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Capital Gains Jabberwocky: Capital Gain, Intangible Property, and Tax

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CAPITAL GAINS JABBERWOCKY: CAPITAL GAINS, INTANGIBLE PROPERTY, AND TAX

*Stephen T. Black**

*'It seems very pretty,' she said when she had finished it, 'but it's rather hard to understand!' (You see she didn't like to confess, even to herself, that she couldn't make it out at all.) 'Somehow it seems to fill my head with ideas—only I don't exactly know what they are! However, somebody killed something: that's clear, at any rate—'*¹

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1. LEWIS CARROLL, *Through the Looking-Glass and What Alice Found There*, in THE WORKS OF LEWIS CARROLL 128 (Roger Lancelyn Green ed., 1965).

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*"[T]he difference between buying and selling as a business and doing so as an investment avocation is rather artificial."*²

I. INTRODUCTION

In the current U.S. tax system, gains derived from capital are taxed preferentially when compared to other types of income. The history of this split in analysis is long and marked by debate—debate whether there is any justification for a preference, debate what that preference should be, and debate as to whether the system is fair. This debate takes on several forms and ranges from the academic to the practical, from the metaphysical to the solid.

The earliest underpinnings of the debate can be found in some of the earliest Supreme Court cases dealing with income. Following the ratification of the Sixteenth Amendment, which provided, "[t]he Congress shall have power to lay and collect taxes on incomes, from

2. HAROLD M. GROVES, POSTWAR TAXATION AND ECONOMIC PROGRESS 217 (1946); *see also* Harold M. Groves in CAPITAL GAINS TAXATION 17 (Tax Institute Symposium, 1946).

whatever source derived, without apportionment among the several States, and without regard to any census or enumeration,”³ the U.S. Supreme Court was presented with the question of whether a stock dividend was income.⁴

In answering in the negative, the Court gave its now famous formulation of the concept of income: “‘Income may be defined as the gain derived from capital, from labor, or from both combined,’ provided it be understood to include profit gained through a sale or conversion of capital assets”⁵ However, the Court went on:

The fundamental relation of “capital” to “income” has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.⁶

As is evident from early cases, there was a clear sense that there should be delineation between gains from labor and gains from capital, even if the border between the two could not easily be found.

That sense was implicit in the Report of the House Committee on Ways and Means, which recommended the enactment of the initial capital gain provisions in 1921:

The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum . . . in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law.⁷

According to one scholar, “[d]espite perennial re-examination of the capital gains provisions, this elliptical utterance remains the authoritative statement as to their justification.”⁸

In today’s market, there is a continuing push, not exclusively from tax counsel, to blur the lines between gain from labor and gain from capital. It is based, in part, upon impetus from the intellectual property movement to recognize and protect, *as assets*, business endeavors and ideas. For example, business method patents did not come into vogue

3. U.S. CONST. amend. XVI.

4. *Eisner v. Macomber*, 252 U.S. 189, 199 (1920).

5. *Id.* at 207 (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)).

6. *Id.* at 206.

7. H.R. REP. NO. 350, at 10-11 (1921).

8. Peter Miller, *The “Capital Asset” Concept: A Critique of Capital Gains Taxation: II*, 59 YALE L.J. 1057, 1057 n.1 (1950).

until the 1980s.⁹ This resulted in the rather curious (and very interesting) result that such *assets* (for example, the method of doing business) could be sold, which in turn begs the question: What would be the character of income realized from such a sale?

This Article will address anomalies in the characterization of such intangible assets. Four cases will be presented, each of which arguably could consistently produce capital gains. As will be shown, however, the treatment of these cases (and others) is anything but consistent. At the conclusion of the four cases, it should be clear that the inconsistency is systemic, which in turn will lead us to ask whether: (1) none of these intangible assets should receive capital gains treatment or (2) whether all of them should.

II. FOUR CASES IN SEARCH OF RECONCILIATION

A. Lawsuit Proceeds

1. Hypothetical

A paid *P* \$10,000 for a judgment against *D* with a face amount of \$40,000. Two years later, *D* pays *A* \$20,000 as a full settlement of the judgment against him.

Would it matter if *A* sold the claim against *D* to *B* for \$12,000?

2. Discussion

A lawsuit is a “chose in action,” which *Black’s Law Dictionary* defines as “[t]he right to bring an action to recover a debt, money, or thing.”¹⁰ Quoting William R. Anson, *Black’s Law Dictionary* sets forth:

The term *chose in action* has been in common use for a long time, but some doubts have been recently raised as to its precise meaning. A Divisional Court, however, has now given us the following definition: “‘chose in action’ is a known legal expression used to describe all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession.” The phrase “rights of property” does not seem a very happy one, but it is quite clear that the court meant to include under the term *chose in action* rights under a contract and rights of action arising from breach of contract.¹¹

9. See Jonathon Masur, *Patent Inflation*, 121 YALE L.J. 470, 523 (2011).

10. BLACK’S LAW DICTIONARY 275 (9th ed. 2009).

11. *Id.* (citations omitted) (quoting WILLIAM R. ANSON, PRINCIPLES OF THE LAW OF CONTRACT WITH A CHAPTER ON THE LAW OF AGENCY 362 n.b (Arthur L. Corbin ed., 3d Am. ed. 1919) (internal quotation marks omitted)).

The Supreme Court has recognized that a chose in action, “an interest in property not immediately reducible to possession,”¹² is property, and the interest was transferable (more or less) at the time of the founding of the nation.¹³

When a chose in action is settled, reduced to judgment,¹⁴ or assigned, a sale or exchange has occurred.¹⁵ The characterization of that sale is governed by § 1221 of the Internal Revenue Code (“IRC”).¹⁶

3. Capital vs. Ordinary Income in Related Cases

Chose in actions have been analyzed by the courts in several contexts.

a. Interest Coupons

Interest coupons are a chose in action.

In *Helvering v. Horst*,¹⁷ the facts were as follows:

[T]he owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that under the applicable § 22 of the Revenue Act of 1934, the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis.¹⁸

Note how the Court explained that the coupons were separate from the bond itself:

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which

12. *Sprint Commc'ns Co. v. APCC Servs., Inc.*, 554 U.S. 269, 275 (2008).

13. *Id.* at 275-85.

14. *Kingvision Pay-Per-View Ltd. v. Lake Alice Bar*, 168 F.3d 347, 352 (9th Cir. 1999) (“A judgment is property, so taking it away requires due process of law.”).

15. See Stephen T. Black, Katherine D. Black & Michael D. Black, *A Capital Gains Anomaly: Commissioner v. Banks and the Proceeds From Lawsuits*, 43 ST. MARY'S L.J. 113, 169 (2011) (“Courts have long viewed the release by one party of another's legal obligations as a sale or disposition of a property interest.”).

16. See I.R.C. § 1221 (2006).

17. 311 U.S. 112 (1940).

18. *Id.* at 114 (citation omitted).

was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.¹⁹

b. Leases

In *Helvering v. Bruun*,²⁰ a landlord regained possession of his land when the tenant defaulted.²¹ The tenant had built a building on the land, and the landlord gained possession of the building, which was valued at more than \$51,000.²² The Court held that the value of the building represented income to the landlord.²³

In *Hort v. Commissioner*,²⁴ a tenant decided to cancel a fifteen-year lease on a building.²⁵ The landlord and tenant agreed to a payment of \$140,000.²⁶ The landlord had claimed a loss, representing the difference between the present value of payments to be received under the lease and the \$140,000 (a smaller figure).²⁷ The Court instead found that the entire \$140,000 represented income.²⁸

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was 'property,' whatever that signifies abstractly. Presumably the bond in *Helvering v. Horst* and the lease in *Helvering v. Bruun* were also 'property,' but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income.²⁹

Abstractly or not, the law treats dispositions of property as income.³⁰ In *Horst*, the issue before the Court was whether the *father*, who had given the coupons to his son, recognized income.³¹ The Court held he did since he disposed of the right to the interest income.³² This is both an issue of realization (when was it income?) and of shifting

19. *Id.* at 115.

20. 309 U.S. 461 (1940).

21. *Id.* at 464.

22. *Id.* at 464-65.

23. *Id.* at 469.

24. 313 U.S. 28 (1941).

25. *Id.* at 29.

26. *Id.*

27. *Id.*

28. *Id.* at 32.

29. *Id.* at 31 (citations omitted).

30. See I.R.C. § 61(a)(3) (2006).

31. *Helvering v. Horst*, 311 U.S. 112, 114 (1940).

32. *Id.* at 120.

(whose income was it?). However, there was no doubt that the coupons were property.³³

In *Bruun*, the taxpayer ended up with an additional building.³⁴ The building itself was not income, but the transfer (voluntary or not) of it to the landlord resulted in income to the landlord.³⁵ Further, according to the Court in *Hort*:

Simply because the lease was 'property' the amount received for its cancellation was not a return of capital, quite apart from the fact that 'property' and 'capital' are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which § 22 (a) [of the Act] expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as 'property' or 'capital.'³⁶

Rents were³⁷ (and are)³⁸ included in gross income. However, the transfer of a lease is not obviously a "substitute for rental payments."³⁹ Consider the following: *L*, a landlord, leases real property to *T* for fifteen years. Six years into the lease, *L* sells the property to *B* for \$100.

L's receipt of \$100 obviously includes *B*'s appraisal of the relative value of having a tenant occupy the property, but it is not obvious that *L* must separately value the land *and* the occupying leasehold. Nor is it obvious that *L* recognizes ordinary income from the portion of the \$100 attributable to the lease.

We would characterize *L*'s gain by application of IRC § 1221. Since the property is being rented, it falls under the definition of "real property used in his trade or business."⁴⁰ Our attention then turns to §§ 1231 and 1250. To the extent *L*'s gain is not due to "additional depreciation,"⁴¹ it becomes a "§ 1231 gain"⁴² and is characterized by the § 1231 hotchpot.⁴³ If *L* has no other § 1231 gains or losses, the gain would be capital.⁴⁴

33. See *id.* at 114.

34. *Helvering v. Bruun*, 309 U.S. 461, 469 (1940).

