Current law. Capital gain is understood to arise from the market appreciation of capital invested by the taxpayer rather than from value added by the personal efforts of the taxpayer or taxpayer's agents, but literally any "property" is a capital asset unless the property is "held primarily for sale to customers in ordinary course of a trade or business." IRC section 1221(3) (withdrawing capital asset treatment from assets created by personal efforts of the taxpayer) applies only to literary or artistic works.

Capital gain is understood to arise from the market appreciation of capital invested by the taxpayer.

Proposal. Exclude all self-produced assets from the definition of "capital asset" by amending now section 1221(3) to read:

"(3) property, whether real or intangible, where the personal efforts of the taxpayer or the taxpayer's agents created or substantially enhanced the value of the property.

Conform IRC section 1231 by replacing IRC section 1231(b)(1)(C) with the above language.

Reasons for the Change. A taxpayer who makes or improves an asset with his or her own personal efforts receives compensation for services when the asset is sold at a profit. Thus, for example, the sale of furniture made by an amateur cabinet maker is salary or compensation and not capital gain as a matter of economics, even if the cabinet maker does not have enough activity to be in a trade or business.

Lower tax rates on some kinds of compensation received by some kinds of taxpayers create a special caste or status system inconsistent with the equality of all people before the law. Capital gain as a matter of economics is the appreciation of a taxpayer's investment occurring because of market fluctuations with no substantial value added to by the taxpayer's own activity. As a matter of history, capital gains were accorded to those things that were considered to be allocable to the corpus or principal account at common law; there was originally some doubt that corpus could be taxed under an "income" tax, but value added by the taxpayer's own services were not part of the corpus or principal account at common law.

In a free market economic system, incentives for compensation should come from pretax income—paid by the people who understand and can value the services provided—and not from government subsidies. Since service

providers have differential access to compensatory situations that might qualify for capital gain, capital gain accorded to some services would distort the real pretax economic demand for the services.

The courts generally exclude the transfer of compensatory assets from the capital gains provisions. "[T]his exclusion is the result of a gentleman's agreement by the courts that they will not in this area take literally the term 'property' in the definition of capital asset, and will exclude from its scope claims to salary and the like." 1 Surrey, Warren, McDaniel & Ault, *Federal Income Taxation: Cases and Materials 1144*(1972). See also cases collected, B. Bittker, *Federal Taxation of Income Estates and Gifts Para. 51.10.4* (1981)(discussing income from personal services as excluded from capital gains). Moreover, a major factor in determining whether property falls within the IRC section 1221(1) exception for "property held for sale in the ordinary course of a trade or business" is whether the seller has undertaken activities improving the property. See, e.g., *Adam v. Commissioner*, 60 T.C. 996 (1973)(taxpayer held to be passive investor, not improver).

The wording of section 1221, however, literally directs the courts to determine whether the compensatory claim qualifies as "property" and, if property, whether the sale was in the ordinary course of a business, and occasionally courts are misled by the statutory language to look to manner of the sale, rather than to the economics of how the gain arose. See, e.g., *Commissioner v. Williams*, 256 F2d 152, 155 (5th Cir. 1958)(taxpayer given capital gain for ship built by taxpayer's agents; there was no trade or business because no other ship purchases were contemplated). Before the enactment of current IRC section 1221(3) in 1950 (making literary and artistic works ordinary assets in the hands of their creators), authors (such as General Eisenhower) or actors (such as Fred MacMurray or Jack Benny) reported capital gain on assets that gave them compensation for their services, arguing that they were amateurs not selling in the ordinary course of business. See discussion, Bittker & Stone, *Fed. Income Tax*. 719-721 (5th ed. 1980).

Under the proposal, "capital asset" would exclude all real and intangible property created or improved by the taxpayer, not just artistic works.

Section 1221(3) was adopted "to close the loophole," recognizing that gain on self-produced assets was supposed to be ordinary (S. Rep. No. 2375, 81st Cong., 2 Sess. 43 (1950), but the exclusion was narrowly drawn to cover only literary or artistic works. Under the proposal here, "capital asset" would exclude all real and intangible property created or improved by the taxpayer, not just artistic works.

The proposal would conform the statutory language to the broader underlying principle that self-produced assets are not economically capital gain. The language, "substantially enhances the value of the [property]" comes from a requirement in current IRC section 1237(a)(1), which gives capital gain to subdivided property under certain restricted conditions.

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The proposal treats improvements by the personal efforts of a taxpayer's agents as having the same status as improvements by the taxpayer him- or herself. Some taxpayers work only through agents. The proposal treats the profit above salary costs attributable to personal efforts as in the nature of compensation, although received by the employer rather than the agent.

Following a long tradition, the proposal would not reach corporate stock, even though much appreciation on small business stock is due to shareholder services with respect to assets or the business of the corporation. For C corporations, the advantages of capital gain are commonly offset by the detriment of double corporate tax and questions of the taxation of corporations are best settled as a part of general integration of corporate income.

Current law reaches the value added by the taxpayer's own activities by poisoning the entire gain when the taxpayer's activities are substantial. The proposal follows current law on this issue. A possible alternative would be to bifurcate gain on sale of taxpayer-improved property held for many years into a capital gain element (the appreciation over many years) and an ordinary income element (the value added by taxpayer's activity) (ALI Discussion Draft of Definitional Problems in Capital Gains 332-333 (1960), but that approach has generally been rejected as not administratively feasible. See discussion by Graetz, *Fed. Inc. Tax.* 699-701 (2d ed. 1988).

Current law reaches the value added by the taxpayer's own activities by poisoning the entire gain when the taxpayer's activities are substantial.

Proposal 2: Property Without Substantial Investment.

Current law. Receipts from sale of income items are held not to constitute "property" within the definition of capital asset under IRC section 1221, even though the items qualify as "property" under state law, where the taxpayer has no basis or capital investment in the income item disposed of. *Commissioner v. Gillette Motor Transp. Inc.*, 364 U.S. 130, 134 (1960); *Luna v. Commissioner*, 42 T.C. 1067, 1079 (1964).

Proposal. Add the italicized wording to the first lines of IRC section 1221: "[T]he term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), in which the taxpayer has a substantial capital investment, but does not include, . . ." Add IRC section 1221(b) to define "capital investment" to include capital expenditure, carryover basis, or basis by reason of prior taxation of the receipt of the property, even if adjusted basis is zero by the time of sale. Value on death (IRC section 1014) would not be a capital investment, although an heir would have a substantial capital investment if the decedent did. Conform IRC section 1221.

Reasons for the Change. If the taxpayer has no substantial investment in an asset, then none of the doctrinal or policy reasons for a preferential tax rate apply to sale of the asset. Capital gain is the gain attributable to appreciation in value over a period of years of capital invested by the taxpayer; if the taxpayer has no investment, his or

her gain cannot be explained by appreciation. Lowered rates cannot create an incentive for the formation of capital nor for mobility of capital if there is no capital investment involved. See, e.g., ALI, *Discussion Draft of a Study of Definitional Problems in Capital Gains Taxation* 53 (1960), which would have explicitly required that the taxpayer have an outlay of funds or commitment of credit at the time of acquisition, for asset to benefit from the advantages of capital gain.

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During inflationary periods, moreover, gain on sale of an asset with no initial investment is not "fool's profit" or purely inflationary gain because the taxpayer has no investment to inflate. High inflation, in fact, suppresses, rather than inflates, the nominal gain on no-investment assets because high discount rates suppress the value of future benefits from the asset sold.

The proposal is intended to codify the no-investment understanding already inherent in the court cases under current law. The courts have held that a sale of an item that is a substitute for ordinary income is not a sale of "property" under IRC section 1221, even though the item constitutes property under state law or the Constitutional requirement of just compensation. *Commissioner v. Gillette Motor Transp. Inc.*, 364 U.S. 130, 134-136 (1960) (the government's taxing of use of property by eminent domain did not yield capital gain). An "item of income," the courts have said, "cannot be converted into a capital asset, having a cost basis, until it is first included in income." *Artis Bryan v. Commissioner*, 16 T.C. 972, 981 (1961); *Vestal v. United States*, 498 F.2d 487, 494 (8th Cir. 1974) (accord); IRC section 83(a) (preventing an employee from having capital gain on appreciation before restricted stock is included in income).

