

# Taxation: Extinguishment of a Contract Obligation as a "Sale or Exchange" of a Capital Asset

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# COMMENTS

## TAXATION—EXTINGUISHMENT OF A CONTRACT OBLIGATION AS A “SALE OR EXCHANGE” OF A CAPITAL ASSET

### I

The capital gains and losses provisions of section 117 of the Internal Revenue Code do not affect the disposition of an asset unless first, the asset is a capital asset as defined by that section,<sup>1</sup> and, second, the disposition is of a type which may be characterized as a “sale or exchange” of the asset.<sup>2</sup> If either of these requirements is lacking in a transaction, section 117 does not apply.

For the purposes of this discussion the question of whether any given asset is a capital asset will generally not be answered; it will usually be assumed without discussion either that the asset qualifies as a capital asset, or that whether it is or is not is of no consequence because no “sale or exchange” has been involved.

The aim of this paper is to discuss the requirement of “sale or exchange”; in particular, to indicate some of the inconsistencies (in approach to the problem of whether a “sale or exchange” has been effected) apparent in one particular area of litigation. Into this area fall cases in which a right under some type of contract is released to the obligor for consideration; specifically, cases involving debts, mortgages, leases and options, and employment and exclusive agency contracts.

### II

#### DEBTS

It has been judicially pronounced that the rule, that terms in the Code are ordinarily to be taken in their usual meaning,<sup>3</sup> applies to the terms “sale or exchange” under section 117.<sup>4</sup> Under this approach it might be said that when a debtor pays money to retire his note or bond there is at least an “exchange” of an obligation for cash. In 1929, the Board of Tax Appeals, calling attention to the fact that the purpose of capital gain and loss treatment, as shown by the legislative history of a predecessor of section 117, was to encourage taxable *dispositions* of property, decided that the redemption of bonds at the “called” date resulted in a “sale or exchange.”<sup>5</sup> This case was over-

<sup>1</sup> INT. REV. CODE §§117(a)(1) and 117(j)(1).

<sup>2</sup> INT. REV. CODE §§117(a)(2),(3),(4),(5) and (b), and 117(j)(2). It will be noted that any loss sustained on the disposition of a 117(j) asset is an ordinary one whether or not an actual sale or exchange has occurred, either under 117(j)(2) or 23(e) or (f).

<sup>3</sup> DeGanay v. Lederer, 250 U.S. 376, 381 (1919).

<sup>4</sup> Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1940).

<sup>5</sup> Henry P. Werner, 15 B.T.A. 482 (1929).

ruled in 1932, when the Board held that no "sale or exchange" was involved in the payment of Liberty bonds at maturity, saying, "There was the satisfaction of an obligation of the United States by payment. Loss incurred or gain realized in such a transaction is not a capital loss or a capital gain under the definition found in the statute."<sup>6</sup>

In 1934, the present section 117(f), which deems proceeds received on the retirement of certain<sup>7</sup> bonds and other debentures as received in "exchange" therefor, was added.<sup>8</sup> The question then arose as to whether section 117(f) was not merely a legislative construction of the Code as it existed prior to the enactment of section 117(f). *Fairbanks v. United States*<sup>9</sup> held that section 117(f) was a material addition to the Code, and that transactions covered by it would not otherwise qualify as "sales or exchanges."

Where an evidence of indebtedness does not fall under section 117(f) because it lacks coupons or is not in registered form or because it was not issued by a corporation, the rule in *Fairbanks v. United States* still applies.<sup>10</sup> In *Hale v. Helvering*<sup>11</sup> it was held that a compromise with the maker of promissory notes for an amount different from their face value does not constitute a "sale or exchange" because there is no acquisition of any property that survives the transaction by the debtor, any property in the notes as capital assets being "extinguished" not "sold." Certainly the payment of an obligation according to its fixed terms has the same effect.<sup>12</sup> The rationale of these cases seems to be that unless *both* parties receive an asset of continuing value, which an obligation in the hands of the obligor is not, there is no "sale or exchange." Certainly the debtor has received an economic benefit of continuing value in being discharged of an obligation, but apparently this is not enough. This rationale is subject to the qualification that if a cooperative creditor accepts the transfer of property instead of cash in satisfaction of his claim, the debtor is said to have effected a "sale or exchange" of that property.<sup>13</sup> This

<sup>6</sup> John H. Watson, Jr., 27 B.T.A. 463, 465 (1932).