35. See *id.*

36. *Hort v. Comm'r*, 313 U.S. 28, 31 (1941).

37. *Id.* at 30.

38. I.R.C. § 61(a)(5) (2006).

39. See *Hort*, 313 U.S. at 31.

40. I.R.C. § 1221.

41. *Id.* § 1250(b)(1) (internal quotation marks omitted).

42. *Id.* § 1231(a)(3)(A).

43. *Id.* § 1231(a)(3).

44. *Id.* § 1231(a)(3)(A).

But now suppose that *L* assigns the lease to *C*. The assigned lease is property. Should the gain *L* realizes be characterized any differently? The Court in *Hort* noted:

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset. But that would not have converted into capital the amount petitioner received from the Trust Co., since § 22 (b) (3) of the 1932 Act would have required him to include in gross income the rent derived from the property, and that section, like § 22 (a), does not distinguish rental payments and a payment which is clearly a substitute for rental payments.⁴⁵

Why is the gain “clearly” a substitute for rental payments? Section 1221 does not make it so, nor does § 1231.⁴⁶

We find some support for a similar, although not exact, argument that would treat the sale as ordinary income because it represented “deemed anticipated rent.”⁴⁷ For example, if *L* leases land to *T*, and *T* prepays the rent, *L* should have ordinary income. Similarly, if *L* were to “assign” to *T* the remainder of his lease (a property interest), *L* should still have ordinary income. The Supreme Court has held that:

The purpose of § 117 was “to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.” And this exception has always been narrowly construed so as to protect the revenue against artful devices.

We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income.⁴⁸

But are those exceptions the same as saying that *every* transaction involving a lease (for example, its sale, transfer, or cancellation) results in ordinary income? Consider that thirty years later, the Court came back with this:

In essence, petitioner argues that “property held by the taxpayer (whether or not connected with his trade or business)” does not include property that is acquired and held for a business purpose. In

45. *Hort v. Comm’r*, 313 U.S. 28, 31 (1941) (footnote omitted) (citations omitted).

46. See I.R.C. §§ 1221, 1231.

47. I.R.S. Gen. Couns. Mem. 33,793 (Apr. 11, 1968).

48. *Comm’r v. P.G. Lake, Inc.*, 356 U.S. 260, 265 (1958) (alteration in original) (citations omitted).

petitioner's view an asset's status as "property" thus turns on the motivation behind its acquisition. This motive test, however, is not only nowhere mentioned in § 1221, but it is also in direct conflict with the parenthetical phrase "whether or not connected with his trade or business." The *broad definition* of the term "capital asset" explicitly makes irrelevant any consideration of the property's connection with the taxpayer's business, whereas petitioner's rule would make this factor dispositive.⁴⁹

It should also be noted that in 1954, Congress clarified that "[a]mounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement . . . , shall be considered as amounts received in exchange for such lease or agreement."⁵⁰ This effectively overrules any of the cases discussing lease or contract cancellation prior to 1954, even though many of them continue to be relied upon, directly or indirectly.⁵¹

Having seen what the law does with bonds and leases, what are we to learn about choses in action?

4. Lawsuit Cases

In *Hudson v. Commissioner*,⁵² a businessman and an attorney bought a judgment for \$11,004.00 that had a face amount of \$75,702.12 in the year 1943.⁵³ In 1945, the defendant paid them \$21,150 as a full settlement of the judgment against him.⁵⁴

Each of the two reported his profit on the settlement of the judgment as a long-term capital gain for 1945.⁵⁵ Judge Johnson of the Tax Court said:

There is no question about the bona fides of the transaction, nor is there any disagreement about the fact that the judgment, when entered and transferred, was property and a capital asset. The parties differ, however, on the question of whether there was a "sale or exchange of a capital asset."⁵⁶

49. *Ark. Best Corp. v. Comm'r*, 485 U.S. 212, 217 (1988) (emphasis added).

50. I.R.C. § 1241.

51. *See, e.g., Ark. Best Corp.*, 483 U.S. at 217 n.5 (citing *Hort v. Comm'r*, 313 U.S. 28 (1941)).

52. 20 T.C. 734 (1953).

53. *Id.* at 735.

54. *Id.*

55. *Id.*

56. *Id.* at 736.

He was presumably troubled by the requirement in the IRC that there be a sale or exchange, and that it appeared to the court that the property was extinguished following the transaction:⁵⁷

We cannot see how there was a transfer of property, or how the judgment debtor acquired property as the result of the transaction wherein the judgment was settled. The most that can be said is that the judgment debtor paid a debt or extinguished a claim so as to preclude execution on the judgment outstanding against him. In a hypothetical case, if the judgment had been transferred to someone other than the judgment debtor, the property transferred would still be in existence after the transaction was completed. However, as it actually happened, when the judgment debtor settled the judgment, the claim arising from the judgment was extinguished without the transfer of any property or property right to the judgment debtor. In their day-to-day transactions, neither businessmen nor lawyers would call the settlement of a judgment a sale; we can see no reason to apply a strained interpretation to the transaction before us. When petitioners received the \$21,150 in full settlement of the judgment, they did not recover the money as the result of any sale or exchange but only as a collection or settlement of the judgment.⁵⁸

a. Extinguished Property

The court made a point of the fact that after the transaction, the debtor appeared to receive no property.⁵⁹ Other courts have faced difficulty with this concept.

For example, in *Commissioner v. Starr Bros., Inc.*,⁶⁰ the Second Circuit said:

Undoubtedly the taxpayer's rights under the 1903 contract were property; and we will assume arguendo, as does the Commissioner, that they were a capital asset. The decisive issue is whether there was a "sale or exchange" of such capital asset when the contract was terminated in 1943. To refer to the contract as a grant of a "franchise" tends, we think, to becloud analysis of the legal relations. What the taxpayer gave in return for the cash payment was a release of United's contract obligations, chief of which was *its promise not to sell its products to other dealers* in New London. Such release not only ended

57. See *id.*

58. *Id.*

59. *Id.*

60. 204 F.2d 673 (2d Cir. 1953).

the promisor's previously existing duty but also destroyed the promisee's rights. They were not transferred to the promisor; they merely came to an end and vanished.⁶¹

Strange how the court could use language such as "what the taxpayer gave in return for the cash payment" and yet not recognize that as an exchange. We may chalk that up to legal trends in the 1940s and 1950s, since they did not treat nearly as many *things* as *assets* as we do today.

Still, it does not necessarily follow that everything that is exchanged for cash or property is necessarily property itself. A contract for services, for example, may be consummated by a transfer of cash or property, but that does not *necessarily* mean that we think the services are property, does it?

Whatever may have been the case in 1953—and this is not really the case because most of my examples will have been in existence back then—there are many examples of property that extinguishes itself.

For example, for many years prior to 1954, courts struggled with the issue of what happens when a lease is cancelled, either by a payment by the tenant (for example, the landlord's income) or by the landlord (the tenant's income).⁶² In 1954, Congress responded to the tenant's income issue by enacting § 1241.⁶³ Pursuant to § 1241, "amounts received by a lessee (not by the lessor) for the cancellation of a lease, or by a distributor (not by the supplier) for the cancellation of a distributor's agreement, if there is a substantial capital investment, are treated as received in a capital transaction."⁶⁴ In fact, the Second Circuit held:

The Commissioner attacks the Golonsky decision on the ground that it is inconsistent with recent decisions of this court holding payments made for the release of contractual rights, such as the right to an exclusive agency, to be ordinary income. In these cases no "sale or exchange" within the meaning of the statute was found because the contractual right was not transferred, but was released and merely vanished. However, we think the right of possession under a lease or

61. *Id.* at 674 (emphasis added); see also *Bingham v. Comm'r*, 105 F.2d 971, 972 (2d Cir. 1939) ("What may have been property in the hands of the holder of the notes simply vanished when the surrender took place and the maker received them.")

62. See, e.g., *Comm'r v. Golonsky*, 200 F.2d 72, 73 (3d Cir. 1952); *United Cigar-Whelan Stores Corp. v. District of Columbia*, 176 F.2d 952, 952 (D.C. Cir. 1949); *Borland v. Comm'r*, 27 B.T.A. 538, 542 (1933); *Bus. Real Estate Trust of Bos. v. Comm'r*, 25 B.T.A. 191, 193 (1932); *Bretzfelder v. Comm'r*, 21 B.T.A. 789, 789 (1930); *Miller v. Comm'r*, 10 B.T.A. 383, 383 (1928).

63. See I.R.C. § 1241 (2006).

64. Brady O. Bryson, *The 1954 Internal Revenue Code: Gains and Losses on Sales and Exchanges*, 42 A.B.A. J. 628, 632 (1956); see also *Comm'r v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752, 753 (2d Cir. 1954); cf. *Starr Bros., Inc.*, 204 F.2d at 674.

otherwise, is a more substantial property right which does not lose its existence when it is transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain, and we see no reason why a different result should be reached here. Moreover, the transaction seems closer to those cases holding that gain derived by the holder of a life interest upon sale to the remainderman is to be taxed as a capital gain. The decision of the Supreme Court in *Hort v. Commissioner* does not require a different result. There, in holding a payment made by the lessee to the landlord to cancel the lease to be ordinary income, reliance was placed on the fact that the payment took the place of what ordinarily would be payments for rent. That argument cannot be advanced here.⁶⁵

The issue for the landlord may involve three types of transfers: (1) payments to cancel a lease; (2) payments to restore the premise to its former condition; and (3) buildings or improvements built or made by the tenant and subsequently left on the premises.

The first category of transfers—those from the tenant to the landlord to cancel a lease—was the subject of the *Hort* case,⁶⁶ even though the Court recognized that “[t]heoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset.”⁶⁷

The second category of transfers—payments to restore the premises—are taxed as a recovery of basis first, then as capital gains.⁶⁸

The third category is excludable pursuant to IRC § 109.⁶⁹

The relevant question after examining the difference in treatment is: To what extent can this be manipulated by the taxpayer? How hard is it to categorize these three types of payments?

