SCHOOL OF LAW
CASE WESTERN RESERVE UNIVERSITY

Case Western Reserve Law Review

Volume 12 | Issue 2 Article 17

1961

Elements of Capital Gain--General What Is a Sale or Exchange

Warren E. Hacker

II

ELEMENTS OF CAPITAL GAIN — GENERAL
WHAT IS A "SALE OR EXCHANGE"?

Warren E. Hacker

As noted above, the statute elsewhere speaks of "dealings" in and "disposition" of property.[1] In order to obtain capital gains treatment, there must be a particular kind of disposition. There must be a "sale or exchange." Even if the property is a capital asset held for more than six months, the profit upon its disposition will be ordinary gain unless there is a "sale or exchange."[2]

In most cases, the terms "sale" and "exchange" will pose no problem. "Sale" implies a transfer of property for a consideration in money or money equivalent; "exchange" implies reciprocal transfers of property;[3] and the disjunctive "or" permits the consideration to be both money and property. Sales and exchanges are not limited to those voluntarily undertaken. They include foreclosures, condemnations and other involuntary sales.[4] The principal problems in determining whether a transaction is a sale or exchange arise in two situations: *first,* when what the taxpayer transfers is less than complete ownership of the property and, *secondly,* when the taxpayer transfers a property interest which disappears as a result of the transaction.

(1) The taxpayer is at liberty to sell all or substantially all the rights to part of his property, and it is nonetheless a sale. The sale may be of fee ownership of an undivided interest in the whole or fee ownership of a segregated portion of the whole property. The segment sold may be either a horizontal or a vertical division of the property. It may be the fee ownership of a metes and bounds portion of Blackacre, it may be the fee ownership of the mineral deposits in place underlying the whole of Blackacre, or it may even be the fee ownership to the top floor of a five-story building constructed on Blackacre. Each of these transactions is a sale. Several recent cases go even to the extent of holding that there

1. See pp. 244-45 and accompanying notes 7 and 8.

2. Thus, in Helvering v. Flaccus Oak Leather Co., 313 U.S. 247 (1941), it was held that the receipt of insurance proceeds upon the destruction of property did not involve a sale or exchange. See INT. REV. CODE OF 1954, §§ 1033 and 1231 (hereinafter cited as §), for present treatment of such involuntary conversions.

3. Helvering v. Flaccus Oak Leather Co., 313 U.S. 247 (1941).

4. Helvering v. Hammel, 311 U.S. 504 (1941).

can be a sale of the top soil of a farm,[5] or of sand and gravel in place.[6] However, there is no sale if the taxpayer merely transfers the right to use property.[7] Such a transaction is simply a lease or license, no matter how labelled by the parties. But if the taxpayer transfers all or substantially all of the rights which he has in the property or in a segment of it, there is a sale.[8]

(2) It is clear that the term "sale or exchange" does not contemplate that the transferred property must continue to exist in the hands of the transferee. It is sufficient that it was property in the seller's hands. Thus, there is a sale or exchange when a life tenant transfers his life estate to the owner of the remainder interest for a consideration, even though the life estate thereupon disappears by operation of law.[9] Where the property interest disappears as the result of a transaction with the other party to the legal relationship, the case is somewhat harder simply because such a transaction is frequently thought of as a "release," "surrender" or "relinquishment" rather than as a "sale." However, even these transactions can be sales. Thus, when the purchaser under a land contract surrenders his beneficial interest in the property to the vendor, there is a sale or exchange even though that interest thereupon merges into the vendor's fee.[10] Similarly, the surrender or cancellation by a tenant of his leasehold or possessory right in favor of the landlord,[11] a tenant's release of

---

5. Robert M. Dann, 30 T.C. 499 (1958), *gov't's appeal dismissed on stipulation,* (2d Cir. 1959); Estate of S. E. Vance, CCH TAX CT. REP. (19 CCH Tax Ct. Mem.) 167 (Dec. 24, 1960).

6. Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957). *Cf.* Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957), involving the transfer of a right to remove gravel when the landowner retained a so-called "economic interest" in the gravel deposit.

7. Gillette Motor Trans., Inc. v. Commissioner, 364 U.S. 130 (1960); Rev. Rul. 57-261, 1957-1 CUM. BULL. 262 (condemnation of use and occupancy); Rev. Rul. 53-38, 1953-1 CUM. BULL. 16.

