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The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests

KENNETH F. JOYCE AND LOUIS A. DEL COTTO *

Introduction

Reserved Economic Interest: The AB Transaction

A owns the fee in Blackacre, income producing real estate, and conveys the remainder therein to B while reserving a present interest in himself. To what extent, if any, is B subject to federal income tax on amounts received by A as rents from Blackacre? This question, and its variations, was addressed by the United States Supreme Court in the early oil and gas cases. The Court held in Thomas v. Perkins that amounts payable to A solely from the oil produced by the land were not to be included in B's income. In recent years, the same issue has again come before the courts in cases involving nonmineral interests. Although the result and reasoning of Perkins prevailed in some of the earlier cases, the later cases have either ignored Perkins or distinguished it as applying only to sales of depletable mineral interests in property. Indeed, in the area of mineral interests, Congress has reversed Perkins and codified the results of these later cases by the enactment in 1969 of section 636(b) of the Code, which treats A as selling the property and thus requires B to include the income. The same result obtains under section 1235 on a sale of a patent with a retained royalty interest. On the other hand, Congress has exhibited the same confusion as the courts by decreeing that B should not include the income where A and B have received their interests by gift or bequest (in trust or otherwise).

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1 See Anderson v. Helvering, 310 U.S. 404 (1940); Thomas v. Perkins, 301 U.S. 655 (1937); Palmer v. Bender, 287 U.S. 551 (1933).

2 301 U.S. 655 (1937).

3 See, e.g., McCulley Ashlock, 18 T.C. 405 (1952); Ruth W. Collins, 14 T.C. 301 (1950).

4 See, e.g., Comm'r v. Brown, 380 U.S. 563 (1965); Bryant v. Comm'r, 399 F.2d 800 (5th Cir. 1968); Alstores Realty Corp., 46 T.C. 363 (1966); Raymond L. Allen, 34 T.C.M. 242 (1975).

5 I.R.C. §§ 102(b)(2), 273, 1001(e).

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Despite the presence of the statutes and the cases which deny Perkins, the issue will not down. The propriety of taxing B on A's receipts raises the basic issue of what (and whose) income it is that is being taxed to B. This article will analyze this basic issue through a fundamental principle of income taxation: Amounts are includable in one's income only to the extent she/he in fact receives the economic benefit of such amounts. We shall also analyze through this fundamental principle the pertinent cases in the area, those dealing directly with the AB issue, such as Bryant v. Commissioner and Alstores Realty Corp., and those which are not so clearly perceived as AB cases but nevertheless raise the same issue, such as Commissioner v. Brown.

"Carved Out" Economic Interest: The BA Transaction

The same basic issue raised by the AB transaction is raised in the BA transaction, where B owns the fee in Blackacre, income producing real estate, and conveys a present interest to A for cash consideration, retaining a reversion in himself. Is this a sale by B, thus requiring A to report the income until B's reversion takes effect in possession, or is it to be treated merely as a loan from A to B to be repaid by B from the income produced by Blackacre and reported by B? This issue is implicit in Commissioner v. P.G. Lake, Inc., and Woodsam Associates, Inc. v. Commissioner, and is addressed in Estate of Stranahan v. Commissioner and J.A. Martin v. Commissioner. It will be analyzed in this article, again by applying the principle of whether B receives the economic benefit of the income received by A.

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6 In the recent case of Carr Staley, Inc. v. United States, 496 F.2d 1366 (5th Cir. 1974), this issue was unsuccessfully argued as a constitutional question.
8 399 F.2d 800 (5th Cir. 1968).
9 46 T.C. 363 (1966).
12 198 F.2d 357 (2d Cir. 1952).
13 472 F.2d 867 (6th Cir. 1973).
14 56 T.C. 1255 (1971), aff'd without opinion, 469 F.2d 1406 (5th Cir. 1972).
Preliminary Analysis of Legal and Economic Issues

At the outset we may conveniently set forth a few boundaries and a proposition we take as generally accepted:

(1) The issues with which we deal herein do not require an exhaustive analysis of the scope of the term "income" under the Internal Revenue Code or the sixteenth amendment to the Constitution. The concept of "realized gain" as it has developed will suffice for our purposes, although obviously the concept is not without its own problems.

(2) We are not required to present a comprehensive discussion of the sources of realized gain since the issues which concern us can be (and most often are) raised with reference to gain from income producing property, such as rental realty, stocks and business assets.\(^7\)

(3) We take as a generally acceptable and applicable proposition under the Code, if not the Constitution, that with respect to any given item of income producing property, a taxpayer is to be taxed only on the amount of realized gain which is attributable to his interest in that particular property.\(^8\)

To begin discussion, let us assume that A owns Blackacre, which is earning, and for the foreseeable future will continue to earn, an annual net ground rent of $10,000. The prevailing interest rate is 10 percent and Blackacre thus has, and for the foreseeable future will continue to have, a present value of $100,000.\(^9\) In fact, assume that A has just

\(^{15}\) This is not to suggest that similar issues do not arise with respect to gain from other sources, such as personal services or windfalls (e.g., prizes or found property).

\(^{16}\) See, e.g., Hoeper v. Tax Commission of Wisconsin, 284 U.S. 206, 215 (1931), where the Supreme Court held that the Wisconsin income tax statute requiring a husband to report on his own return the aggregate income of himself and his wife violated the due process and equal protection clauses of the Constitution, stating: "We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law."

In the course of the article we will have occasion to compare the issues referred to in our introduction with those raised in the assignment of income area where at least arguably an exception has been carved out by the courts and Congress to this general rule taxing a taxpayer only on the gain attributable to his property interest.

\(^{17}\) In order to make the calculations more simple and understandable, we have omitted any reference to depreciable improvements.

\(^{18}\) The figure of $100,000 is derived through the use of the formula:

\[ V = \frac{n}{i} \]

where \( V \) is the present value of property with a permanent net annual yield (\( n \)) of $10,000 where the interest rate (\( i \)) is 10 percent.
purchased Blackacre for $100,000. At the end of year 1, A receives $10,000 rent and Blackacre is still worth $100,000. The $10,000 rent, as we know, will be taxed to A in full as "income."

Why is A considered to have $10,000 realized gain? A typical answer might go something like this: At the beginning of year 1, A had $100,000 (Blackacre). At the end of year 1, A has $110,000 consisting of $10,000 rent and Blackacre worth $100,000. Moreover, the $10,000 rent is "realized," i.e., it has been separated from Blackacre and is not merely an increase in the market value of Blackacre. Such an answer, however, conceals the underlying economic realities and their tax treatment. In the first place, we know that A would be taxed on $10,000 regardless of whether he had moved, with respect to Blackacre, from a $100,000 position at the beginning of year 1 to a $110,000 position at the end of year 1. If, e.g., Blackacre was worth only $95,000 at the end of year 1, A would still be taxed on $10,000.

More important, even if we assume, as we have, that A has had an economic gain of $10,000 with respect to Blackacre in year 1, only a very small part (on our facts, 10 percent) of that gain can be attributed to the $10,000 rent paid to A for the use of Blackacre for year 1. To clarify this last proposition, let us assume that all that A had purchased was a one year term for years in Blackacre. On our facts, A would have paid about $9,000 for that one year term. Therefore, at the end of year 1 when A receives rent of $10,000, his economic gain would be only $1,000. Now, the only difference between the A who buys Blackacre and the A who buys only a one year term in Blackacre is that the A who buys Blackacre has bought a longer (potentially infinite) interest in Blackacre; i.e., the purchaser of the fee has purchased, in addition to year 1, the interest of year 2, et cetera, ad infinitum. But it is clear that the purchaser of the fee has in fact purchased year 1, and it is equally clear that the purchaser of the fee has paid about $9,000 for year 1 since that is its present value. It follows, therefore, that at the end of year 1, A, who has received $10,000 rent, has had the same amount of gain attributable to year 1, whether he has purchased the fee or only a one year term, i.e., $1,000.

There is no doubt, however, as stated at the outset, that the A who has purchased the fee will be taxed on $10,000, whereas the A who has

\[ P = \frac{n}{(1 + i)^t} \]

where \( P \) is the present value of $10,000 \((n)\) to be received one year \((t)\) from the present time where the interest rate \((i)\), expressed as a decimal, is 10 percent.
purchased the one year term will be taxed on only $1,000. Why is this so? The answer under the Code would be explained: The A who has purchased a fee has purchased a nonwasting asset. He is therefore unable to amortize any of his $100,000 cost to reduce his gain from the rent in year 1; i.e., the A who has purchased the fee is not allowed to offset his receipt ($10,000) from year 1 by what he paid ($9,000) for year 1. But the A who has purchased only year 1 is allowed under the principles (if not the letter) of section 167,20 to amortize his $9,000 and thus report only $1,000 because he has purchased a wasting asset.

Now, whatever be the merits of the rationale just stated and, indeed, wholly apart from the soundness of the resulting distinction in the tax treatment of wasting and nonwasting assets, the economic reality remains that the economic gain or what the economists might call the "net productivity" 21 attributable to the use of Blackacre for year 1 is only $1,000 whether the owner of year 1 owns only year 1 or also owns all the other years, i.e., the fee. In what way, then, can A who purchased the fee be considered to have $10,000 of gain at the end of year 1? Or, stating the question in another way, on our assumption that Blackacre is worth $100,000 at the end of year 1, what is the explanation of the fact that A has moved during year 1, vis-à-vis Blackacre, from a $100,000 position to a $110,000 position?

The tax explanation is that A (the one year term owner) is allowed a $9,000 amortization deduction, while A (the fee owner) is disallowed this deduction. Thus, the tax explanation would view the $9,000 difference as a distortion of fee owner A's taxable income. Economically, however, there is no distortion and A who owns the fee is properly taxed on $9,000 more. The economic source of this extra $9,000 is in all of Blackacre's years beyond year 1. In the language of the law of property, A who owns the fee simple in Blackacre can be correctly described, as of the beginning of year 1, as owning a one year term for years plus a remainder in fee simple.22 Using the figures of our example, at the beginning of year 1, A's one year term is worth about $9,00023 and his

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20 The principle of amortization of a shrinking or wasting interest in an intangible asset like a term for years is the counterpart of depreciation for the wear and tear of tangible assets.


22 The remainder in fee simple describes A's interest in all of Blackacre's years other than year 1. When a person like A, with such a remainder, also owns year 1, he is stated, simply, to own the fee simple.

23 See N. 19 supra.
remainder in fee simple is worth about $91,000. At the end of year 1, his one year term, now expired, has generated $10,000 and his remainder in fee simple, i.e., his interest in years 2 ad infinitum, is now worth $100,000. It is this increase in the value of his remainder in fee simple—from $91,000 to $100,000—which is the economic source of $9,000 of the $10,000 on which A is taxed as income. Given our factual assumptions, therefore, when A is taxed on $10,000, $1,000 is attributable to the increase in value of his year 1 interest from $9,000 to $10,000, and $9,000 is attributable to the increase in value of his remainder fee from $91,000 to $100,000.

The importance of the above analysis of A who owns Blackacre in fee simple lies in its implication for the analysis of the situations to which this article is addressed—i.e., situations which involve, by whatever route reached, a temporal division of ownership interests (i.e., “present” versus “future” interests) in Blackacre between or among more than one taxpayer. For example, using the same basic figures as before, suppose that C owns Blackacre which is earning $10,000 net annual ground rent and, at a prevailing interest rate of 10 percent, is worth $100,000. C conveys to A a two year term for years and conveys to B the remainder in fee. A pays C about $17,000 ($9,000 for year 1 and $8,000 for year 2) and B pays C about $83,000. At the end of year 1, A receives $10,000 rent.

At this point, the question asked is typically phrased as follows:

24 The more precise figure is $90,909.09 derived from the use of the formula set forth in N. 19 supra: 
\[ P = \frac{n}{(1 + i)t} \]
where P is the present value of $100,000 to be received a year from the present where the interest rate is 10 percent.

25 It should be noted again that A, the fee owner, will be taxed on $10,000 even if his remainder has not increased from $91,000 to $100,000. If, e.g., Blackacre has suffered market depreciation and is worth only $95,000 at the end of year 1, A will still be taxed on $10,000 if he receives this amount as net rent. By the same token A will not be taxed on any more than $10,000 even if Blackacre is worth more than $100,000 at the end of year 1.

26 The more precise figure for year 1 is $9,090.90 (see N. 19 supra). The more precise figure for year 2 is $8,264.46, derived through the formula set forth in N. 19 supra: 
\[ P = \frac{n}{(1 + i)t} \]
where P is the present value of $10,000 to be received two years from the present time where the interest is 10 percent.

27 The more precise figure is $82,644.63 derived through the formula set forth in N. 19 supra: 
\[ P = \frac{n}{(1 + i)t} \]
where P is the present value of $100,000 to be received two years from the present time where the interest rate is 10 percent.
"Should the net rents from Blackacre be taxed to A or B or to both in some proportion?" Such a question is misleading because, in light of the accepted result that where A owns the fee in Blackacre A is taxed on the full amount of net rents from Blackacre as income, it suggests that the income from Blackacre is to be identified only as the $10,000 rent from Blackacre, and that it is such rent that should be taxed either to A or B or both in some proportion. Proper inquiry should focus on the taxpayers, A and B, and elicit a response to the following: "To what extent, if any, does A (or B) have realized gain attributable to his property interest in Blackacre?" Or stated in another way: "To what extent have the property rights of A (or B), under state law, with respect to the use of Blackacre, given rise, over a given period of time, to realized economic benefit to A (or B)?" The focus, then, is not merely on the rents from Blackacre, but on all economic benefits which flow from Blackacre, including the increase in value of the remainder.

Looking first at A, the owner of the two year term, we see that he has received $10,000 in rent for year 1. Under our prior analysis, A's economic gain attributable to his interest in year 1 is $1,000 since he has paid $9,000 for that year's interest. In addition, A still has the right to receive $10,000 rent for year 2. More importantly, A's right to receive $10,000 at the end of year 2 is now (i.e., at the end of year 1) worth about $9,000—i.e., about $1,000 more than it was worth at the beginning of year 1. Thus, A's economic gain attributable to his property interest in Blackacre during year 1 is approximately $2,000, $1,000 attributable to year 1 and $1,000 attributable to the increase in value of his interest in year 2.

B has received none of the rent. He still, however, has his remainder in fee. More importantly, again, B's remainder is now worth approximately $91,000, i.e., about $8,000 more than it was worth at the beginning of year 1. Thus, B's economic gain attributable to his interest in Blackacre during year 1 is approximately $8,000.

To say, however, that A's economic gain for year 1 is $2,000 and B's economic gain is $8,000 is not to say that these amounts constitute realized gain or "income" to A and B in year 1. A's economic gain has two sources: (1) his receipt of $10,000 rent for year 1 and (2) the increase in value of his right to receive $10,000 rent for year 2. Under present law, A will be considered to have income only with respect to his receipt of the $10,000 rent and then only to the extent that this amount exceeds the amount which A paid for the right to the rent of year 1. A will thus have income of approximately $1,000 for year 1.26

26 In our example, A has bought a two year term for years for $17,000. Proper economic analysis indicates that A paid about $9,000 for year 1 and $8,000 for
A will not be taxed on the increase in value (approximately $1,000) of his right to receive $10,000 in year 2. It should be noted that this element of A’s gain is economically indistinguishable from the kind of gain which is taxed as accrued interest income on an original issue discount bond under section 1232 of the Code. Nevertheless, the principle of section 1232 is not applied by the Code to A’s situation and, in the absence of a specific statutory provision taxing this element of A’s gain, it will not be taxed in year 1. The economic gain of B in year 1 is precisely the same kind of gain as is involved in the second element of A’s gain; i.e., the increase in the value of B’s remainder is in the nature of original issue discount income, but is not reached by section 1232 or any other Code provision. It would seem, therefore, that it should escape taxation for the same reason or reasons which protect A from taxation on the second element of his gain.

Nevertheless, certain cases have required a taxpayer in B’s position to include in his income the amount of the rent paid to A for year 1 minus an amount equal to A’s economic gain for year 1. In terms of our example, this would require B to include in his income the $10,000 rent paid to A minus $2,000 (the measure of A’s economic gain for year 1). These cases, in other words, treat B as though he had bought the entire fee simple paying $83,000 down and $17,000 from the proceeds of a purchase money mortgage loan to be paid out of the 100 percent of the rent from the property for two years (i.e., $20,000). When the $10,000 rent is paid to A in year 1, it is treated as having been received by B as the owner of the fee (and thus his income) and as having been paid by B to A as an $8,000 payment on the principal of the loan and a $2,000 deductible interest payment on the loan of $17,000 in year 1.

What is crucial to note is that the effect of such cases is to tax B on the increase in value of his remainder interest for year 1, $8,000, and thus to increase the amount which is taxed as income from Blackacre year 2. For tax purposes, however, A will be allowed an allowance for amortization which is analogous to the straight line method of depreciation (without salvage value since A’s intangible asset, i.e., the two year term, wastes completely). Thus, A would probably be allowed an offset of only $8,500 rather than $9,000. For the purposes of our discussion in the text we have ignored this distortion.

29 Bryant v. Comm’r, 399 F.2d 800 (5th Cir. 1968); Alstores Realty Corp., 46 T.C. 363 (1966).

30 The $20,000 will include about $3,000 in interest (more precisely, $2,645) on the $17,000 principal of the loan (more precisely, $17,355).

31 More precisely, an interest figure of $1,736 on a loan of $17,355. Likewise, the payment of $10,000 to A in year 2 is treated as a payment by B to A of $9,000 principal (more precisely, $9,091) and interest of $1,000 (more precisely, $909).
from $1,000 to $9,000 ($1,000 to $8,000 to B). These cases have thus given section 1232 treatment to B, albeit unwittingly as we shall see, even though (1) that section only applies to original issue discount corporate bonds and (2) there is no statutory provision corresponding to section 1232 which would reach an "original issue discount remainder" such as B's. Moreover, in extending section 1232 treatment to B, these cases have resulted in discrimination between a taxpayer like B in our example who has an original issue discount remainder in fee and a taxpayer like A in our situation who has an original issue discount remainder for a term of years. It will be recalled that although A's economic gain at the end of year 1 was $2,000, A is taxed only on $1,000 due to $10,000 rent paid to him at the end of year 1. A is not taxed on the $1,000 increase in value for year 1 of his remainder interest, i.e., his right to receive $10,000 at the end of year 2. Yet, as we have pointed out, this element of A's gain is indistinguishable from the $8,000 gain in B's remainder in fee, and there would thus seem to be no justification for taxing B on the increase in value of his remainder interest if A's identical gain is not also taxed.

In order to determine the propriety of the recent decisions which have taxed B on the increase in value we will analyze the development by the Supreme Court of the income tax theory applicable to temporally di-

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22 It should be noted that if there were an actual loan transaction A would be required to report $2,000 as income, and thus $10,000 in the aggregate would be reported by A and B as income. Indeed, in such a transaction, even if interest is not stated, the theory of section 483 is to require a pro rata inclusion by A and deduction by B. (Cf. Example 4 of section 1.483-1(d)(4) of the regulations, where, in a stated interest situation, the interest is not prorated but is treated (in terms of our example) as paid 1 in year 1 and 2 in year 2.)

Where, however, as in our example, no actual loan has been made by A to B and A has merely purchased years 1 and 2 from C, the situation from A's point of view is no different from one where A purchased year 1 for $9,000 and another party purchased year 2 for $8,000. In such a case, no matter how B is treated, A would only have $1,000 of taxable income on receipt of $10,000 for year 1.