Finally, consider the example of a university professor’s tenure:

The right of tenure is granted at the end of the probationary period, in which the professor is an at will employee. This probationary period is most analogous to a term-of-years contract, which upon expiration stirs evaluation for tenured employment. This analogy is valid because the end of the probationary period inevitably marks a fundamental change in the employer-employee relationship. If the professor receives a negative evaluation, then the employment relationship simply ends. If the professor receives a positive evaluation, then the university offers

65. *McCue Bros. & Drummond, Inc.*, 210 F.2d at 753 (citations omitted).

66. *Hort v. Comm’r*, 313 U.S. 28, 28-29 (1941).

67. *Id.* at 31.

68. *See Bos. Fish Mkt. Corp. v. Comm’r*, 57 T.C. 884, 889-90 (1972); *cf. Sirbo Holdings, Inc. v. Comm’r*, 509 F.2d 1220, 1223-24 (2d Cir. 1975).

69. *See I.R.C. § 109* (2006); *see also H. REP. NO. 2333*, at 69 (1942); *S. REP. NO. 1631*, at 78-79 (1942).

the professor a tenured position, which the professor is free to either accept or reject. In this sense, the end of the probationary period marks the beginning of negotiations between the university and the professor for further employment. The agreement struck between the university and the professor is more than just a promotion; it is the beginning of a new employer-employee relationship with newly negotiated rights. . . .

....

Another distinction is that the purchase of tenure rights does not really give any property right back to the university. This so-called “disappearing asset” theory arose in a series of cases from the 1950s, generally stating that no property interest is vested in the purchaser, but for the extinguishing of the right held by the seller. This distinction is also doubtful, as the sale of such tenure rights endows the university with the right to permanently terminate the employment relationship, which is something that it did not possess prior to the transaction. Therefore, as the right shifts from employee to employer, it does not disappear, but merely changes in format.⁷⁰

The IRS has dealt with the “disappearing asset” theory before, in circumstances where it is hard to justify *not* classifying the transaction as one involving property.⁷¹ This occurs in transactions somewhere between the Supreme Court stating that it is:

evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of § 1221] qualifies as a capital asset. [The term] “capital asset” is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time . . .⁷²

or “[t]he lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. . . . In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property,”⁷³ and contrary cases which have held, “[s]imply because the property

70. Christopher Meskill, *The Tenure Tax: Social Security Withholdings on Academic Retirement After University of Pittsburgh v. United States*, 25 J. C.R. & ECON. DEV. 937, 966-67 (2011) (footnotes omitted).

71. I.R.S. Field Serv. Advice 20023805, at 15 (Aug. 16, 2002) (internal quotation marks omitted); I.R.S. Priv. Ltr. Rul. 200215037, at 90-91 (Jan. 14, 2002).

72. *Comm’r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 130, 134, 136 (1960) (explaining that compensation for temporary seizure of business facilities is ordinary income).

73. *Comm’r v. P.G. Lake, Inc.*, 356 U.S. 260, 264-66 (1958) (denying capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas working interests).

transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income.”⁷⁴

In these types of situations, the theory (which the IRS has advanced to a doctrine) is helpful in making believe that the tax system is rational. Otherwise, these edge cases might show that contracts can be converted into property (sometimes multiple times for the same “property”), and this property (or some portion of it) can be transferred for what appears to be capital gain.

Contracts are not the only types of property suffering in this no-mans-land of taxation. Other types of property that may become extinguished are tickets (extinguished when used, upon passage of time, or when refunded), licenses, stock, or nearly any other type of intangible property. That does not mean that if they were to be sold, bartered, or exchanged, that there was not a transfer of property.

Indeed, the example of a chose in action is interesting. If *A* has a claim against *B*, the law says *A* has property. *A* may, among other things, transfer, assign, ignore, or prosecute his rights. If transferred to a third party, *C*, *C* has those same rights. Should the statute of limitations run, *A*’s (or *C*’s) rights will extinguish. But *A* (or *C*) still owned property.

Indeed, we could imagine an example where *A*’s claim is subject to a statute of limitation, which has run, but the legislature subsequently extends the time.⁷⁵ Assume that *A*’s claim expires on December 31, Year 1. Further assume that the legislature takes action on December 31, Year 2, giving *A* until December 31, Year 3 to file her action.

During Year 1, *A* owns a property right. During Year 2, we are not quite sure, but during Year 3, *A* again owns a property right.

It seems clear that during Years 1 and 3, should *A* transfer her right to another, there would have been a sale or exchange. What about a transfer during Year 2?

There are a number of other examples, including the transfer of restricted stock,⁷⁶ the transfer of “extinguished” property which has now

74. *Guggenheim v. Comm’r*, 46 T.C. 559, 565, 569 (1966) (involving the sale of syndicated interests in a racehorse); see also *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 57, 59 (5th Cir. 1963) (involving transfer of an “exclusive” feature of a patent contract); *Comm’r v. Ferrer*, 304 F.2d 125, 126, 132-33 (2d Cir. 1962) (involving various rights in a literary work); *Estate of Shea v. Comm’r*, 57 T.C. 15, 25 (1971) (involving a shipping charter).

75. “[I]t cannot be said that lifting the bar of a statute of limitation so as to restore a remedy lost through mere lapse of time is *per se* an offense against the Fourteenth Amendment.” *Chase Sec. Corp. v. Donaldson*, 325 U.S. 304, 316 (1945).

76. *Coordinated Issue: All Industries: Transfer or Sale of Compensatory Options or Restricted Stock To Related Persons: UIL: 9300.28-00*, IRS, 9-10 (Oct. 15, 2004),

become a collector's item,⁷⁷ the transfer of caught baseballs,⁷⁸ the transfer of a right to rescind that expires after X years,⁷⁹ the transfer of a copyright or patent,⁸⁰ or the transfer of Baltimore ground rents,⁸¹ just to name a few.⁸² Are we prepared to assert that these properties cease to be property for tax purposes when their existence is extinguished (or may be extinguished)?⁸³

Looking at the issue from *B*'s point of view, *B* may feel a risk of loss. That feeling will go away upon the running of the statute of limitations or upon a release of claims. Is *B*'s possession of *A*'s release of claims, whether by implicit or explicit agreement with the possessor of the chose or whether by judicial fiat, considered property?

In this case, *B*'s property (the release of claims) is really not transferable,⁸⁴ but it represents an asset to *B*. It is a bundle of rights, not the least among which is the assurance that *A* (or her assigns) will not prosecute rights against *B*. It can be analogized to a covenant not to compete or any other contract prescribing action on the part of the maker. The holder of such a contract *holds* property, but may he *sell* or *exchange* it for tax purposes?

http://www.irs.gov/pub/irs-utl/compensatory_final.pdf; see also *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 390 (Del. 2010).

77. For example, gambling chips from defunct casinos.

78. Does the value of this expire upon our forgetting to remember who the player was? See Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 FLA. TAX REV. 685, 724-25 (2000); Lawrence A. Zelenak and Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299, 1307-08 (1999).

79. See Elwin Griffith, *The Truth and Nothing but the Truth: Confronting the Challenges in the Truth in Lending Act and Regulation Z*, 40 HOUS. L. REV. 345, 370-71 (2003).

80. See *Valmet Paper Mach., Inc. v. Beloit Corp.*, 868 F. Supp. 1085, 1086 (W.D. Wis. 1994) (holding that one may transfer the right to sue for past infringements of a now-expired patent). However, certain agreements with businesses in China, including those containing payments for expired patents, cannot be registered. David Williams Russell, *Technology Transfers from the United States to the People's Republic of China*, 3 J. INT'L BUS. & L. 81, 87 (2004).

81. *Muskin v. State Dep't of Assessments & Taxation*, 30 A.3d 962, 965 (Md. 2011); Frank A. Kaufman, *The Maryland Ground Rent—Mysterious but Beneficial*, 5 MD. L. REV. 1, 25-26 (1940).

82. Raymond R. Coletta, *The Measuring Stick of Regulatory Takings: A Biological and Cultural Analysis*, 1 U. PA. J. CONST. L. 20, 26 n.25 (1998).

83. *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1011-12 (1992) (permitting review of takings claim where statute extinguished property's value). See also the discussion of *Nahey v. Commissioner*, which noted:

It shouldn't make a difference that Wisconsin law (the governing law in the Xerox case) cut off Nahey's right to recover for Wehr's lost profits as of the date of the sale of the corporation to him, while in the case of the bond the interest is received after the acquisition.

Nahey v. Comm'r, 196 F.3d 866, 868 (7th Cir. 1999). However, the court still held that the "asset" continued to yield income. *Id.* at 869.

84. Or is it?

b. Third-Party Transfer

If putative property is property when sold, exchanged, or transferred to a third party, it should be treated as property for all intents and purposes. For example, if *A* owns something and it is transferred to *B*, the something is property (and remains property in *B*'s hands), then it stands to reason that if *A* were to transfer the something to *C*, it should be treated as property.

In *Hudson*, when the parties settled the lawsuit for cash, the settlement was a transfer of property.⁸⁵ Had they transferred it to a third party for cash (instead of settling), the court would have been prepared to call that a property transfer.⁸⁶ Instead, they transferred their rights to the defendant.⁸⁷

Perhaps the qualm with this analysis lies in the fact that we are using the term "transferred." We speak of transfers of cash (although in today's market, many of those "transfers" are fictional, "electronic" accounting entries), transfers of stock (again, accounting entries—not many individuals ever see the stock certificates they purport to "own"), transfers of land (livery of seizin has not been performed in a while), and so forth.

In fact, many of our modern day transfers involve electronic or paper evidences of ownership—proof, if you will, that our possession or control of "property" is rightful. Part of the mortgage crisis involves the question of proof of ownership, not actual possession.⁸⁸

When we speak of a transfer of intangible property—a copyright, knowhow, a release of a lawsuit—we are talking about an exchange of rights for something else. While that exchange, especially when intangible property is involved, may be embodied in a contract, it is not the contract that is being transferred. The exchange may involve a forbearance of services, but the nature of the exchange is that rights, which were possessed by the plaintiff, have been transferred to the defendant, who now owns them as assurance that the plaintiff will no longer enforce or pursue them.