8. See Rev. Rul. 54-575, 1954-2 CUM. BULL. 145; O.D. 1072, 5 CUM. BULL. 89 (1921) (condemnation of the lessee's entire leasehold interest).

9. Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946), *cert. denied,* 330 U.S. 828 (1947); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied,* 330 U.S. 826 (1947); Estate of F. A. Bell v. Commissioner, 137 F.2d 454 (8th Cir. 1943). These cases all involved donated rather than reserved life estates.

10. C. L. Gransden & Co. v. Commissioner, 117 F.2d 80 (6th Cir. 1941). It is immaterial that from the other party's viewpoint, the transaction may be characterized as a "payment" of the debt, rather than as a "sale or exchange." See Fairbanks v. United States, 306 U.S. 436 (1939); see also Gage Brothers & Co., 13 T.C. 472 (1949), *acq.,* 1950-1 CUM. BULL. 2 (surrender of debt to obligor for stock is an exchange); Alexander E. Duncan, 9 T.C. 468 (1947), *acq.,* 1948-2 CUM. BULL. 2.

11. 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, 73-74 (3d Cir. 1952), *cert. denied,* 345 U.S. 939 (1953). This rule is now confirmed by § 1241 for amounts received by a tenant "for the cancellation of a lease." Note that the landlord receives ordinary income if the tenant pays for such release. Hort v. Commissioner, 313 U.S. 28 (1941).

his landlord from a restrictive covenant,[12] and the surrender of a distributorship agreement to the grantor of the distributorship[13] have all been held to be sales with capital-gain consequences even though the property transferred did not survive the transaction. On the other hand, one court has held that the transfer of an option by the option holder to the grantor for a consideration is not a sale.[14] Also it has been held that the surrender for a consideration of certain other types of contractual rights to the grantor of such rights is not a sale.[15]

It is difficult to reconcile the disappearing asset cases. The rule which is developing may be this: in addition to the lease and distributorship contract cases now expressly covered by statute,[16] when the possessor of rights releases, surrenders or relinquishes them to the grantor of such rights for a consideration, there is a sale or exchange provided that such rights relate to particular property of the grantor and their relinquishment tends to enhance its value in his hands.[17]

---

12. Commissioner v. Ray, 210 F.2d 390 (5th Cir.), *cert. denied,* 348 U.S. 829 (1954); Rev. Rul. 56-531, 1956-2 CUM. BULL. 983. The surrender of restrictive covenants for a consideration, unless part of the cancellation of the lease, is not covered by present § 1241. However, this section is not intended to be exclusive. S. REP. NO. 1622, 83d Cong., 2d Sess. 444-45 (1954).

13. Starr Bros. v. Commissioner, 204 F.2d 673 (2d Cir. 1953). This rule is also now confirmed by § 1241 but only in cases where "the distributor has a substantial capital investment in the distributorship." This section does not prevent other transactions from being considered sales or exchanges. Note 12 *supra.*

14. Milliken v. Commissioner, 196 F.2d 135 (2d Cir.), *cert. denied,* 344 U.S. 884 (1952). The court relied in part upon § 117(g)(2), Int. Rev. Code of 1939, ch. 1, 53 Stat. 52, which required that "gains . . . attributable to failure to exercise . . . options" be treated as short term capital gains. However, the legislative history of that section shows beyond cavil that the section was not intended to cover sales or exchanges of options. See Revenue Act of 1932, ch. 209, § 23(s), 47 Stat. 183; H.R. 7835, 73d Cong., 2d Sess. 23 § 117(e) (1934); H. REP. NO. 1385, 73d Cong., 2d Sess. (1934); 1939-1 CUM. BULL. (Part 2) 633. Observe that the same question may still arise under the corresponding provisions of § 1234(a) and (b) despite the extensive revisions made in 1954. See also Estate of Gordon A. Stouffer, 30 T.C. 1244, 1251 (1958), *rev'd on other grounds sub nom.* Marshman v. Commissioner, 279 F.2d 27 (6th Cir.), *cert. denied,* 364 U.S. 918 (1960), where the *Milliken* case, *supra,* was distinguished.

15. See, *e.g.,* Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir.), *cert. denied,* 357 U.S. 919 (1958); General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir.), *cert. denied,* 346 U.S. 866 (1953).

16. See notes 12 and 13 *supra.*

17. The cases cited in notes 12 and 15 *supra* are consistent with this rule. The *Milliken* case, note 14 *supra,* would appear to be out of line.