23 Indeed, there was a long standing dispute, prior to the 1969 amendments to section 1232, as to whether the original issue discount of a bond was taxable to even an accrual basis taxpayer prior to sale or redemption of the bond. See United States v. Midland-Ross Corp., 381 U.S. 54 and n.4 (1965). For a history of the dispute see the opinion of the district court in 214 F. Supp. 631 (N.D. Ohio 1963) (Kalbfleisch, J.). And see Dixon v. United States, 381 U.S. 68 and n.1 (1965). See also the opinion of the district court in Dixon, 224 F. Supp. 358, 365 (S.D.N.Y. 1963).

24 Nor is it an answer that A will be required to report this element of his gain when he receives the $10,000 rent at the end of year 2, for if B were not taxed on the increase in value of his remainder interest in year 1 or year 2, he likewise would be taxed on such gain if and when he disposed of the fee simple.
vided (present versus future) interests in income producing property. We shall also consider those provisions of the Code through which Congress has spoken to the problem at diverse times and in discrete areas. Finally, we will consider the propriety of taxing $B$ on the increase in value of his remainder in light of the method of taxation accepted by the courts and the Congress where there is no temporal division of interests, i.e., where the fee to Blackacre is owned by a single taxpayer.

**Genesis of Economic Benefit (or Risk) Analysis**

**Burnet v. Whitehouse**

In the 1931 decision of *Burnet v. Whitehouse*, the Supreme Court held a legatee of a fixed dollar annuity, payable in all events, was not an income beneficiary of the estate since the payment of the annuity did not depend on the presence of income. Thus, according to the Court, the annuitant had nothing to lose from the absence of income—had no risk of loss with respect to income—hence received no economic benefit from it, and could not be taxed as a recipient of income. Although couched in different terms, the risk analysis corresponds exactly to the economic benefit analysis set forth above. In other words, the presence of economic benefit depends upon the presence of risk of loss, and is a direct function of such risk. One is the economic owner (beneficiary) of an item only if it is his not only to receive, but also to lose if it fails to materialize. Thus, in *Whitehouse*, the recipient of a trust annuity had no economic interest in trust income, and could not be taxed on trust income despite the fact that his annuity was satisfied from trust income. Since the annuity was also a charge on trust corpus, to the extent corpus was present the annuity did not depend on the presence of income and hence bore no risks with respect to income. Hence, the annuitant was the economic beneficiary only of corpus, and it was the remainderman who bore the risks of income, and who, therefore, was the income beneficiary in the economic sense.

*Whitehouse*, then, can be seen as involving an AB situation with the named trust remainderman recast as $A$, the income beneficiary, and the annuitant recast as $B$, the beneficial owner of the remainder interest. It was as though the testator had bequeathed Blackacre, value $100,000, to the annuitant, $B$, to be paid at the end of one year, with the annual rentals from Blackacre ($10,000) to be paid to $A$ at year's end. At

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testator's death, therefore, B had the right to receive $100,000 at the end of one year. This right was worth about $91,000. A's right at testator's death was to receive $10,000 at the end of one year. This right was then worth about $9,000. When, at the end of one year B received Blackacre, value $100,000, and A received $10,000 of rents, B had economic gain of $9,000 and A had economic gain of $1,000.

In Whitehouse, the controlling statute provided that a bequest of property was exempt from income tax, but that income from property was not exempt. The Court had already decided, in Irwin v. Gavit,\textsuperscript{29} that the statute did not exempt a bequest of an income interest in property even though such a bequest had a present value (and hence could be viewed as property). Thus, Gavit taxed A on his gain from the receipt of $10,000 in rentals. B, however, was seen as having received only exempt property, not income from property, and so had no taxable income. This result for B is analytically supportable for the value of Blackacre when inherited by B, i.e., $91,000. This was exempt property within the statute and so was not taxable income to B. Also not taxed to B, however, was the $9,000 increase in value of Blackacre for the year. The Court did not discuss this issue. The $9,000 gain to B appears to have been either unperceived by all, or not seen as an item of taxable income.

The proper treatment of this item to B—including the effect of sections 102, 273, 1014 and 1015 where B takes by gratuitous transfer—is, of course, the major burden of this article and will be developed in the ensuing discussion. Suffice it to say at this point that Whitehouse refused to tax B, the annuitant (remainderman), on amounts of income (rentals) as to which A alone bore the risk of loss.

\textbf{Palmer v. Bender and Thomas v. Perkins}

The connection between economic benefit and risk of loss was again made by the Court when it turned to the question of allowance of the depletion deduction in the oil and gas cases. In Palmer v. Bender,\textsuperscript{27} A was the lessee under oil and gas leases and assigned his interest to B, receiving a cash bonus and retaining both a production payment and an overriding royalty. The Commissioner refused to allow depletion deductions to A on the ground that A had sold his interest in the assigned leases and therefore no longer owned any interest in the oil.\textsuperscript{35} The Court,

\textsuperscript{29} 268 U.S. 161 (1925).
\textsuperscript{27} 287 U.S. 551 (1933).
\textsuperscript{35} Id. at 554.
however, held for the taxpayer stating that the depletion allowance "does not depend upon his retention of ownership or any particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so, he has an economic interest in the oil in place, which is depleted by production." 

The Court's emphasis is upon the retained production payment as the vehicle for A's recovery of his capital. A necessary corollary of this emphasis is that lack of, or an insufficient amount of, oil production would result in A losing part or all of his capital investment. Thus, A has not sold his interest because he has retained the risk of loss of his capital. The Court alluded to this risk: "The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting . . . a reasonable allowance for depletion . . . ." 

Palmer, and cases which later refined its principle, 

established the basic principle that retention of the risks of production was the retention of an economic interest. In terms of Whitehouse, that retention of the risk of loss from nonproduction of oil identifies the economic beneficiary of the income from oil production.

The holding of Palmer—that A was entitled to the depletion allowance—was applied in Perkins to prevent taxation of B on amounts received by A from oil production. A had owned oil and gas leases on undeveloped lands and had assigned the leases to B for $155,000 in cash and notes and a $395,000 production payment to be paid to A solely from oil produced, without any personal liability on the part of B. The Commissioner included in B's income amounts paid to A in discharge of the production payment and allowed B depletion on those amounts.

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30 Id. at 557. An additional requirement imposed by the Court was that the taxpayer have acquired his interest in the oil by investment. Ibid. There has been much litigation on the meaning of this requirement. See Helvering v. Bankline Oil Co., 303 U.S. 362 (1938); Scofield v. La Gloria Oil & Gas Co., 268 F.2d 699 (5th Cir. 1959), cert. denied, 361 U.S. 933 (1960). Compare Comm'rs v. Southwest Exploration Co., 350 U.S. 308 (1956); Coleman v. United States, 388 F.2d 337 (Ct. Cl. 1967); Tidewater Oil Co. v. United States, 364 F.2d 393 (Ct. Cl. 1966), cert. denied, 386 U.S. 981 (1967); CBN Corp. v. United States, 328 F.2d 316 (Ct. Cl. 1964). There is no need for this article to discuss this problem since we are not concerned with A being allowed the depletion allowance, but only an allowance for any cost he has in the property.

31 287 U.S. at 558.


33 301 U.S. 655 (1937).
The Court held that the assignment from A to B did not transfer the oil in question; ownership of the oil remained with A under Palmer. Hence, A included the production payment as income, subject to a depletion allowance, and no part of A's receipts were chargeable to B.

The reasoning of the Court in Perkins expressly made the tax result for B turn directly upon the tax consequences to A.\(^3\) Since A's production payment was a reserved interest in the oil, A did not sell and B did not buy that oil, and the income is A's, not B's. In short, A is viewed as having retained an ownership interest in the value of the property represented by the production payment, and as having sold the remainder of the property, payment for which is not dependent upon production.\(^4\) These are, of course, the ingredients of the classic ABC transaction whereby A could sell the remainder to B and the production pay-

\(^3\) The dissent in Perkins by Justices Stone and Cardozo argued that the income was B's, and that the tax consequences to A, i.e., the issues of capital gains and depletion, were irrelevant to the issue of how to tax B. 301 U.S. at 663. The position of the dissent is interesting in that it seems to deny the existence of a relationship between what interest A has sold and that which B has purchased. Or, perhaps the dissent viewed the transaction as a sale by A of his entire interest in the oil, with the retained production payment essentially equivalent to a purchase money mortgage lien on the production income. See Hambrick, Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction, 34 GEO. WASH. L. REV. 1 (1965). This latter view is the one eventually adopted by Congress in 1969 when it enacted section 636(b) of the Code.

\(^4\) Perkins did not deal with the issue of whether A had engaged in a sale of the portion of his interest for which he received the down payment of $155,000 in cash and notes. In Palmer the Court had held that both a retained production payment and the cash bonus were retained economic interests, subject to the depletion allowance. Also, in Burnet v. Harmel, 287 U.S. 103 (1932), the Court denied capital gain treatment to a cash bonus received by the lessor of an oil and gas lease. Because of the heavy reliance placed upon Palmer, the Court in Perkins, although it discussed only the oil payment, may well have considered the cash bonus also to be controlled by Palmer. But, this is not an entirely fair reading of Perkins because in both Palmer and Burnet v. Harmel, the assignor had not only received a cash bonus, but also had retained an overriding royalty measured by production over the life of the lease, while in Perkins no such royalty interest was retained. When the issue was raised squarely in the lower courts, where no overriding royalty was retained by A it was held that the cash payment was received by A for an interest sold, hence, the cash was not subject to depletion, while the production payment was an interest reserved by A for which the depletion allowance was proper. Palmer and Burnet v. Harmel have been distinguished on the ground that lack of an overriding royalty prevented treatment of the cash as an advance royalty or bonus. Comm'r v. Cullen, 118 F.2d 651 (5th Cir. 1941); Columbia Oil & Gas Co. v. Comm'r, 118 F.2d 459 (5th Cir. 1941); Hammonds v. Comm'r, 106 F.2d 420 (10th Cir. 1939); Comm'r v. Fleming, 82 F.2d 324 (5th Cir. 1936). See also G.C.M. 22730, 1941–1 C.B. 214, 217, 224. Cf. MacLean v. Comm'r, 120 F.2d 942 (5th Cir. 1941). The net result of this interpretation of Perkins is that B is not taxable on the income received by A in discharge of the production payment: A gets exchange gain from the sale of the
ment to C, at capital gains. C has no net income beyond interest and B will eventually acquire the fee without having been taxed on the production payment. Most importantly, although under Perkins B cannot be taxed on A’s income, neither, as in Whitehouse, was B taxed on his own economic gain, i.e., the annual amount of the increase in value of his remainder interest due to the passage of time. Again, this issue was not discussed by the Court.

**Erosion of Economic Benefit (or Risk) Analysis**

**Clay Brown Case**

In *Commissioner v. Brown*, A owned stock in a corporation which operated a lumber milling business. He conveyed the stock to B, a tax-exempt charity, in return for $5,000 down from the assets of the corporation and B’s promise to pay him $1.3 million solely out of 72 percent of the operating profits of the business, without personal liability. The obligation to pay was secured by a mortgage on the corporate assets. The agreement between A and B also provided that B would liquidate the corporation and lease its assets to an operating company (Fortuna Sawmills, Inc.) and that A was to be employed by Fortuna under a management contract.

The pertinence of *Clay Brown* to this article lies mainly in the Court’s analysis of Perkins and *Anderson v. Helvering*. 4

**Commissioner’s Argument**

The Commissioner initially argued before the Supreme Court that the liquidation of the corporation should be disregarded and that the trans-

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45 This, of course, is aside from depreciation recapture provisions such as sections 1245 and 1250.


action should be recast as a transfer by A of his corporate stock in exchange for notes of $1.3 million and B's obligation to remit to A 72 percent of all dividends paid on the stock in payment of the notes, with the stock pledged to secure payments on the notes. The Commissioner argued in the alternative that if the corporate liquidation was to be given tax effect, then the liquidation was (1) a tax-free liquidation to B under sections 332 and 501 (c) (3), which changed A's interest from a retained interest in corporate stock to an interest in corporate assets, acquired in a nontaxable transaction and hence still retained; or (2) under the step transaction doctrine, since the liquidation was a preplanned part of an integrated transaction, the whole transaction amounted to a liquidation of the corporation by A (requiring him to recognize his capital gains immediately under section 331 and acquire a fair market value basis in the assets under section 334(a)) and a conveyance of the assets to B in return for 72 percent of the income from the assets.

Whatever view is taken as to the substance of the transaction, argued the Commissioner, the amounts received by A after the liquidation are due to a retained interest in the assets and hence are ordinary income, subject to basis offset by way of amortization of basis in a wasting asset.

This argument proceeds, of course, from Perkins. Since A has the risk of loss with respect to the assets producing sufficient income to discharge the note, A necessarily has not sold the assets but has merely retained the income interest up to $1.3 million and conveyed only the remainder beyond $1.3 million. Hence, B cannot be taxed on such income as it gives him no economic benefit and A must be taxed on these amounts as ordinary income, subject to amortization.

The Commissioner also argued that the $1.3 million purchase price was presumptively in excess of the fair market value of the stock conveyed in order to compensate A for retaining the risk of loss, but not so excessively high as to invoke the no sale result of Kolkey v. Commis-

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48 Brief for Petitioner at 29, Comm'r v. Brown, 380 U.S. 563 (1965). The purpose of so recasting the transaction, argued the Commissioner, was to disregard the liquidation of the corporation by B and the transfer of the assets to Fortuna as irrelevant to the transaction since the sole function of those events was to eliminate the corporate income tax on the original corporation, obtain a rent deduction for Fortuna and utilize B's tax-exempt status. Brief for Petitioner at 28.

49 Reply Brief for Petitioner at 24.

50 Id. at 21–24.

51 Id. at 12–20.

52 Brief for Petitioner at 43.

53 Id. at 43–49; Reply Brief for Petitioner at 14–18.

54 Brief for Petitioner at 30–38.
Thus, argued the Commissioner, A not only has retained the risk of loss up to the fair market value of the stock conveyed, but has also retained the right to share in income production or appreciation of the stock in the future, i.e., beyond the fair market value of the stock.\(^5\)

**Opinion of the Court**

The Supreme Court effectively defused the Commissioner's argument with respect to excessive purchase price by relying on the Tax Court's finding that the price was within "reasonable limits based on the earnings and net worth of the company," and on the failure of the Commissioner to offer proof on the point.\(^7\) But if we assume the Commissioner was correct with regard to his suggestion of an excessive price, what are the merits of this argument? If the point is that gain from the sale of an asset is limited to appreciation present in the asset at the time of the sale,\(^8\) then only so much of the gain as is attributable to an excessive purchase price can be seen as not arising from the sale of the asset. To argue, on this ground, that all of the gain arises from a retained interest is a clear case of overkill. Perhaps sensing this, the Commissioner abandoned his argument about excessive price in his reply brief,\(^9\) a fact not alluded to by the Court, and relied only on the risk of loss notion of Perkins.\(^6\)

The response of the Court to Perkins was essentially twofold. The first response is very difficult to discern. Justice White began by reiterating a previous statement of the Court that "Congress . . . has recognized the peculiar character of the business of extracting natural resources."\(^61\)

But the essence of the Court's first response apparently is to be found in the curious juxtaposition of the following two sentences:

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\(^5\) 254 F.2d 51 (7th Cir. 1958); see Brief for Petitioner at 33, Comm'r v. Brown, 380 U.S. 563 (1965).

\(^6\) Brief for Petitioner at 36–38.

\(^7\) 380 U.S. at 573. The Court also referred to the fact that the charity's income tax exemption permitted a faster payout, although the Court did not show the connection between this fact and the possibility of an excessive price. As we will see, the higher payout permits a higher price than a taxable buyer could pay. But, as we will also see, a seller in such case may trade some or all of such excess in price for a faster payout, which is apparently what happened in Clay Brown.


\(^9\) Reply Brief for Petitioner at 7–12.

\(^6\) Id. at 8–9.

\(^61\) 380 U.S. at 575.
ANALYSIS OF INCOME INTERESTS

Percentage depletion allows an arbitrary deduction to compensate for exhaustion of the asset, regardless of cost incurred or any investment which the taxpayer may have made. The Commissioner, however, would assess to respondents as ordinary income the entire amount of all rental payments made by the Institute, regardless of the accumulated values in the corporation which the payments reflected and without regard for the present policy of the tax law to allow the taxpayer to realize on appreciated values at the capital gains rates.62

This first response seems really to consist of two points. One is that in the oil cases the taxpayer is allowed a tax-free recovery beyond cost by the allowance for percentage depletion, whereas the Commissioner is trying to tax the taxpayer in *Clay Brown* without allowing any cost recovery. But this is clearly a misstatement since the Commissioner, as pointed out in the opinion of the Tax Court,63 was trying to tax only the amounts above the basis of the stock, allowing amortization of such basis against the payments received.

The serious point of this first response seems to be that the Commissioner’s position violates “the policy of the tax law to allow the taxpayer to realize on appreciated values at the capital gains rates.”64 But this is surely question begging by the Court since a taxpayer may clearly realize on appreciated value and still be taxed at ordinary income rates. If, e.g., A buys Blackacre (for $100,000) with an annual rental value of $10,000, and the rental value appreciates over the years to $20,000, the value of Blackacre thus appreciates from $100,000 to $200,000, and if A continues to rent at $20,000 he will be taxed on the entire amount as ordinary income “regardless of the accumulated [value] which the payments reflected.”65

The question begged by the Court was whether there had been a “conversion of a capital investment.”66 As the Court had said in *Anderson*, quoted often by Justice White in *Clay Brown*:

The sole owner and operator of oil properties clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his capital. See *Burnet v. Harmel*, supra, at 107–108; *Helvering v. Clifford*, 309 U.S. 331. By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situ-

62 *Id.* at 576.
63 37 T.C. 461, 482 (1961).
64 380 U.S. at 576.
65 *Ibid*.
ation the reasons for the depletion allowance. "The words 'gross income from the property,' as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves." Helvering v. Elbe Oil Land Co., 303 U.S. 372, 375–376.67

Thus, the two points made by the Court in its first response to Perkins will not really stand analysis. The second response, however, is worthy of more attention: That response, stated simply, was that Anderson dictates sale treatment for Clay Brown because there was a mortgage on the property sold. As the Court states: "The respondent in this case, of course, not only had rights against income, but if the income failed to amount to $250,000 in any two consecutive years, the entire amount could be declared due, which was secured by a lien on the real and personal properties of the company."68

Anderson v. Helvering

Suppose A owns Blackacre, value of $100X, and A sells to B only a remainder interest, A reserving the right to the first $20X of rents, which right has a value of $17X. B pays A $83X for the remainder. Under Perkins, B will not include rents received by A during the two year term and B's basis in his interest remains at $83X. If, however, B gives A a mortgage pledging his remainder interest as security for A receiving the first $20X of rents, Anderson holds that B must include the $20X rents in his income.69 A no longer has the risk of loss with respect to the $20X of rents—i.e., A is not solely dependent upon the rents in order to be paid $20X, hence, A has sold to B the entire fee for $100X plus $3X of interest, and B gets the economic benefit of the $20X paid to A from rentals. Why does the presence of the mortgage on B's remainder interest change the result of Perkins and give B the benefit of payments received by A? Because the payments received by A remove the burden of an obligation encumbering B's separate property70 (the remainder interest), hence, they enrich B by the amount of the payments. The situation is the same, says Anderson, as if B had pledged his own personal liability to make the payments to A.71 The rentals received by A benefit

67 310 U.S. at 408–409.
68 380 U.S. at 577 (footnote omitted).
69 310 U.S. 404 (1939). $17X presumably would increase B's basis in Blackacre to $100X and $3X would be deductible by B as interest.
70 See discussion in Christie v. United States, 436 F.2d 1216, 1220–221 (5th Cir. 1971); cf. Standard Oil Co. (Ind.) v. Comm'r, 465 F.2d 246 (7th Cir. 1972).
71 310 U.S. at 413.
B by discharging his liability and freeing up the value of his separate assets.

