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FRUIT-TREE AND THE ORDINARY INCOME BASE

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The distinction between capital gain and ordinary income is one of the great complicating features of the federal income tax. In broad terms, it can be said that capital gains are gains that result from sales of investment property—typically, securities and real estate—and that ordinary income consists chiefly of wages and salaries, business profits, and dividends, interest and rents. But while the main categories are thus familiar, the application of the capital-ordinary distinction in less conventional cases is often problematic, and borderline definitional issues, though inevitable, are generally agreed to be too numerous for comfort.¹ The fault, at the first level, lies with the statute itself. Although Code § 1221 makes some effort to state what qualifies as a “capital asset,” the classification scheme is incomplete and in the end relies too heavily on ambiguous terms like “property” and “business.” At another level, this failing probably reflects a fundamental uncertainty on the part of Congress itself about what it really meant to achieve by exempting² a major fraction of long-term investment gains from the ordinary tax base.

The statute’s well-known incompleteness in the matter of definition has made it necessary for the courts to develop common-law doctrines to deal with uncertain cases, and the history of the capital asset concept is in large part a story of judicial ingenuity in creating doctrinal limits on the scope of the capital gain preference.

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1. Surrey, *Definitional Problems in Capital Gain Taxation*, 69 HARV. L. REV. 985 (1956).

2. I.R.C. §1202 provides that a taxpayer, other than a corporation, shall deduct 60% of net long-term capital gain from gross income.

One such judicially developed limitation—the carved-out interest rule—is the subject of this brief article. The rule traces back to the Supreme Court's decisions in *Hort*,³ *Lake*,⁴ *Earl*,⁵ and other early cases in which the familiar fruit-and-tree distinction was deemed critical, but the scope of the rule and its roots in capital gain policy have never been entirely clear.⁶ To be sure, there is not the same urgency about the matter now as there was in 1969 when Congress acted to resolve the tax treatment of mineral production payments and sales of life estates, two areas in which ill-advised judicial decisions had created a considerable risk of tax avoidance. But even with those risks past, I think there may still be some illumination in sorting through the issues and in attempting to say precisely what the carved-out interest rule is all about.⁷

This done, my hope is that the analysis will throw light on a particular area; namely, the treatment of lease and loan termination payments. Here, as much as anywhere in the law of capital gain, the uncertainty surrounding capital gain policy has generated puzzling and inconsistent results. The Supreme Court's decisions in *Hort v. Commissioner*⁸ and in *U.S. v. Kirby Lumber Co.*⁹ have long dominated the field, but neither is a very splendid instance of tax-opinion writing. My own view, indeed, is that erroneous inferences have been drawn from each, with unfortunate consequences for the administration of the capital gain tax.

I. THE ORDINARY TAX BASE

The capital gain-ordinary income distinction is usually approached in terms of the relationship between the property disposed of and the individual involved in the exchange. If, for example, the "property" consists of personal services—an exchange of time and effort for cash—the receipt is plainly ordinary income. This is so because "services" and "capital assets" are deemed to occupy separate tax universes, and it is well understood that the return to personal efforts is ordinary. The same is true of stock-in-trade. Property held for sale to customers—business inventory—is

3. *Hort v. Commissioner*, 313 U.S. 28 (1941).

4. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

5. *Lucas v. Earl*, 281 U.S. 111 (1930).

6. For a recent discussion, see Joyce & Del Cotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests*, 31 TAX L. REV. 121 (1976).

7. See Section II *infra*.

8. 313 U.S. 28 (1941).

9. 384 U.S. 1 (1931).

obviously non-capital; hence, if the taxpayer is a "dealer" with respect to the property his gains are taxable at ordinary rates.¹⁰ By familiar definition, then, both services and stock-in-trade are outside the class of capital asset, and once identified as such the issue of ordinary income or capital gain is instantly resolved.