<sup>7</sup> Those bonds or other evidences of indebtedness issued by corporations, which have interest coupons or are in registered form.

<sup>8</sup> Revenue Act of 1934 (May 10, 1934, ch. 277, 48 STAT. 680, 714, 715).

<sup>9</sup> 306 U.S. 436 (1939).

<sup>10</sup> See, e.g., *Avery v. Commissioner*, 111 F.2d 19 (9th Cir. 1940) and *Blum v. Higgins*, 150 F.2d 471 (2nd Cir. 1945) holding that surrender of an endowment insurance policy for an amount in excess of the premiums paid was not a "sale or exchange" on the ground that neither life insurance nor endowment contracts are enumerated in section 117(f). Also interesting is *Joseph A. Guthrie*, 42 B.T.A. 696 (1940), where the taxpayer purchased a share in a residuary legacy. The Board held that the gain realized by the taxpayer on a sale of the legacy by the executor was ordinary income since there was no "sale or exchange" of his asset, and further that the sale by the executor could not be imputed to the taxpayer.

<sup>11</sup> 85 F.2d 819 (D.C. Cir. 1936).

<sup>12</sup> *Watson, supra*, n. 6.

qualification seems to be well founded in reason, since the transaction is essentially the same in result to the debtor as if he had sold the property to a third party and used the proceeds to pay his debt. But the character of the transaction with respect to the obligee remains unaffected by the fact that the debtor transfers property instead of money for the satisfaction of his debt; in *Elverson Corp. v. Helvering*,<sup>14</sup> a defaulting pledgor surrendered stock to the owner of notes who cancelled the notes and paid the indebtedness of the pledgor by purchasing unpledged shares at a specific price, all as previously agreed. The court held that there was no "sale or exchange" of the notes for the shares as far as the owner of the notes was concerned.

The transfer of a debt to a third person for consideration is not afflicted with the infirmity of constituting an extinguishment of an obligation. The transaction, therefore, may represent a "sale or exchange."<sup>15</sup> The intent of the taxpayer, to transfer to the third party in order to effect a tax saving, does not alter the effect of the transaction.<sup>16</sup> However, if the transaction is in essence the payment of the debt to the creditor by the debtor, no "sale or exchange" results.<sup>17</sup> If the debtor makes payment to the third party after the transfer, no capital gain or loss treatment follows, because the third party stands on the same ground as the original creditor had there been no transfer.<sup>18</sup>

### III

#### MORTGAGES

A conveyance by a mortgagor of the mortgaged property to a third party for consideration results in a "sale or exchange" giving rise to capital gain or loss,<sup>19</sup> while the abandonment of the premises to

<sup>13</sup> E.g., *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940), where the trustee of an estate transferred securities to a legatee in satisfaction of a claim greater than the basis of the securities in the hands of the trustee; the court held that there had been a "sale or exchange" of the securities. In *Mesta v. Commissioner*, 123 F.2d 986 (3rd Cir. 1941), the taxpayer transferred securities to his wife pursuant to a divorce settlement in satisfaction of a claim held to be in excess of the basis of the securities. The court decided that the taxpayer had realized a capital gain, but did not discuss the question of "sale or exchange."

<sup>14</sup> 122 F.2d 295 (2nd Cir. 1941).

<sup>15</sup> *Levy v. Commissioner*, 131 F.2d 544 (2nd Cir. 1942). However the result is otherwise where the debt has arisen because of personal services or some other activity the proceeds from which are usually taxable as ordinary income. "The courts have said that the sale of a right to receive ordinary income is not the sale of a capital asset. This is so even if the sale is of something which may be termed 'property.' In such a situation the sale price simply replaces the future income, but the sale price does not convert the ordinary income into capital gain." *But see*, *Swiren v. Commissioner*, 183 F.2d 656,661 (7th Cir. 1950).

<sup>16</sup> *Conrad N. Hilton*, 13 T.C. 623 (1949).

<sup>17</sup> *Ibid.*

<sup>18</sup> *Thomas v. Perkins*, 108 F.2d 87 (5th Cir. 1939).

