Limiting the Substitute-for-Ordinary-Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights

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LIMITING THE SUBSTITUTE-FOR-ORDINARY INCOME DOCTRINE: AN ANALYSIS THROUGH ITS MOST RECENT APPLICATION INVOLVING THE SALE OF FUTURE LOTTERY RIGHTS

I. INTRODUCTION

And the winning numbers are 5-10-15-25-46. The next morning Charlie checks his lottery ticket with the winning numbers listed in the newspaper. Much to his surprise and extreme happiness, his ticket matches perfectly. He is estatic. The first thing that pops into his mind is: "Should I accept the winnings through the annual installment method to be paid over twenty years or elect to receive it all up front in a lump sum payment? But more importantly, if I elect annual installments, and subsequently decide to sell my rights to the future annual payments, will the amount received in consideration for my future rights be taxed at ordinary or capital gains rates?" Well, this is probably not the first thing that comes to his mind, but after he thinks about buying his daughter Katherine a new house, Charlie, being an accountant and an aggressive advocate of the taxpayer, might consider this question earlier than other winners would.

Why might this be a consideration for Charlie and other lottery winners? The difference could mean a twenty percent reduction in the tax rate applicable to the lump sum paid for the future annual lottery rights.\(^1\) If Charlie receives a lump sum of $25 million for the sale of his rights to his future lottery payments, he would owe $3.75 million in taxes based on the long-term capital gains rate of fifteen percent. However, if the lump sum payment was taxed at the maximum ordinary income rate of thirty-five percent, his tax liability on the proceeds would increase to $8.75 million. Charlie is quite interested in knowing whether he could save $5 million in taxes.

Although the issue is whether the sale of lottery rights should be taxed at capital gains rates or ordinary rates, the obvious underlying question is whether the rights are considered to be a capital asset. Part II examines the definition of a capital asset and how the courts have interpreted it over the years. Part III analyzes the theory and development of the substitute-for-ordinary income doctrine along with two suggestions for appropriate limitations on the doctrine. Part IV discusses the recent cases involving the sale of rights to future lottery payments. Finally, Part V further examines these lottery cases using the proposed limitations on the substitute-for-ordinary income doctrine suggested in this Comment. These boundaries will help to form a uniform body of case law to guide courts, practitioners, and taxpayers in lottery cases and in other cases that may invoke the substitute-for-ordinary income doctrine.

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1. Assuming that Charlie holds the rights for longer than one year, he could enjoy the reduced long-term capital gains rate of 15%, as opposed to the maximum 35% rate on ordinary income. These rates are based on the 2005 tax year. See I.R.C. § 1(h)(1)(C) and § 1(i)(2) (West Supp. 2005). All of the citations to the Internal Revenue Code (I.R.C.) are to the West Supplement 2005 unless otherwise stated.
II. CAPITAL ASSET ANALYSIS

A. Statutory Definition

From an income tax perspective, the benefit of a capital asset is the possibility of obtaining a reduced maximum tax rate on the sale or exchange of the asset. To obtain this preferential rate treatment, the taxpayer must meet the following requirements: (1) the asset must be within the definition of a capital asset per Section 1221 of the Internal Revenue Code (Code); (2) there must be a sale or exchange of the capital asset; and (3) the asset must meet the holding period requirement, which is longer than one year. If all of these requirements are met, then the taxpayer is said to have incurred a long-term capital gain, which is taxed at fifteen percent instead of the maximum ordinary income rate of thirty-five percent. The twenty percent reduction in the applicable tax rate provides a powerful incentive for taxpayers to seek capital asset characterization.

Section 1221 of the Code provides the definition of a capital asset. The first sentence of this Section states, "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . . .” This Section proceeds to list eight specific exclusions to this definition, which include, among others, inventory, depreciable property used in taxpayer's trade or business, and “accounts or notes receivable acquired in the ordinary course of trade or business.” On its face, the statutory language appears to be clear on the type of property qualifying as a capital asset and property beyond the definition. The corresponding regulation affirms the Internal Revenue Service's (Service) position. However, this seemingly unambiguous definition has been the cause of much litigation.

B. Justifications

2. Although the preferential tax rate characteristic will be the underlying motive for capital asset treatment as examined in this Comment, it is not the only issue at stake in some of the cases in this area of law. For example, a determination of the appropriate basis for capital assets is an important issue. Basis is necessary for calculating the amount of gain or loss recognized on the sale or other disposition of capital assets. See I.R.C. § 1001 and §§ 1011–1012. However, since this Comment focuses on whether income is characterized as ordinary or capital, the basis issue and other ancillary issues will not be discussed.

4. Id. at § 1222(3).
5. Id.
6. Id. at § 1(h)(1)(C) and § 1(i)(2).
7. Id. at § 1221(a) (emphasis added).
8. Id. at § 1221(a).
9. See 26 C.F.R. § 1.1221-1(a) (West Supp. 2004) (“The term capital assets includes all classes of property not specifically excluded by section 1221.”).
10. Some of the litigation has involved other aspects of capital assets, such as what constitutes a "sale or other disposition." See, e.g., Nahey v. Comm'r, 196 F.3d 866 (7th Cir. 1999) (finding that no "sale or exchange" of a chose in action occurred when the taxpayer received proceeds from settlement of a lawsuit for lost profits). However, this Comment will address only cases examining the definition of the word "property."
Before discussing the relevant cases, it is important to the overall analysis to look at proposed justifications for classifying property as a capital asset. Many authorities discuss this issue in depth, but the majority are beyond the scope of this Comment. Since many of the cases involving the definition of property, as it relates to capital assets, mention or, in some cases, examine this issue, it is beneficial to include a section addressing these justifications.