The doctrine has been applied most frequently to deny capital gain treatment to sales proceeds given to the taxpayer to compensate for services (*Artis Bryan* and *Vestal*, *supra*) to intangible assets created by the taxpayer's own efforts (*Ralph Bellamy v. Commissioner*, 43 T.C. 487 (1965)) or to terminations of taxpayer's rights to earn future salary. *Foot v. Commissioner*, 81 T.C. 930 (1983) (consideration given to professor for surrendering tenure). See generally B. Bittker, *Federal Taxation of Income Estates and Gifts Para. 51.10.2 (1981)* (collecting and discussing the cases). See also Proposal 1 denying capital gains to self-produced assets.

The no-investment doctrine also covers noncompensatory cases such as a landlord's receipts for a lease or release from a lease for property, because the landlord is treated as having no basis for the lease. *Hort v. Commissioner*, 313 U.S. 28, 31-32 (1941); *Commissioner v. Gillette Motor Transportation, Inc.*, 364 U.S. 130 (1960). The doctrine would also cover miscellaneous business litigation judgments and settlements, where the taxpayer recovers an expectancy interest in an advantageous business contract, without, however, ever having made a substantial investment for the right. See, e.g., *Norton v. United States*, 551 F.2d 821, 826-827 (Ct. Cl. 1977) *cert. denied*, 434 U.S. 831 (1977) (taxpayer denied capital gain

because of absence of investment when his franchise right bought out). See cases collected, Popkin, *The Deep Structure of Capital Gains*, 33 *Case Western L. Rev.* 153, 197-198 (1983). Cf. IRC section 1241 (allowing capital gain for receipts upon termination of a distributorship contract provided the distributor "has a substantial capital investment in the distributorship.")

The definition of "substantial" would derive from the function to ensure that gains qualifying as capital gains were attributable to market appreciation of the investment. Where a court was convinced that the gain was attributable to forces other than the market appreciation of the taxpayer's investment, then the investment would not be substantial.

A taxpayer's investment would include not only cash invested by the taxpayer, but also the value of property the taxpayer has included in taxable income when received. As explained in Proposal 6, costs expensed when incurred would not qualify for a capital investment.

If a predecessor from whom the taxpayer carries over basis (investment) had a substantial capital investment, then the taxpayer would. A loan, moreover, is best viewed as a temporary carryover of the creditor's basis; if the creditor had a basis in the loan proceeds, then the debtor should have an investment, too. But the fact that an item had a fair market value at the time of decedent's death would not necessarily mean that the successor receiving rights to the item by reason of death would have a capital investment: An "investment" is something more than value at the beginning of the accounting period. Many items, for instance, constituting ordinary income in respect to a decedent (IRC section 691), have a value at death. But if the decedent had a substantial capital investment, then the successor would have a capital investment, too.

Property that has been fully depreciated by the time of sale would still be considered to have a capital investment, if the taxpayer or predecessor originally acquired it with a substantial investment, because the appreciation might have been appreciation of posttax capital that occurred before basis was fully depreciated.

Proposal 3: Sale of Name, Likeness, or Waiver of Privacy of Living or Dead Person.

Current Law. Sale of the rights to use the name, image, likeness, biography or private facts or images of a living or dead person were held not to qualify as a sale of "property" within the meaning of the section 1221 definition of a "capital asset" by *Miller v. Commissioner*, 299 F.2d 706 (2d Cir. 1962) cert. denied 370 U.S. 923 (1962) (waivers by heirs for "Glenn Miller Story"), but the decision depends in part on failure of state law to treat sold rights as property rights.

Proposal. Codify *Miller* excluding the rights from the definition of capital asset, even if rights to name, image, likeness, or biography qualify as "property rights" under state law. Add a new (6) to IRC section 1221 and new (f) to section 1231(b)(1), excluding: "rights to use the name, image, likeness, voice, signature, or private or biographical facts of a living or dead person, acquired by the taxpayer other than by arm's-length purchase."

Reasons for the Change. The *Miller* decision treated the proceeds of sale by heirs of rights to use the name and biographical facts of Glenn Miller as ordinary income. But the decision rested heavily on the fact that the heirs had no property under state law. Since the *Miller* decision, however, there has been an increasing tendency to con-

sider heirs' rights in the name, image, likeness, voice or private biographical facts of a decedent to qualify as "property rights" under state law. See, e.g., Cal. Civ. Code sections 990, 3344 (1985) (making rights in name, voice, signature or likeness of living or dead person, "property rights, freely transferable.") See Felcher & Rubin, *Privacy, Publicity and the Portrayal of Real People* by the Media, 88 *Yale L. J.* 1577 (1977) (arguing for heir's property right).

Federal tax results cannot be made to rest on state law recharacterizations of a transaction. State lawmakers have no loyalty to federal revenue concerns and will readily alter state characterizations if that will save their state citizens some federal tax. Federal tax characterizations are moved by policy reasons independent of the policies behind the state law characterization. State law does define what specific rights a taxpayer has, but not what tax conclusions should be reached because of those rights.

State law makers have no loyalty to federal revenue concerns and will readily alter state characterizations if that will save . . . some federal tax.

As a matter of history, capital gains were accorded to those things that were considered to be allocable to the corpus or principal account at common law because there was originally some doubt that the corpus could be taxed under an "income" tax. But rights to name, likeness, biographical facts, et al., were not corpus or property rights under the common law.

The name, image, likeness, voice or private biographical facts of a person arise without any capital investment on the part of the person. Thus the profit cannot be considered to be market appreciation in the value of capital invested. See, e.g., *Damon Runyon, Jr. v. United States*, 1960-2 USTC Para. 9648 (5th Cir. 1960). The proposal is thus consistent with the proposal to treat assets without any capital investment as not capital assets (Proposal 2). A lower rate of tax on the profits of exploiting one's name, image, biographical facts, etc., cannot be expected, moreover, to increase the production of such image or facts by enough to reach revenue neutrality. Insofar as the profits arise from the purposeful commercial exploitation of the name or image of a person, the profits are self-produced assets appropriately treated as ordinary assets (Proposal 1). While an heir gets a step in basis for rights acquired from a decedent, that does not mean that there is any real investment; step up in basis does not determine tax character.

Proposal 4. Expensed Asset is an Ordinary Asset.

Current law. Expensed assets are sometimes treated as not "property," for instance, within the meaning of statutes giving nonrecognition upon sales of property. See, e.g., *United States v. Bliss Dairy Inc.*, 460 U.S. 370 (1983) (disposal of expensed prepaid feed was recovery of tax deduction, notwithstanding statutory rule that capital gain on sale of property was not recognized). But in general, assets may qualify as capital assets even though the cost of the asset was deducted upon acquisition of the asset ("expensed").

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Proposal. Assets, the cost of which was expensed upon acquisition, would be excluded from the definition of capital asset, by adding a new section 1221(b), defining substantial "capital investment" required for a capital asset (see Proposal 2), to exclude from "capital investment" costs that had been deducted upon acquisition of the asset.

Reasons for the Change. Capital gain is conceived of and debated as a reduction of tax on economic profit, which, however, collects tax at the lower rate. But when a misaccounting is allowed under which the inputs into a transaction are deducted from ordinary income whereas the gross revenue from the transaction qualifies for capital gain, there is an accounting mismatch that ends up giving the transaction treatment better than tax exemption, that is, a negative tax.

Assume, for instance, that a \$100 investment (such as for feed or to enhance goodwill) paid by a 33-percent bracket taxpayer is expensed (deducted immediately) by the investor when acquired. Assume that the investment generates gain of \$100 (such as by sale of livestock or the business) considered to qualify as capital gain. Assume the \$100 capital gain (computed from zero basis) is subject to a new lower 15-percent rate. The \$100 transaction bears tax of \$15 and saves tax of \$33 for a total negative tax (tax savings) of \$18.