<sup>19</sup> *Phillips v. Commissioner*, 112 F.2d 721 (3rd Cir. 1940).

a third party without consideration does not.<sup>20</sup> Further, the payment by the mortgagor of all or a part of the mortgage obligation falls under the rule of *Hale v. Helvering*,<sup>21</sup> and represents no "sale or exchange."<sup>22</sup> Prior to 1941, it was disputed as to whether a sheriff's sale or foreclosure was a "sale or exchange" such as is contemplated by section 117, because of the involuntary nature of that transaction.<sup>23</sup> In that year, however, the Supreme Court of the United States held that the transaction *did* represent a "sale or exchange" by the mortgagor;<sup>24</sup> and this is true even though the mortgagor was not personally liable for the debt.<sup>25</sup>

An interesting situation arises when, in anticipation of foreclosure, the mortgagor conveys the land to the mortgagee. It would seem, at first glance, that the rule of *Hale v. Helvering* would apply, since the result of the transaction is to extinguish an obligation. It is held, however, that *no* "sale or exchange" has been effected by the mortgagor *only if* he was not personally liable on the mortgage debt and received nothing in consideration for the conveyance.<sup>26</sup> Under these facts there is an abandonment of the property, and any loss that results to the mortgagor is an ordinary one.<sup>27</sup> However, when the mortgagor is personally liable on the mortgage debt, and the conveyance to the mortgagee is in consideration of the release in part or in whole of the mortgagor's liability, any loss that the mortgagor sustains is a capital loss, the transaction being treated as a "sale or exchange."<sup>28</sup> Further, there is said to be a "sale or exchange" when the mortgagor receives any sort of consideration from the mortgagee for the conveyance.<sup>29</sup> These decisions are justified by the view that the net result of the transaction is to place the property in the hands of the mortgagee and to extinguish the obligation of the mortgagor and that this result is so little different from a foreclosure that it should be treated in the same manner as a foreclosure.<sup>30</sup> It might further be said that, since the effect of the transaction is the satisfaction by the mortgagor

<sup>20</sup> Park Chamberlain, 41 B.T.A. 10 (1940).

<sup>21</sup> *Supra*, n. 11.

<sup>22</sup> Lee v. Commissioner, 119 F.2d 946 (7th Cir. 1941).

<sup>23</sup> This was held, *e. g.*, in Commissioner v. Freihofer, 102 F.2d 787 (3rd Cir. 1939); *see*, generally, Paul, *Federal Income Tax Problems of Mortgagors and Mortgagees*, 48 Y.L.J. 1315 (1939). Later developments, however, have rendered some of Mr. Paul's conclusions obsolete.

<sup>24</sup> Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Engraving Co. v. Commissioner, 311 U.S. 513 (1941).

<sup>25</sup> Commissioner v. Paulson, 123 F.2d 255 (8th Cir. 1941).

<sup>26</sup> Stokes v. Commissioner, 124 F.2d 335 (3rd Cir. 1941).

<sup>27</sup> *Ibid.*

<sup>28</sup> Commissioner v. Bookstein, 123 F.2d 996 (6th Cir. 1941); Stamler v. Commissioner, 145 F.2d 37 (3rd Cir. 1944).

<sup>29</sup> Aberle v. Commissioner, 121 F.2d 726 (3rd Cir. 1941); Blum v. Commissioner, 133 F.2d 447 (2nd Cir. 1943).

<sup>30</sup> Commissioner v. Electro-Chemical Engraving Co., 110 F.2d 614, 616 (2nd Cir. 1940), *aff'd* 311 U.S. 513 (1940), *supra*, n. 24.

of his creditor's money claim by the transfer of property, it is correctly held, as in similar cases,<sup>31</sup> that he has thereby effected a "sale or exchange" of that property.

As far as the mortgagee is concerned, when he receives part payment of the mortgage obligation and the mortgagor is unable to complete the payment of the total, there is no "sale or exchange";<sup>32</sup> therefore, any loss he may sustain is an ordinary loss, falling under section 23(k) as a bad debt.<sup>33</sup> The situation becomes somewhat more complicated when the mortgagee accepts a conveyance of the encumbered property as consideration for a release of the mortgagor. The Bureau's original position was that there was a "sale or exchange" in that event.<sup>34</sup> However, in *Bingham v. Commissioner*,<sup>35</sup> it was held that no "sale or exchange" arose as far as the mortgagee was concerned; and subsequently, in *Spreckels v. Commissioner*,<sup>36</sup> it was decided that the added element of worthless collateral security did not alter the rule in *Bingham*. In changing its former position, the Bureau placed no emphasis whatever on the fact that the collateral securities in *Spreckels* were worthless.<sup>37</sup> The rule as enunciated by the Bureau is