Several justifications have been offered for granting reduced income tax rates to gains on sales or other dispositions of capital assets. One reason is to relieve taxpayers of the impact of "bunched income," which is gain that accrues over a period of several years, but is realized in a single year. Although this bunching problem could be handled using other methods, such as averaging the gain over each term of the holding period of the asset, for whatever reason, Congress attempted to relieve the burden associated with bunching by taxing long-term capital gains at a lower rate than ordinary income. This anti-bunching purpose is probably the most noted justification relied on by courts addressing the scope of the capital asset definition.

Another justification is to encourage investment mobility, which is designed to reduce the "lock-in" effect that taxpayers may experience. The value of a capital asset held for a long period of time may consist of built-in appreciation that goes untaxed until the taxpayer has a realization event. The "lock-in" effect represents the idea of the taxpayer's desire to hold on to property to avoid paying taxes on the gain built in to the asset. The Code contains a provision that allows a taxpayer to pass on property to others upon his death, and the person who receives the property gets a "stepped-up" basis, thus allowing the built-in gain to go untaxed. This incentive is fairly persuasive on the taxpayer's decision to alienate the property before he dies. In an effort to mitigate this desire to hold on to the property and avoid paying the taxes on the appreciation, Congress elected to give


14. Of course, bunching is the price to be paid by a taxpayer who, because of the realization principle, can control if and when tax will be paid on appreciation of property. The realization principle is that a taxpayer does not realize gain on appreciation of an asset until he sells or otherwise disposes of the asset. See I.R.C. § 1001.

15. Del Cotto, supra note 12, at 4.

16. For an explanation of the realization principle, see supra note 14.

17. See I.R.C. § 1014(a). "Stepped-up" basis refers to the provision that allows the fair market value of the property received from a decedent to become the "new" basis of the property in the hands of the person acquiring the property. This is a major factor used in tax planning for individuals who have property with significant built-in appreciation.
a preferential tax rate to capital gains. By offering this incentive, the Government also receives a benefit because it will receive tax revenue on the gains, which may not have been collected if the taxpayer held the property until death.

Although other justifications for classifying property as a capital asset exist, the final one mentioned here is to encourage capital investment.\textsuperscript{18} Investment property generally has two elements that distinguish it from other property. The first characteristic involves the taxpayer making some financial commitment to the property such as a down payment, a payment in full or by securing some form of financing.\textsuperscript{19} The second characteristic of investment property is that it typically entails an element of risk.\textsuperscript{20} This justification, though independently offered, is closely related to the idea of encouraging capital mobility. As these policies relate to the focus of this Comment, this justification is probably the second most noted reason for distinguishing between property qualifying as a capital asset and property that is an ordinary asset.

In the majority of cases discussed later in this Comment, the courts continuously apply these justifications, using them in their analysis to explain why certain property falls outside the scope of the capital asset definition.\textsuperscript{21} However, these justifications are vulnerable to criticism and each has its flaws and shortcomings. For example, the anti-bunching justification fails to acknowledge the benefit that taxpayers receive under the Code of not being taxed on the appreciation of the asset until a realization event occurs.\textsuperscript{22} In other words, if a taxpayer owns stock at the beginning of the year and the stock increases in value over the course of the year, this appreciation in value is not taxed until the taxpayer sells or otherwise disposes of the property.\textsuperscript{23} This is true even though the taxpayer is in a better financial position with respect to the stock than he was in at the beginning of the year. Perhaps this realization requirement is a matter of administrative convenience.

Although not mentioned above, another justification for the preferential treatment of capital gains is that gains merely represent inflation and do not represent a true increase in the value of the property. This may be true in certain situations, but this is not always the case. For example, if the value of a stock increases over the course of the year by ten percent or sometimes even significantly more than that, which was the case with a number of the technology companies in the late 1990s, this appreciation in value cannot legitimately be classified as being attributable to inflation alone. Therefore, the taxpayer has incurred an increase in

\textsuperscript{18} Note, Distinguishing Ordinary Income From Capital Gain Where Rights To Future Income Are Sold, 69 HARV. L. REV. 737, 741 (1955–56) (discussing the inconsistent tax treatment when a lump sum is exchanged for rights to receive income for a period of time).


\textsuperscript{20} Id.

\textsuperscript{21} See, e.g., Hort v. Comm'r, 313 U.S. 28, 31 (1941) (denying capital asset treatment because no return of capital); Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (finding no conversion of a capital investment); Comm'r v. Gillette Motor Transp., Inc., 364 U.S. 130, 135 (1960) (basing its denial of capital asset status because the transaction was not of the type subject to bunching).

\textsuperscript{22} For an explanation of the realization principle, see supra note 14.

\textsuperscript{23} Id.
his financial position over the course of the year beyond that which can be considered due to inflation. Moreover, as mentioned in the previous paragraph, this increase in value over the inflationary component remains untaxed until the taxpayer has a realization event.

These are only a couple of the examples illustrating the shortcomings of the justifications for preferential treatment of capital gains. Perhaps further clarification from Congress on the definition of a capital asset and its justification for awarding such preferential tax rate treatment would allow more uniformity within the court system. For the time being, however, Congress seems content to give the judicial system the task of making these determinations.