So viewed, Anderson is simply an application of the principles of Crane v. Commissioner²² (on sale of property subject to a mortgage, the face amount of the mortgage is part of the transferor’s amount realized), United States v. Kirby Lumber Co.²³ and Old Colony Trust Co. v. Commissioner²⁴ (the discharge of one’s obligation is equivalent to receipt by the obligor). These tax benefit principles are viable, however, only to the extent that B has assets of his own which are burdened by the obligation to pay A $20X in rentals. If the security provided by B is $20X of escrowed cash, or property other than Blackacre with a value substantially above $20X, then there is a clear burden on B’s cash or other assets which is removed by payment of the rents to A. There is no reason to treat such cases differently from a sale by A to B for $100X in cash or property, with B then keeping 100 percent of the rentals for himself. When, however, the security provided by B is a mortgage on the remainder in Blackacre, the very same property conveyed by A, without any personal liability on B for the $20X, does a different result obtain? The Court was faced with, and decided, this precise problem, in Anderson. There, A reserved the right to receive (to use the numbers of our example) $20X payable from oil produced by the oil properties sold to B. A also retained a “first lien and claim against [the] ‘oil and gas production and fee interest . . . from which the [$20X] was payable.’”²⁵ One of the arguments relied on by the government for the proposition that there had been a sale was that “[A] had a first lien and claim against . . . the oil and gas production and fee interest.”²⁶ As an example of “[s]everal of the distinctions urged upon us by the Government [which] are without substance,” the Court stated “[t]he retention of a lien, if it were construed as a lien only upon the oil and gas production, and nothing more, would not make [A] any the less dependent upon such production for the amounts reserved.”²⁷ But, said the Court:

The reservation of an interest in the fee, in addition to the interest in the oil production . . . materially affects the transaction. [A] is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. . . . We are of

²² 331 U.S. 1 (1947).
²³ 284 U.S. 1 (1931).
²⁴ 279 U.S. 716 (1929).
²⁵ 310 U.S. at 406.
²⁶ Id. at 411.
²⁷ Id. at 412 (footnote omitted).
opinion that the reservation of this additional type of security for the deferred payments serves to distinguish this case from Thomas v. Perkins. It is similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall at all events equal the specified sum. . . . In the interests of a workable rule, Thomas v. Perkins must not be extended beyond the situation in which, as a matter of substance, without regard to the formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas. The deferred payments reserved by [A], accordingly, must be treated as payments received upon a sale to [B].”

In other words, where B, by paying something down, has purchased a remainder interest and has pledged the entire fee as security for payment of the amounts to be received by A, B has burdened separate property of his own (the remainder) and the income payments received by A remove the burden of such obligation and thus are to be considered as B’s income from the property and payments to A from the sale of the property. The fact that the burden is on a remainder (fee) interest in the same property in which the present interest is retained does not make it any less a burden on B’s separate property.

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78 Id. at 412–13 (emphasis added).
79 Where the only separate asset mortgaged is B’s remainder the income still benefits B, even if after payment to A the principal of the debt remains larger than the value of B’s remainder, since the income used to pay off part of the debt has decreased the burden on B’s remainder. As is indicated in Anderson (where a remainder purchased for $50,000 secured a debt of $110,000), it is not necessary that the remainder mortgaged be equal to or greater than the amount of the debt. Otherwise, such a transaction would constitute a sale only if there were the equivalent of a 50 percent or higher down payment.

It would, however, appear logically necessary that the remainder mortgaged have some independent value to B since otherwise it is hard to see how B could be benefitted by the removal of a decreasing burden on such an interest or how A could be said to have a meaningful security interest. In fact, a refined analysis would require that each time an income payment was made to A, B’s remainder be valued and A’s payment be considered income to B only to the extent of the value of B’s remainder at that time. In this respect, however, it is important to recall that Anderson distinguished Perkins with the following statement: “In the interests of a workable rule, Thomas v. Perkins must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas.” 310 U.S. at 413. This is tantamount to saying that where a mortgage is retained on the (remainder in) fee of the property sold, some value in the remainder will be presumed, thus, only where the price clearly exceeds the fair market value of the property will the lien or the fee be disregarded and sale treatment refused. See, e.g., Kolkey v. Comm’r, 254 F.2d 511 (7th Cir. 1958), where, as the Supreme Court in Clay Brown characterized it, “the price was considered grossly excessive and the transaction a sham.” 380 U.S. at 574 n.7.

Similar principles are applied where the sale question arises in the context of whether to include an unassumed mortgage in basis for the purpose of deprecia-
Nor is it relevant that the failure of A’s present interest to generate the reserved payments ($20X in our example) may be reflected in a diminution of A’s security in B’s remainder. Such a possibility differs only in degree from the situation where A receives a security interest in assets other than those conveyed, since A always bears the risk that all of B’s assets could become worthless.

Relationship of Anderson v. Helvering to Clay Brown

In his concurring opinion in Clay Brown, Justice Harlan made the following comment:

The force underlying the Government’s position is that the respondents did clearly retain some risk-bearing interest in the business. Instead of leaping from this premise to the conclusion that there was no sale or exchange, the Government might more profitably have broken the transaction into components and attempted to distinguish between the interest which respondents retained and the interest which they exchanged. The worth of a business depends upon its ability to produce income over time. What respondents gave up was not the entire business, but only their interest in the business’ ability to produce income in excess of that which was necessary to pay them off under the terms of the transaction. The value of such a residual interest is a function of the risk element of the business and the amount of income it is capable of producing per year, and will necessarily be substantially less than the value of the total business.”

These observations not only properly characterize the Clay Brown transaction but also permit us to discuss it in terms of our AB hypothetical analyzed previously. In terms of that example, the charity in Clay Brown is B, Clay Brown is A and the stock is Blackacre, worth $100,000. A has conveyed to B a future interest (remainder in fee) in Blackacre and has retained a present interest, i.e., the right to be paid $100,000 from the rent of Blackacre with interest on the outstanding

See Crane v. Comm’r, 331 U.S. 1 (1947); David F. Bolger, 59 T.C. 760 (1973); Mayerson, 47 T.C. 340 (1966); Rev. Rul. 69-77, 1969-1 C.B. 59 (acquiescing in Mayerson “on the particular facts” and indicating that the Service will disallow depreciation where “the transactions were designed to create or inflate depreciation deductions”).

The workable rule applied in the above contexts is a practical necessity since its alternative would require the continuous investigation of the sufficiency of all security in credit sales, with or without personal (i.e., general asset) liability. Although such a rule may have some logical support, its practical problems are prohibitive. Moreover, such a rule would logically lead to further rules equally impractical, e.g., the owner of a fee simple could be taxed on the rent from such property only if the fee maintained its value so that the rent was an accurate measure of the gain.

380 U.S. at 580–81.
balance. Now if we assume, as in prior hypotheses, that Blackacre has, and will continue to have, an annual rent of $10,000, it becomes apparent that B’s remainder is worth nothing at the beginning of year 1 and will continue to be worth nothing at the end of year 1. This is because, at the assumed prevailing interest rate of 10 percent, the rent will exactly equal the interest due on the outstanding balance, thus, B’s future interest (the remainder) will not have made any advance toward becoming a present interest, i.e., it will not have increased in value.

However, the charity in the Clay Brown case, although it paid nothing down for its future interest, was in a different position from B in our hypothetical because it was a tax-exempt B. Thus, it was able to make payment of the purchase price in larger amounts than a taxable B. Assume, e.g., that Blackacre, worth $100,000, has pretax annual income of about $20,000. If B is not taxed on that $20,000 because B is tax exempt, the full $20,000 may be paid to A instead of, say, only about $10,000 after corporate income tax. Thus, the tax-exempt B can afford to pay a higher price than a taxable B. Theoretically, B could afford a price of $200,000, but, in such case, if the property continued to yield $20,000 net rent, the remainder of even a tax-exempt B would be worth nothing at the outset and continue to be worth nothing because the rent would only meet the interest payment. If, on the other hand, the tax-exempt B were to pay only the same price as a taxable B, i.e., $100,000 (at 10 percent interest), it would, at $20,000 a year, be able to pay that amount in about seven years. Stated another way, B at the very outset would have the right to get the property in about seven years and

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81 In Clay Brown the charity was to keep 8 percent of the profits and the operating company was to keep 20 percent of the profits. To that extent, therefore, Clay Brown had transferred present interests. For our purposes, however, we can ignore those facts and presume that Clay Brown was to be paid out of 100 percent of the profits.

82 If we presume a permanent return of $10,000 and a permanent interest rate of 10 percent, B’s remainder will always be worth nothing, using the formula (see N. 19 supra):

\[ P = \frac{100}{(1 + .1)^\infty} \]

Although the parties’ agreement called for a $5,000 down payment, such down payment was to be made out of the assets of the business. Thus, there was really no down payment forthcoming from the charity, rather, $5,000 was merely withheld from the sale.

84 Generalizing, on the assumption of a continuing level of rent and continuing rate of interest, the lower the price (i.e., the closer the price to that which a non-exempt buyer would pay ($100,000)), the shorter the payout period at $20,000, the higher the price, the longer the payout period.
would thus at the outset have the equivalent of a remainder in fee worth $100,000.\textsuperscript{85}

What does this say with respect to the relationship of \textit{Anderson} to \textit{Clay Brown}? First of all, it seems clear that the tax-exempt charity in \textit{Clay Brown} did have, from the outset, a remainder of some value. This can be inferred from the finding that the negotiated price was within a reasonable range combined with the faster payout due to the income tax exemption of the charity. As Justice Harlan pointed out in his concurring opinion: “The Code gives the Institute a tax exemption which makes it capable of taking a greater after-tax return from a business than could a non tax-exempt individual or corporation. Respondents traded a residual interest in their business for a faster payout apparently made possible by the Institute’s exemption.”\textsuperscript{86}

Since the taxpayers in \textit{Clay Brown} had a mortgage lien on the real and personal properties of Clay Brown and Company and since that lien extended not just to the production of $1.3 million of those properties, but, as in \textit{Anderson}, extended as well to the fee interest in such properties, the lien thus covered the residual or remainder interest which the charity had from the outset.

If this is so, was not \textit{Clay Brown} merely an application of the rule established in \textit{Anderson} that a sale occurs when the risk of loss has been shifted by virtue of the seller’s ability to realize payments on the purchase price from an independent asset of the buyer? Using the figures of our hypothetical, in year 1 when $20,000 of rents are paid to A from \textit{Blackacre}, shouldn’t that be considered income to B under \textit{Anderson} and \textit{Whitehouse}, since it benefits B by preserving B’s independent asset, \textit{i.e.}, the remainder? Conversely, should not the $20,000\textsuperscript{87} paid to A be

\begin{align*}
\text{\textsuperscript{85}This figure comes about by the modification of one of the variables in the normal discount formula where a tax-exempt entity is involved. If, as we have assumed, Blackacre will continue to have pretax rent of $20,000 and the interest rate will continue to be 10 percent, then the value of Blackacre to a tax-exempt entity is $200,000 (see application of formula}
\end{align*}

\begin{equation}
V = \frac{n}{i}
\end{equation}
in N. 18 \textit{supra}). \text{Thus, using the discount formula applied in N. 19 \textit{supra}}

\begin{equation}
\left( P = \frac{n}{(1 + i)^t} \right)
\end{equation}

where \( n = 200,000 \), then

\begin{equation}
P = \frac{200,000}{(1 + i)^7}
\end{equation}

\begin{equation}
\approx \text{approximately $100,000.}
\end{equation}

\begin{equation}
\text{\textsuperscript{86}380 U.S. at 580.}
\end{equation}

\begin{equation}
\text{\textsuperscript{87}An interest payment would be $10,000, \textit{i.e.}, 10 percent of the outstanding balance of $100,000 for year 1.}
\end{equation}
considered payment from the sale since $A$ is not solely dependent on
the earnings of the property for the payment of the $20,000, having an
additional source, i.e., $B$'s remainder, as in Anderson?

The answer to all of these questions is affirmative when the value of
the remainder is measured only by its value to a $B$ which is exempt from
taxation, in this case, $100,000$. The importance of Anderson, how-
ever, lies in measuring the value of the remainder as security to $A$ and,
on our facts, immediately after the conveyance, the value of the remain-
der as security to $A$ would be zero because its value to a nontax-exempt
buyer would be zero. However, this would be only a temporary phe-
nomenon, because after $A$ receives $20,000 of income in the first year,
the principal due $A$ would be reduced to $90,000 and the remainder
would have a value even to a nontax-exempt buyer.88

Viewed in the above fashion, Clay Brown involves a continuation,
not a rejection, albeit perhaps some erosion, of the risk benefit theory
of Anderson.

Effect of Clay Brown on AB Transaction

In General

Clay Brown, then, is properly analyzed as a conveyance of a remain-
der interest from $A$ to $B$, with $A$ reserving a production payment secured
by a mortgage on the remainder. So viewed, the risks of payout to $A$
are borne by $B$ to the extent of the value of the remainder, and Clay
Brown is supported by Anderson. The lower courts, however, have not
clearly perceived Clay Brown as an AB case with a mortgage and have

88 Suppose, however, that the price were $200,000 to a tax-exempt buyer, prin-
cipal and interest to be paid with $20,000 a year. In such a case, a remainder
of value to the tax-exempt buyer would be created if the price carried an interest
rate lower than the earning rate of the property (e.g., if in our hypothesis the
price was $200,000 payable out of $20,000 annual earnings and the interest on
the outstanding balance was only, say, 5 percent, rather than 10 percent).

But such a remainder would not qualify as an independent asset under Anderson,
even after $A$ received $20,000 of income in the first year, since the remainder
at that point would still have no value to a nontax-exempt buyer and, therefore,
no value to $A$ as security. This is true even though, from $B$'s point of view, the
payment to $A$ of $20,000 ($10,000 interest and $10,000 payment of principal)
has had the effect of removing $10,000 of the encumbrance on the fee which to
$B$ is worth $200,000 (due to his tax-exempt status).

On facts similar to those discussed in this footnote, the Second Circuit in Beren-
son v. Commissioner, 507 F.2d 262 (2d Cir. 1974), held that there was a sale
in the amount of the fair market value of the property, specifically confining the
determination of fair market value to a market of nontax-exempt buyers. On the
basis of Anderson and Perkins, however, there was no sale at all in Berenson
until such time as the remainder of the tax-exempt buyer had a value in the
market of nontax-exempt buyers so as to represent security to $A$. 
applied it in situations which are not within the ambit of *Anderson*. In so doing, they have disregarded the doctrine of *Perkins*.

We are concerned here with cases where *A* conveys property to *B* for a cash consideration together with a limited right to the income from the property. Typical of such cases are *Bryant v. Commissioner*, *Boone v. United States*, *Alstores Realty Corp.*, *Kreusel v. United States* and *Raymond L. Allen*.

In *Bryant*, *A* owned farming property which he desired to sell for $1,175,500. *A* accepted *B*'s offer to transfer the land to *B* for cash together with a production payment of $250,000, plus interest on the outstanding balance, payable to *A* from the farm crops, lease rentals and water use payments. *B* undertook no personal liability for the production payment, nor was the payment secured by a mortgage on any asset. The Court held *B* to be taxable on amounts paid to *A* in satisfaction of the production payment, citing three factors to make what the Court described as a "factual determination." *A* sale of the entire fee, rather than a sale only of the remainder, was effected by *A* because the production payment was limited to a specific amount, the duration of the payments was for a short term and interest was payable on the unpaid balance, indicating that the entire amount was *B*'s debt to *A*.

In so holding, the Court distinguished *Perkins*, quoting from *Clay Brown* that *Perkins* "does not have unlimited sweep," but failing to note that *Clay Brown* used this language in distinguishing *Perkins* in favor of *Anderson* due to the presence of a mortgage.

On facts similar to those in *Bryant*, *Boone v. United States* found a sale relying on the three factors cited in *Bryant*, and more generally on the findings approved in *Clay Brown* with respect to arm's length bargaining and a purchase price within a reasonable range.

In *Alstores Realty*, *A* owned real estate which it sold to *B* for

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80 Not discussed are those cases where the income payments to *A* are secured within the meaning of *Anderson*, e.g., *Gyro Engineering Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969); *Pacific Coast Music Jobbers, Inc.*, 55 T.C. 866 (1971), *aff'd*, 457 F.2d 1165 (5th Cir. 1972); *Larry D. Hibler*, 46 T.C. 663 (1966), *aff'd per curiam*, 383 F.2d 989 (5th Cir.), *cert. denied*, 390 U.S. 949 (1967); *cf.*, e.g., *George H. Landreth*, 50 T.C. 803 (1968).
81 399 F.2d 800 (5th Cir. 1968).
82 470 F.2d 232 (10th Cir. 1972).
83 46 T.C. 363 (1966).
84 63–2 U.S.T.C. ¶ 9714 (D. Minn. 1963).
85 34 T.C.M. 242 (1975).
86 399 F.2d at 805.
87 Id. at 806.
88 Id. at 803.
89 380 U.S. at 576–77.
90 470 F.2d at 236.
$750,000 cash together with the right to retain occupancy of a portion of the premises for two and one half years, rent free. The transaction was cast in the form of a conveyance of the fee and a leaseback to A of the two and one half year term, rather than a conveyance of the remainder and a reserved term. The Commissioner contended that B had income of $250,000—the difference between the cash paid and the value of the fee—in the nature of prepaid rent received from A under the lease. B argued that the transaction was a sale of the fee and a leaseback in form only; that the substance of the transaction was a sale only of the remainder and a reserved term for years. The Court found for the Commissioner on a variety of grounds:

(1) B agreed to supply and pay for utilities.
(2) A had only the rights of a lessee under a standard lease form (inability to sublet or assign).
(3) Most important, if A lost occupancy of the premises by reason of an act of God or fault of petitioner, B agreed to pay A $6 1/4 per square foot per month of lost occupancy.

Thus, said the Court, B “bore the risks and burdens of ownership” during the lease term and was therefore taxable on the rental value of the term. Although Perkins was mentioned as involving a “directly analogous” problem, the Tax Court dealt with the risk-benefit theory only to the limited extent of B’s risks with respect to A’s loss of occupancy, never noting that all other risks of the property producing a value of $250,000 were on A. Anderson was not mentioned.

Kreusel v. United States is a pre-Clay Brown case involving facts similar to Alstores Realty, except that A retained a life estate. The Commissioner attempted to increase A’s amount realized on the sale by the value of the life estate, but the Court held the interest had been retained, not sold and leased back. Persuasive to the Court was the form of the transaction (the interest was measured by A’s life) and the fact that A had possession and control of the property for the term. The conveyance provided that A was to pay utilities and B was responsible for taxes, assessments and insurance. The utilities provision was termed to be “lease like,” but the burdens on B were held not to affect the character of A’s life estate; the parties created a “tailored” rather than a “classic” life estate, explained the Court. Perkins was not discussed.

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100 46 T.C. at 372.
101 Ibid.
103 Id. at 89,848.
104 Compare on this point, and with Kreusel and Alstores Realty, McCulley Ashlock, 18 T.C. 405 (1952).
The most recent case dealing with *Clay Brown* in the *AB* transaction is *Raymond L. Allen*. The facts, somewhat simplified, are that *A* sold stock of corporations which manufactured travel trailers and mobile homes for the greater of $900,000 or two thirds of net profits from the business for 15 years. *B* assumed personal liability for the stated purchase price of $900,000 and this liability was secured by a mortgage on the corporate assets. A year later, at a time when *A* was convinced the minimum $900,000 price would be met, *B* was released from his personal liability. After four years, both *A* and *B* sold their respective interests at a large profit.

The Tax Court held that *A* had engaged in a sale of stock to *B* and was entitled to treat his gain as capital gains. The price was not unreasonably excessive, as contended by the Commissioner, but was "within a reasonable range," and controlled by *Clay Brown*, especially when viewed from the hindsight of *B* being able to sell his interest for almost $2 million.