"that where a creditor accepts a voluntary conveyance of property, including property pledged as security for the debt, in partial or full satisfaction of the unpaid portion of the indebtedness, the receipt of the property so conveyed, to the extent of its fair market value at that time, shall be considered as receipt of payment on the obligations satisfied."<sup>38</sup>

An interesting situation is created when the mortgagee buys in at the foreclosure sale. According to the regulations,<sup>39</sup> when an uncollectible deficiency results from a sale of mortgaged property to the mortgagee or a third party, the mortgagee may deduct it as a bad debt; in addition, where the mortgagee has bid in, the difference between the amount of the obligations of the debtor which are applied to the bid price and the fair market value is a capital gain or loss. The fair market value and the mortgagee's bid price are presumed to be equal,<sup>40</sup> but this presumption may be rebutted upon independent inquiry.<sup>41</sup> The Supreme Court has held, in a case involving an insurance

<sup>31</sup> See *supra*, n. 13.

<sup>32</sup> *Lee v. Commissioner*, *supra*, n. 22. I.T. 3121; C.B. 1937-2, p. 138.

<sup>33</sup> *United States v. Burrows Bros.*, 133 F.2d 772 (6th Cir. 1943).

<sup>34</sup> I.T. 3121, *supra*, n. 32.

<sup>35</sup> 105 F.2d 971 (2nd Cir. 1939).

<sup>36</sup> 120 F.2d 517 (9th Cir. 1941).

<sup>37</sup> I.T. 3548; C.B. 1942-1, p. 74.

<sup>38</sup> *Ibid.*

<sup>39</sup> Treas. Reg. 118, §39.23(k)-3.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*; *Huey & Philip Hardware Co.*, 40 B.T.A. 781 (1939). I.T. 3159; C.B. 1938-1, p. 188, gives examples showing the operation of the rule of computation.

company, that if the bid price is sufficient to include accrued interest, the mortgagee has realized income to that extent despite the lesser value of the property.<sup>42</sup> The foregoing rule has been limited to cases involving insurance companies, any income to a mortgagee in this type of situation being deemed purely "imaginary" by one court.<sup>43</sup> The effect of the mortgagee's purchase of the land at the foreclosure sale is to create a transaction, which is at one and the same time a "sale or exchange" for the purpose of computing the mortgagee's capital gain and the mortgagor's capital loss and also an extinguishment of an obligation so as to allow the mortgagee a bad debt deduction. This treatment of the mortgagee's loss as a bad debt is justifiable under *Hale v. Helvering*; but the statement that the mortgagee has also realized a capital gain or loss on the transaction is difficult to sustain on authority. The only theory on which the mortgagee could be said to have realized anything beyond his bad debt loss is to say that he has exchanged the mortgage obligation for the property. That this should be viewed as an "exchange" as contemplated by section 117 is contra to the *Elverson Case*<sup>44</sup> involving a pledge of property as security. There appears to be no justification for different treatment depending on the type of security device involved.

#### IV

#### LEASES AND OPTIONS

Clearly, any amount received by a lessor from his lessee in consideration of cancellation of the lease is ordinary income since it is merely a substitute for future rent and since no "sale or exchange" is involved.<sup>45</sup> The transfer of the lease by the lessee to a third party for consideration, however, is held to be a "sale or exchange" of the lease, not a cancellation.<sup>46</sup> A problem arises when the lessee abandons his right under the lease to the lessor for consideration. If the rule in *Hale v. Helvering*<sup>47</sup> is deemed applicable, the attempted sale of the lease rights to the lessor-obligor results in a termination of the lease agreement which, in turn, extinguishes the right of possession. The Tax Court, however, in *Isadore Golonsky*,<sup>48</sup> refused to follow this line of reasoning. The court said that cases<sup>49</sup> holding that payment by the lessor in such cases was a capital expenditure indicated that the lessor received something which he did not have before, *i.e.*, the very

<sup>42</sup> *Helvering v. Midland Mutual Life Insurance Co.*, 300 U.S. 216 (1937).