Given the negative tax, revenue of up to 220 percent of costs would go untaxed [\$220 x 15% tax on revenue less \$100 x 33% tax savings from the expense equals zero net tax] and the taxpayer could willingly incur economic losses of 27 percent of receipts and still break even with the negative tax. [\$100(1-15%) after-tax revenue less \$127(1-33%) after-tax expense equals zero net cost.]

Allowing taxpayers to lose money economically, while they break even in their own posttax accounting, will encourage the loss and misuse of precious resources. Negative taxes exacerbate the deficit crisis, while worsening rather than improving economic efficiency.

Negative taxes exacerbate the deficit crisis, while worsening rather than improving economic efficiency.

In a democracy the hidden, off-budget subsidies accomplished through negative tax are not legitimated by the legislative process because the true costs of negative taxes are not budgeted or otherwise understood by voters or their representatives.

Characterizing expensed assets as ordinary assets in full is necessary to prevent taxes from becoming negative. A recapture remedy, making the revenue ordinary income up to the amount of prior expenses, is not sufficient. Assume, for example, an investment with \$100 input and \$121 revenue in two years. The investment has an annual pretax income (i.e., the "internal rate of return" or IRR) of 10 percent, because 10 percent is the discount rate that will make the present value of the revenue equal the present value of the cost. $[-\$100 + \$121/(1+10\%)^2 = 0$; therefore IRR = 10%.] Because of what is sometimes called the "Cary Brown thesis," taxes will not reduce the pretax income from the investment, if the costs are expensed when made, even though all of the revenue is subject to tax at the same ordinary tax rate (assume 33%

here): $-\$100 (1-33\%) + \$121 (1-33\%) / (1+10\%)^2 = 0$; therefore IRR still = 10%. Thus tax does not ordinarily reduce the real return from an expensed investment even though the full revenue is taxed at normal rates.

If any part of the revenue from an expensed investment is subject to capital gain—even that part of the revenue in excess of the taxpayer's original investment—then tax will increase the rate of return from an investment, notwithstanding that all of the expenses are "recaptured." Assume on the same \$100 input and \$121 output investment that the excess over original cost is subject to a 15-percent capital gain rate. Then

$$\frac{-\$100 (1-33\%) + [\$100 (1-33\%) + \$21(1-15\%)]}{(1+12.5\%)^2} = 0;$$

therefore IRR = 12.5%.

Even with a "full recapture" remedy, negative tax has improved (rather than reduced) the return from 10-percent pretax to 12.5 percent after tax.

The proposal making expensed investments ordinary would affect . . . self-generated goodwill . . .

The proposal making expensed investments ordinary would affect relatively minor investments like prepaid feed (*Bliss Dairy*), more important investments like crop planting or livestock feeding (see Proposal 14), and some very important and common investments like self-generated goodwill (since advertising is expensed) and technology (since research and experimentation costs are expensed immediately under IRC section 174).

Where the taxpayer has some substantial posttax costs invested in an asset, but also has expensed part of the asset that remains an income-generating investment, it is not so clear that tax is negative just because some of the gain is capital gain. If the taxpayer has some substantial posttax investment in the asset that was not expensed at the time of acquisition, the proposals would not make the asset an ordinary asset in full, but would sometimes impose a recapture remedy (see proposals 5 and 6).

Proposal 5: Recapture of S Corporate Losses.

Current Law. Ordinary losses incurred by an S corporation pass through and are deducted by the shareholder, up to the amount of the shareholder's basis in the S corporation stock. IRC section 1366(a),(b)&(d). S corporation stock is a capital asset, sale of which will generate capital gains, even when the gain represents shareholder recovery of the prior deductions. (IRC section 341(f), moreover, will exempt S corporations from collapsible corporation rules.)

Proposal. Enact a new IRC section 1369 to provide that gains from sale of S stock are recaptured (ordinary) gain to the extent of prior losses passed through under IRC section 1366.

Explanation. The simplest way to convert ordinary income from a general investment that does not qualify for any special rule into capital gain is through an S corporation. Tax losses, whether real or artificial, incurred by the corporation are passed through to the shareholders where they are deducted from ordinary income, subject to a limitation that the shareholder must have basis remaining

in the S stock. The deducted losses reduce the shareholder's basis, so that if the shareholder sells for a price between the adjusted basis and the original cost, the shareholder will have gain, which, however, is ordinarily treated as capital gain.

Gain from a sale for an amount greater than the adjusted basis of the stock represents a recovery of the passed-through losses that the shareholder has previously deducted. Over the course of the entire transaction, the shareholder has not suffered economic loss because the reported tax losses are reimbursed on sale or because the taxpayer has never borne the losses. The gain, between adjusted basis and original cost, is not market appreciation on the taxpayer's original investment, but rather an artificial gain that identifies an artificial loss never in fact suffered.

In *Gavin Millar v. Commissioner*, 67 T.C. 656 (1977) *aff'd*, 577 F.2d 212 (3d Cir. 1978), for instance, the taxpayer incurred nonrecourse liability (but no other cost) to purchase stock of an S corporation. The shareholders deducted \$500,000 passed through from the corporation, then defaulted on the liability when the stock was worthless. The court held that the \$500,000 gain was capital gain, without regard to the zero value of the stock, thereby allowing the shareholders to convert \$500,000 ordinary income into \$500,000 capital gain without incurring any economic cost. There are no limitations on the industry source of the losses incurred by the corporation nor on the nature of the income so converted into capital gain.

Regular C corporations are disincorporating or disgorging their equity

With the rate inversion under which corporate rates are higher than individual rates, regular C corporations are disincorporating or disgorging their equity and S corporations are becoming the form of choice for any business that can qualify. If the most common corporate form provides unrestricted opportunities for converting ordinary income into capital gain, then the revenue impact will be substantial.

Proposal 6: Recapture Prior Expenses.

Current Law. Depreciation is recaptured in part or full when depreciable property is sold (IRC sections 1245 & 1250), but expenses contributing to the taxpayers gain are not. In *Allan v. Commissioner*, 856 F.2d 1169 (8th Cir. 1988) *aff'g* 86 T.C. 655 (1986), the court held that nonrecourse liabilities for accrued and previously deducted expenses that were forgiven in a sale of a capital asset were capital gain to the seller, notwithstanding the tax benefit rule.

Proposal. Amend section 111 to add a new subsection (a):

"(a) *General Rule.* Except as provided in subsection (b), gross income includes amounts received in recovery of a tax benefit, the reversal into income of a prior deduction because of the happening of events fundamentally inconsistent with the original deduction, including the forgiveness of or assumption of a liability to pay an accrued expense previously deducted."

Conform new section 111(a) by deleting "(a) Deductions" and inserting in its place "(b) Exception." Renumber subsequent subsections.

Enact new IRC section 1258 providing for recapture as ordinary income of deductible expenses, forgiven, paid or accrued by reason of the sale of a capital asset. Recapture expenses and interest accrued to maintain or carry the asset for the prior two tax years.

The deduction of expenses that make the capital gain possible, combined with reduced tax rates for amounts realized as capital gain, will cause a negative tax.

Reasons for the Change. The deduction of expenses that make capital gain possible, combined with reduced tax rates for amounts realized as capital gain, will cause a negative tax. The deduction of the expense from ordinary income combined with capital gain for the gross revenue will mean that profitable transactions reduce tax, rather than incurring tax. As noted (Proposal 4), assuming a capital gains rate of 15 percent and a 33-percent bracket taxpayer, break-even pretax investments benefitting from the mismatch will save tax of 18 percent of the investment,¹ revenue of up to 220 percent of costs will go untaxed,² and the taxpayer can lose 27 percent economically and still break even after tax.³

The proposal adopts a recapture remedy, much like current IRC sections 1245 and 1250, to prevent negative tax on investments made in part with expensed amounts and in part with capitalized amounts. The economic damage and deficit impact of negative taxes means that it is important to recapture expenses recovered on sale and necessary to the capital gain, even though the expenses are deductible under generally accepted accounting practices and normal section 162 rules. Accounting has a bias toward conservative statement of income and assets. It allows ordinary deduction of many expenses that are necessary for the taxpayer to achieve or have access to the capital gain. If the expenses are recovered, however, they should be recaptured (i.e., treated as ordinary on sale).