C. Judicial Development and Interpretations

As discussed earlier, the scope of what constitutes property within the meaning of Section 1221 has been at the heart of much litigation involving capital assets. The statutory definition is clear and concise in its use of the term "property" and "it contains nothing to suggest that 'property'—a term used frequently in legal discourse—should be given a restricted or technical meaning." Even the regulations are clear that capital assets include "all classes of property not specifically excluded by section 1221." However, the Supreme Court stated that not all assets labeled property in the ordinary sense and not within the statutory exclusions qualify as a capital asset. Courts and scholars have deemed this area of property outside of Congress' intended definition of a capital asset and explained that Congress' intent was not to make the federal income tax primarily a capital gains tax. Rather, it is noted that if following Congressional intent, then ordinary income should be the rule and capital gain the exception. This judicial restriction on the definition of capital assets will be traced through some of the most important Supreme Court cases, in particular, those cases involving the substitute-for-ordinary income doctrine.

Two important cases have shaped the definition of capital assets: Corn Products Refining Co. v. Commissioner and Arkansas Best Corp. v. Commissioner. These cases can be viewed as two ends of a spectrum involving the Court's interpretation of a capital asset with the former being a narrow view and the latter being a more expansive definition.

I. Corn Products Refining Co. v. Commissioner

27. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 17.01 (7th ed. 1994).
28. Id. at 310–11.
Corn Products Refining Co. (Corn Products) was a manufacturer of products made from corn, such as starch, syrup, and sugar.\textsuperscript{31} Due to small storage facilities, Corn Products began purchasing corn futures to alleviate the pressure on its profits when sales contracts proved to be unprofitable because of a rise in corn prices occurring after the contract was already formed.\textsuperscript{32} If the price of corn rose, then Corn Products could decide to take delivery of the corn at the lower price secured in the futures contract.\textsuperscript{33} Alternatively, it could elect to pay the higher price for corn on the spot market and then sell its futures contracts at a profit.\textsuperscript{34} If the opposite situation occurred and corn prices on the spot market dropped, Corn Products would purchase the corn and sell the futures contracts at a loss.\textsuperscript{35}

Corn Products sought capital asset treatment for the futures contracts so that, upon sale of these futures, it would receive a reduced tax liability due to the preferential tax rates applied to capital gains. It argued that, although the futures contracts were a part of its business, they were property for purposes of the predecessor to Section 1221 and, therefore, were separate and distinct from its manufacturing business.\textsuperscript{36} The Court disagreed and found that the futures contracts “were vitally important to the company’s business as a form of insurance against increases in the price of raw corn.”\textsuperscript{37} The Court admitted the corn futures did not fall squarely within any of the exceptions to the capital asset definition, but it stated “the capital-asset provision . . . must not be so broadly applied as to defeat rather than further the purpose of Congress.”\textsuperscript{38} It also stated that, in order to conform to Congressional intent, the capital asset definition must be narrowly construed and its exclusions interpreted broadly.\textsuperscript{39} Lastly, the Court noted that if it agreed with Corn Products’ contentions, then the outcome would create a loophole in the statute, which would frustrate Congress’ purpose.\textsuperscript{40} As a result of Corn Products, courts began focusing on whether the transaction “was integrally related to the taxpayer’s everyday business operations” and on the taxpayer’s motivation for the transactions.\textsuperscript{41} This line-of-business and motivation test led to inconsistent decisions and a “[preclusion of] capital asset treatment in an ever expanding set of circumstances.”\textsuperscript{42} Thirty years later, the Supreme Court revisited this issue in Arkansas Best Corp. v. Commissioner.\textsuperscript{43}

\textsuperscript{31} Corn Prods., 350 U.S. at 48.
\textsuperscript{32} Id.
\textsuperscript{33} Myron C. Grauer, A Case for Congressional Facilitation of a Collaborative Model of Statutory Interpretation in the Tax Area: Lessons to be Learned from the Corn Products and Arkansas Best Cases and the Historical Development of the Statutory Definition of “Capital Asset(s),” 84 KY. L.J. 1, 12 (1995–96).
\textsuperscript{34} Id.
\textsuperscript{35} Id.
\textsuperscript{36} Corn Prods., 350 U.S. at 49.
\textsuperscript{37} Id. at 50.
\textsuperscript{38} Id. at 51–52 (citing Burnet v. Harmel, 287 U.S. 103, 108 (1932)).
\textsuperscript{39} Corn Products Refining Co. v. Comm’r, 350 U.S. 46, 52 (1955).
\textsuperscript{40} Id. at 53–54.
\textsuperscript{41} Grauer, supra note 33, at 22.
\textsuperscript{42} Id. at 22–23.
\textsuperscript{43} 485 U.S. 212 (1988).
2. Arkansas Best Corp. v. Commissioner

Arkansas Best Corp. (Arkansas Best), a holding company, purchased stock in the National Bank of Commerce in Dallas, Texas in an effort to assist the bank by giving it much needed capital and later to help the bank with its loan portfolio problems. Arkansas Best later sold the majority of its stock in the Bank for approximately a $10 million loss, which it claimed as an ordinary loss. The Tax Court held that a portion of the loss was ordinary because the stock was purchased with a business purpose. The Court of Appeals reversed the Tax Court and held the entire loss was capital, reasoning the stock was clearly within the statutory definition of capital asset and the stock was outside the scope of any of the specific statutory exceptions. Furthermore, the court noted that in determining whether an asset is capital or ordinary, the purpose for purchasing the asset is irrelevant.

Arkansas Best argued that the determination of property as a capital asset was subject to not only the statutory definition, but also to the business purpose and motivation test utilized in Corn Products. However, the Supreme Court affirmed the Court of Appeals, holding that Arkansas Best's reliance on Corn Products was not supported by the literal language of Section 1221. "This motive test . . . [was] not only nowhere mentioned in § 1221, but it [was] also in direct conflict with the parenthetical phrase 'whether or not connected with his trade or business.'"