<sup>43</sup> *Nichols v. Commissioner*, 141 F.2d 870 (6th Cir. 1944).

<sup>44</sup> See *supra*, n. 14.

<sup>45</sup> *Hort v. Commissioner*, 313 U.S. 28 (1940).

<sup>46</sup> *Walter H. Sutliff*, 46 B.T.A. 446 (1942).

<sup>47</sup> *Supra*, n. 11.

<sup>48</sup> 16 T.C. 1450 (1951).

<sup>49</sup> *Charles B. Bretzfelder*, 21 B.T.A. 789 (1930); *Harriet B. Borland*, 27 B.T.A. 538 (1933).

real and valuable right to the use and possession of the leased premises, and that the transfer of the right was a sufficient transfer to constitute a "sale or exchange." Without discussion, *Hale v. Helvering* was said to be unlike the case at hand. *Golonsky* was affirmed on appeal to the Third Circuit;<sup>50</sup> of especial interest is the Third Circuit's treatment of a facet of the Commissioner's argument not discussed by the Tax Court in its opinion. The Commissioner—apparently basing his contention upon *Helvering v. William Flaccus Oak Leather Co.*,<sup>51</sup> which stated<sup>52</sup> that "These sections [Sections 115(c), 117(e), and 117(f)] demonstrate that Congress has expressly specified the ambiguous transactions which are to be regarded as sales or exchanges for income tax purposes". . . made much of the fact that this type of transaction was not mentioned by section 117. The answer of the Court was short and to the point:<sup>53</sup>

"We are not impressed by this argument. If the transaction fits the legal requirements for a sale, we see no reason for specific mention of it among a list classifying as a sale that which would not ordinarily be regarded as such a transaction."

Similar results have followed in the Tax Court in a case<sup>54</sup> involving the release to the lessor of a restrictive covenant in a lease and in a case<sup>55</sup> in which a lessee who had become a statutory tenant under a New York emergency rent control law vacated and surrendered the premises to his former lessor for consideration. Both of these cases, however, have been appealed by the Commissioner.<sup>56</sup> It is difficult to see how a right under a lease has actually been transferred to the lessor-obligor anymore than in the debt cases. The right to possession, for example, seems to spring from the reversionary interest. But, practically speaking, the lessor has acquired a valuable right, and the lessee clearly has received an asset of continuing value. The only real difficulty is in finding a transfer of the lessor's right from the lessee.

Options are treated more consistently with the doctrine of the debt cases; it is held that surrender of the option to the optionor for cash merely terminates the existence of the option and does not result in a "sale or exchange."<sup>57</sup>

<sup>50</sup> Commissioner v. Golonsky, 200 F.2d 72 (3rd Cir. 1952).

<sup>51</sup> *Supra*, n. 4.

<sup>52</sup> 313 U.S. at 251.

<sup>53</sup> 200 F.2d at 74.

<sup>54</sup> Louis W. Ray, 18 T.C. 438 (1952).

<sup>55</sup> McCue Bros. & Drummond, Inc., 19 T.C. 667 (1953).

<sup>56</sup> McCue Bros. & Drummond, Inc. to the Second Circuit and Ray to the Fifth. Compare on this problem, *United Cigar-Whelan Stores Corp. v. District of Columbia*, 176 F.2d 952 (D.C. Cir. 1949), in which it was held that the cancellation of a lease with consideration to the lessee is not a "sale or exchange" under the District of Columbia income tax law.

<sup>57</sup> Seth M. Milliken, 15 T.C. 243 (1950), *aff'd* 196 F.2d 135 (2nd Cir. 1952).