Investment property presents a different, and to some extent a closer question. Here, the issue relates not to the character of the property held—concededly capital—but to whether capital gain (or loss) is consistent with the necessary assumptions that define the ordinary income base. Two such assumptions—one positive, so to speak, the other negative—can be cited as fundamental. The positive assumption is that a tax at ordinary rates shall be imposed on the net yield from investment in land, buildings, machinery and other productive capital assets. For this purpose, "net yield" refers to gross revenues from the lease or operation of the property, reduced by (i) current expenses such as wages and salaries and (ii) depreciation. There is wide agreement, I think, that depreciation is overstated in the early years of an asset's useful life under any of the currently permissible methods of cost-allocation—so that, in general, taxable income is deferred from the earlier to the later years of use—but there appears to be no practical way by which an accurate scheme of calculating cost-recovery can be imposed and certainly no impulse on Congress' part to try to find one. Accepting that, "net yield" means revenues less the sum of current expenses and depreciation as specially defined for tax purposes; and this, together with business profits and personal service income, makes up the ordinary tax base for all practical purposes.

What I have described, of course, is simply the annual or periodic return to the owners of the firm—to those who hold financial assets such as stocks and bonds. In many instances, these financial asset-holders will have created a structure of priorities among themselves to reflect their varying preferences for risk—with bondholders coming ahead of preferred stockholders, and the latter coming ahead of the common—but such private arrangements are of no special interest to the individual income tax. However split among the investors, it is the overall return on the capital invested in the enterprise that is the object of the ordinary income tax. If, for example, all tangible assets of a certain class—say office buildings—currently return 12% on investment taken at market

10. I.R.C. § 1221(1).

value, then it is this 12% return that must be taxed at ordinary rates. Viewed "nationally," ordinary income must embrace the entire return to security-holders; there is a "deficiency" if the includable amount is less.

In contrast—and as a second assumption—the law anticipates that *changes* in the value of an expected income stream will, if realized, be taxed as capital gain. Thus, if anticipated earnings increase, whether because of an increase in demand for the firm's product or a decline in current operating expenses, the value of the property from which such earnings derive (still discounted at the 12% rate) will necessarily rise as well. Similarly, if anticipated earnings are unchanged but the applicable discount rate drops from 12% to 10%—whether because the firm is viewed as less risky than formerly or because the time-value of money has declined—the value of the firm's productive assets will go up. In either event, the rise in value, if realized through sale, is the proper and intended subject of the capital gain preference. In the first case—where anticipated earnings increase but the discount rate of 12% is unchanged—the Code "wants" to tax at ordinary rates only a 12% return. The adjustment in value of the income stream is therefore conceded to the capital gain preference, while the buyer of the property takes up a higher depreciable basis which yields *him* the 12% return. In the second case—where earnings are unchanged but the discount rate drops from 12% to 10%—the Code "wants" to impose the ordinary tax on no more than the new 10% return, and again, the adjustment in present value, if realized, is capital gain with a stepped-up basis to the purchaser. If market value changes were simply credited to the owners of depreciable property, with bases adjusted correspondingly, precisely these would be the outcomes on a year-to-year basis. Under our system of accounting, however, a realization through sale is required before gain can be recognized and a new basis for the property can be established. The ordinary income base therefore will be "overstated" until the underlying tangible asset is passed on to a new user at the higher depreciable value. A realization is needed to "correct" the base, but once it occurs and a capital gain is imposed on the seller the tax base will be properly reoriented.

At all events, the scope, but also the limit, of capital gain treatment should be evident. The tax law *must* collect an ordinary tax on the net yield from investment in tangible assets. No rule or combination of rules should be tolerated which converts net yield

into capital gain. By the same token, however, no rule is needed, and none is appropriate, which treats (realized) changes in the market value of the anticipated income stream as ordinary income.

All this is well known (especially to real estate investors), but it is worth repeating in the present context because it shows very clearly what the carved-out interest rule ought to achieve. In effect, the rule should operate to protect the ordinary income base by assuring that the net yield on tangible property investment will *always* be subject to the regular tax rates. If it does less than that, it needs extension; if more, restriction. In practice, it has done *both* more and less, and it is this circumstance that has made it, on occasion, a doctrine of confusion.

II. THE CARVED-OUT INTEREST RULE

The carved-out interest rule itself can be restated quickly. Judging from *Hort*, *Lake*, and other decisions, the rule imposes a twofold limitation on the owners of capital assets. Where a term interest in property is sold, but a reversion to take effect after the term expires is retained by the seller, the carved-out interest rule (a) denies the seller an offsetting basis for the interest sold and requires that the entire amount received be included in income, and (b) treats that income as ordinary. By obvious contrast, a sale of the "underlying property" entitles the seller to offset his basis against the proceeds of sale and to treat the gain, if any, as capital gain.