85. *Hudson v. Comm'r*, 20 T.C. 734, 735-36 (1953).

86. *Id.* at 736.

87. *Id.*

88. See Ariana Eunjung Cha, *A Free House, and Other N.Y. Foreclosure Tales*, WASH. POST, Nov. 9, 2010, at A1.

c. A Rose by Any Other Name: Sale or Exchange.

In *Hudson*, the court argued that businessmen would not term the settlement of a lawsuit a sale.⁸⁹ While this may be true, we do not rely upon the parties' language to determine federal tax consequences.⁹⁰ The economic substance of this exchange is this: One party owned a chose in action, which the law treats as property. That party transferred those rights for cash. The appropriate treatment is to treat the exchange as a "sale or exchange."⁹¹

5. Origin of the Claim

In looking for a clear path,⁹² we might be tempted to follow some courts that latch on to the origin of the claim test.⁹³ In doing so, however, we will eventually come to chase our own tails. Consider, for example, the conundrum the Seventh Circuit found itself in when deciding *Nahey v. Commissioner*.⁹⁴ Nahey (actually, his S corporations) had purchased a corporation that had a pending suit against Xerox.⁹⁵ Six years later, Xerox settled the suit for \$6 million.⁹⁶

Nahey conceded that if the original corporation had collected from Xerox, the \$6 million would be ordinary income.⁹⁷ His claim, however, was that since the chose in action in his hands was a capital asset—the claim the court bought—the gain from the disposition of that asset should also be capital—which the court disagreed with.⁹⁸

Strangely enough, the *Nahey* court relied upon *Alexander v. Commissioner*,⁹⁹ which in turn relied upon the 1943 Third Circuit

89. *Hudson*, 20 T.C. at 736.

90. "In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes." *Union Planters Nat'l Bank of Memphis v. United States*, 426 F.2d 115, 118 (6th Cir. 1970).

91. See I.R.C. § 1222 (2006).

92. Alice and the Cheshire Cat's conversation is instructive:

Alice: Oh, no, no. I was just wondering if you could help me find my way.

Cheshire Cat: Well that depends on where you want to get to.

Alice: Oh, it really doesn't matter, as long as . . .

Cheshire Cat: Then it really doesn't matter which way you go.

ALICE IN WONDERLAND (Walt Disney Productions 1951).

93. Katherine D. Black, Michael D. Black & Stephen T. Black, *Taxation of Contingency Fees: Deductions for Expenses?*, TAX NOTES: TAX PRAC., Feb. 8, 2010, at 1-2.

94. 196 F.3d 866 (7th Cir. 1999).

95. *Id.* at 867.

96. *Id.*

97. *Id.*

98. *Id.* at 868.

99. *Nahey*, 196 F.3d at 867-68; 72 F.3d 938 (1st Cir. 1995).

decision, *Herbert's Estate v. Commissioner*.¹⁰⁰ There, the Third Circuit explained, "[w]e have no doubt that the payment here of the claim held by the estate was a 'disposition' of the claim within the meaning of [the predecessor of § 1001]."¹⁰¹ The *Alexander* court, however, decided that settling a lawsuit was unlike settling a debt (presumably because a debt is more marketable?), and therefore the suit would generate ordinary income because it had not been sold or disposed of.¹⁰²

Alexander further decided that the test in *Raytheon Production Corp. v. Commissioner*¹⁰³ should be dispositive.¹⁰⁴ *Raytheon* involved the recovery by one corporation against another in an antitrust suit.¹⁰⁵ The court actually held two things. First:

Damages recovered in an antitrust action are not necessarily nontaxable as a return of capital. As in other types of tort damage suits, recoveries which represent a reimbursement for lost profits are income. . . . The reasoning is that since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner.¹⁰⁶

This has been formulated using the court's own language: "[T]he question to be asked is '[i]n lieu of what were the damages awarded?'"¹⁰⁷

However, the court continued:

Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitations to be set forth below, is not taxable. "Care must certainly be taken in such cases to avoid taxing recoveries for injuries to good will or loss of capital."¹⁰⁸

Finally, the court concluded:

Upon examination of *Raytheon's* declaration in its anti-trust suit we find nothing to indicate that the suit was for the recovery of lost profits. The allegations were that the illegal conduct of R.C.A. "completely destroyed the profitable interstate and foreign commerce of the plaintiff and thereby, by the early part of 1928, the said tube business of the plaintiff and the property good will of the plaintiff therein had

100. *Alexander*, 72 F.3d at 943; 139 F.2d 756 (3d Cir. 1943).

101. *Herbert's Estate*, 139 F.2d at 758.

102. See *Alexander*, 72 F.3d at 942-44.

103. 144 F.2d 110 (1st Cir. 1944).

104. *Alexander*, 72 F.3d at 942.

105. *Raytheon*, 144 F.2d at 112-13.

106. *Id.* at 113 (citations omitted).

107. *Id.*

108. *Id.* (citations omitted).

been totally destroyed at a time when it then had a present value in excess of three million dollars and thereby the plaintiff was then injured in its business and property in a sum in excess of three million dollars.” This was not the sort of antitrust suit where the plaintiff’s business still exists and where the injury was merely for loss of profits. The allegations and evidence as to the amount of profits were necessary in order to establish the value of the good will and business since that is derived by a capitalization of profits. A somewhat similar idea was expressed in *Farmers’ & Merchants’ Bank v. Commissioner*. “Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery.” Since the suit was to recover damages for the destruction of the business and good will, the recovery represents a return of capital. Nor does the fact that the suit ended in a compromise settlement change the nature of the recovery; “the determining factor is the nature of the basis claim from which the compromised amount was realized.”¹⁰⁹

That brings us back to *Nahey*, which decided that *Raytheon*’s analysis was too broad.¹¹⁰ In fact, the *Nahey* court stated, “we add that we cannot find any practical reason for why the tax treatment of the proceeds of a suit should change merely because of an intervening change in ownership.”¹¹¹ The court dismissed *Nahey*’s claim that the “nature and basis of” *Nahey*’s claim was the purchase of a business.¹¹²

Which in turn leaves us with a slightly sour aftertaste. Why? It seems that *Nahey* and *Alexander* cite to *Raytheon* and *Hebert*,¹¹³ but miss the fact that those two suits support the claim that dispositions of claims may be capital in nature. Lawsuits are, in the words of the Supreme Court, “property”¹¹⁴ and “income producing assets.”¹¹⁵ Under

109. *Id.* at 113-14 (citation omitted).

110. See *Nahey v. Comm’r*, 196 F.3d 866, 868-69 (7th Cir. 1999).

111. *Id.* at 869.

112. *Id.* at 867-69.

113. See *supra* notes 100-12 and accompanying text.

114. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 807 (1985) (“[A] chose in action is a constitutionally recognized property interest”); see also *Standard Oil Co. v. New Jersey*, 341 U.S. 428, 439 (1951). Further:

[I]n 1816, Justice Story, writing for a unanimous Court, summarized the practice in American courts as follows: “Courts of law, following in this respect the rules of equity, now take notice of assignments of choses in action, and exert themselves to afford them every support and protection.” He added that courts of equity have “disregarded the rigid strictness of the common law, and protected the rights of the assignee of choses in action,” and noted that courts of common law “now consider an assignment of a chose in action as substantially valid, only preserving, in certain cases, the form of an action commenced in the name of the assignor.”

the relevant tax statutes, the sale or exchange of those assets should produce capital gains. However, a minefield of subsequent, well-meaning but well-confused cases have left a group of judicial doctrines with no firm underpinnings except a vague notion that there is a potential to convert the income from those “assets” into capital gains and a sense that that result is undesirable.

B. Sale of Copyright and Sale of Patent

1. Hypothetical

A creates an invention and applies for and is granted a patent for the invention. He sells the patent to *C* for \$10,000. The \$10,000 (less *A*’s costs) is treated as long-term capital gain.

B writes a novel, which is protected under U.S. copyright law. She sells the rights to her book to *D* for \$10,000. *B*’s \$10,000 (less some costs) is treated as ordinary income.

2. History

In 1950, Congress amended IRC § 117:

The bill as passed by the House amended section 117 (a) (1) of the Internal Revenue Code so as to exclude copyrights, patents, inventions, designs, and literary, musical, or artistic compositions, and similar property from the definition of “capital assets” when held by certain taxpayers. Amendments Nos. 77 and 78 remove patents, inventions, and designs from this exclusion.¹¹⁶

The Senate Report of the bill stated:

When a person is in the profession of writing books, or creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income. This is true whether he receives royalties from the use of his products or sells them outright, since the products of his work are held by him “primarily for sale to customers in the ordinary course of his trade or business” and are, therefore, not treated as capital assets.

If an amateur receives royalties on his book or other artistic work, they are treated as ordinary income, but if he holds his book or other

It bears noting, however, that at the time of the founding (and in some States well before then) the law did permit the assignment of legal title to at least some choses in action. In such cases, the assignee could bring suit on the assigned claim in his own name, in a court of law.

Sprint Commc’ns Co. v. APCC Servs., Inc., 554 U.S. 269, 278-79 (2008) (citations omitted).

115. *Comm’r v. Banks*, 543 U.S. 426, 435 (2005).

116. H.R. REP. NO. 81-3124, at 27 (1950) (Conf. Rep.).

artistic work for 6 months (3 months under this bill) and then sells it outright he can avail himself of a loophole which treats such a sale as the sale of a capital asset, not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As a result the taxpayer receives long-term capital gain treatment on the product of his personal effort.

....

It is estimated that this amendment may yield nearly \$1 million annually in additional revenue.

The House bill also would have treated as ordinary income gains from the sale of an invention or patent by the occasional inventor. Your committee believes that the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words "invention," "patent," and "design" have been eliminated from this section of the bill.¹¹⁷

Beginning in 1950, copyrights were excluded from the definition of capital asset. This meant that, while an asset, a copyright that was sold would generate ordinary income (as would any property that was being held for sale to customers).