On the other hand, sometimes costs and revenues should be disaggregated rather than netted. A taxpayer can have a loss of some costs, while his or her underlying capital investment is appreciating. If the loss is unrelated to the capital appreciation, it is appropriate within the assumption of a lower tax on capital gain to allow both ordinary deduction of the loss and capital gain for the appreciation.

The proposal compromises the necessity of netting to avoid negative tax and the appropriateness of disaggre-

¹Tax on revenue of \$15 per \$100 and tax savings of \$33 per \$100 cost yields net tax savings of \$18 per \$100 cost.

²Tax on revenue of \$220 times 15 percent tax less \$100 cost times 33 percent tax savings from the expense equals zero net tax.

³After-tax revenue of \$100 (1 - 15 percent) less after-tax expense \$127 (1 - 33 percent) equals zero net cost after tax.

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gating truly unrelated loss costs. Under the proposal, business expenses (such as maintenance costs) or interest expenses paid or incurred within the two tax years before sale would be recaptured if they relate to the property sold. Interest would be identified through the avoided cost method. IRC section 263A(f)(2)(ii). A recapture remedy works only if there is gain; if the gain is not sufficient to cover the expenses, the expenses would not be capitalized so as to generate capital loss. Costs incurred *and* paid more than two tax years before sale would not be recaptured if they were current expenses and not affected by any other provision.

Business expenses . . . or interest expenses paid or incurred within the two tax years before sale would be recaptured if they relate to the property sold.

The proposal would also provide that expenses forgiven, paid or accrued by reason of sale would be recaptured against the capital gain. Costs considered to satisfy "economic performance" only by reason of the sale would be recaptured. Prop. Treas. Reg. section 1.461-4(g)(1)(ii)(C)(1990).

The proposal, moreover, would reverse *Allan v. Commissioner*, 856 F.2d 1169 (8th Cir. 1988), where the courts allowed compounding accrued interest—on nonrecourse liability that was plausibly never expected to be paid—to be deducted even though on sale the interest was forgiven and would never be paid by anyone. The court thought that it was forced to allow capital gain upon the recovery of a previously deducted expense, because it read *Tufts v. Commissioner*, 461 U.S. 300 (1983) as overriding the tax benefit rule if the recovery was an assumption of the expense liability in connection with a sale. That reading of *Tufts* was unnecessary because *Tufts* is a decision on the amount of the gain rather than its character. Cunningham, Reprise: Character of Income Recovered under the Tax Benefit Doctrine, 43 *Tax Lawyer* 121 (1989). In *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 382 (1983), moreover, the court cited with approval the established rule that failure by an accrual method taxpayer to pay a deducted expense is ordinary income to the taxpayer. In any event, a reading of the law that mandates negative taxes must be changed by Congress in favor of better accounting.

The amendment to section 111 is written to encourage the courts to adopt a broad common law of recapture.

Proposal 7: Conversion into Capital Asset by Gift or Contribution.

Current law. Literary and artistic works created by the author or artist remain ordinary assets in the hands of a donee or other person with a carryover basis from the creator (IRC section 1221(3)(C)), but otherwise a new taxpayer may establish that property is a capital asset even if it is inventory or other ordinary asset in the hands of a predecessor from whom basis carries over.

Proposal. Ordinary asset will remain an ordinary asset if the seller carries over basis (for gain) from a person or entity in whose hands the asset was ordinary. Add new section 1221(7) to read "property held by a taxpayer who has a carryover of basis in whole or in part, for purposes

of determining gain on a sale or exchange, from a taxpayer in whose hands the property is an ordinary asset." Conform IRC section 1231(b)(1) by adding the same exception.

Reasons for the Change. Literally, a taxpayer with inventory, property held for sale to customers in the ordinary course of a trade or business, or any other ordinary asset can avoid the adverse tax results of the ordinary asset character by transferring the property to a related taxpayer in a tax-free transaction. The donee or corporate transferee would carry over the basis and holding period of the original taxpayer, but there is no provision for general carryover of the ordinary asset character. Farmers are thus advised to give their wheat crop to their children because the child, if not a farmer, can treat the gain from the wheat as capital gain. Harris, *When is Grain a Capital Asset?*, 30 *S. Dak. L. Rev.* 275, 278 (1985). A contractor who builds houses can give the houses to his child or corporation and if the successor sells the houses in one lump transaction (not in the course of a trade or business), the gain will literally be capital gain. While the statutory error is undoubtedly mostly used as a manipulation, it sometimes hurts the taxpayer. See, e.g., *Acro Mfg. Co. v. Commissioner*, 334 F.2d 40 (6th Cir. 1964) (parent corporation had capital loss on sale of subsidiary's inventory received in a tax-free section 332 liquidation).

There is no provision for general carryover of the ordinary asset character.

The general rationale for nonrecognition rules is that nothing of substance has occurred to merit taxation of the appreciation. A gift or a transfer to a partnership or controlled corporation is considered to be a mere change in form. That principle, consistently applied, would mean that the character of an asset cannot change because of the nonrecognition transaction. An asset produced or improved by one taxpayer, for example, should in principle remain an ordinary asset (see Proposal 1), although it goes through a transaction that is a mere change in form.

IRC section 1221(3)(C) now contains the principle that ordinary character carries over if basis does, but only for the artistic works covered by subsection 1221(3). The proposal would generalize the principle for all assets. IRC section 724 now taints the character of inventory or capital loss property contributed by a partner to a partnership for 5 years after the contribution. The proposal does not adopt a temporary "taint" rule, such as section 724, but adopts the more general principle that a mere change in form cannot change character.

Proposal 8: The Installment Method.

Current Law. Under the installment method, a seller of property reports gain from sale of property for debt obligations of the purchaser only as the debt obligations are paid. The installment method is not available for sale of marketable securities, inventory, and real property held for sale to customers in the ordinary course of business, nor for sales of depreciable property to controlled corporations, nor if the buyer's obligations are payable on demand or are in a form readily tradable on established market. Recaptured depreciation is taxable immediately

on sale. IRC section 453. A seller must pay interest to the government (nondeductible by an individual seller) on tax deferred beyond sale on many kinds of installment obligations if seller's outstanding installment obligations exceed \$5,000,000. IRC section 453A(1987).

Proposal. Prevent the combining of tax reductions under both capital gain and installment reporting, by adding subsection (8) to IRC section 1221, to provide that capital asset shall not include any asset reported under the installment method of IRC section 453(a), unless the taxpayer elects out of the method under IRC section 453(d).

Reasons for the Change. Given the size of the deficit (which will exceed \$200 billion without significant political sacrifice), the function of capital gains rate cuts is to maximize government revenue. Congress will attempt to cut nominal capital gains rates to reach the optimal point, i.e., the point where voluntary realizations increase such that the product of the nominal capital gains rate times the rate of voluntary realization will generate the highest possible effective tax on capital appreciation. If nominal capital gains tax rates are inadvertently reduced below the optimal revenue point, then that will exacerbate the deficit crisis, incurring real revenue losses to the benefit of those taxpayers least in need of redistribution.

The installment sale provisions reduce the effective or economic burden of tax by allowing the taxpayer to delay tax beyond sale until the payments are received. Because of the time value of money, mere deferral of tax reduces the economic burden of the tax. Assume, for instance, that Taxpayer A sells property for a note of \$1,000,000 payable in 10 years and the tax on the gain computed under optimal, revenue-maximizing rates would be \$150,000. The ability to defer the \$150,000 tax for 10 years means under current FMV interest rates that a mere \$75,000 set aside will grow after tax to be sufficient to pay the \$150,000 tax when due. The real burden of the tax has thus been cut in half (from \$150,000 to \$75,000) and the effective tax rate imposed on the gain has been cut to half of the optimal rate. When Congress debates an optimal rate for sales, it cannot simultaneously reach the optimal rate for sales that are taxed immediately and for sales that have been tax deferred under the installment method.

The installment sale provisions reduce the effective or economic burden of tax. . . .