The Commissioner also urged the inapplicability of *Clay Brown* because the purchase price was not fixed, but was contingent on earnings. Relying on *Burnet v. Logan* and other variable price cases, especially the tax cases in the patent field and section 1235, the Tax Court found that a price based on future productivity is consistent with a sale.

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1. 34 T.C.M. 242 (1975).
2. Id. at 257–58.
3. Id. at 255.
4. Id. at 255.
5. 283 U.S. 404 (1931).
6. 34 T.C.M. at 259–60. The cases in the patent area where the question was whether the transfer of patent rights constituted a sale or a license were heavily influenced by the Supreme Court's decisions in Waterman v. MacKenzie, 138 U.S. 252 (1891), and Rude v. Westcott, 130 U.S. 152 (1889). There, the Court was faced with the issue of what was an assignment (sale) versus a license since only an assignee was permitted to sue for infringement. The Court decided the issue solely on the extent of the rights transferred to the transferee to make, sell and use products covered by the patent. Nothing turned on economic risk shifting since the question of who benefitted by the income was not deemed relevant. In *Rude v. Westcott*, the Court stated: "The concluding provision, that the net profits arising from sales, royalties, or settlements, or other source, are to be divided between the parties to the assignment so as to give the patentee one fourth thereof, does not, in any respect, modify or limit the absolute transfer of title. It is a provision by which the consideration for the transfer is to be paid to the grantor out of the net profits made." 130 U.S. at 162–63.

When the sale issue arose in tax cases, these infringement decisions were held to be controlling; therefore, again there was no discussion of the tax issue from the point of view of economic benefit and risk shifting. See United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955), and cases cited therein. The Commissioner at first agreed with this approach, acquiescing in the Tax Court's decision in Edward C. Myers, 6 T.C. 258 (1946), 1946–1 C.B. 3, but later withdrew his
acquiescence (1950–1 C.B. 7) and issued Mimeo 6490, 1950–1 C.B. 9. The
congressional response in the 1954 Code was section 1235. As stated in the report
of the Senate Committee on Finance:

Under present law, an express assignment of patent rights by the owner, or
an exclusive license of the right to manufacture, use, and sell, the invention
thereunder for the life of the patent, can qualify as a "sale or exchange" for
tax purposes; thus, the holder can obtain capital-gains treatment on such a
transfer if he falls within the "amateur" category. Many court decisions have
arrived at this result, not only where the manner of payment has been a lump
sum, but also where the purchase price has been conditioned on the use or
profitability of the invention, i.e., where it takes the form of "royalty" pay-
ments. (See, e.g., Kronner v. United States, 110 F.Sup. 730 (Ct.Cls.1953);
Commissioner v. Celanese Corp., 140 F.2d 339 (C.A. of D.C. 1944); Com-
missioner v. Hopkinson, 126 F.2d 406 (C.C.A.2d 1942); Edward C. Myers, 6
T.C. 258 (1946), Non. Acq. 1950–1 CB 7.) However, in 1950 the prospect
of continued litigation was engendered in this area by the issuance of Mimeo-
graph 6490 (1950–1 CB 9), in which the Commissioner of Internal Revenue
announced that he would thereafter regard such assignments or licenses as "pro-
viding for the payment of royalties taxable as ordinary income" if payment is
measured by the production, sale, or use of the property transferred or if it is
payable periodically over a period generally coterminous with the transferee's
use of the patent. To obviate the uncertainty caused by this mimeograph and
to provide an incentive to inventors to contribute to the welfare of the Nation,
your committee intends, in subsection (a), to give statutory assurance to cer-
tain patent holders that the sale of a patent (whether as an "assignment" or
"exclusive license") shall not be deemed not to constitute a "sale or exchange"
for tax purposes solely on account of the mode of payment.


In 1958, after the passage of section 1235, the Commissioner finally relented.

With respect to the issues with which we deal in this article, several points con-
cerning section 1235 should be noted: First, the committee reports to the 1954
Code, and the 1956 amendment which made section 1235 retroactive to the 1939
Code, state that "no inference is to be drawn from this section as to what con-
stitutes a 'sale or exchange' in other than the patent field." S. REP. No. 1622,
83d Cong., 2d Sess. 441 (1954). Second, after reviewing the history of the de-
velopments in the patent area, the Supreme Court in Clay Brown specifically
refused to take sides on the issue:

These developments in the patent field obviously do not help the position of
the Commissioner. Nor does § 1235, I. R. C. 1954 which expressly permits
specified patent sales to be treated as sales of capital assets entitled to capital
gains treatment. We need not, however, decide here whether the extraction
and patent cases are irreconcilable or whether, instead, each situation has its
own peculiar characteristics justifying discrete treatment under the sale and ex-
change language of § 1222. Whether the patent cases are correct or not, absent
§ 1235, the fact remains that this case involves the transfer of corporate stock
which has substantially appreciated in value and a purchase price payable from
income which has been held to reflect the fair market value of the assets which
the stock represents.

380 U.S. at 577 n.8.

Last, as we will discuss in some detail in the conclusion of this article, the
treatment of the transferee in the patent area has rendered the issue of sale moot
as to him, leaving the issue only one of capital gains to the transferor.
Nowhere does the lengthy opinion note Clay Brown’s reliance on Anderson, nor does it discuss Perkins. The Court noted B’s personal liability for $900,000 but did not limit the amount realized from the sale to $900,000, as would be required under Anderson and Perkins. Beyond $900,000, A clearly retained the entire risk of loss; that portion of his stock was retained, not sold.

What then is the legacy of Clay Brown for the AB transaction? The single most discernible effect is the erosion, if not the complete demise, of Perkins and the risk-benefit notion of what constitutes a sale. In Allen, for example, the opinion does not discuss Perkins; nor does it mention the Commissioner’s risk shifting argument. In apparent reference to these points, the Tax Court noted that these “arguments of law decided against respondent in Clay Brown are not subject to relitigation here.” True enough that Clay Brown refused to adopt wholesale risk shifting test in place of a “common understanding of what constitutes a sale.” It is also true, however, that the Court went to great lengths to distinguish Perkins under the doctrine of Anderson, and thus apparently continues to view risk shifting as relevant.

The second clearly discernible effect of Clay Brown has to do with reasonableness of purchase price, or price within a reasonable range. Indeed, the Commissioner dramatizes the importance of this issue by his post-Clay Brown insistence upon it in Revenue Ruling 66–153 as the criterion for a sale. The courts, as a result, tend to focus on this question as dispositive, in whole or in part, of the sale issue. Resolution of the issue along these lines, however, only begs the question. Proper inquiry demands that there be shown a relationship between a fair price and a sale. A fair price, standing alone, does not and cannot determine whether one has retained or ended an interest in property.

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210 34 T.C.M. at 255–56.
212 34 T.C.M. at 258. See also Larry D. Hibler, 46 T.C. 663 (1966), aff'd per curiam, 383 F.2d 989 (5th Cir. 1967), cert. denied, 390 U.S. 949 (1968).
213 380 U.S. at 575.
214 Id. at 576–77.
217 See, e.g., Allen and Boone (found the price within a reasonable range and held for the taxpayer); Berenson v. Comm’r, 507 F.2d 262 (2d Cir. 1974) (found sale up to the amount of a fair price and nonsale for amounts beyond that price); Aaron Kraut, 62 T.C. 420 (1974) (followed Kolkey on similar facts); Emanuel N. Kolkey, 27 T.C. 37 (1956), aff’d, 254 F.2d 51 (7th Cir. 1958) (pre-Clay Brown case which held for the Commissioner where the purchase price was some four times fair value).
Thus, the undisputed presence of a fair price in *Perkins* did not make *B* the purchaser of the production payments received by *A*. Further inquiry was required to determine the economic beneficiary of those payments. That inquiry properly goes to the issue of which of *A* and *B* bears the economic risk of loss due to nonproduction. And so, while in both cases the price was fair, in *Perkins* *B* had no risks as to the production payments and was not a purchaser thereof, and in *Anderson* *B* was such a purchaser due to a mortgage on his own assets.

So viewed, the question of reasonable price may be part of the overall issue of risk shifting. Even though secured by a mortgage, a price which is patently gross, payable solely from the earnings of the assets conveyed, may, as we have shown, prevent any shifting of risks to *B* because he can never acquire an interest in the remainder. Where, however, the price is secured neither by a mortgage, either on the assets conveyed or on *B*'s independent assets, nor by the personal liability of a solvent *B*, then the price—reasonable or unreasonable, fixed or contingent—is totally irrelevant. There can be no sale to *B* of amounts to be received by *A* for which *B* has no risk of loss.

**AB Transaction Under a Risk-Benefit Theory**

Viewed through this risk-benefit theory, cases such as *Bryant* fall within the principle of *Perkins* and are outside of *Anderson*. Where *A* conveys to *B* a remainder for cash, retaining a production payment limited by a fixed sum, none of the production payments to *A* are of benefit to *B* if *A* can recover that sum solely from the produce of the property. As a practical matter, there may be only a few situations in which *A* would not demand a security interest, such as a mortgage on the remainder. This is a matter which can only be left to the parties' assessment of the degree of risk and their bargaining strength and abilities with respect to such risks. There are situations, however, in which a security interest such as a mortgage would be meaningless. If *A* reserves a right of occupancy for two and one half years pending completion of its new plant, as in *Alstores Realty*, or if *A* reserves a life estate in a homestead, as in *Kreusel*, there is no amount of money present which could be affected by a security interest, and necessarily it is only *A* who bears the risks of the reserved term. Likewise, if *A* reserves a right to a percentage of profits for a period of time without any dollar limit thereon, there is no sum which can be subject to a security interest.

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If, as in *Allen*, the reserved right is to a percentage of profits for 15 years but is no less than $900,000, then the presence of a mortgage to secure payment of $900,000 may shift the risk of loss to *B* because his remainder is burdened by the mortgage, but not beyond the time it takes for *A* to receive $900,000. After that the mortgage is a nullity; *B* bears none of the risks of *A*'s right to receive a percentage of profits and only *A* should be taxable on these profits.

To what extent, if at all, is this risk-benefit analysis affected by the formal legal trappings used by the parties in structuring the transaction? In *Bryant*, the transaction was structured in the classic *ABC* mold whereby *A*, desiring $1,175,000 for his entire interest, transferred the remainder to *B* for cash, and reserved a production payment in the amount of $250,000, plus interest on the outstanding balance, which *A* sold to *C*.\(^1\) *B* undertook no personal liability for the production payment, nor was it secured by a mortgage on any asset. Standing alone, under *Perkins* these facts compel a finding of complete lack of risk shifting. Nevertheless, the court taxed the production payments to *B*, citing three factors in making what it termed a "factual determination."\(^2\)

1. The production payment was limited to a specific amount and was part of a total figure "which the seller expects to receive and the purchaser expects to pay."\(^3\)
2. The duration of the payments: "If limited to a short term and a sum certain, they are less likely to be deemed attributable to continued ownership by the seller."\(^4\)
3. "Finally, when interest is to accrue on the unpaid balance of the total sum, it would seem that the entire amount is a debt from the time of the sale and that the periodic payments are simply made in reduction of the debt. We stress this interest factor, for we consider

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\(^1\) It should be noted that the $250,000 production payment was purchased by a short-term Clifford-type trust created by *B* for the benefit of his children, and funded by *B* with $100,000. This $100,000, together with $150,000, advanced by a bank on the security of the production payment, was used to buy the production payment. Under the rationale of the court that *Perkins* did not apply, *B* was taxed on the entire amount of the production payment. Thus, there was no discussion of *B*'s taxability on the independent ground that *B*'s funds, in which *B* had a reversionary interest, had been used to purchase 100/250 of the production payment. Indeed, the opinion of the Tax Court noted that "we do not have to consider what effect, if any, the use of 10 year reversionary trusts has in the arrangement," Olin Bryant, 46 T.C. 848, 858 (1966). This view was apparently acquiesced in by the court of appeals. 399 F.2d 800, 804 n.3 (5th Cir. 1968).
\(^2\) 399 F.2d at 805.
\(^3\) *Ibid.*
\(^4\) *Id.* at 805–806.
it a sure sign that the parties in this case intended to complete a sale of the entire property for $1,175,000." 124

How do these three factors change the result in Perkins? The phenomenon of a production payment limited to a specific amount which is part of a total figure which is no doubt the full value of the property was also present in Perkins. Without the presence of a mortgage or other security interest, these facts indicate no shift of any risk to B. Likewise, a short payout period for a sum certain has relevance to risk shifting only when coupled with a security interest in the remainder conveyed, or B’s other assets. With a mortgage on B’s remainder interest, the shorter the payout period, the less time it takes to produce A’s cushion, i.e., his independent source for satisfaction of his claim, thereby more quickly increasing B’s risks and diminishing A’s.

The court stressed the interest factor. This is truly a red herring because it begs the entire question of whether B has purchased the production payment on credit. Unless B has an obligation, whether personal or by pledge of some asset of his, to purchase the production payment, he has no debt upon which he will owe or pay interest. Lacking B’s personal obligation guaranteeing the production payment, or a mortgage on any asset of his securing the payment, B owes nothing on account of the payment—has no debt with respect thereto—hence, pays no interest. The fact that the agreement calls for interest indicates only that A wants compensation for having to wait for his money, which is interest, but it is part of A’s reserved rights, payable only from produce of the property, entirely at A’s risk, and not an obligation of B’s. In terms of a familiar example, if A owns Blackacre, value $100X, and sells to B the remainder for $83X, A will reserve the right to the first $20X of rents, or will reserve the first $17X plus interest of $3X. The form in which the transaction is cast makes no difference to A or B, economically or legally. Unless some asset, or B’s personal liability, is pledged to secure payment of interest, it is not B who pays it.

Another fact present in Bryant was the provision of the conveyance that bound B to work the farm presumably to produce the crops out of which the production payment would be satisfied. The Bryant court attributed no significance to these facts, but a refined analysis would require B to reflect in his income payments received by A attributable to labor supplied by B, and that B add the same amount to the cost basis of his remainder interest in Blackacre. Thus, if B himself did the necessary work, he has sold to A the fair market value of his services in exchange for a portion of the remainder interest. B has income from ser-

124 Id. at 806.
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vices and a capital expenditure for the remainder in Blackacre. If B pays an employee to perform services, again, this is a cost of the remainder to B, although he gets no further inclusion in income if the salary is paid with after-tax dollars. In neither case do B’s services effect a shift of risks from A to B unless the production payment to A is secured by a mortgage on B’s remainder interest.

Most importantly, the court is not, as stated in Bryant, required to make a factual determination. The factors involved were clear and undisputed; the only issue to be resolved was the legal issue, which must be resolved under the principles of Perkins and Anderson.

Alstores Realty presents a unique treatment of the AB transaction. Usually the Commissioner is attempting to tax B on income received by A as A receives it, and in the amount received, as in Bryant. In Alstores Realty, however, where A sold B the remainder in real estate and reserved occupancy for a two and one half year term, the Commissioner asserted that B, an accrual basis taxpayer, had rental income in the amount of the rental value of the two and one half year term. In other words, instead of taxing to B the rental value of the property as it benefitted A—over the period of time it was received by A through profits in the manufacture and sale of pianos—the Commissioner taxed B in advance of actual receipt by A, on the capitalized value of A’s future receipts, attributable to rental value. So viewed, and aside from questions of accounting methods, the basic issue raised by Alstores Realty is identical to that in Bryant, to wit, to what extent shall B be considered the economic beneficiary of amounts received by A as rental value of the property during the two and one half year term? And under Perkins and Anderson the answer remains: only to the extent such income is at B’s risk rather than A’s.

In Alstores Realty, the Tax Court appeared to approach the problem through a risk-benefit theory, relying on McCulley Ashlock and Perkins for the proposition that rents received by A could not be taxed to B unless B had “the benefits of ownership.” Applying this test, B was taxable on $250,000 of prepaid rent because of the form in which the transaction was cast (A acquired the two and one half year term under a standard form lease, B was to bear the cost of utilities and A could not alter the building or assign its interest without B’s consent) and because B agreed to pay to A a certain amount in the event A lost

126 18 T.C. 405 (1952).
127 46 T.C. at 371–72.
occupancy by reason of act of God, or fault of B, computed at 64¢
per square foot per month of occupied space.\textsuperscript{128} This was the fair rental
value of the space occupied.\textsuperscript{129}

Of "key significance"\textsuperscript{130} to the Tax Court was B's
liability for A's loss of occupancy. This the court found "entirely inconsistent with the
theory that Steinway had a reserved estate for years; why should petitioner, the alleged remainderman, be required to make payments to Steinway, the alleged owner of an estate for years, as a result of non-
occupancy by the latter? What we really have here is a provision for reimbursement of prepaid rent in the event the tenant is denied . . . occupancy, the prepaid rent being in the form of the value of the property received by petitioner in excess of the $750,000 cash paid there-
for."\textsuperscript{131}

It is submitted that the label attached to B of fee owner-landlord
rather than remainderman in no way resolves the issue of whether B is
taxable on rental value received by A. Whether A's term for years is
leased from B or is reserved by A, in both situations A will have the
rights and burdens of a temporary occupant of the premises and B will
basically have a future interest taking effect in possession when A's term
is over. The landlord-tenant category, into which the Tax Court seems
to place the Alstores Realty transaction, does not, without more, make
B taxable on A's receipts of profits. The only result of such a relation-
ship is that A, the tenant, will be taxable on profits received by him and
B. the landlord, on rentals in fact paid (or payable) to him by A. Thus,
if B buys the fee in Blackacre from C for $1 million and then sells A
a term for two and one half years, in an arm's length transaction, B will
not convey the term for less than its value, $250,000. B will be taxed
on $250,000 prepaid rents because he will in fact have received them.
He will not be taxed on the rents derived by A from use of the property
and in which he has no interest.\textsuperscript{132}

\textsuperscript{128} Id. at 372.
\textsuperscript{129} Id. at 368.
\textsuperscript{130} Id. at 372.
\textsuperscript{131} Id. at 372–73.
\textsuperscript{132} The actual issue raised by the Commissioner before the Tax Court was
whether B was taxable on the value of the two and one half year term as prepaid
rent, and the actual decision of the Tax Court upheld the Commissioner. To sup-
port such a holding, however, the Tax Court should have used a step transaction
or integrated transaction doctrine to find that the overall substance of the con-
veyance was two independent transactions, neither of which depended on the
other, the effect of which was for B to pay $1 million for the fee, acquire a cost
basis of $1 million and lease back a two and one half year term to A for $250,000
in an unrelated transaction. In such case B is properly taxed on the cash received
from A, and not on A's income from rental value in which B has no economic
So, it is not the form of the transaction that should determine B’s tax-
ability for A’s receipt of rental value. This issue turns on whether B is
the economic beneficiary of such payments. Certainly if B had guaran-
teed to A a return of 6¼¢ per square foot per month in all events, then
Anderson would apply and B would be taxable because B would then
bear the entire risk of A receiving such rental value. The guarantee in
Alstores Realty was a contingent one, however, basically limited to ouster
on account of acts of God. B’s risks were so remote as to justify com-
pletely disregarding them. In no event, however, should B have been
taxed on an overall amount greater than the cost of an insurance policy
to protect against these risks for the two and one half year term.

Nor can one see how B’s responsibility for the payment of utilities
gave him the benefit of rental value received by A. B’s liability for
utilities was absolute and would be in no way affected (i.e., reduced or
increased) by the production (or lack thereof) of rental profits. In no
manner did this liability shift any of the risks of profits from A to B.
The utility payments are properly treated as part of B’s cost for the re-
mainder; or if B were receiving any income from A, such as rent (which
was not the case in Alstores Realty), the utility payments would be the
cost of producing such income, giving rise to a deduction under section
162 or section 212. Similarly, the fact that A could not alter the build-
ing or sublet did not shift any of the income producing risks to B. If
anything, these restrictions increased A’s risks by locking him into the
lease.