Patents, however, were accorded different status, due in part to the Cold War then in process. It was felt that encouraging scientists via a tax break (ordinary income rates were as high as 88% in the 1950s)¹¹⁸ would benefit the national interest. In fact, one historian has credited, in part, the differential in capital gains tax rates for the success of Silicon Valley.¹¹⁹

Patents were not within the exclusion from capital gains and thus were still considered to be capital assets, at least as long as they did not meet any of the other exclusionary tests.¹²⁰ One of the biggest exclusions was for assets held for sale to customers in the regular course of the taxpayer's business.¹²¹ This test led to the common understanding that professional inventors' patents were not capital assets (and the sale of

117. S. REP. NO. 81-2375, at 43-44 (1950).

118. *U.S. Individual Income Tax: Personal Exemptions and Lowest and Highest Tax Bracket Tax Rates and Tax Base for Regular Tax, Tax Years 1913-2013*, TAX POLICY CTR. (Jan. 10, 2012), http://www.taxpolicycenter.org/taxfacts/Content/PDF/historical_parameters.pdf.

119. Paul Kedrosky, *Conversation With Steve Blank, Serial Entrepreneur, Professor and Author*, KAUFFMAN FOUNDATION (Sept. 21, 2013, 8:00 AM), <http://www.kauffman.org/InfectiousTalk/Blog/September-2010/Conversation-with-Steve-Blank,-serial-entrepreneur.aspx>.

Mr. Blank does get the tax facts wrong, however, since the capital gains rate differential was much greater during the 1950s and 60s than it was in the 70s. See *Top Federal Income Tax Since 1913*, CITIZENS FOR TAX JUSTICE (Nov. 2011), <http://www.ctj.org/pdf/regcg.pdf>.

120. See *supra* note 117 and accompanying text.

121. See I.R.C. § 1221(a)(8) (2006).

which would generate ordinary income), while amateur inventors' patents would generate capital gains.¹²²

This situation only lasted a few years before Congress decided to put an end to the confusion and legal wrangling, and enacted § 1235:

Under existing law, only amateur as distinct from professional inventors can obtain capital gain treatment; and, to make this distinction, it has become necessary to determine whether sufficient prior inventions exist to warrant placing the taxpayer in the business of selling inventions to customers, a requirement that has in many instances caused confusion and litigation. To obviate this difficulty in the case of gain, and to provide a larger incentive to all inventors to contribute to the welfare of the nation, this section is applicable equally to all inventors, whether amateur or professional, regardless how often they sell their [inventions].¹²³

So if a professional inventor with 100 patents sells her newest patent, she is treated to capital gains rates, while the amateur or professional author is relegated to ordinary income.¹²⁴

3. What Is a Copyright?

What types of rights does it involve? Do they all derive from my labor? Or are some derived from the capital that my labor produces? Once I have created the story, is some of the copyright gain due to that capital asset (and not my labor)?

It is important to distinguish between the physical work and the underlying copyright in the work. For example, in the case of an artist, the community [(the artist and his/her spouse)] will be entitled to the market value of any unsold paintings in a divorce but if the painter is famous there may be value to the other reproduction and merchandising rights in the paintings.¹²⁵

This could mean, for example, that an unsold painting is worth \$1000, but if retained by the painter, there may be additional value in reproduction and merchandising rights (for example, rights to make copies and derivatives of the painting). If sold for \$200, would the gain

122. H.R. REP. NO. 83-1337, at A280 (1954).

123. *Id.*

124. See Xuan-Thao Nguyen & Jeffrey A. Maine, *The History of Intellectual Property Taxation: Promoting Innovation and Other Intellectual Property Goals?*, 64 SMU L. REV. 795, 833-34 (2011). However, the musician may be able to elect capital gains treatment pursuant to § 1221(b)(3). *Id.* at 834-35.

125. *A Writer's Guide: Copyright, Divorce Community Property in California*, L.A. DIVORCE & FAM. L. (Jan. 6, 2009, 4:33 PM), <http://lafamilylaw.typepad.com/lafamilylaw/2009/01/a-writers-guide-copyright-divorce-community-property-in-california.html> [hereinafter *A Writer's Guide*].

from those additional rights be attributable to the painter's labor in creating the retained painting? Would it be due to the painter's reputation? Would it be due to the painter's agent's work?

As the Ninth Circuit noted in *Siegel v. United States*,¹²⁶ "the line between earned income and income from property is not always marked with dazzling clarity."¹²⁷ In such a case, the copyright would be treated as property, and the amounts received by the son upon the sale of the story to a publisher would constitute income to the son and not to the author.¹²⁸ How does this example differ from the situation presented in *Helvering v. Eubank*?¹²⁹

If this is the first time the painter has sold merchandising rights, are they considered property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"?¹³⁰

The DROID line of phones is developed by Motorola, who licenses the trademark "DROID" from Lucasfilm LTD.¹³¹ From 1973 to 1974, George Lucas began writing the screenplay for *Star Wars*.¹³² The screenplay was turned down by several studios until he was able to strike a deal with Twentieth Century Fox.¹³³ Lucas agreed to forgo his salary in exchange for forty percent of the film's box office take and all merchandising rights.¹³⁴ Are the trademark rights still attributable directly to Lucas's personal efforts in creating the screenplay?

Consider the case of Jerry Lewis and Patti Lewis who divorced after 35 years. In the divorce, Patti reached a settlement under which she was entitled to a one half interest in royalties from "Community Titles" over which Jerry retained control. This included the Nutty Professor which was remade by Universal with Eddie Murphy. In a subsequent lawsuit, Patti alleged that Jerry structured the deal with Universal i[n] such a way that minimized the "remake rights" (to which she was entitled to 50%) but paid him substantial personal service fees as writer and producer (which did not).¹³⁵

126. 464 F.2d 891 (9th Cir. 1972).

127. *Id.* at 894.

128. See Rev. Rul. 54-599, 1954-1 C.B. 52.

129. 311 U.S. 149 (1940).

130. I.R.C. § 1221(a)(1) (2006).

131. See *George Lucas Owns the Droid: The Name, Not the Phone*, GEEKSUGAR (Nov. 6, 2009, 3:50 AM), <http://www.geeksugar.com/George-Lucas-Owns-Term-DROID-Motorola-Pays-Fee-License-6051336>.

132. *Biography for George Lucas*, INTERNET MOVIE DATABASE, <http://www.imdb.com/name/nm0000184/bio> (last visited Mar. 29, 2013).

133. *Id.*

134. *Id.*

135. *A Writer's Guide*, *supra* note 125.

Could Jerry have structured the deal the opposite way—maximizing the remake rights and minimizing the personal service fees? If so, then the gain from the deal would be due not to Jerry’s “services,” but rather to the property. And are we taxing him on labor he performed some decades earlier? That was exactly what one of the arguments was in favor of lower capital gains rates—to tax gains that matured over many years at a lower rate to avoid the bunching problem.

4. Fruit of Tree vs. Creating the Tree

In the 1950s, Congress considered that the relative tax loss from leaving patents in § 1221 (for example, the loss in revenue in treating gain from a sale of a patent as capital gains instead of ordinary income) would be minor.¹³⁶ Some analysts have estimated that U.S. patents may account for in excess of \$9 trillion dollars in value¹³⁷ and that royalties paid may total in excess of \$36.5 billion.¹³⁸

Congress also considered that gains from the sales of intellectual property assets were really due to the labor of the creators and thus properly taxable as ordinary income.¹³⁹ However, Congress has significantly eroded the justification by removing patents from the exception and then recently treating some copyrights as capital gains while leaving others taxed at ordinary income rates.¹⁴⁰

This makes less sense when we consider the current landscape of copyright transfers. The copyright property itself may be divided up in so many ways and over so long a period of time¹⁴¹ that it is no longer simple to say that copyright gains are due to the personal labor of the author.

136. S. REP. NO. 81-2375, at 44 (1950).

137. See *Intangible Asset Market Value*, OCEAN TOMO, <http://www.oceantomo.com/productsandservices/investments/intangible-market-value> (last visited Mar. 29, 2013) (stating that eighty percent of the S&P 500 market value consists of intangible assets, a significant portion of which is represented by patented technology); *S&P 500*, STANDARD & POOR’S (Jan. 24, 2013), <http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usdof-p-us-l-> (estimating the value of the S&P 500).

138. *Royalty and License Fees, Payments (BoP, Current US\$)*, WORLD BANK, <http://data.worldbank.org/indicator/BM.GSR.ROYL.CD> (last visited Mar. 29, 2013).

139. S. REP. NO. 81-2375, at 43-44 (1950).

140. See *supra* Part II.B.2.

141. For copyrights in a work created on or after January 1, 1978, copyright protection “endures for . . . the life of the author and 70 years after the author’s death.” 17 U.S.C. § 302(a) (2006).

C. Whistleblower Awards

1. Hypothetical

Employee copies the past three years' worth of financial data from her Employer's computer system to a thumb drive. She then gives the thumb drive to the IRS. The IRS, some years later, pays Employee \$50,000, because they used the information to collect taxes from Employer.

2. New Whistleblower Provisions

The IRS Whistleblower Office has established the practice of:

[P]ay[ing] money to people who blow the whistle on persons who fail to pay the tax that they owe. If the IRS uses information provided by the whistleblower, it can award the whistleblower up to 30 percent of the additional tax, penalty and other amounts it collects.

The IRS may pay awards to people who provide specific and credible information to the IRS if the information results in the collection of taxes, penalties, interest or other amounts from the noncompliant taxpayer.¹⁴²

It has been noted that:

The law provides for two types of awards. If the taxes, penalties, interest and other amounts in dispute exceed \$2 million, and a few other qualifications are met, the IRS will pay 15 percent to 30 percent of the amount collected. If the case deals with an individual, his or her annual gross income must be more than \$200,000. If the whistleblower disagrees with the outcome of the claim, he or she can appeal to the Tax Court. . . .

The IRS also has an award program for other whistleblowers—generally those who do not meet the dollar thresholds of \$2 million in dispute or cases involving individual taxpayers with gross income of less than \$200,000. The awards through this program are less, with a maximum award of 15 percent up to \$10 million. In addition, the awards are discretionary and the informant cannot dispute the outcome of the claim in Tax Court.¹⁴³

142. *IRS Whistleblower—IRS Informant Award—Receive Money from the IRS*, FRESH START, <http://freshstarttax.com/irs-whistleblower/> (last visited Mar. 29, 2013).