Arkansas Best also argued the statutory exclusions found in Section 1221 were "illustrative, rather than exhaustive, and that courts [were] therefore free to fashion additional exceptions in order to further the general purposes of the capital-asset provisions." Again, the Court disagreed and noted the specific language used in the statute, "but does not include" and referred to legislative history to make its determination that the enumerated exclusions were exhaustive. The Court attempted to reconcile its earlier decision in Corn Products as being a broad reading of the inventory exclusion in Section 1221, thus it had no application in this case.

The Court determined that the Corn Products doctrine had to be limited because it was close to negating the purpose of Section 1221. This doctrine was subject to abuse by both the Service and taxpayers in order to obtain the most

44. Id. at 213–14.
45. Id. at 214.
46. Id. at 215.
47. Id.
48. Id.
50. Id. at 216.
51. Id. at 217 (quoting I.R.C. § 1221).
52. Id.
53. Id. at 217–18.
54. Id. at 220–22. The hedging transactions found in Corn Products have subsequently been codified as an exclusion. See I.R.C. § 1221(7). Although the Court did not expressly overrule Corn Products, it appears that no other interpretation of the Arkansas Best decision can be reached.
beneficial results. Due to this abuse, the Court decided to use a bright line test to preserve the meaning of Section 1221. Given the strict interpretation of the capital asset definition, the decision in *Arkansas Best* appears to have left little or no room for judicial exceptions. However, even given this conclusion, the Court clearly stated that its decision had no bearing on the "line of cases, [that were] based on the premise that § 1221 'property' does not include claims or rights to ordinary income . . . ." This line of cases, decided on the substitute-for-ordinary income doctrine, is the focus of the balance of this Comment.

III. THE DEVELOPMENT AND APPLICATION OF THE SUBSTITUTE-FOR-ORDINARY INCOME DOCTRINE

The essence of the substitute-for-ordinary income doctrine is: When property is sold for a lump sum amount and the property was "essentially a substitute for what would otherwise be received at a future time as ordinary income," the amount received will be treated as ordinary income and not capital gains. This treatment disregards the fact that the asset sold is considered property for other purposes, which would normally be considered a capital asset per Section 1221, giving rise to capital gain treatment upon sale. Although this rule theoretically has merit, its application has ventured beyond its appropriate limits. The four cases that follow are often cited by courts and the Commissioner in an attempt to apply the substitute-for-ordinary income doctrine to other fact patterns, including the lottery cases examined later in this Comment.

A. Caselaw Development

1. Hort v. Commissioner

The seminal case establishing the substitute-for-ordinary income doctrine is *Hort v. Commissioner*. This case dealt with the cancellation of a leasehold contract between Hort and Irving Trust Company (ITC). In 1928, Hort inherited a ten-story office building in New York from his father. ITC entered into a lease contract with Hort's father for 15 years with annual rent of $25,000. Due to lagging economic conditions caused by the Depression, the leased premises became unprofitable for ITC. Hort agreed to cancel the lease for a lump sum payment of

56. For a discussion on the abuses of the *Corn Products* doctrine, see Jesse V. Boyles, *The Supreme Court Kills the Corn Products Doctrine—But Will it Rest in Peace?*, TAXES, Oct. 1988, at 723, 734–35.
57. Id. For a discussion on the criticisms of *Arkansas Best*, see Grauer, supra note 33, at 56.
58. Ark. Best Corp. v. Comm'r, 485 U.S. 212, 217 n.5 (1988). The Court's list of four cases that have adopted this principle is the subject of the foregoing discussion.
60. 313 U.S. 28 (1941).
61. Id. at 28–29.
62. Id. at 29.
63. Id.
64. Id.
$140,000. Instead of including this amount in his gross income, Hort showed a loss of $21,494.75. He argued that this amount reflected the difference between the amount he received for the cancellation and the amount he would have received had the lease not been cancelled. In other words, Hort claimed he had a basis in the lease equal to the future rental payments. The Commissioner disagreed with Hort and included the entire $140,000 in gross income. This treatment was upheld by the Board of Tax Appeals, the Circuit Court of Appeals, and the Supreme Court.

Hort further argued that the lump sum payment should be a capital gain instead of ordinary income. Although not specifically stated in the opinion, the Court’s language implies that Hort attempted to characterize the lease as property within the definition of a capital asset, which upon cancellation produced a capital gain. In disagreeing with Hort, the Court stated that the lump sum payment clearly falls within the definition of gross income because that definition “would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement.” The fact that Hort obtained the money by means of a settlement instead of through a lawsuit did not alter the characterization of the proceeds because the lump sum was merely a substitute for the rent due under the lease. Moreover, the Court noted that although the lease was considered property, the proceeds received due to the cancellation were not a return of capital. Hort did not have any investment in the lease, but, if he did, it would have been a return of capital and given him a basis for the property. It also may be inferred that the Court was alluding to the fact that although something is deemed property under state law, it is not necessarily considered property under the Code. In concluding that Hort must include the amount in gross income, the Court stated that “[t]he cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises.” It also noted that nothing in the Code’s loss provisions would allow Hort to report a loss on income not yet realized.