Analyzed under a theory of economic benefit, it is seen that such
cases as Bryant, Alstores Realty and Allen are taxing B on income
received by A even though B has no economic connection with that
income. The implicit effect of these cases, though unperceived and un-
intended, is to tax B on some presumed increase in the value of his
remainder interest on an original issue discount notion, such as is em-
bodyed in section 1232, even though there is no warrant for doing so
either in the statute or in the cases.

As stated by Bryant with respect to B: “The new owner of the prop-
erty derived a benefit from all the income, including that later remitted
to the seller, because with that income he purchased an asset. The profits
from the property were ordinary income to him.”

interest. In Alstores Realty, however, A would not have agreed to a sale unless
it could retain possession until its new plant was ready for occupancy. 46 T.C.
at 366. Therefore, it would appear that the substance of the transaction was that
A reserved the two and one half year term, did not pay B rent of $250,000 for
it, and conveyed to B only the remainder interest at a cost to B of $750,000.

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133 399 F.2d at 805 (emphasis added).
The court perceives a connection between the income received by A and gain to B, but sees the connection as B’s income being used to purchase A’s term for years (B already having purchased the remainder for cash). Properly viewed, however, the only nexus between A’s income and B’s gain is that payments to A bring the remainder closer in time to, so that it will eventually become, a fee interest in all of the property. Such gain is not presently taxed by section 1232, nor any similar statute. And if it were to be taxed to B, in no event would it necessarily be the same as amounts received by A as production payments because there is no necessary relationship between the amounts of payments received by A and the amount of increase in the value of B’s remainder.

**Congress and the AB Transaction**

**Section 636(b)**

As will be seen, the same analytical error which led the court in *Bryant* to conclude that in an AB situation the income paid to A benefits B even without a mortgage on any separate asset of B became the stated basis for the enactment in 1969 of section 636(b) which provides:

A production payment retained on the sale of a mineral property shall be treated, for purposes of this subtitle, as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

This section was originally recommended as part of the *Tax Reform Studies and Proposals* of the Treasury Department formulated during the Kennedy and Johnson administrations and adopted by the Nixon administration in 1969.\(^{134}\) Although this provision, from the beginning, was considered together with a similar proposal which dealt with carved out production payments and which became section 636(a), we may conveniently treat section 636(b) separately at this point since it is addressed to a different type of transaction than is section 636(a).

The fullest discussion of the reasons for the enactment of section 636(b) is contained in the House report which begins by setting forth the “Present Law” on the subject:

A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. The payment is secured by an interest

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\(^{134}\) **STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 91ST CONG., 1ST SESS., SUMMARY OF H.R. 13270, TAX REFORM ACT OF 1969 (Part 2), at 256–60 (Comm. Print 1969) (herein cited as TREASURY PROPOSALS).**
in the minerals, the right to the production is for a period of time shorter than the expected life of the property, and the production payment usually bears interest. Depending on how a production payment is created, it may be classified as a carved-out production payment, or retained production payment which may then be used in a so-called A-B-C transaction.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law the owner of the retained production payment receives income for which percentage depletion may be taken during the payout period, or period during which he receives a part of the production (or a payment based on production). The purchaser of the working interest excludes the amounts used to satisfy the production payment during the payout period. . . .

The so-called A-B-C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A-B-C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.\textsuperscript{125}

With this introduction the report then states the "General reasons for change":

The treatment of mineral production payments under present law has resulted in what are essentially two problems, one relating to carved-out production payments and one relating to retained production payments and A-B-C transactions. . . .

In each of the three situations (the carved-out production payment, the retained production payment, and the A-B-C transaction), the transaction is similar, in fact, to a loan transaction with the loan secured by a mortgage on the property and the "borrower" not personally liable for the loan. . . . In an A-B-C transaction, the analogy is to the sale of a property but subject to a mortgage subsequently sold to someone else.

The factual similarity between the creation of a production payment and a loan transaction and the disparate tax treatment of production payments and loans can be illustrated by examining two hypothetical A-B-C transactions, one involving an oil payment, and the other the sale of an apartment.

Assume that A sells an operating business to B—the business may be an oil well, or it may be an apartment building. However, assume that A retains the right to a production payment—a payment equivalent to the current price of a specified number of barrels of oil—or in the case of the apartment building, a mortgage, which is not much different from the production payment. Then suppose that A sells the production payment or mortgage to C.

From A's standpoint, the two transactions are treated the same—they both result in a capital gain—or loss—to A depending upon his cost or other basis whether it is the apartment building or oil well which is being sold.

However, the similarity between the oil well and the apartment building ends here. In the case of the apartment building, all of the rental income after ordinary expenses and depreciation is taxable income to B and he must pay off the mortgage out of "after tax" dollars.

In the case of the oil well, however, B is not considered as receiving the production payment at all—which, in the typical case, may well amount to as much as 90 percent of the income from the well. Thus, in this case B is, in effect, paying the production payment out of "before-tax dollars." This privilege of paying off capital interests out of tax-free dollars is not a privilege accorded ordinary taxpayers. . . .

At the same time, B is paying little or no tax in the case of the oil well, C who is receiving the production payment is receiving cost depletion on this payment. Thus, he is amortizing his entire cost over the period he receives his payments.

The C who has the mortgage on the apartment house fares no better than his counterpart with the production payment despite the special advantages of the B with the oil well. The C with the mortgage can spread his cost over the period of the mortgage but, presumably, any excess he receive [sic] is interest income and therefore ordinary income.

The crucial difference between the A-B-C transaction in oil and the mortgage for the apartment, therefore, lies in the treatment of B and the fact that in the A-B-C transaction B can amortize C's capital interest out of tax-free dollars rather than the "after-tax dollars" he must use in the apartment case.

. . . . .

Your committee can see no reason why a person who, in effect, is the borrower in a production payment transaction should be allowed to pay off the loan with tax-free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars. . . . Moreover, the committee is concerned with the substantial revenue loss which results from the use of production payments. It is estimated that the combined revenue loss from ABC transactions and carved-out production payments is between $200 and $350 million annually. An acceleration of the revenue loss can be expected unless corrective action is taken.136

The committee's and eventually Congress' solution for the ABC problem was:

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the bill provides that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property). Accordingly, the income derived from the property which is used to satisfy the

136 Id. at 139–41 (emphasis added).
payment would be taxable to the owner of the mineral property subject, of course, to the allowance for depletion.\footnote{137 Id. at 141.}

The difficulty with the committee's presentation is that it is based on a false premise, \textit{i.e.}, that there is no difference between an \textit{AB} transaction where \textit{A} has a lien on a separate asset of \textit{B} and an \textit{AB} transaction where no such lien exists. In comparing the sale of an oil well with the sale of an apartment building, the committee states that the \textit{A} who sold the apartment building retained "a mortgage, which is not much different from the production payment." But, as we have seen, this is the \textit{crucial} difference established by the Supreme Court in \textit{Anderson} in distinguishing \textit{Perkins}. The mortgage on the apartment building in the committee's hypothetical is the equivalent of the "lien on the fee," the presence of which made all the difference to the Court in \textit{Anderson} as compared to a lien merely on the production of oil in \textit{Perkins} which, as the Supreme Court in \textit{Anderson} said, left \textit{A} still dependent solely on the production of oil.

In the language of the \textit{Treasury Proposals} which preceded the committee's report, the error is even clearer. In its discussion of "\textit{ABC} transactions and retained production payments," the Treasury stated: "The proposal \ldots corrects disparate treatment of \textit{ABC} transactions that exists under present law. \ldots Under present law if \textit{B}, in an \textit{ABC} transaction, guarantees the production payment, then the transaction is treated as a loan. There is no reason to differentiate the tax treatment of these financing transactions, and the proposal reaches this result."\footnote{138 \textit{TREASURY PROPOSALS}, at 260.}

To say that there is no difference between an \textit{AB} (or \textit{ABC}) where \textit{A} has no lien on any of \textit{B}'s assets (\textit{i.e.}, the transaction is treated as a loan by section 636(b)) and the \textit{AB} transaction where \textit{B} guarantees the production payment, flies right in the face of the distinction between \textit{Anderson} and \textit{Perkins}. The reason for the Treasury's error in this regard seems apparent from the footnote to this proposition in which it is stated: "This conforms to tax treatment of financing transactions in other areas. For example, the tax treatment of the mortgagor and mortgagee in a real estate transaction is the same regardless of whether the mortgagee looks only to the property as security or whether he also has the personal liability of the mortgagor. There is no reason for a different rule where the property involved is a mineral interest."\footnote{139 Id. at 260 n.3.}

What this footnote implies, of course, is that the situation where a mortgagee can look only to the property mortgaged and not to any other assets of the mortgagor is the same as the situation where there
is no mortgage at all on any assets. Now it is one thing to equate a mortgage without personal liability to a mortgage with personal liability, since personal liability merely means general asset liability so that the mortgagee who has the personal liability of the mortgagor can look to assets other than the specific property mortgaged. It is totally different, and erroneous, to equate a mortgage situation to a nonmortgage situation as does section 636(b).

The Treasury elaborated on its position in a department memorandum prepared during the course of the legislative hearings on section 636(b), in response to a constitutional challenge to that proposed section. The challenge was based on the argument that section 636(b) would have the effect of taxing C's (or A's) income to B in an ABC (or AB) situation where there was no mortgage given by B to A or to C on any of B's separate assets. In response to this argument the Treasury discussed Anderson and Perkins in the following manner:

In Anderson v. Helvering, 310 U.S. 404 (1940), the Court held that the owner of the working interest in mineral property was taxable on the proceeds of mineral production used to pay off a "production payment." This "production payment" was secured by an interest in the oil and gas production and by an interest in the fee title to the lands conveyed. This additional security, in the opinion of the Court, served to distinguish a contrary result reached in Thomas v. Perkins, 301 U.S. 655 (1937), where a production payment was only payable out of oil if, as and when produced.

This difference in the security interest involved in the Thomas v. Perkins and Anderson v. Helvering cases is, of course, not a difference of constitutional dimensions. The essence of a lending transaction is not affected by the nature of the security interest involved. It follows that there can be no constitutional objection to the Treasury proposal which would merely extend the rule of Anderson v. Helvering to all production payment transactions, regardless of the nature of the underlying security.

Aside from whether the question involved is of "constitutional dimensions" the key language in the Treasury's position is its statement: "The essence of a lending transaction is not affected by the nature of the security interest involved."

But again, it is one thing to say that a transaction is a loan if there is a security interest involved, regardless of the nature of the security interest (i.e., whether the security is a specific asset as opposed to a pool of assets or is one specific asset as opposed to another specific asset). It is quite a different theory to say that a "lending transaction is not

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affected by the [existence of any] security interest.” Such a proposition is the equivalent of saying that a loan has taken place even where there is no liability (specific asset or general asset, i.e., personal) for payment. This, of course, renders the word “loan” or the phrase “lending transaction” meaningless. And yet this is exactly what section 636(b) does, since it treats as a loan a transaction where B has no liability to pay, since none of B's assets are the subject of a lien for payments either by way of specific lien or general personal liability.

It is thus erroneous to say, as the Treasury's memorandum does, that section 636(b) “merely extend[s] the rule of Anderson v. Helvering to all production payment transactions, regardless of the nature of the underlying security.” What section 636(b) actually does is reject Anderson's distinction of Perkins and overrule the holding of the latter case.

If section 636(b) treats as a loan what is not a loan, what, it may be asked, moved the Congress to enact such a provision? The answer seems to lie in the proposition which originated with the Treasury Proposals,\(^1\) was repeated in the House and Senate reports\(^2\) and was finally confirmed in the following language of the General Explanation of the Tax Reform Act of 1969, prepared by the staff of the Joint Committee on Internal Revenue Taxation: “The Congress saw no reason why a person who, in effect, is the borrower in a production payment transaction should be allowed to pay off the loan with tax-free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars.”\(^3\)

Why is it that Congress saw B in an AB or ABC transaction as being allowed “to pay off” a loan when B was not liable, personally or otherwise, for such payment? For the same reason, it would seem, that the Fifth Circuit in Bryant saw B there as having had the benefit of the income paid to A—namely, “because with that income [B] purchased an asset.”\(^4\) But, that statement, in a situation where B has no liability, means nothing other than that B's remainder interest in fee is approaching a present interest in fee. Whatever gain B has he has solely by virtue of that phenomenon. The effect of section 636(b), therefore, is to tax B on a section 1232 original issue discount theory without regard, however, to whether there is any correlation between the increase in the value of B's remainder and the amounts paid to A. Such a result cer-

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\(^1\) See N. 134 supra and the accompanying text.
\(^4\) 399 F.2d at 805.
tainly does not seem to have been adverted to by Congress when it en-
acted section 636(b), any more than the Bryant court seems to have
been aware of the real effect of its holding.

Gratuitous Transfers

Just as cases like Bryant and Alstores Realty create a direct conflict
with the basic economic benefit theory of Whitehouse and Perkins, so
also is section 636(b) in direct conflict with the statutory treatment of
AB situations which arise as a result of a gift or bequest. Suppose, e.g.,
that X devises Blackacre to T in trust to pay the income to A until such
income reaches $250,000, the trust then to end and T to convey Blackacre
to B. Does B include any of the income from Blackacre as it is paid to
A? Clearly not. The specific provisions of subchapter J of the Code
tax the trust income only to A and there is no attempt to tax B, even
though B’s remainder is (or may be) increasing in value, or to put it in
the words of the Bryant court, even though “with that income he [B]
has purchased an asset.” Moreover, if Blackacre is an oil well, the result
is not changed, since section 636(b) applies only “on the sale of a
mineral property.”

And yet the fact is that the B who has acquired
his remainder by gift or bequest is in precisely the same position as the
B who has purchased his remainder without giving a mortgage on any
of his assets (including the remainder) to secure the payment of any

\[\text{145 The same result occurs if there is no trust, but A is devised the income from}
\text{Blackacre up to a certain amount, with the remainder in fee to B. Here the apply-
able section is section 102(b)(2) which excepts from the gift exclusion a gift}
or bequest “of income.” An interesting question is presented by the first sentence
of the flush material to section 102(b) which provides: “Where, under the terms
of the gift, bequest, devise, or inheritance, the payment . . . is to be made at inter-
vals, then to the extent that it is paid . . . out of income from property, it shall
be treated . . . as a gift, bequest, devise, or inheritance of income from property.”
In light of this provision, if, e.g., T bequeathed a certain fund to B but charged
that fund with an annuity to be paid to A, say of $5,000 a year for 20 years, to
be paid in any event, i.e., whether or not there was sufficient income from the
fund, it would appear that under the holding of Whitehouse, B and not A would
pay the tax on the income generated by the fund upon which the annuity was a
charge. Such a result would be entirely consistent with Anderson, since such a
situation is the equivalent of a mortgage on a separate asset of B and the income
generated by the fund benefits B since A’s annuity is to be paid in any event. On
the other hand, if the annuity is set up by way of a trust with the trustee to pay
A the annuity, in any event, i.e., out of corpus if income is not sufficient, the
specific provisions of subchapter J tax the income to A (to the extent of dis-
tributable net income) and not to B. See Del Cotto & Joyce, Taxation of the
Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue
Code, 23 Tax L. Rev. 257, 270 et seq. (1968). To this extent, therefore, there
is an inconsistency in the statutory treatment of the AB situations even within the
gift and bequest context.}
ANALYSIS OF INCOME INTERESTS

amount to A. Neither is liable for payments to A and the remainder of both will (or will not) progress in value without regard to whether the remainder was acquired by gift or purchase.\footnote{146}

If there is no theoretical justification for treating B differently depending on whether he purchases his remainder or receives it by gift, is there some practical explanation for the difference in treatment? Put another way, why, in the case where A and B receive their interests by gift, does the government not attempt to tax B on the amounts received by A in the same way in which it convinced the court in Bryant, and the Congress in section 636(b), to tax B in the case where B purchases his remainder? The answer seems to be that in a gift situation the government can tax the income fully to A and therefore need not pursue B. This is not only because of the statutory provisions which require A to include the income in his gross income, but, equally as important, because of section 273 which prevents A from taking a deduction by way of amortization for the wasting of his asset, i.e., the income interest.\footnote{147}

However, in cases like Bryant, and those in the mineral area covered by section 636(b), A is not governed by section 273, since that section only applies to income interests acquired by gift, bequest or inheritance.

Thus, where, e.g., A has acquired Blackacre by purchase, if A sells a

\footnote{146}Indeed, if one had to choose between the B who purchased his remainder and the B who received his remainder by gift or bequest, the more likely candidate of whom to require the inclusion in income of amounts paid to A would be the B who acquired his remainder by gift or bequest, not because he is able to exclude the value of his remainder as a tax-exempt gift under section 102(a), but because of the regulations which dictate an increase in the basis of B in his remainder interest merely by the passage of time without regard to the fact that B is not required to include any amount in income by virtue of any increase in the value of his remainder due to such passage of time. Reg. §§ 1.1014-5(a)(2); 1.1015-1(b).

\footnote{147}The legislative history to section 273 sheds little light on the reason for its enactment. Both the House and Senate reports say only:

Under existing law persons receiving by gift, bequest, devise, or inheritance a life or other terminable interest in property, frequently capitalize the expected future income, set up the value of this expectation as corpus or principal, and thereafter claim a deduction for exhaustion of this so-called principal on the ground that with the passage of time the "principal" or corpus is gradually shrinking or wasting. This section explicitly provides that no such deduction shall be recognized.


No reason is given why the value of a terminable interest should be viewed as "so-called principal" and thus denied a basis for amortization, where the same type of interest would, if purchased, be principal and would thus have an eligible basis for amortization.
remainder to \( B \) and retains an income interest, \( A \) would not be prevented by section 273 from taking an amortization deduction. In the classic \( ABC \) oil transaction, \( A \) would sell his income interest to \( C \) and \( C \), having purchased the interest, would not be prevented by section 273 from taking his amortization deduction. The situation would thus have changed dramatically from the government’s point of view. Whereas, prior to the transaction \( A \) was being taxed on all the income from \( Blackacre \), now a large portion of the income was being offset by \( C \)’s amortization deduction. To illustrate, using a familiar example, suppose \( A \) owned \( Blackacre \) purchased for $100X with a present fair market value of $100X, and \( Blackacre \) earns an annual net rent of $10X. If \( A \) remains the owner of the fee and receives the $10X rent for year 1 and year 2, the government receives tax on $10X in year 1 and $10X in year 2. Now suppose \( A \) sells a remainder to \( B \) for $83X, and reserves a two year term (or a $20X production payment) which \( A \) simultaneously sells to \( C \) for $17X. Without more, when \( C \) receives $10X in year 1 and year 2, \( C \) will offset those amounts by $17X and the government loses the tax on $17X. Again, without more, after the end of the two year period or the $20X payout, \( B \) would own the full fee interest in \( Blackacre \) and the government would again be able to collect tax on $10X per year. Would this mean the government would have lost forever the tax on the $17X of year 1 and year 2? Not necessarily, since \( B \)’s basis would remain at $83X, i.e., what he paid for the remainder. If \( B \) sold the property for $100X, the government would recoup its tax on $17X (perhaps even at ordinary income rates\(^{148} \)), but that tax would have been deferred until such time as \( B \) sold the property.\(^{149} \) It was this loss of immediate tax, i.e., the deferral effect, which was the source of the government’s loss of revenue in the \( ABC \) transaction. It was (and is) the presence of section 273 which prevents this deferral loss in a case where \( A \) acquires his income interest by gift or bequest. To prevent this loss of revenue, in the \( ABC \) nongift cases, i.e., transactions and cases like Bryant, the government has attempted to tax \( B \). Essentially what the government has done in these nongift situations—where \( A \), who once owned in fee simple and paid tax on all the income, has split the interests in \( Blackacre \) between himself and \( B \) (\( AB \)) or between \( B \)

\(^{148} \) See Jones v. Comm’r, 330 F.2d 302 (3d Cir. 1964).