## V

## EMPLOYMENT AND EXCLUSIVE AGENCY CONTRACTS

No doubt arises as to the taxability of compensation for services as ordinary income,<sup>58</sup> and this is true even though it is conceivable that the right not to render services is somehow a capital asset which has been the subject of a "sale or exchange" the consideration for which is the compensation in question. Similarly, amounts received for promises not to compete are considered as substitutes for wages and are also taxable as ordinary income.<sup>59</sup> However, question is often made of the character of transactions in which a lump sum payment is made which is somehow connected with the performance of services of one sort or another. The courts have been diligent in these cases to prevent capital treatment of income which is the equivalent of compensation, especially where the transaction is cast in its form in order to get capital treatment.<sup>60</sup> In *Thurlow E. McFall*,<sup>61</sup> where the taxpayers, skilled employees, had "sold" their employment contracts to a third person who was in no position to perform, the Board held that the "Petitioner did not sell their contracts, for this inherently they could not do. The contracts bound them to perform services of skill."<sup>62</sup> In *George K. Gann*,<sup>63</sup> the Board held that an amount received by the taxpayer-employee from his employer in consideration of cancellation of his employment contract was ordinary income, because, just as in *McFall*, the taxpayer could not "sell" his contract, and further that the amount paid was merely a translation of the taxpayer's right to receive future compensation into a single sum payable at once. Most interesting, however, is the fact that the Board quoted from its decision in *Walter M. Hort*,<sup>64</sup> in which it held that money paid by a lessee to his lessor for cancellation of the lease was ordinary income, since "the lease was extinguished, not sold or exchanged. The lessee did not acquire any valuable asset but merely obtained a release from his liabilities under the lease."<sup>65</sup> This language indicates that the rule in *Hale v. Helvering*<sup>66</sup> applies also to this sort of situation. This is, however, no longer true of *all* employment contract cancellations; to conform to section 329 of the Revenue Act of 1951, section 29.117-14 was added to Regulations 111, deeming a "sale or

<sup>58</sup> Treas. Reg. 118, §39.22(a)-1, *et seq.*

<sup>59</sup> *Beal's Estate v. Commissioner*, 82 F.2d 268 (2nd Cir. 1936).

<sup>60</sup> *Cf. supra*, n. 15.

<sup>61</sup> 34 B.T.A. 108 (1936).

<sup>62</sup> *Ibid.*, at 110, citing *Arkansas Valley Smelting Co. v. Beldin Mining Co.*, 127 U.S. 379 (1888).

<sup>63</sup> 41 B.T.A. 388 (1940).

<sup>64</sup> 39 B.T.A. 922 (1939), *aff'd* 313 U.S. 28 (1940): *supra*, n. 45.

<sup>65</sup> 39 B.T.A. at 926.

<sup>66</sup> *Supra*, n. 11.

exchange" to be present with respect to certain employment contract termination payments.<sup>67</sup>

A situation somewhat related to the cancellation of an employment contract arises when an exclusive agency contract is cancelled for consideration to the agent; but in this area the decisions are somewhat confused, and a conflict of authority exists between the circuits on the precise point of whether the transaction represents a "sale or exchange," or the mere extinguishment of an obligation.

In 1941, the case of *Elliott B. Smoak*<sup>68</sup> came before the Board; in this case, the taxpayer for consideration had relinquished to his principal his exclusive right to develop his sales territory, the right to royalties from future sales and from existing licensees, his records and office files and the good will he had built up over the previous two years. The Board held that the case was unlike *McFall* and *Gann* in that the taxpayer transferred a going agency business with all its assets, not merely the contractual right to receive future royalties. In determining that there was a "sale" of the business, the Board emphasized that if the transfer of his interest by a partner is a "sale,"<sup>69</sup> *a fortiori* the transfer of a going agency business is also a "sale." To the extent that goodwill and tangible assets are concerned, there would seem to be a "sale or exchange." But the question arises as to whether in such situations the "single entity" or "fragmentization" approach should be applied: in determining whether capital assets were involved the Second Circuit has applied the "fragmentization" approach, declaring that on the transfer of a sole proprietorship each asset must be considered individually.<sup>70</sup> The approach, however, has relevance *only* in determining whether capital assets are involved; the matter of whether a "sale or exchange" is present is another question. In *Jones v. Corbyn*,<sup>71</sup> the Tenth Circuit decided that, where the taxpayers received a lump sum in consideration of the cancellation of a lifetime exclusive insurance agency contract and the transfer of the records and office files of the agency, there was a "sale" within the meaning of section 117. A dissenting judge expressed the opinion that the case should have been decided with the application of the rules in *McFall* and *Gann*, since the taxpayers had apparently transferred nothing but their right to receive compensation in the future. The dissent in *Jones v. Corbyn* appears to be the more logical view, but it weakened its

<sup>67</sup> See INT. REV. Code §117(p); Treas. Reg. 118, §39.117(p). An employee who releases, for consideration, his right to a percentage of his employer's profits after termination of employment is deemed to have "sold or exchanged" that right if certain conditions are fulfilled.