It is easy to see why the carved-out interest rule plays a role in respect to financial assets—stocks, bonds—that is not merely important, but absolutely indispensable to the revenues. Assume that S, an investor, purchases 100 shares of stock for \$1,000 in the expectation of an annual dividend of \$80. Suppose he sells to V, a vendee, the right to receive the dividend for the next 5 years. The sale price is \$320, which represents the present value of \$80 a year for 5 years discounted at 8%. Can S offset an equivalent proportion of his basis, *i.e.*, \$320, against the receipt and hence report no gain? The answer—on which everyone agrees—is that he must report the full \$320 as income, and as ordinary income at that. The explanation usually given¹¹—and quite correct as far as it goes—is that permission to offset basis against the sale proceeds would permit S both to defer the recognition of income indefinitely—that is, until the stock is finally sold—and to convert his ordinary dividend

11. ALI DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 273-74 (1960).

income into capital gain. Thus, if a basis offset of \$320 were allowed, no gain would be recognized in Year 1 when the dividend right was disposed of, and S's basis for his stock would be reduced from \$1,000 to \$680. Assuming the stock is still worth \$1,000 at the end of Year 5 when the carved-out dividend expires, S could sell his shares outright and recognize a \$320 capital gain. This would follow even though the stock had not changed in value between Year 1 and Year 5 and the entire positive return was attributable to the dividends paid during that 5-year period. The same routine could of course be repeated until S's basis for his shares was exhausted, or, indeed, perpetually. It seems plain, however, that S is actually receiving "dividends"—even though at 5-year rather than 1-year intervals—and almost everyone, I think, would say that the mere act of anticipatory disposition ought not to alter the ordinary treatment that customarily attaches to a dividend receipt.¹² This, presumably, is what the Supreme Court had in mind in the *Hort* case when it characterized the receipt of commuted rentals as "a substitute for future income" taxable at ordinary rates.

But while adequate, the explanation just given is not complete. What it lacks is a description of the tax status of V, the vendee of the 5-year dividend right. If, for example, V were required to include each annual \$80 dividend in income without an offsetting amortization deduction, no very urgent reason would exist (indeed, it would be anomalous) to treat the \$320 payment received by S as ordinary income. No more (but no less) than \$400 of dividends should be taxed in respect to the stock over the 5-year period, but there is no particular reason to tax that amount to one taxpayer rather than the other. One knows, however, that V, being the purchaser of a wasting asset, is entitled to recover his \$320 investment through annual amortization allowances,¹³ and it is really *this* rule that has to be regarded as fixed. The result is that V deducts \$64 a year ($\$320/5$) and includes in income only the net amount of \$16, a total of \$80 over the 5-year term. Once this is seen, the treatment of S follows mechanically. Doctrinal argument is in a sense irrelevant, because the Treasury simply *must* have \$400 of ordinary income in total. The effect is, of course, very different if S sells V the stock itself, or even one share out of the

12. The assignment of the right to receive a future dividend has been held not to alter the character of the amount received. See, e.g., *Rhodes' Estate v. Commissioner*, 131 F.2d 50, 30 A.F.T.R. 220, *aff'g* 43 B.T.A. 780 (6th Cir. 1942).

13. I.R.C. § 167.

100-share lot, because then V's investment (like S's before him) is non-amortizable. Hence, there is obviously no objection to S's offsetting his basis against the proceeds of sale: it is V who will annually report the full \$80 of dividend income in the future.

Putting the whole matter briefly: we cannot (without irreparable harm to the revenues) allow an investor to carve an amortizable interest out of a perpetuity unless the proceeds are fully recognized to the seller and taxed at ordinary rates.

The carved-out interest rule achieves the result just stated, but it is not the only way of doing so, and is probably not the best way. An alternative—one that is reflected in Code § 636, but there confined to mineral properties—would be to recharacterize the carving out as a loan, *i.e.*, from “vendee” to stockowner, and then treat the annual dividends as repayment of principal. Since the stockholder's debt obligation is thus being satisfied, each yearly dividend would be regarded as applied for his benefit and would be taxed to him when received by the (recharacterized) lender. Presumably the \$80 difference between total dividends—\$400 in our example—and amount “loaned”—\$320—would be allowed to the stockholder-borrower as an interest deduction and included in the income of the “lender” over the term of the “loan.”