The Hort case and the doctrine it established are discussed in many legal articles and judicial decisions. Even though the substitute-for-ordinary income

65. Id.
67. Id.
68. Id.
69. Id. at 29–33.
70. Id. at 30.
71. Id. at 30–31.
73. Id.
74. Id. at 31–32.
75. Id. at 32.
76. Id. at 32–33.
77. For discussions of Hort and the substitute-for-ordinary income doctrine, refer to other cases examined and articles cited in this Comment. See also Miller v. Comm’r, 48 T.C. 649, 652 (1967) (distinguishing Hort because Hort retained an interest in the underlying property whereas Miller
doctrine is sometimes referred to as overbroad, the Court's intention was reasonably clear: "In effect, the sale of an income right, unaccompanied by a disposition of the underlying property, result[ed] in ordinary income to the seller equal in amount to the entire proceeds of the sale."78 In other words, the doctrine was another way of stating that carved-out interests do not qualify as capital assets.79

Another way the Court looked at the carved-out interest concept in Hort was by characterizing the lease cancellation as not constituting a return of capital. Since Hort retained his ownership in the building, the lump-sum payment was a return on capital, not a return of capital.80 However, the emphasis on investment of capital was unnecessary for the Court to reach the correct result. The decision could have narrowed the substitute-for-ordinary income doctrine at its inception by limiting its application to carved-out interests. If the owner of the asset retained some interest in it, he would receive ordinary income; but, if he completely disposed of the asset, then he would avoid the doctrine.81 "Thus, it is reasonable to assume that the term 'property' as used in the capital gain provisions includes property which is productive of ordinary income, but it does not include a limited income-producing interest carved out of a larger interest owned by the taxpayer."82


The next case applying the substitute-for-ordinary income doctrine is Commissioner v. P.G. Lake, Inc.83 Lake was a corporate entity which owned a working interest in two oil and gas leases.84 In 1950, the company owed its president $600,000.85 The president agreed to cancel the debt in exchange for an assignment of an oil payment right equal to $600,000 plus three percent interest on the unpaid balance each month.86 The assignment was to be paid out of twenty-five percent of the oil obtained from the company's two leases.87 The Court noted that "[a]t the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years.

disposed of his entire interest in the property). 78. CHIRELSTEIN, supra note 27, ¶ 17.03, at 321.
79. Id. The term "carved-out" means that something less than the owner's entire interest in the property was sold or disposed of in some other way. This idea is discussed throughout this Comment to show its effect on the substitute doctrine. Another term used to describe this limited transfer is a "horizontal-slice," as compared to a "vertical-slice," which is a complete transfer of the interest in the property. These terms are compared later in the Comment to examine the justification for distinguishing between them for purposes of the substitute doctrine. See infra notes 152–62 and accompanying text.
80. Shores, supra note 13, at 467.
81. Id. at 469.
82. Id.
83. 356 U.S. 260 (1958). This case was a consolidation of five cases arising from the Fifth Circuit Court of Appeals involving the same questions of law. Although the Court discusses the factual differences among the cases, this Comment will focus only on the Lake case.
84. Id. at 261–62.
85. Id. at 262.
86. Id.
87. Id.
It did in fact pay out in a little over three years." Lake classified the assignment as a sale of property and reported a capital gain of $600,000. The Commissioner determined the amount was ordinary income.

The Court mentioned that "[t]he purpose of [the capital asset provision] was 'to relieve the taxpayer from . . . excessive tax burdens [i.e., bunching] on gains resulting from a conversion of capital investments, and to remove the deterrent effect [i.e., lock-in] of those burdens on such conversions.'" It noted there was no conversion of capital investment and the lump sum consideration was merely a substitute for what would otherwise be received as ordinary income in the future. In addition, the Court pointed out a couple of characteristics regarding the payments that help form the basis for its ruling: first, the pay-out of the assigned rights could be determined with reasonable accuracy; second, the assignee received cash that was equal to the amount of the income that was set to accrue during the time period of the assignment, and he was being paid interest in advance. It went on to state:

The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

The Court utilized the substance-over-form rationale and concluded by describing the assignments as "transparent devices.

Lake and its application of the substitute-for-ordinary income doctrine has also been characterized as being broader than necessary because the Court was merely striving to assure that carved-out interests would receive ordinary income treatment. "'[I]f the life of the oil-payment and the life of the working-interest had been coterminous,'" the sale would probably have been considered a capital gain, "since then the fatal element of carving-out would have been absent." Lake broadened Hort's substitute language "by [applying the doctrine] to a case where the consideration was received from a third party, i.e., not from the person who otherwise would have been the payor of future ordinary income." While the Lake

88. Id.
90. Id.
91. Id. at 265 (quoting Burnet v. Harmel, 287 U.S. 103, 106 (1932)).
92. Id.
93. Id. at 265–66.
94. Id. at 266.
95. Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 266–67 (1958). Essentially, the substance-over-form rationale permits the Service and the courts to look beyond the technical form of the transaction. Instead, the focus is on the true substance of what occurred.
96. Chirelstein, supra note 27, ¶ 17.03, at 322.
97. Id. at 322–23.
Court did not specifically cite Hort in its opinion, it is clear that the principles in Hort strongly influenced its decision.99 "And in its broader implications, Lake represents a powerful and pervasive influence . . . against the attempt to convert future rights to ordinary income into present capital gain through the device of a sale of these rights."100

According to one scholar, the Court could have avoided the use of the substitute doctrine by focusing on its language that no capital investment had been converted.101 "The Court could simply have found that the taxpayer's investment in Lake was not in the oil payment; rather, it was in the working interest retained by the assignor."102 Since the assignor did not terminate his interest in the investment, there cannot be said to have been a conversion of a capital investment. The scholar continues by noting that the Lake Court should have placed emphasis on the lack of a termination of investment.103 However, this analysis, which is applied in subsequent cases, contributed to the confusion surrounding the substitute-for-ordinary income doctrine's application. The Court should have limited its decision and the doctrine itself to the evil found in this case, which was the element of a carved-out interest. Due to the carved-out interest, Lake was similar to Hort, and simply another example in which the Court could have achieved the same correct decision without alluding to ambiguous ideas of investment and return of capital.