<sup>68</sup> 43 B.T.A. 907 (1941).

<sup>69</sup> *United States v. Adamson*, 161 F.2d 942 (9th Cir. 1947).

<sup>70</sup> *Williams v. McGowan*, 152 F.2d 570 (2nd Cir. 1945).

<sup>71</sup> 186 F.2d 450 (10th Cir. 1950).

position by attempting to distinguish *Smoak* which clearly must stand or fall on the same ground.

In 1949, confronted with a case<sup>72</sup> in which the taxpayer had received cash for releasing a company of its contract to pay him monthly sums based on sales of gas to another organization, the Tax Court, without hesitation, said,<sup>73</sup> "The contract here was not sold, it was extinguished. Lomita [the company] acquired no exchangeable asset. The transaction, although in form a sale, was a release of an obligation." But in 1952, when *Starr Bros., Inc.*<sup>74</sup> was presented to them, involving the same sort of situation as *Jones v. Corbyn*, the Court ignored the argument of the Commissioner . . . that no "sale or exchange" could have resulted from the transaction, since there was merely the extinguishment of an obligation . . . and followed *Jones v. Corbyn*. The Commissioner appealed to the Second Circuit, which reversed the Tax Court,<sup>75</sup> saying that the case was analogous to cases involving surrender of notes to their maker, clearly instances of the extinguishment of an obligation since nothing survives the transaction in the hands of the maker.<sup>76</sup> It was further stated that cases<sup>77</sup> of surrender of a life tenant's interest to his remainderman were not applicable, and the fact was stressed that the transaction was not of a type deemed specifically by the Code as a "sale or exchange."<sup>78</sup> *Jones v. Corbyn* was disapproved, but might possibly have been distinguished, since that case involved a transfer of goodwill.

Shortly after *Commissioner v. Starr Bros., Inc.*, the Second Circuit again dealt with a similar problem when it decided the case of *General Artists Corp. v. Commissioner*.<sup>79</sup> In this case, the taxpayer corporation had transferred its contracts with a singer as his exclusive booking agent to another agent by an agreement providing for the cancellation of those contracts and the execution of new contracts between the singer and the other agent. It was again held that no "sale or exchange" was involved in the transaction. The Court anticipated any attempt to distinguish the *Starr Bros., Inc.* case stating:

"It might be suggested that the instant case differs from that of *Starr Bros.* because the latter involved a release of a binding negative covenant to the obligor, whereas here there was a transfer to a third party of the rights under the covenant.

<sup>72</sup> Charles E. McCartney, 12 T.C. 320 (1949).

<sup>73</sup> *Ibid.*, at 324.

<sup>74</sup> 18 T.C. 149 (1952). In this case, a dealer in drugs received a sum of money in exchange for releasing a manufacturer from its contract obligation not to sell its products to other dealers in the community.

<sup>75</sup> *Commissioner v. Starr Bros., Inc.*, 204 F.2d 673 (2nd Cir. 1953).

<sup>76</sup> *Bingham v. Commissioner*, *supra*, n. 35. Cf. *Hale v. Helvering*, *supra*, n. 11.

<sup>77</sup> E.g., *McAllister v. Commissioner*, 157 F.2d 235 (2nd Cir. 1946), *cert. denied* 330 U.S. 826 (1947).

<sup>78</sup> Citing *Helvering v. William Flaccus Oak Leather Co.*, *supra*, n. 4.

<sup>79</sup> 205 F.2d 360 (2nd Cir. 1953).

But we think that there was a release to the obligor of a negative covenant in order to allow a new covenant to be made with the third party."<sup>80</sup>