If sustainable, the loan characterization produces a better outcome than the carved-out interest rule—from a national perspective, at least—because it taxes dividends when they are actually paid. The Treasury really has no plausible interest in collecting an ordinary dividend tax prior to the time of actual distribution, and it is only the vagaries of tax accounting that leads to a tax on \$320 in Year 1. On the other hand, absent the *form* of a borrowing, the loan characterization may be difficult to achieve through judicial construction. In *Estate of Stranahan*,¹⁴ for example, the taxpayer, having excess personal deduction in Year 1, sold a carved-out dividend right to his son in an effort to anticipate ordinary income against which the excess deductions could be used. Opposing this result, the government sought to recharacterize the sale as a loan, in which event the dividends (net of discount) would have been imputed to the taxpayer ratably as the “loan” was repaid. The Court of Appeals rejected the government's position and held that the entire proceeds were includable in the year of sale. The Court's reasoning, quite simply, was that since the vendee's ulti-

14. *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973).

mate collections were uncertain—future dividends might exceed or fall short of expectations—the transaction lacked the fixed-obligation feature of a true loan and could not be treated as such by mere assertion.¹⁵

Still another route to ratable inclusion of carved-out income rights exists, and it is one that may well be superior—theoretically, at least—to either the lump-sum inclusion rule of *Stranahan* or the Commissioner's unsuccessful loan characterization. The approach is suggested (but not supported in this context) by § 1232(b), which requires the purchaser of a bond issued at a discount to include the discount in income ratably as the bond moves towards maturity. The very same approach could be taken to the "stripped remainder" that is left in the hands of the stockholder after the carved-out dividend right is sold off. The value of the stockholder's remainder is then (in our example) \$1,000 less the \$320 value of the dividend right, or \$680. As the 5-year period elapses, the remainder increases from \$680 to \$1,000, everything else being equal, and it would be entirely appropriate to impute income to the stockholder at the rate of \$64 a year ($\$320/5$). Together with the vendee's annual income of \$16, the yearly income taxable to both parties is the correct sum of \$80, and the inclusion takes place on a year-by-year basis as dividends are paid. The ordinary tax is thus imposed on the annual increase in the net worth of each party, and both the revenues and the individuals' taxable incomes are in this respect at the right level.

The difficulty is that the tax law has traditionally lacked the capacity to tax the increase in value of a remainder resulting from the passage of time or to impute taxable interest to the annual increase in the value of discount obligations. Sections 1232(b) and (c) do pick up discount in a limited class of cases—where corporate bonds are originally issued at less than face or are sold with interest coupons detached—but in situations not explicitly covered by the statute, imputation is unlikely to be accomplished by judicial construction.¹⁶ The reason no doubt is a practical one (unless attributed to mere economic ignorance): the proper rate of imputation, or discount, that would be appropriate in a given case may be uncertain, and the absence of an actual cash receipt with which to pay the taxes due makes it difficult to insist on the mere *principle* of impu-

15. *Id.* at 871.

16. *See* *United States v. Midland-Ross Corp.*, 381 U.S. 54 & n.4 (1965).

tation. For this and other reasons, interest imputation has generally been beyond the reach of a court applying § 61 without aid of other more explicit statutory provisions, so that the taxation of stripped remainders is simply not a result that is likely to be achieved by unaided interpretation. The existing carved-out interest rule—which has the strength, but also the weakness, of taxing the receipt of cash—represents a clumsy but apparently a necessary substitute.

As a further note at this stage, it is also easy to see why the carved-out interest rule needs to be applied more stringently in the capital gain area than it does in the income-attribution field (where the fruit-tree formulation originated). In early cases like *Helvering v. Horst*¹⁷ and *Harrison v. Schaffner*,¹⁸ the Supreme Court held that the gratuitous assignment of a short-term income right—in *Horst*, two-years' coupons detached from a bond—would be ineffective to shift tax to the donee. Such income would be regarded, in effect, as belonging to the donor despite the assignment and despite the receipt of actual cash by the donee. The reason for the rule, one supposes, was that the Court feared a large-scale evasion of the progressive rates: property-owners could, through short-term gifts of income, pick and choose among family members (including family trusts) depending on where the marginal tax rate was the lowest, and in that way defeat or impair the graduated rate structure.