The next case incorporating the substitute-for-ordinary income doctrine is Commissioner v. Gillette Motor Transport, Inc.104 Gillette Motor Transport, Inc. (Gillette) was a motor vehicle transportation company, and in 1944 its drivers went on strike causing it to completely terminate operations.105 In response to the need to transport military goods, the government took control of Gillette's vehicles and used them for transporting these goods.106 The government ordered Gillette to resume operations, stating that title of the vehicles was to remain in Gillette's name and interference with Gillette management would be kept to a minimum.107 This arrangement terminated less than a year later, and Gillette pursued a claim to receive just compensation for the taking of its property.108 The government denied a taking, but the Motor Carrier Claims Commission determined that when the government took actual control and possession of the vehicles, Gillette was "deprived . . . of the valuable right to determine freely what use was to be made of

99. Id. at 303.
100. Id. at 303-04.
101. Del Cotto, supra note 12, at 19.
102. Id.
103. Id. at 20.
104. 64 U.S. 130 (1960).
105. Id. at 131.
106. Id.
107. Id.
108. Id.
them."\textsuperscript{109} The loss sustained by the company was based on the fair rental value it would have received if it actually rented the vehicles, which was assigned a value of $122,926.21 plus interest of $34,917.78, bringing the total compensation to $154,843.99.\textsuperscript{110}

Gillette argued the amount received was a capital gain because it represented an involuntary conversion of property, but the Commissioner classified it as ordinary income.\textsuperscript{111} The Tax Court agreed with the Commissioner, but the Court of Appeals reversed the decision.\textsuperscript{112} Gillette based its argument on the Motor Carrier Claims Commission’s determination that a taking of property had occurred.\textsuperscript{113} The Court disagreed with Gillette’s position stating that “[w]hile a capital asset is defined in [the Code] as ‘property held by the taxpayer,’ it [was] evident that not everything which [could] be called property in the ordinary sense and which [was] outside the statutory exclusions qualify[ed] as a capital asset.”\textsuperscript{114} Then, the Court pointed out that the capital asset definition was “to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.”\textsuperscript{115} For support of its position that not everything constituting property qualifies as a capital asset, the Court cited \textit{Hort, Corn Products, and Lake}.\textsuperscript{116}

The Court explained that if the government had “taken a fee in those facilities, or damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion of capital assets.”\textsuperscript{117} In concluding the amount received by Gillette was ordinary income, the Court stated that “the right to use [was] not a capital asset, but [was] simply an incident of the underlying physical property, the recompense for which [was] commonly regarded as rent.”\textsuperscript{118} Moreover, Gillette did not have any investment in the right to use that could be considered separate from its investment in the physical assets themselves.\textsuperscript{119}

\textit{Gillette} extended the substitute-for-ordinary income doctrine, as applied in \textit{Hort} and \textit{Lake}, to a payment for the temporary use of assets by the federal government.\textsuperscript{120} Although the Court relied on \textit{Hort} and \textit{Lake} in determining that the amount was ordinary income, it recognized that no investment was converted. Even though the right to use the transport facilities was property, it was not the

\begin{itemize}
  \item \textsuperscript{109} Id.
  \item \textsuperscript{111} Id. at 132.
  \item \textsuperscript{112} Id. at 133.
  \item \textsuperscript{113} Id.
  \item \textsuperscript{114} Id. at 134.
  \item \textsuperscript{115} Id. (citing Burnet v. Harmel, 287 U.S. 103, 106 (1932)).
  \item \textsuperscript{117} Id. at 135.
  \item \textsuperscript{118} Id.
  \item \textsuperscript{119} Id.
  \item \textsuperscript{120} Lyon & Eustice, \textit{supra} note 98, at 300.
\end{itemize}
actual investment. The emphasis on investment was unnecessary and the Court should have confined its decision to hold that the "right to use" was not property within the meaning of Section 1221. This idea is similar to the carve-out exception because Gillette merely rented the vehicles while maintaining ownership of them: The vehicles were the underlying property and Gillette did not divest itself of its interest in this property. Gillette is yet another example of how the Court uses ambiguous reasons to further complicate application of the substitute-for-ordinary income doctrine.

4. United States v. Midland-Ross Corp.

The last case often cited for its application of the substitute-for-ordinary income doctrine is United States v. Midland-Ross Corp. This case involved the purchase and resale of non-interest bearing promissory notes. Midland-Ross Corp. (Midland-Ross) bought the notes directly from the issuers at a discount below the face amounts and then resold them for more than the issue price but less than the face amount. It reported the gains from the sales as capital gains, even though it admitted that the gains realized were essentially "interest for the use of the money to the date of sale." The Commissioner classified these gains as ordinary income because they were "attributable to original issue discount [and] were interest in another form . . ." Midland-Ross paid the deficiency and sued for a refund. The district court as well as the court of appeals ruled in its favor, awarding capital gain status to the amount received from the sale.