On the very same day<sup>81</sup> that *Commissioner v. Starr Bros., Inc.* was decided by the Second Circuit, the Tax Court handed down an opinion which handled a similar problem and came to an opposite result. The case was that of *Henrietta B. Goff*.<sup>82</sup> Here, the taxpayer corporation had sold certain machinery to another corporation, but had retained the right to have the machinery used exclusively for a specified period for the production of at least 750 pairs of hosiery which were to be sold to it at prices stipulated in the agreement of sale. The Tax Court decided that the proceeds received by the taxpayer for release of this right were derived from a "sale or exchange," since from the time of the release the other corporation possessed something which it did not have before, namely, the right to do with the machinery as it wished. Relied on in *Goff* as authority were *Commissioner v. Golonsky*,<sup>83</sup> *McCue Bros. & Drummond, Inc.*,<sup>84</sup> *Louis W. Ray*,<sup>85</sup> *Jones v. Corbyn*,<sup>86</sup> *Elliott B. Smoak*,<sup>87</sup> and the Tax Court decision in *Starr Bros., Inc.*<sup>88</sup> This imposing array of precedent loses its force, however, when it is observed that *Starr Bros., Inc.* was reversed by the Second Circuit in a decision that expressly ignored the majority opinion in *Jones v. Corbyn* and followed the dissent in that case, while citing *Commissioner v. Golonsky* merely as an example of the broad construction given to "sale or exchange" by the Third Circuit. *McCue Bros. & Drummond, Inc.* and *Louis W. Ray* have both been appealed by the Commissioner,<sup>89</sup> *McCue Bros. & Drummond, Inc.* to the Second Circuit, whose attitude on the question will undoubtedly be conditioned by its decision in *Commissioner v. Starr Bros., Inc.* The *Smoak* case is the only decision cited in *Goff* that has not been challenged, but its value as precedent in the light of the decision in *Commissioner v. Starr Bros., Inc.* is questionable.

## VI

### CONCLUSION

In its decision affirming the Tax Court in *Seth M. Milliken*, the Second Circuit expressed doubt as to whether a mere extinguishment

<sup>80</sup> *Ibid.*, at 361.

<sup>81</sup> May 29, 1953.

<sup>82</sup> 20 T.C. 7 (1953).

<sup>83</sup> *Supra*, n. 48 and n. 50.

<sup>84</sup> *Supra*, n. 55.

<sup>85</sup> *Supra*, n. 54.

<sup>86</sup> *Supra*, n. 71.

<sup>87</sup> *Supra*, n. 68.

<sup>88</sup> *Supra*, n. 74.

<sup>89</sup> See *supra*, n. 56.

of an obligor's duty can ever constitute a "sale or exchange."<sup>90</sup> The decision in the *Starr Bros., Inc.*, case<sup>91</sup> is perfectly consistent with this view, and the language used in *General Artists Corp. v. Commissioner*<sup>92</sup> indicates that the court is still similarly minded. But it is questionable whether the principle can be stated so broadly; the mortgage cases, discussed in Section III of this comment apparently have rules of their own; and it is clear that when a claim is satisfied by the transfer of property, the property is regarded as having been the subject of a "sale or exchange."<sup>93</sup> The lease cases represent another exception to the rule; but, as mentioned in the *Starr Bros., Inc.* case, they involve a broad interpretation of "sale or exchange." This broad interpretation may not continue to be followed in the atmosphere created by *Starr Bros., Inc.*

The *Starr Bros., Inc.* rule is sound law, but there nevertheless seems to be a valid question of public policy as to whether or not that rule frustrates the very purpose of the favorable treatment given to capital gains, *i.e.*, to encourage the taxable transfer of property which would otherwise be untransferred and untaxed. This purpose is certainly just as applicable to the release of exclusive agency contracts and leases, especially those contracts or leases of long duration, as it is to the transfer of any other capital asset. In the *Werner* case,<sup>94</sup> the Board, on an examination of legislative history, took this point of view and stated that "sale or exchange" were very broad terms . . . broad enough to include the retirement of bonds before maturity. *Werner* was soon overruled,<sup>95</sup> however, the Board taking the position that inspection of the legislative history of the capital gains and losses statute was improper since the statute was sufficiently clear on its face as far as "sale or exchange" was concerned. A return to the broad concept of "sale or exchange" outlined in *Werner* might not be unwarranted . . . not only to encourage taxable disposition of property whose value has appreciated, but also to reduce costly tax litigation based upon a group of filmy legal fictions, and to simplify tax administration.

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<sup>90</sup> 196 F.2d at 136, (n. 1); *supra*. n. 57.

<sup>91</sup> *Supra*, n. 75.

<sup>92</sup> *Supra*, n. 79 and n. 80.

<sup>93</sup> *See* n. 14.

<sup>94</sup> *Supra*, n. 5.

<sup>95</sup> *Watson, supra*, n. 6.