143. *Whistleblower – Informant Award*, IRS, <http://www.irs.gov/uac/Whistleblower-Informant-Award> (last updated Jan. 9, 2013).

3. History

“What is now 26 USC § 7623(a) has been on the books since March 1867”¹⁴⁴ Section 7623(a) allows the Secretary of the Treasury “to pay such sums as he deems necessary for . . . detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.”¹⁴⁵

The IRS has stated that:

Prior to 2006 the only substantive change since 1867 was in 1996, when a clause was added allowing payments to be made “for detecting underpayments of tax” as another basis for an informant award, and making the payments from proceeds collected rather than appropriated funds.

. . . .

In December of 2006, the Tax Relief and Health Care Act of 2006 made fundamental changes to the IRS informant awards program[, including] the addition of a new section 7623(b), under which [the larger] awards are no longer discretionary.¹⁴⁶

4. Tax Consequences

The IRC codified that:

The Secretary, under regulations prescribed by the Secretary, is authorized to pay such sums as he deems necessary for . . . detecting underpayments of tax, or . . . detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same, in cases where such expenses are not otherwise provided for by law. Any amount payable under the preceding sentence shall be paid from the proceeds of amounts collected *by reason of the information provided*, and any amount so collected shall be available for such payments.¹⁴⁷

144. *History of the Whistleblower/Informant Program*, IRS, <http://www.irs.gov/uac/History-of-the-Whistleblower-Informant-Program> (last updated Aug. 3, 2012) [hereinafter *History of the Whistleblower*].

145. I.R.C. § 7623(a)(2) (2006).

146. *History of the Whistleblower*, *supra* note 144. “The new law says that the whistleblower shall receive 15 to 30 percent of the collected proceeds[.] . . . added whistleblower appeal rights[.] . . . [and required the creation of] a Whistleblower Office reporting to the Commissioner to implement the law.” *Id.*

147. I.R.C. § 7623(a) (2006) (emphasis added).

The Service treats such awards as ordinary income from services.¹⁴⁸ The statute, however, refers to information provided, saying that:

The new program (found at 26 U.S.C. § 7623) focuses on large claims. To qualify for the expanded rewards, \$2 million of taxes, penalties and interest must be involved. In a redundant provision, individual tax cheats must have \$200,000 of taxable income in any year (obviously, to have \$2 million owing, one would need to also have at least \$200,000 of taxable income). Because of these large amounts, the primary targets under the new program are businesses whose employees and former employees are willing to report malfeasance.¹⁴⁹

What is the nature of the malfeasance reporting? Is the IRS paying for services?

Yes and no. In a sense, the IRS wants individuals to be willing to root out and detect fraud when it cannot. It wants individuals to offer to turn over information to the IRS. Both of these activities sound like services performed.

However, what the IRS really wants is *information*. It will not pay a reward unless it can collect the tax, and it cannot collect the tax without the proof, the evidence, or the information that will lead its auditors to find and prove the fraud.¹⁵⁰ In short, if the IRS cannot collect, neither can the whistleblower.

Therefore, the whistleblower awards are really awards for the transfer of information. Is information property? Yes. Why? Because the IRS is willing to pay for it. (That is the cynical answer). The analytical answer is because information likely to lead to an award is also likely to constitute knowhow and documents.

As a result, the thumb drive is very likely to be the property worth the IRS's award, and as such, constitutes property, which is a capital asset.¹⁵¹

148. This was the answer the author got when he asked the question at a recent ABA Tax Section meeting. The IRS provides the whistleblower with a Form 1099. *What Happens to a Claim for an Informant Award (Whistleblower)*, IRS, [http://www.irs.gov/uac/What-Happens-to-a-Claim-for-an-Informant-Award-\(Whistleblower\)](http://www.irs.gov/uac/What-Happens-to-a-Claim-for-an-Informant-Award-(Whistleblower)) (last updated Aug. 3, 2012). One firm cited Rev. Rul. 70-576, however, this Revenue Ruling deals with a Canadian citizen and the U.S.-Canada Tax treaty. Rev. Rul. 70-576, 1970-2 C.B. 331. Article XIII of that treaty would exempt from U.S. tax the sale or exchange by a Canadian citizen of capital gain property in the United States, which would include, for example, intangible information transferred to the IRS. Double Taxation: Taxes on Income and Capital, U.S.-Can., art. XIII, Sept. 26, 1980, T.I.A.S. No. 11087.

149. *IRS Raises Stakes on Tax Whistleblower Claims*, FULCRUM INQUIRY (Feb. 2007), http://www.fulcrum.com/IRS_Informant.htm [hereinafter *IRS Raises Stakes*].

150. *See id.*

151. Is there such a thing as services to transfer or deliver property? Sure—truck drivers or UPS delivery persons. Is that what the IRS is paying for? No, because the payment is dependent

The IRS has demonstrated its position on taxation and whistleblowing by showing that:

For the Treasury's audit sample, it took over 7½ years on average for the informant's [sic] to be paid. This lengthy time occurred because the IRS makes no reward payments until the IRS collects all amounts owing and the matter is closed. However, an informant can speed this amount by accepting an initial early payment on amounts collected by agreeing to waive further award on subsequent collections.¹⁵²

5. Transfer of Stolen Property

An additional argument to be made is that perhaps the whistleblower is guilty of theft and therefore the "property" is not his. If the property is not his, then he cannot transfer it to another, and if there is no transfer, then the payment must be ordinary income (because it was not in exchange for anything).¹⁵³

The analysis might then turn to the cases construing § 1341, notably *McKinney v. United States*.¹⁵⁴ Section 1341 allows a deduction when the taxpayer discovers that income she previously included (because she thought it was hers) turns out to belong to another. The *McKinney* court held that the benefits of § 1341 are not available when the "item" in question is embezzled funds.¹⁵⁵ It stated simply and straightforwardly that § 1341 could not be read to cover embezzled funds because "it could not appear to the taxpayer that he had any right to the funds, much less 'an unrestricted right' to them."¹⁵⁶

The court in *Perez v. United States*¹⁵⁷ was trying to decide whether a taxpayer/embezzler could use § 1341 to apply deductions due to restitution payments to a prior year (instead of applying the deduction to the year in which the payment was made).¹⁵⁸ The court was looking at whether the taxpayer had a right to the funds because the statutory language asks if the taxpayer had an "unrestricted right."¹⁵⁹

upon tax being collected. Good evidence equals good payment.

152. *IRS Raises Stakes*, *supra* note 149. Seven years to pay after the transfer of information has occurred? If informant is paid, the IRS has accepted the information. Is that long-term gain?

153. Can I transfer property that I do not own? Possession is enough to create gain. *Armory v. Delamirie*, (1722) 93 Eng. Rep. 664 (K.B.) 664; 1 Str. 505, 505.

154. 574 F.2d 1240 (5th Cir. 1978).

155. *Id.* at 1243.

156. *Id.* (emphasis omitted).

157. 553 F. Supp. 558 (M.D. Fla. 1982).

158. *Id.* at 559.

159. *Id.*

However, other courts, such as the one that decided *Wise v. Montgomery*,¹⁶⁰ have conducted similar inquiries: “[t]hus, some courts have held that, because a thief has no right to the property he has stolen, the IRS cannot impose a tax lien on stolen property because of the thief’s delinquent taxes.”¹⁶¹

In *Wise*, the inquiry was whether the IRS could impose a tax lien.¹⁶² That question, according to the court, could depend on whether the taxpayer had a right to the stolen property.¹⁶³ The court raised the issue but then dodged it because the funds over which the IRS imposed a lien could not be traced to the stolen property.¹⁶⁴

The question of whether a thief who sold stolen property could claim capital gains could depend on the same analysis. Section 61(a)(3) imposes a tax on “dealings in property,”¹⁶⁵ § 1001 addresses “[t]he gain from the sale or other disposition of property,”¹⁶⁶ § 1221 defines a capital asset as “property held by the taxpayer,”¹⁶⁷ and § 1222 defines a capital gain as “gain from the sale or exchange of a capital asset.”¹⁶⁸

D. Gambling

1. Hypothetical

G wins \$1000 at a casino, which is converted to ten \$100 table chips. Instead of cashing the chips in, G, knowing the casino to be in rough financial shape, decides to hold on to them.¹⁶⁹ A year later, after the casino has been imploded on TV, a collector approaches G and offers him \$1200 for the ten chips.

2. *Zarin* and Other Cases

In *Zarin v. Commissioner of Internal Revenue (Zarin I)*,¹⁷⁰ the Third Circuit held that:

[G]ambling chips were not property, but rather, “a medium of exchange within the Resorts casino” and a “substitute for cash.” Alternatively, the Tax Court viewed the chips as nothing more than

160. No. CIV H-02-1242, 2003 WL 21805922 (S.D. Tex. 2003).

161. *Id.* at *2 (citing *Atlas, Inc. v. United States*, 459 F. Supp. 1000 (D.N.D. 1978)).

162. *Id.* at *1.

163. *See id.* at *2.

164. *Id.*

165. I.R.C. § 61(a)(3) (2006).

166. *Id.* at § 1001(a).

167. *Id.* at § 1221(a).

168. *Id.* at § 1222(1).

169. You gotta know when to hold 'em.

170. 916 F.2d 110 (3d Cir. 1990).

“the opportunity to gamble and incidental services . . .” We agree with the gist of these characterizations, and hold that gambling chips are merely an accounting mechanism to evidence debt.¹⁷¹

The Court elaborated:

Gaming chips in New Jersey during 1980 were regarded “solely as evidence of a debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them.” Thus, under N.J. state law, gambling chips were Resorts’ property until transferred to Zarin in exchange for the markers, at which point the chips became “evidence” of indebtedness (and not the property of Zarin).