The Supreme Court disagreed with the lower courts and Midland-Ross. It began its analysis by explaining that even though an asset was deemed property and did not fall within the statutory exclusions, it was not necessarily classified as a capital asset. Gains derived from earned original issue discount were not within the Congressional purpose for permitting capital gain status because they do not typically involve the appreciation in value over a period of time and thus do not present the need to ameliorate the adverse effect from bunching. Furthermore, the Court consistently excluded property representing items of income from the definition of a capital asset. "Unlike the typical case of capital appreciation, the earning of discount to maturity [was] predictable and measurable, and [was] 'essentially a substitute for . . . payments which [the Code] expressly

121. Del Cotto, supra note 12, at 20.
122. 381 U.S. 54 (1965).
123. Id. at 55.
124. Id.
125. Id. at 55–56.
126. Id. at 56.
127. Id.
129. Id. at 56–57.
130. Id. (quoting Comm'r v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960)).
131. Id. at 57 (quoting same language from Gillette Motor, supra note 130).
characterize[d] as gross income." Therefore, the Court held that earned original issue discount was ordinary income.\(^{134}\)

Midland-Ross presented a different underlying fact pattern from Hort, Lake, and Gillette because there was neither a carve-out interest nor a mere right to use present. In Midland-Ross, the taxpayer sold his entire interest in the property; therefore, the principles of Hort, Lake, and Gillette were not directly applicable.\(^{135}\) The Court accurately determined that "gain due to original issue discount [was] not gain due to appreciation."\(^{136}\) However, the Court still cited Hort, Lake, and Gillette to reach its result even though these references were not necessary to achieve the correct result because the gain was essentially stated interest on the notes, which is properly taxed at ordinary income rates.

B. Proposed Limitations on the Substitute-for-Ordinary Income Doctrine

This Section continues examining the substitute doctrine by laying the foundation for limitations that should be placed on it. To better facilitate this discussion, it is helpful to list the two major limitations on the doctrine that this Comment proposes. The first boundary is to draw a line between those cases involving horizontal slices, temporal divisions in a property interest in which the person owning the interest disposes of part of his interest but also retains a portion of it, and those involving vertical slices, a complete disposition of a person's interest in property. The former leads to ordinary income treatment and the latter to capital gains.\(^{137}\) The other boundary, which is somewhat tied to the first but nevertheless operates as a separate limit, is to distinguish between those cases involving the sale of the right to earn future income versus those involving the sale of the right to earned income; the former treated as capital gains and the latter as ordinary income. These two limits will be examined below and applied to various cases to test their viability.

The unifying concept of the cases discussed in the previous section is that the asset sold was not considered property under Section 1221. Therefore, Section 1221 is not triggered, which means the enumerated exclusions outlined in the statute for the capital asset definition are never considered. The asset or interest sold, although characterized as property for state law purposes, was classified as income for federal income tax purposes, thus beyond the definition of a capital asset.

In referring to the application of the substitute-for-ordinary income doctrine, one scholar stated:

[The] substitution analysis looks to the result of applying the capital gains provisions. If the result is deemed incompatible with

\(^{133}\) Id. (quoting Hort v. Comm'r, 313 U.S. 28, 31 (1941)).
\(^{135}\) Del Cotto, supra note 12, at 25.
\(^{136}\) Id.
\(^{137}\) Examples of these two slices will be illustrated further below.
the congressional intent of taxing an item as ordinary income, the item cannot be property within the meaning of the capital gain provisions regardless of its characterization under local law. ¹³⁸

Although this statement refers to congressional intent, which is subject to criticism in its own right, the idea that items representing income are beyond the capital asset definition is an accurate premise. As mentioned earlier, a more precise definition of capital asset from Congress could possibly alleviate the struggle courts have endured in attempting to define this elusive concept. The definition has been subject to abuse by both the Commissioner and the taxpayers.

The courts continue to use congressional intent as a basis in their definition and application of the capital asset provision by repeating the justifications Congress offered through its legislative history. However, Congress itself has struggled to maintain a consistent view on the treatment of capital assets. Furthermore, the capital asset definition goes beyond the justifications for preferential tax treatment given to those assets qualifying under Section 1221. ¹³⁹

As shown in the cases above, the substitute-for-ordinary income doctrine has been applied to cases in which the doctrine could have been limited. The overbroad and seemingly over-inclusive language used by the Court appears to have limitless applications to situations in which capital asset status should be granted. The court in United States v. Dresser Industries, Inc. ¹⁴⁰ discussed the scope of the substitute doctrine by interpreting it “to mean that any money paid which represent[ed] the present value of future income to be earned [should] always [be] taxed as ordinary gains.” ¹⁴¹ The court went on to state that this could not be true from “a legal or economic position.” ¹⁴² In fact, “[t]he only commercial value of any property is the present worth of future earnings or usefulness.” ¹⁴³ The court provided a vending machine as an example because the body of the machine itself, constructed of metal and plastic, has little value, but indeed it has greater value based on the income it will produce. ¹⁴⁴ These statements form the foundation for the argument that the substitute-for-ordinary income doctrine must be confined in order to prevent the capital gains provisions from becoming moot.

After making these statements regarding the breadth of the substitute-for-ordinary income doctrine, the court briefly mentioned a limit that should serve as

¹³⁸ Shores, supra note 13, at 467.
¹³⁹ For example, as part of the tax reform amendments in 1986, the capital gains rate was raised to the equivalent of the ordinary income tax rate. In effect, this change disregarded the justification of a lower preferential rate, while still giving qualifying property capital asset status. Also, in 1942, the holding period was reduced to six or more months to qualify for the preferential rate. This short holding period is inconsistent with the congressional purpose of alleviating the harshness of bunched income that accrues from the appreciation of property held for a long period of time. Although both of these changes have been amended time and again, the purpose of these examples is to show that the definition of a capital asset goes beyond the justifications for a preferential tax rate for capital gains.
¹⁴⁰ 324 F.2d 56 (5th Cir. 1963).
¹⁴¹ Id. at 59.
¹⁴² Id.
¹⁴³ Id.
¹⁴⁴ Id.
one of the appropriate boundaries on the scope of this doctrine. The court stated that "[t]here is, in law and fact, a vast difference between the present sale of the future right to earn income and the present sale of the future right to earned income." In holding the exclusive right to practice the patent for hire was a capital asset, the court clarified that:

[T]he sale was not merely the present sale of the right to earned income, to be paid in the future. Taxpayer had an asset, a right, a property which would produce income. The fact that the income which could be earned would be ordinary income [was] immaterial; such would be true of the sale of all income-producing property.