\(^{149} \) As in many deferral situations, of course, the deferral could become a permanent exclusion. If, e.g., the property decreased in value to $83X and was sold at that price by \( B \), the tax on $17X would be lost. If \( B \) died when the property was worth $100X, section 1014 might give \( B \)’s heirs a stepped-up basis of $100X, although it could be argued that the $17X is income in respect of a decedent under section 691 (similar to accrued interest on a bond), and that the basis of \( B \)’s heirs should therefore remain at $83X.
and C (ABC)—is to attempt to have the situation viewed as if B owned the entire fee simple and should thus be treated as A was treated before the interests in Blackacre were split. This solution is unnecessary where the income interest is acquired by gift because section 273 provides the same result for the government, i.e., the entire income is taxed to one individual (now the income beneficiary rather than the remainderman) as though that individual owned the entire fee simple.

Thus, the government isn't concerned with favoring remaindermen over those who own income interests, or vice versa. What the government has sought to avoid is deferral loss. In the gift area this is done at the expense of the owner of the income interest; in the nongift area like Bryant and the ABC transactions, the remainderman pays the bill.

Section 1001(e)

Nothing would serve to illustrate these propositions more clearly than the recent reaction of the government to the attempt by the owner of the income interest acquired by gift to escape the disadvantage of section 273. The story is best told in the House report on what became section 1001(e) of the Code:

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property divided between the life estate and the remainder. (As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.)

The life tenant is not permitted to amortize his basis over the length of the life estate because this would reduce for tax purposes the amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used in reducing the gain he receives on the sale.150

At this point we may interrupt and consider what solutions were available for the perceived problem. Note that the actors in this scenario closely resemble those in the ABC transaction: A the owner-seller of the income interest, C the purchaser of the income interest and B the owner of the remainder. Should not the solution then be the same? Shouldn't B be required to include the income on the Bryant theory that he benefits by the income since "with it he has purchased an asset" or on the congressional rationale of section 636(b) that B should not, unlike everyone else, be able to pay off what is, in effect, a loan with before-tax dollars?

But this was not the solution chosen; rather, the decision was to continue to prefer $B$ over $A$. As the report continued:

*Explanation of provision.*—Your committee's bill provides a new rule for determining the amount of gain or loss from the sale or other disposition of a life interest (or an interest for a term of years) in property or an income interest in a trust. In such a case, the bill provides that any portion of a taxpayer's adjusted basis determined under sections 1014 or 1015 of the code (dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust) is disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis for the property.

Thus, where there is a sale or other disposition of a life (or term of years) interest in property, or an income interest in a trust—which was acquired by gift, bequest, inheritance, or by a transfer in trust—there is to be no cost or other basis to offset the proceeds received from the disposition. Accordingly, the person disposing of such an interest is to be required to treat as gain the entire amount he receives from the disposition of his interest, rather than only the excess of the amount received over his basis.\(^1\)

Thus, the deferral loss is avoided by requiring $A$ to accelerate the income he would be taxed on if he did not dispose of his interest, a rather drastic solution from $A$'s point of view.\(^2\)

But suppose that in addition to $A$ selling his income interest, $B$ sells his remainder. Suppose, i.e., both $A$ and $B$ sell to $C$. $A$, of course, is in precisely the same economic position as he would have been in if $B$ had not sold his remainder. Isn't he therefore to be treated in the same way, i.e., required to report his entire amount realized as gain?

"No," said the committee, with the following explanation:

The bill, however, does not change present law in the situation where there is a sale or other disposition of a life or term of years interest in property (or an income interest in trust) which is a part of a transaction in which the entire fee interest is transferred to any person or persons. Thus, where a life tenant and remainderman simultaneously sell the entire fee interest in property in a single transaction, it is to be treated in the same manner as under existing law; the gain each [sic] receives is to be measured by the excess of the proceeds received on the disposition over the adjusted basis in the life estate. Your committee believes this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.\(^3\)

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\(^{1}\) *Id.* at 157.

\(^{2}\) Presumably, however, $A$’s gain could still qualify for preferential capital gain treatment. *See* *McAllister v. Comm’r*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

\(^{3}\) H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 157 (1969) (emphasis added). It should also be noted in this situation that unless $A$ is given his basis as an offset against the amount he realizes, that portion of the uniform basis will
From the above it seems clear that the motivating force of the government's position in the various AB and ABC situations is the avoidance of deferral loss by the taxation of the income from particular property to some person as though that person owned the property in fee simple. Where the property interests are split between taxpayers, one owning a future interest (remainder), the other a present (income) interest, the choice of the taxable person is made to depend on whether the interests are received gratuitously or for consideration. If the income interest has been acquired gratuitously, the owner of that interest must shoulder the burden of the income. If the income interest and remainder have been purchased, the remainderman is chosen to pay the tax by being equated with a borrower who has purchased the fee simple on credit even though no loan exists.

Sales and Gifts in Combination

The extent to which the government's position is supported by artificial notions is made clear if we consider a combination of gratuitous and nongratuitous cases. Suppose, e.g., that X transfers Blackacre to T in trust to pay A the income up to $50X, the trust then to end and Blackacre to be conveyed by T to B. If the interests of both A and B are acquired by gift, A clearly is taxed on all the income. But suppose only A's interest is acquired by gift, B having purchased his remainder interest from X. Are the provisions of subchapter J now to be considered overridden by section 636(b) (if Blackacre is mineral property) or Bryant (if Blackacre is not mineral property)? On the one hand such a case is no different from the situation where X sells a remainder and retains a production payment. Surely section 636(b) or the Bryant holding cannot be circumvented merely by X giving his production payment to someone else at the same time that the remainder is sold. But if section 636(b) and Bryant apply to tax B on the income paid to A, surely A will not also be taxed on such income without any amortization under the provisions of subchapter J and section 273. From the point of view of the government, of course, deferral loss would be avoided by taxing either A or B, but that hardly solves the question of which of A and B to tax. That question, however, cannot really be answered as long as the conflict remains between the government's position in gratuitous and nongratuitous situations.

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be lost to everyone. C acquires his basis by cost, not as a carryover from A (or B). B will have only such part of the uniform basis as he acquired under section 1014 or section 1015, together with any increase therein due to the passage of time, under section 1.1014–5(a)(2) of the regulations. The balance of the uniform basis must be allowed to A, or be lost to all concerned.
If the combination just discussed presents an insoluble problem because of statutory or statutory/judicial inconsistencies, what of the converse combination? Suppose, e.g., that A purchased the production payment and B’s remainder interest was gratuitously transferred. Now who is taxed on all the income? B is not reached by section 636(b) since there is no sale of mineral property; nor, for the same reason, would Bryant seem to apply. A would be able to amortize since section 273 applies only to income interests which are gratuitously acquired. The government would thus suffer deferral loss of the same type (and for the same reason) involved in the AB situations covered by Bryant and section 636(b).

The basic question would thus seem to be whether the deferral loss which is still possible in this situation should be viewed as just a loophole that has not been closed or rather as representing the proper result which should prevail for all of the AB (and ABC) situations. Before attempting an answer to that question, however, we will analyze the judicial and congressional treatment of the BA transactions.

Carve Out or BA Transactions

In General

The carve out transaction is essentially the reverse of the AB transaction. Instead of viewing A as a fee owner who conveys a remainder interest and reserves a production payment or term for years, B can be seen as owning the fee interest and conveying to A a production payment or term for years. Hence, the BA transaction.

Until recently, the issue which has been litigated with respect to the carve out is whether B’s gain on the amount received from A was capital gains or ordinary income. This issue was settled by the Supreme Court in Commissioner v. P.G. Lake, Inc.\(^{15}\) which held B’s gain to be ordinary income.\(^{15}\) Apparently not presented as an issue in P.G. Lake was the question of whether the transaction was properly characterized as a loan from A to B, to be repaid by the production payment. In such case, the common assumption is that B’s receipt of the proceeds is not a taxable event and that B is taxable on the income from the property which is used to repay the loan from A. A, of course, has basis offset to prevent him from being taxed on any more than the interest on the loan.


\(^{15}\) For a detailed discussion of the capital gains-ordinary income issue, see Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 295 (1962); Del Cotto, “Property” in the Capital Asset Definition: Influence of “Fruit and Tree,” 15 Buffalo L. Rev. 1 (1965).
In *P.G. Lake*, the taxpayer, *B*, reported the transaction as a sale, producing income in the year the proceeds were received, and both the Commissioner and the Supreme Court accepted the characterization of the transaction. Indeed, in *General Counsel's Memorandum 24849* the Service had taken the position that:

Assignments of income rights by the earner for cash or other property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has *elected to anticipate normal realization* by assigning or discounting such right. *Consideration received* by him *represents* ordinary income realized by him upon anticipatory assignment of his right to income.

Although this ruling deals with the capital gains-ordinary income issue on assignment of oil payments for consideration, in holding such consideration to be ordinary income the ruling also stresses that the assignor "has elected to anticipate normal realization" and that the "consideration received" represents income. Also, *A*, the assignee of the oil payment, is characterized as a "purchaser" of "property rights," with a basis in his hands equal to the consideration paid. Thus, *B* is a seller, who must account for any gain from the proceeds in the year of the sale, and *A* is a purchaser, not a lender. The Service continued to hold this position in *Income Tax Ruling 4003* which held: "the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him."

In these rulings, the Service was treating the *BA* transaction not as a loan, but as a "sale" and "purchase," requiring *B* to be taxed immediately on the receipt of the consideration from *A*, rather than taxing *B* only as the property earned the income. This result prevents *B* from deferring tax to future years and, in the usual case, is detrimental to *B* and favorable to the government. Recently, however, the unusual case has arisen where early taxation helps *B* and hurts the government. Such

156 356 U.S. at 262.
157 1946-1 C.B. 66.
158 *Id.* at 68 (emphasis added).
160 1950-1 C.B. 10. Income Tax Ruling 4003 expanded the application of General Counsel's Memorandum 24849 from short lived carve outs to carve outs of any length extending over a period less than the life of the underlying property interest.
161 1950-1 C.B. at 11 (emphasis added). *But see* Comm'r v. Slagter, 238 F.2d 901 (7th Cir. 1956), where, prior to the decision in *P.G. Lake*, the Commissioner was upheld in characterizing the transaction as a loan.
a case is *Estate of Stranahan v. Commissioner.* The facts, briefly, were that, in 1964, paid a large federal tax deficiency plus interest thereon. Because his 1964 income was not high enough to absorb the resulting interest deduction, tried to accelerate his future income into the year 1964. He did this by assigning to his son all the dividends to be declared and paid to him on certain stock owned by him until the assignee received $122,820. His son paid him $115,000 in consideration of the assignment and included this amount in his 1964 income as proceeds from the sale of the stock. He did not report as his income amounts received by his son in 1965 under the assignment. The Commissioner asserted that the 1965 receipts of his son were income to in 1965.

The Tax Court upheld the Commissioner concluding that the "whole undertaking, though conducted in the form of an assignment of a property right, was in reality a loan to petitioner masquerading as a sale and so disguised lacked any business purpose." The "lack of business purpose" language is an apparent response to, and agreement with, the Commissioner's position that the assignment had "no commercial substance for tax purposes, but was designed solely to circumvent the payment of . . . proper taxes." The reasoning of the Tax Court, however, was "that the transaction in dispute was not a bona fide sale but merely an anticipatory assignment of the undeclared dividend income to an intermediary, decedent's son, for collection and was devoid of any substantive purpose other than tax avoidance. . . . In our judgment, decedent still received the dividend income in 1965, albeit in a more indirect fashion. In effect, the son-assignee merely acted as a conduit for transmitting to decedent his dividend income when actually paid in that year."

In expanding upon this analysis the Tax Court relied on the principles of *Helvering v. Horst* and *Helvering v. Clifford* to state:

> [T]he 1964 assignment was of the fruit of the tree and not the assignment of the tree itself. In other words, the decedent kept the "tree" and assigned part of the "fruit." By retaining the stock, the decedent controlled the source of the income and he directed its disposition in "assigning" or diverting it to his son. The alleged assignment did not result in any substantial change in decedent's dominion or control over the property. The

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162 472 F.2d 867 (6th Cir. 1973).
164 Estate of Frank D. Stranahan, 30 T.C.M. 1078 (1971).
165 Id. at 1084.
166 Id. at 1081.
167 Id. at 1082.
168 311 U.S. 112 (1940).
169 309 U.S. 331 (1940).
decedent . . . merely exercised his power to dispose of the income. Under these circumstances, there has been no effective separation of the “fruit” from the “tree” and the decedent is clearly taxable on the income when and as received by the son.\textsuperscript{109}

The Tax Court was reversed by the Sixth Circuit Court of Appeals\textsuperscript{170} which held the transaction to be a sale because the risks of ownership of the dividends passed to the son.\textsuperscript{171} The assignment of income cases relied on by the Tax Court were held inapplicable to a transfer for full consideration.\textsuperscript{172}

**Stranahan Under Perkins and Anderson**

*Stranahan* represents a classic type of BA transaction which can readily be analyzed under the now familiar principles of *Perkins* and *Anderson*. Did $B$ shift risks of ownership from himself to $A$? Clearly $A$’s only source for recovery of the consideration he paid was the future dividends, if declared and paid. Failure of the stock to pay dividends was a risk borne only by $A$, only he had the risk of loss. $B$ had cashed out all of his economic interest in such dividends and ended all risks with respect to them. Therefore, the cash received by $B$ was fully realized in the tax sense—he had completely ended any relationship to, and any investment he had in, the assigned dividends. Thus, $B$ had engaged in a taxable event and should account for any gain arising from the consideration received.

What of the fact that the risks of not receiving dividends was so remote that the consideration paid by $A$ was computed merely as a discount at the prevailing interest rate? The court of appeals met this point by stating:

\[\text{[It seems clear that risks, however remote, did in fact exist. The fact that }\]
\[\text{the risks did not materialize is irrelevant. Assessment of risks is a matter of }\]
\[\text{negotiation between the parties and is usually reflected in the terms of }\]
\[\text{the agreement. Since we are not in a position to evaluate those terms, and }\]
\[\text{since we are not aware of any terms which dilute the son’s dependence on }\]
\[\text{the dividends alone to return his investment, we cannot say he does not }\]
\[\text{bear the risks of ownership.}\]

*Perkins* would agree with *Stranahan* that $B$ could not be taxed on the dividends received by $A$, because $B$ had no economic interest in the dividends. If $B$ had pledged the underlying stock as security for pay-

\textsuperscript{109} 30 T.C.M. at 1083.

\textsuperscript{170} Estate of Stranahan v. Comm’r, 472 F.2d 867 (6th Cir. 1973).

\textsuperscript{171} *Id.* at 870–71.

\textsuperscript{172} *Ibid.*

\textsuperscript{173} 472 F.2d at 871.
ment of $122,820 in absence of dividends or if B had personally guaran-
teed such security, however, then Anderson would tax B on the divi-
dends received by A because of A’s right to be paid in all events from
B’s independent assets.174 In such case there would be no sale by B to
A, but a loan from A to B with B retaining his economic interest in the
assigned dividends.

The effect of Anderson will be developed at greater length shortly.
What we wish to stress here is the nature of the transaction and the tax
consequences to A and B. Essentially, A is always conveying a present
interest in his property for a right to future payments from B’s property.
Usually A conveys money for a right to future money. If A’s interest is
secured within the principle of Anderson, then receipt of the future
money (i.e., the dividends) simply repays A for his advance to B, plus
interest. Although A has a right to the dividends as such, since he is
not totally dependent upon them, the dividends are income to B and
are received by A as repayment of a loan to B, with interest.176

If, on the other hand, A’s sole source of recovery for the amounts
conveyed to B is the income from the property, without any security by
way of a mortgage on the property or otherwise, then A has no right of
repayment from B. The transaction is not a loan to B to be repaid either
from the property’s income or B’s independent assets, rather, it is a sale
by B of future income from property in return for a purchase price paid
therefor by A. As held in Stranahan, B has ended his risks in whether
A will in fact receive what he purchased, and B should account for the
purchase price in the year he receives it.176

174 See, e.g., Christie v. United States, 436 F.2d 1216 (5th Cir. 1971), and
cases cited therein.

175 The interest is ordinary income under United States v. Midland-Ross Corp.,
381 U.S. 54 (1965).

176 So viewed, the terms “sale” and “loan” are being used as if they describe
mutually exclusive transactions, with the implication that there is only a single
taxable event requiring a symmetry of treatment both as between A and B, and
also as to each of A and B separately. Thus, B is viewed as having engaged in
either a sale or a borrowing, the result turning on whether Anderson views B as
keeping the risks of payments to A. This view is, however, misleading. If Anderson
applies to B then certainly he will be required to include in his income the
payments made to A, but this does not tell us how B should treat the initial
amount received from A. To call it a loan is to beg the question, because a loan
can be viewed as a sale of money by A in return for a promise by B to repay,
giving B immediate gain in the full amount received due to a zero basis in B’s
promise to repay. Such treatment would require that B receive a loss deduction
when his debt to A is discharged by A’s receipt of the production payments. See
Rev. Rul. 65-254, 1965-2 C.B. 50. Accordingly, B’s gain on A’s receipt of the
payments would not be taxed (disregarding interest which would be washed by a
deduction in any event). To call such a sale a loan, then, is merely to reflect
common agreement that B should not treat the receipt of money from A as a

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Martin v. Commissioner and Hydrometals, Inc. v. Commissioner: Effect of Anderson

In Martin v. Commissioner the taxpayer (B) owned an apartment building. In 1966, in order to utilize a loss for that year, B assigned $225,000 of future rents payable by its tenants, plus 7 percent on the outstanding balance, receiving in consideration $225,000 from the assignee, A. B in no way guaranteed the rents would be collected, but did agree to pay all bills and obligations of the apartments and to keep them open and operating in a businesslike manner for a period of two years. B also agreed to repair or reconstruct the apartment building in the event of its partial or total destruction, and in such event the two year period was extended for the period the apartments would be closed.

Accordingly, as the debt is satisfied by the production payments to A, B has income in the full amount of the production payments. If, on the other hand, we have facts such as in Stranahan, where Anderson does not apply to B, then there is only one taxable event to B and only one opportunity to tax B—on the receipt of money from A. Here, B is said to have sold the production payment, and he has in fact done so by ending all risks in it. Most importantly, B must be taxed at the time of the sale since, under Perkins, he cannot be taxed as A receives the production payments. This, of course, is the holding of Stranahan.

Turning to A, the tax treatment to be given him does not depend on how B is treated. Whatever A conveys to B, cash or appreciated property, A has engaged in a sale. This is clear when Anderson does not apply to B, as in Stranahan. A has ended all risks, retaining not even a security interest in the property he conveys, and A has acquired the risks of a different asset, the right to production payments. For example, if A conveys Blackacre to B for the right to rents from Whiteacre, B's property, for a period of years, A has sold Blackacre just as B has sold the rentals from Whiteacre. Each must account for gain or loss at that time.

Where the Anderson principle does apply to B because A keeps a security interest in, or B's personal liability for the value of, the property conveyed, A has nevertheless engaged in a sale of the property, whether it be cash or Blackacre, because his right to payment for the property is not limited to Blackacre or the cash conveyed; rather, A has two sources for payment, primarily the production payments, secondarily the property conveyed, and, under the Anderson principle, A has engaged in a sale of whatever property A conveys. The fact that B is not taxed on receipt of the cash from A, or of Blackacre from A, because we call it a loan as to B, in no way affects the fact that Anderson treats A as a seller. Nor is it relevant to A's situation that Anderson also requires B to include as income the production payments received by A since B includes them as owner of the property while A includes them as proceeds from a sale. To illustrate, using the above example, suppose A conveys Blackacre to B for rentals from Whiteacre totaling $100X, secured by a mortgage on Whiteacre (or Blackacre). B, of course, is treated simply as purchasing Blackacre on credit—i.e., as a borrower by way of a purchase money mortgage—and does not include the value of Blackacre in his income. A, nevertheless, has engaged in a sale of Blackacre.