The latter concern led naturally and properly to a dividing-line-principle—now reflected in the 10-year rule of § 673. If the transferred income-interest exceeds 10 years in term, then the tax shifts to the donee despite the element of carving out. Presumably, 10 years is a long enough period to deprive the donor of any real ability to manipulate the income flow from the affected property, and thus the graduated rate structure is adequately defended. Moreover, the present value of a 10-year income interest is likely to be greater than that of the reversion retained by the donor, so that, using an “ownership” criterion, the donee may well appear to have the larger interest in the property.

In the capital gain field, by contrast, no time dividing-line limitation can be accepted. Given the vendee's right to amortize his cost for the acquired interest, it becomes imperative to tax at ordi-

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

18. 312 U.S. 579 (1941).

nary rates the entire proceeds of sale. No matter how long the term of the interest sold, the proceeds must be treated as ordinary income to the seller. A rule that allowed an offset of basis and/or capital gain on the sale of long-term rights would reduce the ordinary income base below the appropriate level and hence would simply extend the mischief which the carved-out interest limitation is designed to prevent.

Precisely this mistake was made by Congress when it adopted § 1001(e), a provision whose aim was to correct the error made by the Second Circuit in the well-known *McAllister* case.¹⁹ In *McAllister*, the court held that the seller of a life estate was entitled both to offset her basis for the interest sold against the proceeds of sale and to treat any gain or loss as capital gain or loss. The effect—given the right of the remainderman to the full basis of the trust property on expiration of the life estate—was to allow an overcounting of basis and to permit a substantial portion of the future income from the trust to be wiped out entirely. Section 1001(e) restores that income by denying the life tenant a basis for the life estate; but it fails to classify the life estate as a non-capital asset and thus in effect permits the net yield from the trust property to escape the ordinary tax base and to be treated as capital gain. Capital gain treatment in this context is presumably to be explained on the ground that sellers of life estates will receive a substantial amount of future income in a single year; this, in turn, creates a “bunched” income problem and hence a need for averaging relief of some kind. The result, however, is to impair the ordinary income base by transferring net yield into the capital gain category, and if viewed from that perspective, the outcome under § 1001(e) is flatly incorrect.

One final observation can be made (before attempting to apply the ideas sketched out above to lease and loan terminations specifically). Although the carved-out interest rule apparently applies to depreciable property (machines, buildings, patents, etc.) and to non-depreciable property (stocks, bonds, unimproved land) alike, there is actually little or no need for such a rule in the case of depreciable assets. If the underlying property is a wasting asset, the act of carving out a short-term interest—drawing a shorter out of a longer “annuity”—presents no threat to the ordinary tax base and

19. *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

could, without harm, be treated in accordance with the usual capital gain and basis-offset rules—those that apply where property is sold in its entirety. The reason, obviously, is that no *new* right of amortization has been created by the carving-out. The original owner of the property having been entitled to depreciate his investment, his vendee can do no more. Putting it another way, there is no reason to apply a different rule when a term interest in depreciable property is sold than when the entire property is sold, because the two transactions have an equivalent impact on the ordinary tax base. Hence, where tangible property is concerned, temporal and vertical dispositions (sale of a term interest and sale of an undivided interest) are in theory the same.

The result of applying the carved-out interest rule to sales of term interests in depreciable property is simply to require the taxpayer to anticipate income by separating the advance payment from the related depreciation allowance. In effect, the proceeds of the carving-out are reported currently; the related depreciation, however, is not permitted to be anticipated under tax accounting rules, and the opportunity for capital gain (where the prepayment would exceed the present value of related depreciation) is lost. Wrong in theory, these outcomes are nevertheless readily avoided by engaging in loan transactions rather than sales. An owner of depreciable property can obviously raise funds by borrowing—assigning the property as collateral—without *any* present tax consequences. Properly advised, no one would seek the same end by sale of a carved-out interest, and at least since the hey-day of the oil-production deals which culminated in the *Lake* case, no doubt very few have.