The proposal would give the taxpayer an election to use either installment reporting or capital gains but not both. Taxpayers who want installment reporting would do nothing and be excluded from capital gains; taxpayers who want capital gain would elect out of installment method and so avoid the exclusion from capital gain. A taxpayer would take the installment sale option only when it is more valuable than the capital gain rate reduction—i.e., only when installment reporting gives them an effective rate less than the capital gain rate that Congress deems to be optimal.

Installment sales are not sufficiently meritorious to benefit from both capital gains and deferral. Buyer notes eligible for installment reporting have a fair market value equal to the amount of the sale price: If the interest on the note is inadequate, then IRC section 1274 restates the

principal downward to account for the inadequate interest. Moreover, the amount realized on a sale for buyer notes is only the fair market value of the notes. *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975). The lower rate on buyer notes (half of the general rate in the given 10-year deferral example) gives sellers an incentive to lock their capital into the buyer notes rather than move their capital into investments that would be more beneficial to the economy as a whole. The sellers eligible for section 453 are the kind of risk-takers who should be providing entrepreneurial capital; the tax advantages of buyer notes are encouraging their placing their capital into low risk, less productive buyer notes instead. The proposal does not provide for repeal of section 453 installment reporting, but it is consistent with the legislation since 1980 restricting the scope of section 453.

Installment sales are not sufficiently meritorious to benefit from both capital gains and deferral.

Proposal 9: Open Transactions.

Current Law. In *Burnet v. Logan*, 283 U. S. 404 (1931), the Supreme Court held that sales of property for assets that had no ascertainable value would not be taxed in the year of the sale based upon mere conjecture, but that the transaction would be kept "open" and taxed only when the seller received the cash (or property that had ascertainable value.) Once the open transaction doctrine applies, the first cash is tax-exempt recovery of basis up to seller's original basis and gain thereafter is generally considered to be capital gain. See, e.g., Bittker & Eustice, *FED. INC. TAX OF CORPS. & SHS* para. 11.03(2)(1987) and sources cited there. The regulations claim open transactions are available only in rare and extraordinary circumstances involving contingent payments (Treas. Reg. section 1.1001-1(a)(1972); Temp. Reg. section 151A.453-1(d)(2)(iii) (1981)), but the courts are sometimes more generous. See, e.g., *Gralapp v. United States*, 458 F.2d 1158 (10th Cir. 1972).

Proposal. Make amounts taxed under the open transaction doctrine ordinary income, by adding a new subsection (b) to IRC section 1222: "(b) SALE OR EXCHANGE. The term 'sale or exchange' shall not include amounts received in a year after the year of sale reported under the open transaction doctrine." Conform IRC section 1222.

Reasons for the Change. The open transaction doctrine reduces the effective tax on the sale of property by allowing the tax to be deferred until cash (or property of ascertainable value) is received. If Congress reduced the nominal tax rate on realized capital gain to the optimal point, then the combination of capital gain and deferral under the open transaction doctrine will reduce the gain and deferral under the open transaction doctrine will reduce the rates to less than the optimal level. See Proposal 8 (to prevent combined use of the installment method and capital gains).

Gain under the open transaction doctrine is also appropriately excluded from gain from a sale or exchange for independent reasons. The taxpayer receiving open trans-

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action payments has not liquidated his or her interest. Instead the taxpayer is receiving amounts, spread out over many years, that are usually contingent upon normal business operations or interest or other normally ordinary income events. For instance, in *Burnet v. Logan*, a shareholder sold stock by liquidation of her corporation in exchange for a royalty interest in a mine distributed by the corporation. Because the royalty interest had no ascertainable value, the sale of stock was "open." Although *Logan* itself involved a year before capital gains were taxed at a lower rate, it is assumed that now the gain would be taxed as capital gain. But the royalty income would normally have been ordinary income, and there was no policy reason why the fact that the taxpayer had originally received the interest in a transaction accounted for in an advantageous way should have also converted the character of the ordinary royalty income into capital gain. The character of the income from the asset should be determined independently of whether it was possible to value the asset when received. Some courts, albeit a minority, have accordingly looked to the nature of the receipts (rather than the nature of the asset originally sold) to determine character. *Miller v. United States*, 235 F.2d 553 (6th Cir. 1956) (payments on speculative value notes received in an open transaction were not from sale or exchange) on remand 262 F.2d 584 (1958).

Adverse restrictions on open transactions are also meritorious because they allow an inappropriately rapid method of cost recovery: The seller recovers the basis in the asset sold against the first cash receipts from the transaction. The logic of the rule is, absurdly, that the more cash the taxpayer has received, the more investment he must have lost. The proposal does not abolish the open transaction doctrine, but it appropriately limits the number of occasions it will be used by giving sellers an incentive to value sales proceeds to close the transaction to benefit from capital gain.

Proposal 10: Limitation to Fair Market Value.

Current Law. Current law provides that nonrecourse liability forgiven on sale of a capital asset is capital gain in full even though the nonrecourse liability exceeds the fair market value of the capital asset. *Tufts v. Comissioner*, 461 U.S. 300 (1983) reh. den. 463 U.S. 1215. IRC section 7701(g).

Proposal. Amend IRC section 7701(g) to provide that for the purpose of determining gain or loss, the amount realized with respect to the sale or exchange of a capital asset shall not exceed the fair market value of the asset at the time of the sale, but that the excess of the outstanding nonrecourse liability over value of the capital asset shall be treated, except as provided in section 108, as cancellation of indebtedness income.

Reason for the Change. The proposal limits the amount of capital gain on a sale of a capital asset to the fair market value of the capital asset. Market appreciation of a capital asset explains the gain economically only to the extent of the fair market value. The remainder of the cancelled or forgiven nonrecourse liability is ordinary income, subject to the deferred tax recognition given to forgiveness of indebtedness by section 108 in certain hardship cases. Forgiveness of tax-recognized indebtedness is generally ordinary income because the taxpayer has previously received proceeds of borrowing without paying tax on them or took depreciation or other deductions without bearing any economic cost. The proposal,

bifurcating the total economic gain into a capital gain element and an ordinary (or section 108) element, brings the treatment of nonrecourse liability into accord with the treatment of a recourse liability forgiven on sale. Treas. Reg. section 1.1001-2(c) Example (8) (1980). If the capital asset has declined in value below adjusted basis, but the outstanding nonrecourse liability exceeds adjusted basis, the bifurcation approach generates capital loss and added forgiveness of indebtedness.

Market appreciation of a capital asset explains the gain economically only to the extent of the fair market value.

Current law, treating the gain as entirely capital gain, is based on legal fictions adopted to prevent the excess of outstanding liabilities over value from slipping out from under tax entirely. Prior to the Supreme Court's decision in *Tufts*, there was some doubt as to whether the excess of an outstanding nonrecourse liability over the fair market value of the sold property was a taxable amount of any character. Nonrecourse liability secured by property worth less than the outstanding liability is not an economic detriment, except by loss of the property, because the nonrecourse liability will not be paid even in part. The disappearance of a nondetrimental liability is not an economic benefit in the year of the sale. But failing to tax the nonrecourse liability in excess of value would badly misaccount for the taxpayer's tax benefit from the prior respect given to the liability and would understate the taxpayer's income over the total years of the transaction. It would have allowed tax shelters, for instance, to generate massive depreciation deductions from liabilities included in basis, on the assumption that the liabilities will be paid, without the taxpayer having any economic cost of actually paying the liability. To prevent the accounting mistake of ignoring the gain over value entirely, section 7701(g) adopted a legal fiction that the nonrecourse liability is in fact adequately secured and *Tufts* adopted a legal fiction that there was no economic difference between a recourse and nonrecourse liability on sale. (Inconsistently, *Tufts* computed the character of the nonrecourse liability generated gain as all capital gain, ignoring the bifurcation treatment that is accorded recourse liability.) The legal fictions adopted pragmatically to explain the amount of gain on sale misdescribe the character of gain.