\footnote{469 F.2d 1406 (5th Cir. 1972), affirming without opinion J.A. Martin, 56 T.C. 1255 (1971).}

\footnote{56 T.C. at 1257.}
The Commissioner characterized the transaction as a loan from A to B so that B was required to include as 1967 income the $225,000 received by A as rentals in that year. The Tax Court agreed, relying on the assignment of income cases.\textsuperscript{170} No reliance was placed on Anderson. The court of appeals in Stranahan, however, although it did not cite Anderson, did distinguish Martin from Stranahan "as there the premises were required to remain open for two full years' rental operation, suggesting a guarantee toward repayment."\textsuperscript{180}

What then is the effect of this guarantee in Martin? It is certainly not an assumption of any risk by B that the apartments will in fact earn rents, or that the tenants will pay them. Indeed, B did not even covenant to collect the rents, and expressly stated he did not guarantee their collection.\textsuperscript{181} B did, however, agree to operate the apartments and pay its bills so the rents could be earned, and to repair or reconstruct them, if necessary.

Like the agreement by B to pay for utilities in Alstores Realty, B's duty to pay the bills and obligations of the apartment business does not make B the economic beneficiary of the rentals received by A. Payment of the bills is a cost to B of the consideration paid by A for the rentals, i.e., a cost of the amount realized from A, and should reduce the amount realized by B.\textsuperscript{182} It is a fixed cost that does not depend on the actual presence of rental income; B would not be relieved of the obligation to any extent by production of rents. Thus, B had nothing to gain from presence of rental income and nothing to lose from a lack of such income. These risks of loss are borne by A and B has only a fixed cost to provide a service which A has paid for as part of his purchase price (which presumably would have been reduced somewhat if A had to perform these tasks himself).

An identical analysis applies to B's duty to perform, or supply, services to provide management for the apartments. B has sold A services as well as rentals and the cost of providing services is a fixed cost to B, not dependent on rentals. Thus, the obligation will not be reduced or removed by the presence of rents. Like payment of utilities, the services are necessary to production of the rentals, but the cost of providing them does not depend on the presence of rents. Therefore, B is not the economic beneficiary of the rents.

The agreement by B to repair or reconstruct the apartments in the event of partial or total destruction, on the other hand, is similar to B's

\textsuperscript{170} 56 T.C. at 1259–260.

\textsuperscript{180} 472 F.2d at 871 (emphasis added).

\textsuperscript{181} See, e.g., Baker v. United States, 514 F.2d 722 (5th Cir. 1975); Reg. § 1.263(a)–2(e). Cf. cases cited in N. 125 supra.

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obligation in *Alstores Realty* to pay *A* the rental value in the event of *A*'s ouster by act of God. This is not a fixed obligation which is unaffected by the presence of rents. So long as the apartment building remains undestroyed, this obligation remains inchoate and therefore *B* is benefited (i.e., relieved of the obligation) by the rental payments. The extent of the benefit, as in *Alstores Realty*, is properly measured by the cost of an insurance policy protecting against any destruction of the apartment house. To this limited extent, the amount received from *A* should be treated as a loan rather than proceeds of a sale, reportable by *B* as rental payments are received by *A*, and reducing *pro tanto* the amount taxable to *B* as proceeds from the sale of rentals. Or, as a practical matter, the risks may be disregarded on the ground of remoteness. By no means, however, is there a guarantee by *B* that *A* will receive all rentals due him in all events. In *Martin*, therefore, *B* should not be treated as a recipient of a loan in the full amount payable to *A*, as suggested by the court's distinguishing of *Martin* in *Stranahan*.

*Hydrometals, Inc. v. Commissioner* appears to involve an attempted application of the *Anderson* principle. *B*, in order to utilize the last year of a net operating loss carry forward, assigned to *A* $1.3 million, plus interest on the unpaid balance, in consideration of *A* paying to *B* $1.3 million. The assignment to *A* was payable solely from *B*'s manufacturing revenues. *B* had no personal liability for the payment and made the usual covenants with respect to operating the business, paying business debts and repairs. *A* had borrowed the $1.3 million from *C*, a bank, assigning the production payment as security for the loan. Without more, the facts of *Hydrometals* are fully analyzed by the discussion of *Stranahan* and *Martin*. *Anderson* has limited, if any, application to *B* and *B* has sold the production payment, rather than being the recipient of a loan from *A*. The Tax Court, however, found that *B* was the recipient of a loan from *C*, through *A*, to be repaid from the production payment. The reason, apparently, for this holding was the conclusion of the Tax Court that *B* "left for safekeeping with [C] certificates of deposit for $1,300,000 which it had purchased with proceeds it received from the loan made by [C] to [A]. There was in effect an agreement between [B] and the bank that these certificates would be maintained until [A] had repaid the $1,300,000 to [C]."
If B had in fact guaranteed to C repayment of A's borrowing from C, and if A had no personal liability on the loan against which B would have recourse, then neither A nor C would bear the risks of the production payment. B would have pledged his own separate property and continued to be the economic beneficiary of the production payments made to A.\(^{166}\) However, whether in Hydrometals there was such an agreement on B’s part is dubious. B did use the proceeds of C’s loan to A to buy certificates of deposit from C and apparently did agree to leave them in C’s possession until their maturity, but nowhere agreed they could be used to satisfy A’s debt to C.\(^{167}\) Hydrometals would thus appear to be a questionable application of Anderson. Indeed, the Tax Court nowhere stated any reliance on Anderson, but did expressly rely on Martin, stating that the holding of that case was correct, and should be followed in Hydrometals.\(^{188}\)

So, Stranahan appears to be the only one of the three BA cases which is properly decided under a risk-benefit notion.\(^{189}\) Martin and Hydrometals tax B as the recipient of the production payment, even though he has no risks of loss with respect to the production payment and is not a borrower from A on the security thereof. Again, albeit in an unperceived way, B is being taxed on gain due to the increase in value of his remainder interest as A receives the production payments, a treatment of B for which there is no authority.

**Relationship of the Assignment of Income Doctrine to the BA Transaction**

The Tax Court’s decisions in Stranahan, Martin and Hydrometals have been bottomed on the anticipatory assignment of income doctrine.\(^{190}\) Basically, the Tax Court has invoked such cases as Horst, Clif-

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166 See, e.g., Comm'r v. Estate of Donnell, 427 F.2d 106 (5th Cir. 1969).
167 31 T.C.M. at 1263, 1264. Cf. George H. Landreth, 50 T.C. 803 (1968); Holbrook v. Comm'r, 451 F.2d 134, petition for rehearing denied, 451 F.2d 1350 (5th Cir. 1971) (B's guarantee of A's debt to C gives B no economic interest in the production payment where B has a right of subrogation against A).
188 31 T.C.M. at 1265.
168 Anderson is properly applied to a situation where B pledges his independent assets, by way of a mortgage or his personal liability, securing payout to A in the amount of the production payment conveyed to A. Also, the type of transaction in Woodsam Associates, Inc. v. Comm'r, 198 F.2d 357 (2d. Cir. 1952), can be seen as a common garden variety Anderson situation. There, B owned appreciated property and borrowed $400,000 from A, without personal liability, but secured by a mortgage on the property. Although A did not receive a production payment as such, it is easily seen that the presence of rentals from the property enrich B by enabling him to amortize the mortgage and free the remainder from the burden of the mortgage.
190 See 56 T.C. at 1259–60; 30 T.C.M. at 1082.
ford and Lucas v. Earl\[101\] to find that B is taxable on the production payments in the year they are received by A, thus preventing acceleration of that income by B to a prior year.

Suppose B owns the fee simple in Blackacre and makes a gratuitous conveyance to A of a certain number of dollars from rentals of Blackacre. This is the factual pattern which has traditionally been within the domain of the assignment of income doctrine. B can avoid being taxed on A's receipts if he takes certain precautions.\[102\] Lacking such precautions, B might very well be taxed on the rentals paid to A\[103\] and A will not be taxed.\[104\] When B is not taxed (and A is taxed), it is because the assignment of income doctrine is not being applied, and the normal rule of taxation is applied, i.e., only A is taxed because it is only A who is the economic beneficiary of the income received by him. When, however, B is taxed under the assignment of income doctrine, he is taxed (and A is not) despite the fact that A, not B, is the economic beneficiary. In both situations it is only A who bears the entire risk of Blackacre paying the assigned rentals and, yet, under the assignment of income doctrine A avoids the tax and B does not.

Thus, the assignment of income doctrine is seen as the very antithesis of the risk-benefit notions embodied in the principles of Perkins and Anderson. That doctrine embodies an overriding principle which supersedes risk-benefit notions in favor of preservation of the tax rates of a progressive income tax.

The methodology by which the doctrine accomplishes its purpose is to employ a legal fiction: B is the owner of the property (Blackacre) producing the income and he is therefore the recipient of the income, which he pays over to A as a tax-free gift of corpus.\[105\] Hence, B is taxed on the income in the year it is collected by A, the assignee.\[106\] The overall purpose of this methodology is to determine who, i.e., which of A and B, should be taxed on the income received by A. Its only effect

\[101\] 281 U.S. 111 (1930).
\[103\] See, e.g., Helvering v. Horst, 311 U.S. 112 (1940); Galt v. Comm'r, 216 F.2d 41 (7th Cir. 1954); I.R.C. § 673.
\[104\] I.R.C. § 102(a); Reg. § 1.102-1(e).
\[105\] See, e.g., I.R.C. §§ 671-677. Section 671 states: "Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor . . . those items of income, deductions and credits against tax of the trust which are attributable to that portion of the trust."
\[106\] Rev. Rul. 69-102, 1969-1 C.B. 32. See also 30 T.C.M. at 1082 (held B taxable on the income "when and as received by the son"); Harrison v. Schaffner, 312 U.S. 579 (1941); Austin v. Comm'r, 161 F.2d 666 (6th Cir. 1947). Cf. Helvering v. Horst, 311 U.S. 112 (1940).
is to change the taxpayer from A to B in order to prevent spreading of income among related persons. It does not change the taxable event, i.e., the time of taxation. B is taxed only when A receives the income.

To what extent is this doctrine viable when B conveys a production payment to A, not as a gift, but for fair consideration? Clearly B is achieving no exclusion from his gross income of the value of the rentals assigned to A, much less total exclusion. The receipt by B of fair consideration should be enough to render the assignment of income doctrine inapplicable. The purpose of this doctrine is to make B the taxpayer and here this purpose is accomplished under risk-benefit notions by taxing B on the consideration paid by A. Furthermore, it is not the purpose of the assignment of income doctrine to change the when of taxation—i.e., to a year other than the year of actual receipt. Therefore, it should not be applied as it was by the Tax Court in Stranahan, Martin and Hydrometals to tax B as A receives the production payments.

There is an argument, of course, that the Stranahan-type carve out is within the broad reach of the assignment of income doctrine: By accelerating his receipt of income, B in effect achieves an exclusion from gross income due to the ability to utilize an otherwise wasted deduction and thus frustrates the progressive income tax. It is submitted, however, that in the historical development of the assignment of income doctrine, the doctrine has not been viewed as reaching cases of acceleration of income. In dealing with carve outs, the Service has taken the position that B is taxable upon the consideration received from A and in doing so has distinguished the assignment of income cases:

The issue presented by such assignments of expected income between strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as Lucas v. Earl ... Helvering v. Horst ... and Helvering v. Eubank ... involving donative assignments of income by the earner thereof in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization.

In other words, there is no justification for applying the assignment of income doctrine where the assignor receives a fair consideration and

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197 It was so held in Estate of Stranahan v. Commissioner, 471 F.2d 867, at 870 (6th Cir. 1973).
199 G.C.M. 24849, 1946-1 C.B. at 67-68 (emphasis added). See also Income Tax Ruling 4003, 1950-1 C.B. 10, 11, which makes the same basic distinction: A B who is a gratuitous assignor of a carve out is taxed when A receives the income; a B who conveys a carve out for fair consideration is taxable on the consideration when received.
in fact expedites rather than avoids realization of the income.

Similarly, if $B$, owner of *Blackacre*, enters into a ten year lease of *Blackacre* to $A$ and $A$ prepays the rents for the full term, $B$, if he is a cash basis taxpayer, must include such rents as income on receipt.\(^{200}\) The year of inclusion is not seen as an issue of assignment of income, but only as an accounting issue: how properly to report an advance receipt under the taxpayer's method of accounting. And yet this situation is no different in substance from the transaction in *Martin*, where $B$, instead of receiving rent prepayments from his tenants, received the value of the future rentals from $A$. The issue is still one only of accounting and does not involve the assignment of income doctrine unless that doctrine is to be distorted beyond recognition. Where $B$ receives fair consideration for a carve out, he is not attempting to shift income to other persons, and the problem is not within the purview of the assignment of income doctrine.\(^{201}\)

**Congress and the BA Transaction**

In 1961, Congress enacted section 636(a) which, in pertinent part, provides: “A production payment carved out of mineral property shall be treated for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as a mineral interest in property.”

The reasons for this statute, originally proposed by the Treasury in 1969,\(^{202}\) and eventually adopted by both the House\(^{203}\) and Senate\(^{204}\) in enacting section 636(a), are fully discussed in the *Treasury Proposals*:

Under present law, the seller of the production payment receives depletable income in the year of the sale. But the expenses of producing the income necessary to pay off the production payment are then claimed as

\(^{200}\) See, e.g., Reg. § 1.61–8(b); Kohler-Campbell Corp. v. United States, 298 F.2d 911 (4th Cir. 1962); Astor Holding Co. v. Comm'r, 135 F.2d 47 (5th Cir. 1943). Cf. Clinton Hotel Realty Corp. v. Comm'r, 128 F.2d 968 (5th Cir. 1942); Warren Service Corp. v. Comm'r, 110 F.2d 723 (2d Cir. 1940).

\(^{201}\) The assignment of income cases have been used by the Supreme Court in cases where $B$ sells a carved-out production payment for a fair consideration (see, e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958)), but for the purpose of deciding the capital gains-ordinary income issue, not in order to prevent acceleration of the income by $B$. Also, the pertinency of the assignment of income cases even on the issue of the nature of gain is criticized in Del Cotto, “Property” In The Capital Asset Definition: Influence of “Fruit and Tree,” 15 BUFFALO L. REV. 1 (1965). Cf. Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 TAX L. REV. 295 (1962).

\(^{202}\) See *Treasury Proposals*, at 256–60.


deductions in the subsequent years when the mineral is produced. Thus income and the expenses attributable thereto are mismatched with a consequent distortion of income in each of the years involved.

This mismatching has produced tax benefits that are far in excess of the advantage Congress intended to grant. First, the sale of the carved-out production payment is used to obtain a greater percentage depletion allowance than Congress intended to grant. In the case of percentage depletion, the present rules provide that the deduction with respect to any mineral property shall not exceed 50 percent of the net income (before depletion) for the taxable year from the property. That is, the maximum benefit to be derived from percentage depletion during any one year is to cut in half the taxable income from a mineral property.

But the use of carved-out production payments has vitiated this statutory limitation of 50 percent. For example, assume that a corporation derives all of its income from a lead mine which it operates at a profit of $1 million each year, having $10 million each year in gross income and $9 million of expenses. Before applying the 50 percent limitation, the percentage depletion deduction would be $2,300,000 (23 percent of $10 million) but the 50-percent limitation in the statute limits the percentage depletion deduction in this case to $500,000 (50 percent of the net profit of $1 million). Thus, if the company operates its mine in a normal manner it would pay Federal income taxes of approximately $240,000 and the percentage depletion deduction would have reduced its taxable income each year to one-half of what it would otherwise be. But, by resort to carved-out production payments, the company can drastically alter its tax picture. If it sells an $8 million production payment payable out of the following year's production, the percentage depletion allowance in the year of sale is increased from $500,000 to $4,140,000 (23 percent of $18 million). This result follows because the $8 million is treated not as a loan, but as income subject to the depletion allowance in the year of the sale. While the company will pay Federal income taxes in the year of sale of approximately $2.3 million, these are claimed as refunds in the following year when the company will claim a net operating loss carryback of $7 million. (This results from the fact that the $8 million production payment is excluded from income by the seller in the following year, leaving $2 million gross income and $9 million in expenses.) Thus, by the simple expedient of selling a production payment, the corporation has eliminated payment of Federal income taxes over the 2-year period of approximately $480,000. Yet for its book purposes it has continued to show a $1 million operating profit. Each year the corporation repeats this cycle, it can continue in a tax-free status.

The net result of the use of production payments in the manner described is to permit a mineral operator to obtain the benefit of the depletion allowance far in excess of 50 percent of the profit derived from a mineral property and to distort the purposes of the net operating loss carryback and carryforward provisions. This impact is even greater if, in the above example, the corporation had nondepletable income to absorb the unused portion of the “loss” in the year of the payout of the production payment.\(^{205}\)
In the mineral area, then, the Treasury viewed the sale of carved-out production payments as producing a mismatch of income (which is included by the seller \( B \) in the year of the sale) with expenses (which are deducted by the seller in the subsequent production years), which mismatch created an unintended distortion in the depletion deduction. In effect, a large deduction is manufactured out of whole cloth since, as demonstrated by the above-quoted example, it would not exist in such an inflated amount without anticipation of mineral income through sale of the production payment.

The solution to this problem, \textit{i.e.}, section 636(a), was described by the Treasury:

Under the proposal, the seller of a carved-out production payment will be required to match the income from the production payment with the expenses incurred to generate that income. This result will be accomplished by treating the transaction as a loan. Thus, in the year of the "sale" of the production payment, the owner of the working interest will not take the proceeds into income. In the year(s) in which the production payment is paid off, the income used to make the payment will be depletable income in the hands of the operator and he will be allowed a deduction for the expenses incurred to produce the income. The corollary of this rule is that the "purchaser" of this production payment does not have an economic interest in the mineral production; therefore, the income he receives is not subject to depletion. However, his tax position will not be changed from present law, since his receipts will constitute a non-taxable return of principal and taxable interest . . . .

This proposal will also correct an existing disparate treatment of production payments. Under present rules, if the "seller" of the production payment guarantees the payout of a production payment, the transaction is treated as a loan. The seller does not report the proceeds as income in the year of "sale," and he pays out the production payment with depletable taxable income. This same result will now obtain whether the production payment is guaranteed or not.

Thus, section 636(a) treats a carved-out production payment as a mortgage loan on the property irrespective of whether the seller, \( B \), secures the payment thereof with a mortgage.

To what extent does the rationale behind section 636(a) apply to sales of carved-out production payments of nonmineral properties? The mismatching of income and expenses is a problem which may be entirely absent as in \textit{Stranahan} (sale of future cash dividends on stock) or may be present to a greater or lesser extent as in \textit{Martin} (sale of apartment rentals) and \textit{Hydrometals} (sale of manufacturing revenues). This leg of the Treasury's rationale does not, however, quite reach nonmineral carve outs because there will not be created an inflated deduction as

\footnote{\textit{Id.} at 259–60.} \footnote{See Reg. § 1.636–1(a)(3) Ex. 1.}
occurs with depletion. The interest deduction in *Stranahan*, for example, did not depend upon the acceleration of income from a later year to the year of sale as does the depletion deduction in sales of mineral carve outs. The interest deduction, then, is not allowed in a greater amount than Congress intended to grant.208

More importantly, the second reason used by the Treasury to give loan treatment to carve outs, and the one without which section 636(a) cannot be justified, will not stand analysis. As quoted above, in discussing the proposed section 636(a), the Treasury says that the statute will treat the nonsecured production payment in the same manner as one that is guaranteed, as a loan—suggesting that the two situations are indistinguishable in legal effect. As noted in our discussion of section 636(b) (with respect to the *AB* and *ABC* transactions) the Treasury had argued elsewhere that “[t]he essence of a lending transaction is not affected by the nature of the security interest involved”209 thereby rendering *Perkins* and *Anderson* indistinguishable. Our discussion throughout identifies such reasoning as clearly erroneous. Neither the rule of section 636(a), nor the reasons behind it, are persuasive in analyzing the proper tax effect of sales of nonsecured carved-out production payments, in the mineral area, and most certainly not with respect to such sales of nonmineral property.