III. LEASE AND LOAN TERMINATIONS

The discussion to this point has attempted to establish two ideas:

First: Insofar as property investment is concerned, the ordinary income base must include the net yield from investment in tangible property—typically, interest and dividends. By contrast, if a change occurs in anticipated yield—whether because of an increase in expected cash flows or because of a decline in rate of discount—that change is entitled to be capitalized by the owner of the property through sale or other form of realization. And the resulting gain, if any, should be treated for tax purposes as a capital gain.

Second: The carved-out interest rule plays an indispensable role in protecting the ordinary income base from being understated. Absent the rule, holders of financial assets would be in a position to convert ordinary income into capital gain by conveying an amortizable term interest to another investor—in effect, by carving an annuity out of a perpetuity. The carved-out interest rules prevents this distortion (even if rather clumsily) by denying the stock or bond owner a basis for the term interest and by treating the proceeds of sale as ordinary.

Again by contrast, the limitation on carving out should have *no* application where the effect of a transaction is simply to adjust the present value of an income-stream—where, in other words, the transaction serves merely to reduce the amount includable in the ordinary tax base to an appropriate current level. In the latter event, capital gain, plus a stepped-up basis for depreciation or amortization, is the correct set of outcomes.

From this vantage point it may be possible to say something useful about two related transactions—lease and loan cancellations—whose contrasting tax treatment under the decided cases represents a long-standing puzzle. A change in expected rate of return—whether of rentals on real estate or of interest on borrowings—necessarily affects the values of existing contractual commitments, whether leases or bonds. If sufficiently dramatic, such a change may induce one of the parties to propose a termination of the commitment in exchange for a cash payment. For tax purposes, the question is how such a payment, if accepted, should be treated by the payee. Is it gain from the sale of a capital asset (the lease or bond), or just a substitute for the ordinary income which the payee would have received had the contract been carried out to completion?

In the famous *Hort* case, the Supreme Court held that a cash payment received by a lessor from a lessee on the cancellation of a lease was ordinary income to the lessor. The taxpayer argued that the lease-cancellation had resulted in a loss—rental-values having fallen substantially as a result of the Depression—or, in the alternative, that the lease itself should be viewed as a capital asset, with the cash payment therefore being capital gain. The Court rejected both arguments. Finding that the cash payment was merely a lump-sum substitute for future rents, and holding that no separate basis could be allocated to the leasehold, the Court sustained the Commissioner in treating the entire receipt as ordinary income.

The result in *Hort*—which involved a payment by a lessee to a lessor—can be contrasted with the results in cases where rents rise during the term of an existing lease and the lease grows onerous to the lessor. If the lessor makes a cash payment to his lessee in exchange for a cancellation of the lease, the courts uniformly hold that the lessee thereby realizes capital gain, the lease being treated in the lessee's hands as a capital asset.²⁰ The benefit to the lessee—namely, the difference between the rentals called for by the existing lease and the higher rents that could be anticipated if a new lease were entered into—plainly represents a substitute for future income, but the reasoning of the *Hort* decision is largely disregarded when the transaction is “reversed” and there is no dissent from the proposition that a cancellation payment to a lessee is capital gain.

Where the subject matter of the original contract is money rather than real estate or other tangible property, the tax results of cancellation payments are exactly *opposite* to those just described. Thus, if bonds are retired at a premium, the lender has a capital gain.²¹ Here, of course, it may be assumed that interest rates have declined since the bond was issued. By contrast, if bonds are retired at a discount—interest rates having risen—the issuer-borrower has ordinary income. The latter conclusion is a settled inference from *U.S. v. Kirby Lumber Co.*,²² in which the repurchase of outstanding debentures at a discount from face led to debt-forgiveness income to the corporation. While the capital-ordinary distinction was not at issue in the *Kirby* case, it has long been accepted that forgiveness income is ordinary on the ground that the loan contract is not a capital asset from the debtor's standpoint or that debt retirement is not a “sale or exchange.”²³

20. *Commissioner v. McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2d Cir.), *cert. denied*, 348 U.S. 829 (1954); *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

21. I.R.C. § 1232(a).

22. 284 U.S. 1 (1931).