There are, however, adequate nonfictive explanations as to why the excess nonrecourse liabilities generates taxable amounts, which do not require that the gain be mischaracterized as capital. Justice O'Connor, concurring in *Tufts*, would have adopted the bifurcation treatment suggested by Professor Barnett of Stanford Law School, filing as *amicus curiae*, except that the government had not argued for the treatment. Professor Barnett's brief espoused an "anti-basis" accounting theory leading to (ordinary) taxation of the nonrecourse liability in excess of value. The debt previously caused added basis, much of which generated depreciation deductions, or the debt justified deferral of taxation of borrowed proceeds. Just as basis arises from the tax deferral of recognition of costs (or taxable income received), so "anti-basis" arises from the tax deferral of recognition of receipts (or tax

deductions generated). When the debt disappears there is need to close the books ending the previously deferred anti-basis by reversing the anti-basis account into income, just as basis yields a deduction (or gain offset) upon the final disposition of an asset. Of that anti-basis income, only the amount up to the value of the capital asset is eligible for capital gain.

Similarly, Magruder, J., concurring in *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950) argued that depreciation deductions brought the adjusted basis into negative basis, so that even though the disappearance of the nondetrimental nonrecourse liabilities generated zero amount realized, as a matter of economics, the taxpayer had gain from the negative basis.

Finally, the excess liability can be taxed under the tax benefit theory: Nonpayment of a debt is an event fundamentally inconsistent with the accrual and depreciation deductions given only on the assumption that the liabilities justifying the deduction would be paid.

In any event, because there are adequate theories explaining the taxability of the excess nonrecourse liability, there is no need to continue the legal fictions that mischaracterize the gain and give more capital gain (or less capital loss) than explained by the value of the capital asset.

Proposal 11: Corporate Distributions Not from E&P.

Current Law. Current law provides that a corporate distribution on stock in excess of its earnings and profits and the shareholder's basis will be treated as a sale or exchange by the shareholder, even when the distribution effects neither a liquidation nor a meaningful reduction in the shareholder interest. IRC section 301(c)(3).

Proposal. Repeal IRC section 301(c)(3)(A) so that corporate distributions not out of earnings and profits would have to qualify under the redemption or liquidation rules to qualify as capital gain.

Corporate distributions on stock in excess of its earnings and profits would have to qualify under the redemption or liquidation rules to qualify as capital gain.

Reasons for the Change. Corporate distributions on stock are normally ordinary income rather than capital gain because "[t]he shareholder retains his underlying investment interest, and neither his voting power or rights to future income have been altered." Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM L. REV. 1, 5 (1952). Distributions described by section 301(c)(3) (but no other sale or exchange rule) are not sales or exchanges in fact nor reductions in the shareholder's interest in the corporation.

The fact that a distribution exceeds corporate earnings and profits and shareholder basis provides no independent reason for the capital gain advantage. Distributions falling under section 301(c)(3) are not subject to double tax on corporate income: If the corporation had paid corporate tax on the amounts distributed, the corporate income would have increased earnings and profits and made section 301(c)(3) inapplicable to the distribution. The distribution cannot be viewed as a pass-through to

the shareholder of the tax character of the transaction determined at the corporate level because corporate capital gain produces earnings and profits that make section 301(c)(3) inapplicable.

The shareholder has recovered all of his capital before section 301(c)(3) can apply so that the shareholder has no capital that needs to be indexed for inflation. Since the shareholder has withdrawn and recovered all his capital for section 301(c)(3) to apply, the distribution cannot fairly be attributed to a return on or appreciation of the shareholder's already-taxed capital. Given rate inversion under which corporate rates are higher than individual rates, increasing corporate distributions by reducing the tax rate on distributions will decrease rather than increase government revenue.

Distributions by a corporation in excess of earnings and profits tend to occur because the corporation's earnings and profits account failed to describe the corporation's unrestricted and distributable income. Taxpayer's who get into section 301(c)(3) situations tend to be scoundrels who take advantage of the accounting misdescriptions. See, e.g., *Commissioner v. Gross*, 236 F.2d 612 (2d Cir. 1956) (profits of construction distributed before corporation sold constructed assets); *Divine v. Commissioner*, 500 F.2d 1041 (2d Cir. 1974) (corp. allowed double reduction of earnings and profits for stock: once when stock given and once when dividends on stock were given).

As a matter of history, section 301(c)(3) arose as a compromise with the view that distributions in excess of the "harvest" were distributions of corpus that could not be taxed (See, e.g., L. Seltzer, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 26-35 (1951)), but now that it is well settled that receipts in excess of basis are not "capital," immune from tax, there is no need to compromise with outdated views of "capital."

The proposal is consistent with, but does not go as far as, proposals to repeal the earnings and profits limitation on "dividends." See, e.g., Colby, Blackburn & Trier, *Eliminating Earnings and Profits From the Internal Revenue Code*, 39 TAX LAWYER 285 (1986)(ABA Task Force) and sources there cited.

Proposal 12: Incentive Stock Options.

Current Law. Nontransferable "incentive stock options" issued to executives as compensation are not taxable to the executives when issued nor when exercised, provided, e.g., that the option strike price is no less than value as of the time of issuance and the executive holds on to the stock for at least three years after the option issuance. The executive's gains are taxed as capital gains only if and when the stock is sold. The corporate employer gets no compensation deduction. IRC section 422A.

Proposal. Repeal IRC section 422A.

Reasons for the Change. Under general law, an executive must pay ordinary income tax on property received in connection with the performance of services. IRC section 83. Stock options are taxed when issued if their value can be readily ascertained, and otherwise the exercise of the option is the date for measurement of the compensation. Treas. Reg. section 1.83-7 (1978). As a fundamental principle, "capital gain" does not encompass compensation (see Proposal 1) and stock options given in return for the employee services are compensation.

Lower tax rates for some kinds of compensation received by some kinds of taxpayers create a special caste or status system inconsistent with the equality of all

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people before the law. Most taxpayers are subject to section 1 tax rates and when Congress debates individual rates rationally it does so under section 1. In a free market economic system, incentives for compensation come from pretax income—paid by the people who understand and can value the services provided—and not from government subsidies. Government subsidies must be budgeted to be legitimated by the legislative process. When subsidies are off-budget, neither the voters nor their representatives know what they are doing.

Capital gain plans for executives entail loss of the employer's tax deduction for compensation and that means incentive stock options are bad tax planning in the ordinary case: The corporate employer's tax deduction (at 34 cents per \$1) is usually more valuable than the tax the executive saves by getting capital gain instead of ordinary income. Repeal of IRC section 422A will have little impact on rational taxpayers who plan with both employer and employee in mind.

Repeal of IRC section 422A will have little impact on rational taxpayers who plan with both employer and employee in mind.

The major exception, where forfeitures of the employer deduction is rational, is where the corporate employer is in a loss situation and the value of the NOLs generated by the deductions would be less than the difference between executive ordinary income and capital gain. Such cases constitute trafficking in NOLs; the corporation passes over its NOL status to the personal benefit of the executive. Congress has recently reviewed the issue of trafficking in NOLs and settled on legal limitations after years of debate. IRC section 382. Incentive stock options are just a shunt around those restrictions.

Executive stock options arose as a matter of history from a doctrinal argument that purchase of property, even by employees, was not an event constituting the "realization" of gain. *Rosshem v. Commissioner*, 92 F.2d 247 (3d Cir. 1937). Executive stock options would never have developed their significant role in the economy had the IRS more vigorously opposed the early cases adopting the doctrinal realization argument. B. Bittker & L. Stone, *FEDERAL INCOME TAX* 36 (5th Cir. 1980). But after *Commissioner v. LoBue*, 351 U.S. 243 (1956), there is no longer any doubt that bargain purchases of stock pursuant to options are taxable as compensation. Given the relatively small scope within which they are rational, plans giving executives capital gain can be repealed without major political impact.

Proposal 13: Sales of Patents.

Current Law. An inventor whose efforts created a patent and an individual (other than employer or related party) who paid for an interest before the invention was reduced to practice has capital gain on sale of the patent, even though the sale price is contingent on future actual use of the patent. IRC section 1235. Research and experimental costs are deducted when incurred, even if they are really investments. IRC section 174. There is a 20-percent credit for increased research and experimentation costs for use in a trade or business over base amounts, but section 174 deductions are reduced by the amount of the credit. IRC section 41, 280C(c).

Proposal. Repeal IRC section 1235.