**Summary and Conclusion**

We began our discussion with the basic principle that the income from property should be taxed to the person benefitted by that income. Analysis of that principle in the *AB* and *BA* cases indicates that if the income from particular property is paid to *A* it should be considered income of *A* and not *B*, unless *B* has the risk of loss of such income. *B* will have such risk either by acquiring it (in an *AB* case) or retaining it (in a *BA* case) by virtue of some separate asset or assets of *B* being burdened by an obligation to make payments to *A*, which obligation is redeemed by the income generated and paid to *A*. Where *B* has such risk of loss, the income from the property is properly considered as income from the property as to *B*. As to *A*, it is properly considered as payments from the sale of the property.

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208 In any event a more proper solution to the problem of mismatch, and one not involving a conflict with the *Perkins-Anderson* rationale, is a rule which would require the expenses of production to be capitalized as a cost of the proceeds received on the sale of the carve out. *See* authorities cited in N. 182 *supra*. *Cf.* the cases cited in N. 125 *supra.*

The application of these principles has given rise to difficulty for the government in both the AB and BA areas. In the AB area, the problem is one of deferral loss. To refer again to a familiar example, assume A owns a two year term for years in Blackacre and B owns the remainder. Assume further that A's interest is worth $17X, B's remainder is worth $83X, and the basis of both A and B is equal to the value of their respective interests. If A, who is paid $10X of rent in year 1, is allowed to amortize his basis of $9X and B is not required to include any of the $10X in his income, the government loses the tax on $9X for at least year 1. The government's remedy, in the courts and in Congress, has been to require some taxpayer (or taxpayers) to include all of the income from the property without any amortization offset. Where A, who is receiving the payments, has received his interest by gift or bequest, it is A who must include all the income without amortization. In this example, A would include for year 1 the entire $10X of rent without an offsetting amortization deduction. Where, however, A has acquired by purchase, and is seen therefore as clearly entitled to amortization, B is required to include all income without amortization.

Where A has acquired by gift or bequest, it cannot be argued that he is being taxed on gain which he does not have. Where payments to such an A depend upon the presence of income, then he is the economic beneficiary of such income and his only complaint is that section 273 distorts the gift and bequest exclusion by giving it entirely to B (the remainderman), thus disallowing any amortization offset to A and requiring A to include the entire amount of income. Where, however, A is not prevented from amortizing by section 273 and the government seeks to tax B under section 636(b) or as in Bryant, even though the income received by A does not benefit B, a much different question is presented. B's complaint is that he is being taxed on income that is not his. And, as we have seen, under basic income tax principles, B's complaint is justified.

This does not necessarily mean, however, that B is thereby being taxed on more gain than he has had with respect to the particular property, because, as we have seen, any increase in the value of B's remainder can be properly viewed as an element of economic gain. But, as we have further seen, such increase in value does not give rise to gross income to B in the absence of a provision like the 1969 amendment to section 1232. Moreover, a statute taxing B on such increase in value would necessarily require a continual valuation of the fee interest in the underlying property because the value of a remainder is a direct function of the value of the entire fee interest in property. Thus, to tax B on the payments received by A when B is not benefitted by them, is not only
statutorily incorrect, but, not being tied to any value increase in B's remainder interest, it may have the effect of taxing B on gain that he does not have, a result which surely would raise constitutional questions.\(^{210}\)

Nor, as we pointed out in our preliminary analysis, does the government's solution insure it against deferral loss. In terms of our example, although B is treated as an owner in fee simple, and must therefore include the $10X of rents for year 1 without an offsetting amortization deduction, B is also treated as having borrowed $17X from A and thus is allowed an offsetting interest deduction of $2X. This interest deduction, however, is not fully reflected in A's income. Although A must include $10X, he amortizes $9X, thus paying tax on only $1X. How is the difference between B's $2X interest payment and A's taxable income of only $1X to be accounted for? B, having an outstanding loan of $17X for year 1 is allowed (approximately) a $2X interest deduction for year 1, as would a fee owner who actually borrowed $17X to pay for the fee. But $1X of this $2X is not included by A, as it represents the untaxed increase in value of A's term remainder in year 1. Thus, A pays tax on $1X and B on $8X and the government still loses present tax on $1X.

We need not set forth precise calculations to indicate that the longer A's interest and thus the larger B's loan, the higher B's interest deduction and the greater the government's tax loss. The government's strategy

\(^{210}\) In its brief to the Supreme Court in *Clay Brown*, the government posited a hypothetical where A transferred corporate stock to B subject to B's remitting to A the dividends for a stated term of years or until a certain amount was remitted. Of such a transaction the brief states in part:

The inappropriateness of treating the yield from A's retained income interest in such a transaction—i.e., the annual dividends collected by B and paid over to him—as payments of a "purchase price" taxable to A only as capital gains is obvious enough. But even more incongruous would be the necessary corollary to that treatment—namely, taxing B on the full amount of the dividends collected by him notwithstanding his obligation to remit them to A. . . . The total amount of the dividends collected by B and paid over to A is . . . wholly unrelated to the value of the stock, either at the time of the transfer or at the time B's "remainder" becomes possessory. The ultimate receipt of the stock itself is, in turn, the only economic benefit that will ever accrue to B from the transaction. To tax him on the dividends, therefore, would be to tax him on amounts having no relation to any benefits realized by him. Whether or not the meaning of "income" as used in the Sixteenth Amendment requires it, the policy of the income-tax laws is to tax only values or benefits actually accruing to a taxpayer. Taxing B on 40 years' dividends because he will have the full beneficial ownership of the underlying stock at the end of that time could hardly be reconciled with that policy.

in the AB area is, therefore, not only legally incorrect, but also (1) does not entirely insure against deferral loss, and (2) to the extent that it does, it does so haphazardly, i.e., depending on the extent of A’s interest.

It should be observed, however, that the strategy of taxing B on income payments which are made to A and which do not benefit B corresponds to the treatment accorded a taxpayer who owns all the interests (the fee simple) in income producing property. Thus, the fee owner of Blackacre is taxed on the full amount of rents despite the fact that his gain attributable to those rents is only the amount of rents less what he paid for the use of the property which produced the rents, any further gain being due to whatever value increase has occurred in his remainder in fee. If A, for example, owned the entire fee simple, he would be taxed on $10X of rents for year 1, despite the fact that he paid $9X for the $10X of rents.

This result is modified to the extent that such a fee owner is permitted depreciation deductions, i.e., to the extent that the fee owner is considered the owner of an asset that is physically wearing out. This is because where an income producing asset is physically wearing out it is clearly recognized that the gross income it is producing is not all gain, but is partially a return to the owner of the cost of the asset. The same recognition that the gross product of the year is not the net product is accorded the purchaser of an intangible asset which will produce income for only a limited period, such as a patent where amortization is allowed.

And also, as we have seen, where a person has purchased a present interest (income interest or production payment) in an asset which has a longer income producing life than the interest purchased, such a person is also recognized as having a return of cost or capital each year and is allowed an amortization deduction. Thus, where A purchases a two year term in Blackacre, or in a patent with a useful life of 17 years, A is allowed to amortize his cost.

Where, however, a taxpayer owns all the interest in an asset that is considered to have an unlimited income producing life (a fee simple in Blackacre), the gross product each year (the ground rent) is arbitrarily considered the net product and is taxed in full with no amortization allowed.211 The failure to accord proper basis by way of amortization to a fee owner is the result of the feudal concept of a fee as an interest of perpetual duration. Thus, the purchaser of a fee is seen as purchasing an infinite series of production units and his investment is

211 Such an approach is not only arbitrary, but is not even consistently applied to fee owners. If, e.g., an owner who has purchased Blackacre for $100,000 leases it to another for one year in return for $10,000, retaining the remainder in fee, no basis offset (amortization) is allowed. If instead he sells for $10,000,
seen as never wasting, resulting in the economically fallacious conclusion that he has paid nothing for the gross product generated by the asset in any given year.\textsuperscript{212}

However, even if such treatment of the owner in fee simple is embedded in the tax law, this does not justify extending its treatment to a taxpayer who has purchased only a future interest, not the entire fee simple. In other words, even if $B$, who purchases a remainder in fee is to be accorded the same tax treatment, when his remainder takes effect in possession—that is accorded a taxpayer who has purchased the entire fee from the beginning—this does not justify treating $B$ the same as if he did purchase the entire fee simple from the beginning. If, when $B$'s remainder becomes possessor, we are to treat his investment as never wasting, we should not compound the error by requiring him to include amounts in his income before his investment begins to pay off. The proper treatment of $B$ in such cases is to allow him to exclude the amounts paid to $A$ under the principle of Perkins, unless the amounts benefit him in a way which renders him taxable under the principle of Whitehouse and Anderson. Thus, in our example where $A$ owns the two year term and $B$ the remainder, $B$ should not be taxed on the $10X$ of one tenth of the fee (geographically divided or not), and retains the fee in nine tenths, he is allowed, in fact required, to allocate proper basis offset to the amounts realized.

In such a case, it may also be objected that the tax consequences are determined without regard to the value of the remaining nine tenths of the fee. At least, however, there has been proper recognition that one tenth of the fee sold has an allocable cost basis, a fact which is not recognized where one year is sold by way of leasing.\textsuperscript{212} In a recent case, Gordan P. Connolly, 34 T.C.M. 1379 (1975), the Commissioner allowed, indeed required, a taxpayer to allocate a portion of the cost of his land to offset a lump-sum payment for a 99 year lease. The facts of Connolly, simplified, were these:

Taxpayer purchased Blackacre for $10X. At an additional cost of $100X, he erected a building on the land. Thereafter he entered into a 99 year lease of the land and building in return for a payment of $120X, retaining a reversion in fee simple. In a taxable year subsequent to the year of the lease transaction, taxpayer sold his reversion for $20X. The taxpayer reported the 99 year lease transaction as giving rise to $20X of gain (offsetting the $120X lump-sum payment with the entire $100X cost of the building). He reported the subsequent sale of the reversion as giving rise to $10X of gain ($20X minus the $10X paid for the land).

The Commissioner contended that the proper approach was to allocate a portion of the aggregate basis of land and building ($10X) to each transaction. Accordingly, he allocated $120/140 of the $110X to the lease transaction since the leasehold had sold for $120X and the value of the entire fee (leasehold and reversion) was $140X. This resulted in gain of $26X (as opposed to $20X) on the earlier lease transaction.

The Tax Court sustained the Commissioner on the authority of Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir. 1960), where the Fourth Circuit
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had upheld the Commissioner's approach in a situation viewed by the Tax Court in Connolly as closely analogous. (It should be noted that although the Fourth Circuit in Welsh Homes treated the case as involving a 99 year lease with a retained reversion in fee, closer scrutiny of the facts indicates that the taxpayer-seller in that case did not, in economic reality, retain a reversion. The 99 year lease, for which the purchaser paid $11,250, was renewable forever by the purchaser at a nominal rent of $96 a year. Moreover, after five years the purchaser could relieve himself of the rental obligation and acquire a fee simple by redeeming the rental obligation for an amount equal to the capitalized (at 6 percent) value of $96 a year (say $2,000). The transaction was thus the economic equivalent of a sale of the fee with a retained purchase money mortgage in an amount equal to the present value, at 6 percent, of the right to $96 a year, the purchaser having forever the election either to pay that amount, or to pay $96 a year forever. This analysis was rejected by the Fourth Circuit, but in 1963 it was adopted by Congress in sections 163(c) and 1055 of the Code. See S. REP. No. 72, 88th Cong., 1st Sess. 1 (1963).

In Connolly the Tax Court relied heavily on the following reasoning of the Fourth Circuit in Welsh Homes:

Allocation of costs is normally employed for the establishment of a cost basis of property when a taxpayer acquires an aggregate of assets for a single unallocated purchase price and subsequently sells a portion of the whole. . . . The pending case presents the reverse of the situation. The cost of the land and the cost of the building, the constituent elements of the property which the builder has acquired are known, but in the building operation they have been incorporated into a single property and when a part interest in the whole—the leasehold—is granted to the lessee and the reversionary interest or ground rent is retained by the lessor, it is impossible to ascertain what part of the value of these interests is attributable to the land and what part to the building. It follows that the cost of land and building must be allocated between the interest granted and the interest retained. The taxpayer's contention that the allocation of costs is not necessary must be rejected since it is based on the mistaken notion that the purchaser of the leasehold acquires an interest in the building but no interest in the land. In various types of situations, more or less analogous to that in the pending case, the allocation of costs or expenses has been approved when it is the only practicable method of reaching a fair and equitable result. . . . In our opinion the costs were properly allocated in computing the taxable gain in the instant suit.

It must be kept in mind that in the above excerpt, the court was responding to the argument of the taxpayer-seller that he should be permitted to offset the entire cost of his building against the payment for the leasehold. The court was not responding to an argument, made by the Commissioner in the Tax Court but apparently not pressed on appeal, that none of the cost of either land or building should be allowed as a basis offset. Perhaps the reason this latter argument was not pressed on appeal was that it had been rejected as "fantastic" by the Tax Court. Be that as it may, the posture of the case on appeal made the choice appear to be only between allowing the entire cost of the building as a basis offset or only some allocable portion thereof. For the reasons stated above the Fourth Circuit chose the latter.

The Tax Court in Connolly viewed themselves as being put by the parties in the same position as the Fourth Circuit in Welsh Homes. As the Tax Court stated: "We reemphasize what we have indicated at the outset of this opinion. In view of the condition of this record we do no more than decide the narrow issue presented by the parties. Our disposition of this issue follows the Welsh
rents received each year by A. B would be taxed on those rents only when A's term was over and B became the owner of the entire fee.\textsuperscript{213}

Homes computation. It is not intended as suggesting that the parties properly analyzed the situation in presenting the issue as they did. [In a footnote the Court continued]: Indeed, perplexing questions present themselves as to whether any cost basis should be deducted from the amounts received in the light of such cases as \textit{Crile v. Commissioner} (1932 CCH 9068), 55 F.2d 804 (C.A. 6), certiorari denied 287 U.S. 600, and \textit{Gates v. Helvering} (4 U.S.T.C. 1237), 69 F.2d 277 (C.A. 8), but see \textit{Welsh Homes, Inc.} (Dec. 23,568), 32 T.C. 239, 252–254.”

In the cases referred to by the Tax Court it had been held that no basis offset (of either land or building) should be permitted even where the taxpayer purports to sell the building and lease the fee for 99 years, since the payment received was bonus rent.

Viewing the issues raised in \textit{Connolly} as open questions, a persuasive argument could be made for allowing (indeed requiring) the entire cost of the building to be offset against the payment for a 99 year lease at least if the useful life of the building was no less than the term of the lease. Moreover, if, in view of the length of the lease and the value of the property (land or land and building), the reversion is negligible, a further argument could be made that the entire basis of both land and building should offset the amount paid for the leasehold, which in an arm's length transaction should closely approximate the fair market value of the fee.

If, on the other hand, the length of the lease is such that only a portion of the building is sold, there is no reason to allow any more than an allocable portion of the building's basis to offset the payment for the lease.

Moreover, if there is anything more than a negligible reversion, it would be an astounding turnabout in the law to allow any offset for the basis of the land which is considered nondepreciable. Reg. §§ 1.167(a)–2, 1.167(a)–5; cf. John J. Sexton, 42 T.C. 1094 (1964). (As we have argued, however, the refusal to allow an allocable portion as an offset will not withstand analysis.) Perhaps because of a fear that its opinion would be read as such a radical departure from established principles, the Tax Court in \textit{Connolly}, in approving the formula which, as one of its features, allowed an offset of land basis against payment for a leasehold interest, felt it necessary to say: “The conclusion we reach is based strictly upon the issue as presented and as we understand it in the very dim light of a most unsatisfactory record. In the circumstances our disposition of this case can hardly have any useful precedential value in other cases where the matters in controversy are more sharply brought into focus against the background of a more clearly developed record.”\textsuperscript{214}

In the patent area the proper result with respect to B has been reached by allowing B to amortize dollar for dollar the amounts paid to A where A sells B the patent for a percentage of the profits. In \textit{Associated Patentees, Inc.}, 4 T.C. 949 (1945), the taxpayer, who had acquired title to the patent for a consideration of 80 percent of the yearly income from the use of the patent, paid over $42,000 in the first year to the seller. The Commissioner contended that this amount should be capitalized and depreciated over the useful life of the patent. The Tax Court stated its agreement that the amount must be capitalized but then went on to hold that the taxpayer could deduct the full amount in the year paid as depreciation of cost basis. “[T]he method urged by the [Commissioner],” said the Tax Court, “might deny petitioner the recovery of its cost and would unquestionably result in a distortion of income.” 4 T.C. at 986. The Commissioner eventually acquiesced.
The government's position in the BA area suffers from the same doctrinal weakness as in the AB (and ABC) area. In attempting to tax B on amounts received by A as proceeds of a carved-out production payment, both section 636(a) and the Commissioner's stance in the decided cases violate the principle of Anderson and Perkins. The Tax Court perceives the issue as involving assignment of income problems and essentially disregards risk-benefit notions in the decided cases. Also, the same phenomenon is occurring in the newly emerging BA area as occurred over many years in the AB (ABC) area: The government is viewing each case only as a target of opportunity. B will normally be given sale treatment for the transfer of the production payment and will be taxed in the year the proceeds are received from A. Thus, B will not get deferral advantage. If such treatment is to the government's disadvantage, however, the government apparently argues for loan consequences to both the Congress and the courts. This mechanism requires B to exclude the proceeds received from A and to include as income the payments received by A in the years received. Like B in the AB situation, the B in the BA situation is effectively taxed on a presumptive increase in the value of his reserved remainder interest, without sanction of statute. And the deferral allowed to B under this mechanism is, of course, to his disadvantage.

Thus, in both the AB and the BA areas the government's test for the distinction between sale and loan is essentially one of self-interest. The risk-benefit theory has been submerged even though the government saw it as the critical consideration in Clay Brown. Hopefully, we have not come so far down the road that we cannot turn back to basic principles of economics and taxation.

The result of inclusion, capitalization and 100 percent deduction is the same, of course, as exclusion. It makes no difference to B which way it is done. (Nor does it make a difference to A if he can get capital gains, a result assured for him if he is within the provisions of section 1235. See N. 109 supra).

But a patent is a wasting asset; thus, Associated Patentees, Inc. would not be considered precedent for B who has purchased a remainder in fee in a nonwasting asset like land or stocks. Moreover, to follow the inclusion/deduction route of Associated Patentees, Inc. with respect to B who purchased a remainder in fee would be blatantly inconsistent with the treatment accorded a taxpayer who has purchased the entire fee simple. The proper methodology, therefore, is an exclusion by B.

It should be noted that in the ABC oil transactions, a wasting asset is involved. If, therefore, B had not achieved exclusion as he did in Perkins, there is no reason why he could not have reached the same result under the route of Associated Patentees, Inc. Indeed, even under section 636(b) there is an argument that B has dollar for dollar amortization against the amounts required to be included by him under that section. Associated Patentees, Inc. would support such an argument, although the legislative history of section 636(b) does not contemplate it.