Even were there no relevant legislative pronouncement on which to rely, simple common sense would lead to the conclusion that chips were not property in Zarin’s hands. Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves were of little use to Zarin, other than as a means of facilitating gambling. They could not have been used outside the casino. They could have been used to purchase services and privileges within the casino, including food, drink, entertainment, and lodging, but Zarin would not have utilized them as such, since he received those services from Resorts on a complimentary basis. In short, the chips had no economic substance.”¹⁷²

Before the Tax Court, the parties had stipulated that N.J. casino “chips are property which are not negotiable and may not be used to gamble or for any other purpose outside the casino where they were issued.”¹⁷³ Addressing this stipulation, the Third Circuit acknowledged that:

It could be argued that we are bound by this stipulation to accept the proposition that chips are property. We do not dispute the notion that chips are property, but . . . they are only property in the hands of the casino. The stipulation is consistent with this idea. In fact, both parties agreed in their briefs that chips are property of the casino. Moreover, during oral arguments, both parties agreed that chips were not property when held by the gambler.¹⁷⁴

171. *Zarin I*, 916 F.2d at 113-14 (alteration in original) (citations omitted).

172. *Id.* at 114 (citation omitted) (quoting N.J. ADMIN. CODE § 19:46-1.5(d) (1990)).

173. *Zarin v. Comm’r (Zarin II)*, 92 T.C. 1084, 1097 (1989).

174. *Zarin I*, 916 F.2d at 114 n.9.

A quick search on eBay for the term “casino chips” reveals over 36,000 auctions.¹⁷⁵ Obviously, the auction market considers casino chips as property.

Nevada law considers casino chips to be property.¹⁷⁶ N.J. law considers casino chips to be property.¹⁷⁷ In fact, the section of the N.J. Administrative Code cited by *Zarin I* has been changed to read:

Each gaming chip and plaque is solely evidence of a debt that the issuing casino licensee owes to the person legally in possession of the gaming chip or plaque, and shall remain the property of the issuing casino licensee. Each casino licensee shall have the right at any time to demand that the person in possession of the gaming chip or plaque surrender the item for redemption¹⁷⁸

“Solely evidence of a debt” is an interesting term. Arguably, New Jersey was trying either to prevent chips from becoming a second currency or to prevent patrons taking chips from one casino to another. However, marking the chips as evidence of debt hardly makes them less property. For example, bonds are evidence of debt, and they enjoy a rather robust market.

As for the argument that, at the time *Zarin I* was decided, N.J. law provided that the chips were only the property of the casino and no one else, several questions arise.

First, if I possess property of another, and sell it, does the gain therefrom become gain from property? In other words, possession of another’s property does not change the fact that the item is still property.

Second, can a state legislate that a tangible item is not property? Arguably, it could prevent the trappings and rights attributable to property in its own laws from attaching to that item, but what would happen when that item moved across its borders?

Third, for federal tax issues, do we care what a state has to say about an item being property or not? No. Federal tax law looks to what rights a taxpayer may have, and then assigns tax consequences based upon federal law. The Supreme Court explained that “[they] look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine

175. EBAY, <http://www.ebay.com/> (search for “casino chips” in “Browse by Category”) (last visited Mar. 29, 2013).

176. Section 120A.135 of Nevada’s Revised Statutes Annotated excludes found casino chips from “Unclaimed Property,” and instead treats them under the “finders keepers” rule. NEV. REV. STAT. ANN. § 120A.135 (West 2008); *Las Vegas FAQs*, LAS VEGAS ADVISOR, <http://www.lasvegasadvisor.com/faq.cfm> (last visited Mar. 29, 2013).

177. See N.J. ADMIN. CODE § 19:46-1.5(f) (2012).

178. *Id.*

whether the taxpayer's state-delineated rights qualify as 'property' or 'rights to property' within the compass of the federal tax lien legislation."¹⁷⁹

3. Tax Consequences

Accordingly, *G*, upon winning the chips, should take a \$1000 basis in them and will be taxed on the \$1000 he won. If he were to later sell the chips for \$1200, the chips would be characterized (in his hands) as capital assets, and the resulting gain (\$200) would be a long-term capital gain.

E. What's the Point?

*Eisner v. Macomber*¹⁸⁰ defined income as arising from labor, or from capital, or from both.¹⁸¹ What happens when you cannot tell the difference between labor and capital? Between services and property?

In our pro-intangible property market, more and more things are being classified as "property": tenure,¹⁸² advanced degrees,¹⁸³ body parts and cells,¹⁸⁴ methods of doing business,¹⁸⁵ and whatever other weird examples I can come up with. Is the proper tax treatment to give them preferential low rates?

179. *United States v. Craft*, 535 U.S. 274, 278 (2002) (quoting *Drye v. United States*, 528 U.S. 49, 58 (1999)).

180. 252 U.S. 189 (1920).

181. *Id.* at 207.

182. *Gilbert v. Homar*, 520 U.S. 924, 928-29 (1997) ("[W]e have previously held that public employees who can be discharged only for cause have a constitutionally protected property interest in their tenure and cannot be fired without due process . . .").

183. *Hinsberg v. Hinsberg*, No. 290481, 2010 WL 3296081, at *6 (Mich. Ct. App. Aug. 19, 2010). In *Hinsberg*, the Court of Appeals agreed with defendant's argument that: the trial court erred by failing to identify defendant's medical degree as a marital asset, for which she was entitled to a "substantial" compensatory award . . . [The Court held that] one spouse's attainment of an advanced academic degree during marriage can create a marital asset in which the other spouse holds an equitable claim.

Id.

184. See *Evanston Ins. Co. v. Legacy of Life, Inc.*, 645 F.3d 739, 747 (5th Cir. 2011) ("[A] dead man's body 'may be considered as a sort of quasi property, in which certain persons have rights therein, and have duties to perform.'") (quoting *Burnett v. Surratt*, 67 S.W.2d 1041, 1042 (Tex. Ct. App. 1934)); William Boulier, Note, *Sperm, Spleens, and Other Valuables: The Need to Recognize Property Rights in Human Body Parts*, 23 HOFSTRA L. REV. 693, 712-13 (1995); see generally E. RICHARD GOLD, *BODY PARTS: PROPERTY RIGHTS AND THE OWNERSHIP OF HUMAN BIOLOGICAL MATERIALS* (1996); RUSSELL SCOTT, *THE BODY AS PROPERTY* (1981).

185. See *Bilski v. Kappos*, 130 S. Ct. 3218, 3228 (2010).

III. JUSTIFICATION FOR CAPITAL GAINS

A. History

1. *Merchants' Loan & Trust Co.*

In 1921, the Supreme Court decided *Merchants' Loan & Trust Co. v. Smietanka*¹⁸⁶—one of the earliest cases dealing with the taxation of capital gains. Arthur Ryerson died in 1912, and his will directed income “to be paid to his widow during her life and after her death to be used for the benefit of his children, or their representatives, until each child should arrive at twenty-five years of age, when each should receive his or her share of the trust fund.”¹⁸⁷

The will provided “accretions of selling values shall be considered principal and not income,”¹⁸⁸ which meant they would be saved for the children and not allocated to his widow.¹⁸⁹ In 1917, the trust sold stock it owned for \$1,280,996.64.¹⁹⁰ The trust’s basis in the stock was \$561,798.¹⁹¹ The Commissioner of Internal Revenue treated the difference as income in the year of the sale.¹⁹²

The trustee argued that the terms of the will rendered the gain untaxable.¹⁹³

Plaintiff argued that:

[I]t was not income to the widow, for she did not receive it in 1917, and never can receive it, that it was not income in that year to the children for they did not then, and may never, receive it, and that it was not income to the trustee, not only because the will creating the trust required that “stock dividends and accretions of selling values shall be considered principal and not income,” but also because in the “common understanding” the term “income” does not comprehend such a gain or profit as we have here, which it is contended is really an accretion to capital and therefore not constitutionally taxable under *Eisner v. Macomber*.”¹⁹⁴

The Court dismissed the argument and allowed the tax to be imposed upon the trustee.¹⁹⁵

186. 255 U.S. 509 (1921).

187. *Id.* at 514.

188. *Id.* at 514-15.

189. *See id.*

190. *Id.* at 515.

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.* (citation omitted).

195. *See id.* at 516-17.

2. Congressional Response

Calvin H. Johnson has observed that “*Smietanka* was decided in March, 1921 and within months, Congress mostly rejected it. In the Revenue Act of 1921, Congress gave capital gain the benefit of a maximum 12½% tax, when ordinary income bore tax rates as high as 54%.”¹⁹⁶

B. Rationale

Many authors have wrestled with the task of providing a concise rationale for a separate system for taxing capital gains.

According to Marjorie E. Kornhauser, “[o]pinions were divided as to whether [capital] gains were constitutionally taxable under an income tax. The *New York Times*, which devoted many articles and editorials to the issue, was adamantly against the income taxation of capital gains.”¹⁹⁷ One editorial in the *New York Times* contended that:

The economic distinction between capital and income is one of natural law, independent of either statutes or Constitutions. The Constitution controls the procedure of Congress, but the Constitution and Congress together would find difficulty in defeating natural law. A tax on capital gains is a direct tax, and if the Sixteenth Amendment means anything at all it confirms the principle that direct taxes must be apportioned to population¹⁹⁸

Assuming there is a difference between capital gains and other types of income, the process of discerning between the two is difficult.

What type of income is “capital?” Section 1222 attempts to answer this question: “[t]he term ‘long-term capital gain’ means gain from the sale or exchange of a capital asset held for more than 1 year”¹⁹⁹ The IRC states that:

[T]he term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer

196. Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 VA. TAX REV. 477, 487 (2009) (footnotes omitted).

197. Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 SW. L.J. 869, 877 (1985).