Reasons for the Change. For the inventor whose personal effort created the patent, the gain from the sale of the patent is salary or compensation. Lower tax rates on some kinds of compensation received by some kinds of taxpayers create a special caste or status system inconsistent with the equality of all people before the law. In a free market system, incentives for compensation come from pretax income—paid by the people who understand and can value the services provided—and not from government subsidies.

"Research and experimentation" is an honorific title and many kinds of specifically targeted subsidies for worthy research would be extremely wise. But there is a long history of uncontrolled abuses in the tax system that has gone on in the name of research. See, e.g., *Levin v. Commissioner*, 832 F.2d 403 (7th Cir. 1987) (Easterbrook, J.) (confetti money debt incurred for food processor research); *United States v. United Energy Corp.*, 59 AFTR.2d 5593 (D. Calif. 1987) (syndication of solar energy modules enjoined as abusive tax shelter). See Saunders, *The R&D Dilemma*, *FORBES* 130 (Feb. 25, 1985) (concluding that "If Congress wants to save another billion dollars, it could start by cutting back on the ill-conceived R&D tax credit). When subsidies are off budget and extended without regard to the merits of the project, neither the voters nor their representatives know what they are doing.

The tax benefits for research and experimentation can pile up, such that a taxpayer will willingly lose money, made up by the tax subsidy. Assume that a single project "triple dips," i.e., qualifies for capital gain (IRC section 1235), expensing (IRC section 174) and the 20-percent incremental credit (IRC section 41). If the taxpayer takes the full 20-percent credit, only 80 percent of his or her costs are deductible under IRC section 174. IRC section 280C(c). Still assuming a 33-percent bracket taxpayer and adoption of 15-percent capital gain rates, a taxpayer qualifying for all three benefits could lose 37 percent of his or her costs and still break even after tax: Revenue of \$63 less 15-percent tax and expenses of \$100 (less 20-percent credit and less 33 percent of \$80 tax savings from deduction), equal breakeven (0). For projects in which no one has ever judged the merits of the project, that loss is too much. The money would be better spent, for instance, by the National Science Foundation for competitive grants.

Section 1235 also gives capital gain to an individual who purchased an interest before the invention was reduced to practice, even though the sales price is contingent on the use or productivity of the invention. A sales price contingent on use or productivity would under general principles mean that the seller has not really liquidated the investment, but is sharing in the profits or income from an ordinary business. See, e.g., IRC section 856(f) (amount that depends upon "income" or "profits" of a business is not passive interest, which a Real Estate Investment Trust may receive). But many individual investors, who invested in the patent either before or after it was reduced to practice, would be eligible to receive capital gain, even in absence of section 1235, because their gain is in fact appreciation of their capital investment.

Proposal 14: Timber.

Current Law. The fair market value of timber cut in the ordinary course of the timber business is deemed to be

capital gain. IRC sections 631(a), 1231(b)(2). But the costs of timber are ordinary deductions if they are for management or maintenance of timber or reforestation. [IRC section 194 (reforestation costs); *Kinley v. Commissioner*, 51 T.C. 1000 (1969)(shaping of Christmas trees, amounting to 50 percent of labor costs of tree nursery, were expenses; insect control deductible); *Barham v. United States*, 301 F.Supp. 43 (M.D. Ga. 1969) aff'd. per curiam, 429 F. 2d 40 (5th Cir. 1970)(brush clearing deductible); *Union Bag-Camp Paper Corp. v. United States*, 325 F.2d 730 (1963)(marking trees for cutting was part of overall forest management expenses); Rev. Rul. 68-281, 1968-1 C.B. 22 (temporary road gave ordinary deductions)]. Timber is exempted from uniform capitalization. IRC section 263A(c)(5).

Proposal. Repeal capital gain for timber by repealing section 1231(b)(2). Absent repeal, capitalize all costs connected with the timber business, including overhead, management and interest costs stacked first to timber.

Reasons for the Change. The paradigm of the income account at common law was the harvest from the land (or fruit from the tree). The harvest was never a corpus or capital item. Timber is a harvest from the land. It is the product of capital (i.e. yield or income) and not the capital or principal or corpus that generated the product.

True capital gain arises from the market fluctuation of capital that has already been taxed and from the change in future income streams that will be subject to ordinary tax when realized—true capital gain is what Irving Fischer would call a double tax. So-called "capital gain" on timber by contrast is the first and only tax on the harvest.

A lower rate on timber cannot be expected to increase realizations enough to increase government revenue. The taxpayer does not have a great deal of voluntary control over the realization of timber gains because the optimal time for harvesting timber is determined by interest carrying costs and the maturity of the trees. Delayed realization increases the risks of disease, fire, insects, wind and rot. The normal rule for sales in the ordinary course of a trade or business, moreover, is that they are inventory, so that capital gain for timber inventory is a major exception. If timber gets a lower tax rate, there is no business in America that has a lesser case for the low rate.

A lower rate on timber cannot be expected to increase realizations enough to increase government revenue.

Since the sole purpose of section 1231(b)(2) is to reduce tax rates on a favored industry, if timber is to get a lower tax rate, it should be set in IRC section 1, which fixes rates. Cutting rates for timber is not rationally related to cutting rates for capital gains.

Ordinary deductions of timber industry costs, moreover, grant the timber industry a negative tax rate when combined with capital gain on the revenue. The maintenance, overhead, and management costs and the interest costs of carrying timber are deducted currently against ordinary income. Timber is the major remaining natural resource with no recapture of the prior "tax expenditure" expenses items upon sale. (See IRC section 1254, 617(b)-(d)). The combination of ordinary deduction combined with capital

gain gives the taxpayer the alchemy of turning ordinary income into capital gain.

As noted (Proposal 4), the mismatch between ordinary deduction of costs and capital gain for the gross revenue causes negative taxes. A \$100 cost, saving tax in the 33-percent tax bracket, combined with an (assumed) 15-percent capital gain tax on the \$100 revenue, would mean that a breakeven \$100 investment would generate net tax savings of \$18. Revenue of up to 220 percent would go totally untaxed and the taxpayer could unwillingly incur economic losses of 27 percent and still break even with the negative tax. The tax treatment of timber will allow us to sell our timber resources to the Japanese at a loss of up to 27 percent, with the difference being made up by the government.

Ordinary deductions of timber industry costs, moreover, grant the timber industry a negative tax rate when combined with capital gain on the revenue.

Proposal 15: Coal and Iron Ore.

Current Law. Sale of coal and iron ore by an owner (who does not mine the coal or ore) is capital gain, even if it is inventory and even if the lease by which it is sold would not otherwise be a sale or exchange. IRC sections 631(c), 1231(b)(2). Exploration expenses are expensed, even if investments, although they are recaptured from sale or production. IRC section 617. Development expenses, incurred after commercially marketable quantities have been disclosed, are expenses, and not recaptured, even though they would otherwise be inventoried or capitalized costs. IRC section 616.

Proposal. Repeal sections 616, 617, and 1232(b)(2), so as to treat coal and iron ore as inventory.

Reasons for the Change. Capital gain for the coal and iron industry is an off-budget hidden government subsidy because it gives capital gain to inventory, which is ordinary income under normal principles, and because it gives capital gain to leases, which do not qualify as sales or exchanges under normal principles. Percentage depletion is 15 percent for iron ore and 10 percent for coal (IRC section 613(b)(2)&(4)) so that an exclusion like the 60-percent exclusion for capital gain given before 1986 gave an automatic exclusion, independent of cost basis, that is 4 or 6 times what otherwise would be allowed. There has never been any attempt to justify the capital gain for coal and iron in terms of normal tax doctrine or wise expenditure of government costs.

Off-budget subsidies, accomplished through manipulation of normal tax terms, survive all review when they should expire. Congress, in adopting the capital gain for coal, said only that the capital gain was tax relief to "extend benefits already available for timber," (S. Rep. no. 781, 82d Cong., 1st Sess. 42, 1951-2 C.B. at 488 (1951)) but the capital gain for timber is also without merit. Capital gain for coal was also said to have been made available because the coal industry was facing strong competition from alternative fuels (S. Rep. no. 830, 88th Cong., 1st Sess. 253, 1964-1 (Part 2) C.B. 217 (1963)), but the hard mineral industry is now facing excess capacity (DEP'T of TREAS, 2 TAX REFORM FOR

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FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH ("Treasury I") at 235 (1984)) so that subsidies to it waste rather than improve economic resources. The reduction in tax rate on coal and iron, accomplished thoughtlessly because of unrelated debates about rates for voluntary realization, will distort the use of resources and harm the economy.