23. Rev. Rul. 69-613, 1969-2 C.B. 163. Ordinary treatment may also be explained as a kind of informal recapture rule. Assuming the original loan proceeds were used to pay current expenses or to purchase depreciable assets, their expenditure will have resulted in ordinary business deductions for the borrower. Arguably, the “related” forgiveness income should be ordinary as well. On the other hand, ordinary treatment would be imposed even if the loan proceeds could be traced into capital assets or into real estate that is depreciable on a straight-line basis—property normally not affected by recapture—so that the link-up, if any, is not systematic. H.R. 5043, 96th Cong., 2d Sess. (1980), the so-called Bankruptcy Tax Act, does tend to stress the relationship between debt forgiveness and recapture, however, by re-

Equating lessor with lender, and lessee with borrower, it is evident that the two sets of results are inconsistent. A fall in rents produces ordinary income to a lessor, while a fall in interest rates produces capital gain to a bondholder. A rise in rents produces capital gain to a lessee, but a rise in interest rates produces ordinary income to a bond-issuer. Since lessor-and-lender, and lessee-and-borrower, are perfectly matched pairs from an economic point of view, the obvious question is: Why should the tax outcomes differ depending on whether it is a lease or a loan that is being cancelled or retired?

The answer usually given—as Professor Andrews has noted²⁴—is that lessors and borrowers are thought to be engaged in a carving-out, while lessees and lenders are seen as disposing of their “entire property.” In the case of a lessor (*Hort*), we apparently identify the fee interest in the real estate as the relevant “underlying property,” and plainly that has not been disposed of when the lease is cancelled. Hence, a carving-out occurs. But where a lender is concerned, the underlying property is the bond that he owns—not the funds it represents and certainly not the investment portfolio of which it is a part. If the bond is retired at a premium, then a disposition of “the property” occurs and there is no carving out. From the standpoint of a lessee, similarly, the only “property” is assumed to be the lease itself (not, for example, the lessee’s larger operating business), so that cancellation is viewed as a disposition of the property in its entirety. But where a borrower is concerned, while the carved-out interest rule is not usually invoked in terms, ordinary income results for a reason that is roughly analogous, namely, that debt-retirement is not deemed a “sale or exchange” from the debtor’s standpoint.

All this is obviously mere semantics. If one focuses on the ordinary income base—that is, the net yield from investment in tangible property—rather than seeking metaphoric distinctions between fruit and tree, the right results are reasonably clear. In fact, all *four* cases are entitled to be treated as capital transactions; lessors and borrowers, no less than lessees and lenders, are entitled to treat the premiums they realize on termination of their contracts as capital gains. The reason has already been given: in effect, the

quiring that in the case of an elective exclusion of forgiveness income under I.R.C. § 108 only the basis of depreciable property shall be reduced under the corollary § 1017.

24. W. ANDREWS, BASIC FEDERAL INCOME TAXATION 902 (2d ed. 1979).

Treasury's only legitimate interest is in taxing at ordinary rates the *current* yield from investment in tangible property. Property yields obviously change from time to time, either for reasons that are specific to the firm or, more often, because of overall changes in the economy. Private investors do of course make long-term contracts that contain *promised* rates of return which reflect their expectations at the time the contracts are entered into. But such contracts, though binding on the parties, have no effect on *true* rates of return and are not made for the benefit of the Treasury. If the market rate departs from the contractual rate (in *either* direction), then a windfall develops for the party in whose favor the market has moved and a penalty results to the other. Once more, this is a matter for the parties to rejoice or sorrow over, but it has nothing to do with the Treasury.

If, in these circumstances, the parties elect to terminate their contract for a cash payment, the amount so paid is simply the price of adjusting the contract-value of the income-stream up or down to market value and as such it belongs *outside* the ordinary income base. The carved-out interest rule, of which the larger object is to protect the ordinary tax base, need have no application whatever. Lessors and borrowers are just as much "investors" as lessees and lenders: in every case, the "underlying property" is the parties' contractual commitment, and the right result for all parties is capital gain.²⁵

In my view, it would be correct and consistent for Congress to amend the Code so as to extend capital gain treatment to both *Hort* and *Kirby*-type taxpayers. The amendment—presumably to present § 1241—would simply provide that *all* lease cancellation premiums, whether paid to lessees or lessors, and *all* bond redemption gains, whether realized by lenders or borrowers, will be regarded as arising from the sale or exchange of a capital asset. In