198. Editorial, *Taxation of Capital Gains*, N.Y. TIMES, Feb. 15, 1921, at 8.

199. I.R.C. § 1222(3) (2006).

primarily for sale to customers in the ordinary course of his trade or business[.]²⁰⁰

Thus, “capital” gains are those gains arising from property transactions, but only certain types. Peter Miller, explaining the taxation of capital gains, said:

The rather curious statutory prerequisites to capital gains treatment are attributable chiefly to Congress’s attempt to tax gains realized upon the sale of “investments” more leniently than income from other sources. The statute seeks to distinguish “investment” from the other types of profit-making activity—and especially from “speculation” and “business” which also involve sales of property—primarily by means of two requirements. To differentiate between “investment” and “speculation,” the statute provides that favorable treatment is to be accorded to profit realized upon the sale of only such assets as were owned by the taxpayer for more than [one year]. To separate “investment” from “business,” the statute provides that special treatment is not to be given to profit realized upon the sale of various kinds of business assets, particularly “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” (the “trade or business clause”).²⁰¹

The statute has been expanded to cover other types of “business assets” (for example, depreciable assets and copyrights),²⁰² and it is somewhat of a historical mistake that the definition was written in the negative.²⁰³ Future versions of the statute retained the format so that capital asset treatment was the norm.²⁰⁴ But what do these two requirements (the lengthy holding period and the trade or business clause) mean for intangible assets?

200. *Id.* at § 1221(a)(1).

201. Peter Miller, *The “Capital Asset” Concept: A Critique of Capital Gains Taxation: I*, 59 YALE L.J. 837, 838-39 (1950) (footnotes omitted) [hereinafter Miller, *The “Capital Asset” Concept I*].

202. See I.R.C. §§ 1221(a)(3), 1221(a)(8).

203. The first “capital gains” definition was found in § 206(a)(6) of the Revenue Act of 1921 and read:

The term “capital assets” as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Revenue Act of 1921, ch. 136, 42 Stat. 227, 233 (1921).

204. See I.R.C. § 1221 (“[T]he term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), *but does not include—...*”) (emphasis added).

1. Investment vs. Speculation

Most of the cases discussed in this Article (lawsuits, whistleblower awards, copyrights, and patents) are not the type of assets that would normally fall into the category of “speculation.” For one reason, these types of assets take a good deal of time to create and then are not the type that are normally subject to a quick transfer.

However, in recent years, the speculation rationale has morphed into a query as to whether the taxpayer was engaged in personal services activities in order to bring the asset into being or to arrange for its sale. That is one justification heard frequently when dealing with copyrights, even though the actual reason for its separation out from capital asset treatment is due to a failure on Congress’s part.²⁰⁵

Since all assets derive some of their reason for being from some form of personal services (land is valuable because of its location to human activity; stock is valuable because of the efforts of the promoters, officers, or board members; lawsuits are valuable because of the human interactions that gave rise to them), this cannot be seen as the primary test for capital asset status. Nor does it make sense when capital assets share so much in common with assets denied that status.

2. Speculation vs. Business

Assuming that an asset does not fall into one of the other categories set forth in § 1221,²⁰⁶ the test then becomes whether the intangible asset has been held for sale to customers. Miller stated that:

It has often been difficult to distinguish between a sale made by a professional speculator and that made by a businessman out of his stock-in-trade for the reason that they share an important common factor; in both cases the property sold has, before its disposition, been held primarily for the purpose of resale as part of a more or less systematic course of buying and selling. This factual similarity is so much more conspicuous than the legal distinction (*i.e.*, that a businessman is one who sells “to customers” whereas a speculator does not) that it is not surprising to find much hair-splitting as to the meaning of these magic words.²⁰⁷

Does the transfer of a thumb-drive to a government agent constitute being held for sale to customers? Who is the customer of a whistleblower?

205. See *supra* Part II.B.

206. See I.R.C. § 1221(a).

207. Miller, *The “Capital Asset” Concept I*, *supra* note 201, at 848 (footnotes omitted).

3. Business vs. Investment

Prior to the enactment of § 1253,²⁰⁸ the question of whether the sale of a patent was one involving sale to customers was relevant. Consider Miller's discussion:

Most of the judicial opinions which address themselves to this question purport to answer it by comparing the facts of the case at bar with those found in the case of *Harold T. Avery*. Avery, the chief engineer of a manufacturing corporation, was required by contract to assign to his employer any inventions he might make while directing its experimental work, except for about a dozen inventions conceived before his employment commenced. In 1935 Avery sold to the corporation one of the dozen inventions. Before this sale, he had sold two patents and licensed two others out of the dozen. The Board of Tax Appeals held that the proceeds of sale in 1935 were not capital gain.

The Board of Tax Appeals found that:

[P]etitioner was engaged outside of his regular hours of employment in the business of inventing and selling and licensing of patents obtained by him, and that the inventions and patents which he was not contractually obligated to transfer to his employer constituted property held by him primarily for sale to customers in the ordinary course of trade or business.²⁰⁹

Consider Miller's further discussion:

The *Avery* case is to be contrasted with the case of John W. Hogg, a clerk employed in a non-inventive capacity in an engineering department. Mr. Hogg invented several devices by working about four hours each week at night in his basement. Over twenty years he took out four patents. In 1937 he licensed one of them to an airplane manufacturer. In 1940 he sold this patent to the licensee. The Tax Court decided that Mr. Hogg had realized only capital gain because an isolated sale did not constitute a "course of business."

In common parlance, Mr. Hogg could hardly be said to have been "in business," since that term connotes repeated transactions, and the entire extent of his dealings was to license a single patent and then sell it. Yet is this result really as self-evident as it appears at first blush? After all, if Mr. Hogg was not in business, what was he doing when he was tinkering down in the basement in his spare time? If his activity were only a hobby, it is fair to ask, as did the Board in the *Avery* case, why did he trouble himself to patent his inventions? Suppose that Mr. Hogg subsequently found purchasers for his three other patents;

208. I.R.C. § 1253. The Effective Date of § 1253 was January 1, 1970. *Id.*

209. *Avery v. Comm'r*, 47 B.T.A. 538, 541 (1942).

presumably the repetition of the sale would cause a finding that he had gone into “business” and therefore that his profits were no longer taxable merely as capital gain. Yet is it not strange that one of the sales, identical with the others except that it happened first, should receive a different tax treatment? This anomaly springs from the conception of “business” as a series of recurrent dealings. But why should “business” be defined in this way? There is no reason to suppose that Hogg’s first sale gave rise to a lesser ability to pay than did Avery’s third. Whatever may be the validity of discriminating in favor of gain arising upon a change in the form of investments, the invention sold by Hogg hardly presents a very close analogy to the corporate stock or real estate sold by the typical investor.

Assuming that Mr. Hogg and Mr. Avery are so similarly circumstanced that they should be taxed similarly, the question arises whether parity of treatment could be established under any reasonable interpretation of the present statute.²¹⁰

IV. CONCLUSION

With world economies becoming more and more knowledge-based, the number of intangible assets will only grow. That is exciting in many instances, but it does produce difficulties with characterizing the gain when intangible assets are transferred. In fact, we might view the treatment of intangible assets as something of a bellwether in terms of whether capital gains treatment can survive the rationality test.

When we view the disparity with which intangible assets are treated under the tax code, we come to one of two conclusions. First, we may say that intangible asset treatment marks the death of capital gains. After all, if our legal system is content to allow assets to be converted into other types of capital assets, then this would allow capital gain treatment in cases that Congress had never intended to be taxed at preferential rates.

On the other hand, perhaps throwing out the baby with the bathwater, capital gains is just the treatment we want. If we are content to allow asset treatment (which would give preference for the law of property over other types of law), then we should also be content to allow the tax treatment to follow the form. Trusts are a good example of this. When a beneficiary is named in a trust (a contract between a grantor and her trustee), we may ask: What are the beneficiary’s rights? May the beneficiary transfer those rights? If so, then the beneficiary’s rights begin to look like property, and we might ask if the beneficiary’s transfer gives rise to capital gains.

210. Miller, *The “Capital Asset” Concept I*, *supra* note 201, at 852-53.

On the other hand, we might look through the transaction and ask if the beneficiary has received a stream of income or owns the source of the stream outright. Classifying every possible permutation of ownership, possession, or right as property muddies the water²¹¹ and leaves us—well—thirsty for a solution.

A. The Death of Capital Gains?

One way to fix the discrepancy between treating the transfer of some assets as capital while subjecting others to ordinary income rates is to do away with capital gains preferences altogether. After all, if all assets, contracts, and exchanges can be recouched in terms of what the law would allow as capital, is there any real difference between capital gains transactions and ordinary sales?

One example highlighted earlier should suffice to make the point. If *A* has a cause of action against *B* (and would be taxed on ordinary income if she collected) but then “sells” that right to *C*, *A* should have capital gains on the exchange.

If that is not the desired result, the law provides no easy justification for the opposite case. We have a myriad cases trying to decide when a chose in action (whether in tort, bankruptcy, or contract, whether transferred as part of the sale of a business or alone, and when effected) is a capital asset. As a result, we have borrowed judicial doctrines and analyses over and over until the law is murky and vague, and to the point where the cases no longer even look to relevant tax statutes.

Had the legal cognoscenti been aware, they could have tried to fix this “problem” by statute or regulation. The explosion of intellectual and intangible property protection, however, left the financial and tax laws behind. And maybe that lack of concern for tax law is a good justification for a limited rule: Transfers of intangible property are to be treated as ordinary income. After all, if tax consequences were no concern when we created and protected the assets, then it can hardly be said to be a factor in their sale or transfer.

B. Capital Gains Is the Appropriate Tax Avenue

On the other hand, good tax policy rarely takes such a petty view when it has to “clean up” after the party.²¹² This party promises to go on

211. If not the metaphor as well!

212. See, e.g., Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-42, 121 Stat. 1803 (2007).

for a while, so perhaps a long-term view is the right way to look at things.

If our legal system is content with an expansive view of property and quasi-property, including sweeping in contracts, ideas, and processes, then our tax system ought to follow suit. In that case, the operative question should really turn on whether the property in question is of a type that we want to tax at preferential rates. This, in turn, would require us to revisit § 1221 and its categories of ordinary income exclusions, because leaving the structure as is only encourages taxpayers to formulate transactions so as to turn everything into capital gains.

As Alice once said, “[i]f I had a world of my own, everything would be nonsense. Nothing would be what it is because everything would be what it isn’t. And contrary-wise, what is it wouldn’t be, and what it wouldn’t be, it would. You see?”²¹³

213. ALICE IN WONDERLAND, *supra* note 92.