The tax rates on many coal and iron investments drop below tax exemption into negative tax because capital gain is combined with expensing of investments. The ability to expense investments like exploratory or development costs (IRC sections 616 and 671) gives the industry a benefit as valuable as not having to pay tax on the subsequent income from the property: the expense privilege allows the taxpayer to expand the investment, with reimbursement by tax savings from the government, and the expanded investment means that the taxpayer's rate of return is not reduced below its pretax rate by subsequent tax. Giving capital gain on top of the expensing reduces the tax to below zero tax on the income. To keep the tax rate above negative, coal or iron investments which have been expensed should be ordinary assets in full.

The tax rates on many coal and iron investments drop below tax exemption into negative tax

Proposal 16: Livestock and Crops.

Current Law. Sale of livestock (but not poultry) held for draft, breeding, dairy or sporting purposes will be capital gain. Cattle and horses must have been held for 2 years, other livestock for 1 year. Costs of feed, seed and fertilizer are expenses when made by a farmer, even if otherwise inventoried costs (IRC section 180, Treas. Reg. section 1.162-12(1972), section 1.471-6(a)), but nonfarmers face an array of barriers to access to the benefits of expensing that farmers can get. IRC sections 263A(d)(1)(B), (d)(3)(B) (denying shelters and agribusiness access to the farmer's exception from uniform capitalization rules); 447(d) (exempting family farms from rules forcing "agribusiness" on accrual method); 461(i)(4) (exempting farmers from prepaid expenses rules); 464(c)(2), (f)(3) (exempting farm families from rules deferring deductions until use of supplies); section 469 (preventing losses from activities taxpayer does not participate in may not be used against regular income). Purchased (but not costs of birthing) livestock are capitalized. Treas. Reg. section 1.162-12(1972). Unharvested crop sold with the land is capital gain, but the expenses of the crop are then capitalized rather than deducted. IRC section 1231(b)(4), 268, 1016(A)(11).

Proposal. Repeal section 1232(b)(3)&(4).

Reasons for the Change. Capital gain for sale of livestock converts ordinary deductions into capital gain because the costs of feeding livestock are ordinary expenses, while the gain from sale of the livestock are capital gain. Capital gain under IRC section 1231(b)(3) is not available for livestock raised for sale or slaughter, but it does apply to livestock even though held "for sale to customers" because of the amount of the activity. Treas. Reg. section 1.1232-2(b)(2) Ex. (3) (1971). The mismatch between ordinary deductions for the inputs and capital

gain for the revenue remains within the scope allowed. As noted (Proposals 4, 5, 14 and 15.), assuming the capital gain rate drops to 15 percent, a farmer could plan to lose 27 percent of his or her costs economically on transactions benefitting from the mismatch of ordinary deductions and capital gain and still break even after tax.

Capital gain for sale of livestock converts ordinary deductions into capital gain

The tax advantages means that farmers face an onslaught of outside capital which drives up the price of feed and farm labor and drives down the sale price of livestock. Farmers who are not in high enough tax brackets to use the negative tax fully are then driven into failure. On the other hand, the current attempts to block outside capital, while retaining the advantages for true farmers with mud on their boots, if successful, blocks whatever benefit the economy might get from the negative tax. It is only by driving down the pretax profit from farming that the public at large gets any benefit from the farm subsidies.

Expensing of farm investments first arose under Treasury regulations issued in 1915. The most plausible historical explanation for the expensing of farm costs that would otherwise be inventoried or capitalized is that the regulation drafters thought that the timing did not make any difference. Johnson, *Soft Money Investing Under the Income Tax*, 1989 ILL. L. REV. 1019, 1089 (1990). But when combined with capital gain for the product of the expense, expensing has the impact of less than no tax.

The proposal would also repeal IRC section 1231(b)(4), which now provides that sale of an unharvested crop with the underlying farmland is capital gain. Crops are expiring assets that must be sold or left to rot, so there is no possibility of causing significantly earlier realizations of crop gain by reducing the tax rate. Absent IRC section 1231(b)(4), the crop would be an ordinary asset even though sold with the land. *Watson v. Commissioner*, 345 U.S. 544 (1953).

Proposal 17: Section 1231.

Current Law. Gains and losses on the sale of section 1231 assets are aggregated for the year. Net gain is capital gain. Net losses are ordinary losses. Assets brought within section 1231 includes real estate and depreciable property used in a trade or business (other than inventory and artistic compositions), timber, coal, iron ore, and livestock. Net gains (from insurance) on property lost to casualty or theft, but not net losses, are included in the section 1231 aggregation. IRC section 1231.

Proposal. Repeal section 1231. Treat gain or loss from market fluctuations of invested capital as capital in either direction. Gain from created or improved assets (including livestock, trees and mined assets) would be ordinary. Depreciation deductions and recapture would be ordinary. Casualty gain (from insurance) would benefit from rollover (section 1033), but would otherwise be ordinary income.

Reasons for the Change. Gains and losses on assets brought within section 1231 are treated asymmetrically. If market fluctuations cause gain, the gain will benefit from the lower rate on capital gains; if they cause loss, the loss

saves higher-rate tax on ordinary income. The asymmetry benefits assets expected to fluctuate, *vis a vis* more stable assets and more stable sources of income. For losses, moreover, section 1231 allows taxpayers to avoid the section 1211 limitations on deduction of discretionary losses, even when the taxpayer has full control as to whether to show or hide the changes in value of the assets.

The aggregation within section 1231 to compute net gains or losses partially offsets the asymmetry in the treatment of section 1231 assets, but the aggregation affects business behavior. Tactically, a taxpayer should sell all section 1231 assets having a gain in one year and all section 1231 assets having a loss in another year. The section can thus cause lock-ins of assets, rationally sold as a matter of economic efficiency, which the whole capital gain system was intended to prevent.

The asymmetry in section 1231 is a product not of tax policy, but of political log rolling: Congress was under pressure from farmers with appreciated livestock to treat gain as capital and under pressure from owners of depreciated trains and rolling stock to treat losses as ordinary, and they "compromised" by giving both "stocks" (but not corporate stock), the best of either capital gain or ordinary loss. Surrey, *Definitional Problems in Capital Gains Taxation*, 2 TAX REVISION COMPENDIUM 1203, 1209 (Ways and Means Comm. Print 1959).

Section 1231 is no longer very important as to depreciable property because rapid depreciation now makes it unusual that depreciable property will be sold below basis and depreciation recapture of the depreciation usually makes the gain ordinary. Gain or loss on unimproved land (i.e., nondepreciable real estate) is market fluctuation that should be capital gain or capital loss in theory. Proposal 14 (timber), Proposal 15 (coal and iron ore) and Proposal 16 (livestock) would repeal other important parts of section 1231. Section 1231 is complicated; it has a convoluted form (Form 4797) all its own. The tax effects it accomplishes are not worth the complexity it generates.

With the repeal of section 1231, capital or ordinary character would be determined by general theory.

With the repeal of section 1231, capital or ordinary character would be determined by general theory. Gain from self-created or improved assets and gain on property the taxpayer had no investment in would be ordinary (Proposals 1 and 2). Gain from the appreciation of invested capital would be a capital gain.

Gain from insurance proceeds covering casualty losses or thefts would usually be ordinary because of recapture of depreciation. Such gain, moreover, is involuntary—the taxpayer does not control the timing of the realization of the casualty or theft so that reduction in rate would not increase realizations enough to reach revenue gains. Section 1033 of the Code gives the taxpayer the ability to avoid recognition of gains from casualties or thefts if the insurance proceeds are reinvested. Since sales proceeds that fail to meet the reinvestment requirement of section 1033 are consumable income (not timeable by the taxpayer), there is no policy reason for the differentially lower rate.