25. Perhaps this point needs special emphasis in regard to borrowers. While one who contracts a debt is not usually thought of as an "investor" speculating on market movements, realistically a corporation that issues bonds in exchange for capital funds is simply taking a "short" position in its own securities. If interest rates rise, the issuer may choose to close that position out and realize its gain by repurchasing its bonds at a discount from the issue price. If the same corporation had chosen to raise funds by short-selling the bonds of *another* company, and then, after interest rates had risen, had bought those bonds at a discount for delivery to purchasers, the "investment" nature of its gain would be apparent. No reason exists for treating the matter differently merely because the taxpayer deals in its own bonds rather than those of an unrelated concern.

the case of lease premiums, where, as in *Hort*, the lessor owns the underlying reversion, it would probably be simpler to treat the entire premium as gain rather than attempt to allocate some portion of the lessor's basis to the lease. In the case of bond redemptions, the measure of gain is obviously the difference between the original loan proceeds and the lower redemption price.

But would a Code amendment along these lines make any real difference in the present climate of affairs? Is it worth the trouble, from a practical standpoint, to alter rules of such long standing? As to *Hort*-type taxpayers—lessors accepting premiums to cancel overvalued leases—the answer is only marginally affirmative. In an era of rising rents, lease cancellations, when they do occur, would almost always run in favor of lessees, who are assured capital gain in any event by both § 1241 and the decided cases.

On the other hand, capital gain for *Kirby*-type taxpayers—for the most part corporations retiring outstanding bonds at a discount from face—would be likely to have considerable practical importance at present. With interest rates having risen so sharply over the past few years, many corporate bonds have recently been quoted at very substantial discounts in the market and hence in economic terms present a tempting target for retirement. In these circumstances, it may be that capital treatment for bond redemption gains would offer more encouragement to corporate treasurers who contemplate the early retirement of outstanding debt than the present combination of ordinary income under § 61(a)(12) and elective deferral under §§ 108 and 1017²⁶—especially if the issuer has offsetting capital losses from other sources. Hence, if the Code were amended as proposed, the pace of such retirements might be expected to increase.

In one important respect any such trend toward the speedier redemption of discounted bonds would actually be favorable to the revenues—and to tax equity. Thus, although the Code now taxes *original issue* discount to bond investors at ordinary rates, § 1232(a) explicitly extends capital gain treatment to investors who purchase, and who simply hold to maturity, bonds which have *fallen* to a dis-

26. Forgiveness of indebtedness generally results in income to the debtor. I.R.C. § 108 provides that the taxpayer may exclude this amount if the indebtedness was incurred or assumed by a corporation or by an individual in connection with property used in his trade or business. The taxpayer can exclude this income but must consent to reduce his basis by the amount of the exclusion, in accordance with § 1017.

count because of a rise in interest rates. Yet it is perfectly plain that high-bracket individuals who invest in "deep-discount bonds" are thereby in effect converting ordinary interest income into capital gain. For practical reasons, nothing can be done about this directly; but in principle capital gain in this context is indefensible. "Thus, when interest rates have risen, rich men buy bonds at a discount from poor men so that part of the bond's true interest will appear as a so-called capital gain that is lightly taxed. Such a tax swap involves the purchase by the rich of the low tax base of the poor, at the expense of the government."²⁷ If the taxation of bond redemption gains were corrected—and if, as suggested, corporate issuers were thereby prompted to retire discounted debt before maturity—the opportunities to obtain unwarranted individual tax benefits through the purchase of discount bonds would become less abundant, with a consequent gain in equity and fairness.

CONCLUSION

My effort in this discussion has been to relate the familiar carved-out interest rule to the ordinary income base and to show how important the former is in protecting the latter. This, however, leads to the observation that in two major applications of the carved-out interest doctrine—the *Hort* and the *Kirby Lumber* decisions (the latter in its ordinary income aspect)—the Court was in fact misguided, and that capital gain treatment would be proper both for lessors' premiums and for borrowers' redemption gains. Finally, I have suggested that any change in the tax rules that encourages issuers to advance the retirement of discounted bonds will tend to reduce the ability of high-bracket investors to turn interest income into capital gain, a matter of no little importance at the present writing.

27. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604, 606 (1964).