This limitation is important to confining the Court's application of the overbroad substitute-for-ordinary income doctrine into areas that it should not apply.

Many commentators have also discussed the need to define the scope of the substitute-for-ordinary income doctrine. Professor David Shores stated that the value of "all income-producing property is equal to the present value of the future income it is expected to produce." Consequently, the sale of income-producing property is a lump sum given in exchange for the right to a flow of future income. Moreover, he cautioned that the capital gains provision would become obsolete "unless the substitution doctrine is limited to transactions not involving a termination of [an entire] interest." Transactions involving a sale or other disposition of only a partial interest are not intended to be within the scope of the capital gain provisions. Professor Shores would define the scope of the substitute-for-ordinary income doctrine by drawing a line between those sales or other dispositions that involve a partial termination of interest and those that involve a complete termination of interest. In addition to the limit taken from Dresser, this line—the distinction between horizontal and vertical slices—is a valid and appropriate limit placed on the doctrine.

1. Limitation on the Sale of a Vertical Slice

The carve-out exception leads to an interesting question: Should there be different tax treatment to sales or other dispositions of horizontal slices versus vertical slices? The correct answer is yes, at least according to many commentators. As one commentator stated, "Capital gains treatment turns on whether or not the

145. Id.
146. United States v. Dresser Indus., Inc. 324 F.2d 56, 59 (5th Cir. 1963).
147. Id.
148. Id.
149. Shores, supra note 13, at 495 (citing Dresser, 324 F.2d at 59).
150. Id.
151. Id. (referring to the anti-bunching justification as an intended purpose for the capital gain provisions).
152. Id.
assignor retains a reversion in the property assigned."\textsuperscript{153} The key difference between these two slices is that with horizontal, the taxpayer sells only a portion of his interest in the property, which consists of the future right to ordinary income.\textsuperscript{154} On the other hand, a vertical slice involves a sale of the taxpayer's entire interest in the underlying property. In this situation, the taxpayer sells not only his interest attributable to rights to future ordinary income but also his entire interest in the underlying property. In other words, the interest sold conveys the income-producing property itself, not just the income that the property produces.

To illustrate this further, consider taxpayer $X$, who owns a rental house. The rental house is a capital asset that produces ordinary income to $X$ in the form of rental payments. Assume $X$ decides that he wants to sell $Y$ one-half of his interest in the house to be held as tenants in common. When this one-half interest is sold, $X$ sells his entire interest in that half of the house, divesting him of the right to collect one-half of the future rental payments. The underlying income-producing property, the rental house, has been transferred to $Y$. This is an example of a sale of a vertical slice of $X$'s ownership in the house. Obviously, the same result is achieved if $X$ sold his entire interest in the house.

Now, consider the result if $X$, owning the same rental house, sold or assigned his right to the rental payments for the next two years. Upon sale or assignment, $X$ no longer has a legal right to his interest in the property right of receiving the rent which accompanies owning the house. This transaction is an example of a horizontal slice of $X$'s ownership of the house. In selling this property right, $X$ could try to report the amount received for the sale as a capital gain by classifying the rights sold as property within Section 1221. This characterization does not seem consistent with the justifications for granting capital asset treatment to certain property rights. More importantly, however, if $X$ were allowed to achieve this result, the income tax system could be transformed into a system that would tax income as capital gains, at least with respect to income payments susceptible to being factored. Clearly, it is not appropriate to permit taxpayers to effectively choose between the tax rules applicable to ordinary income and capital gain.

First, $X$ sold or assigned the right to rental payments only, which if held by $X$, would constitute ordinary income. Next, $X$ still retained his entire ownership in the underlying house that produced the rent. In this case, $X$, in essence, has attempted to transform his right to future ordinary income into capital gains while maintaining ownership in the house. No transfer of the income-producing property occurred. Once the two years are up, $X$ could then again sell his right to the rental payments for another period of time, obtaining capital gain treatment on the subsequent sale of the rental income rights. Therefore, $X$ could abuse the Code by converting all of his future rights to ordinary income into capital gains and getting the benefit of the preferential tax rate granted to these gains. This potential for abuse is the primary

\textsuperscript{153} Del Cotto, supra note 12, at 18.

\textsuperscript{154} Another justification for drawing a line between horizontal and vertical slices is that the taxpayer who receives a horizontal slice does not have the same property rights as the owner of a vertical slice. However, this aspect will not be discussed here because it is beyond the scope of this Comment.
justification for the validity of the substitute-for-ordinary income doctrine and is evidence that the doctrine is necessary to maintain the integrity of the preferential rate afforded to long-term capital gains.

This distinction between horizontal and vertical slices is crucial to defining the limits of the substitute doctrine. "If one has not terminated his interest in property, all income to be realized from the property is not assessed in a single year, and capital gain treatment is appropriately withheld."155 With the sale of a vertical slice, the taxpayer maintains no interest in the underlying income-producing property, alleviating the potential abuse that could result with the sale of a horizontal slice.

The Hort and Lake cases are further examples, endorsed by the Supreme Court, of the different treatment given to horizontal and vertical slices. Clearly they would have achieved different results if they involved vertical slices as opposed to horizontal slices. In Hort, the taxpayer cancelled only the lease contract but maintained ownership of the underlying property.156 In canceling the lease and retaining ownership of the property, Hort was able to re-lease the property to another party. Therefore, Hort’s sale, or cancellation, was a horizontal slice because he retained ownership of the underlying income-producing property. If Hort sold the property along with the lease contract, the result would have been a capital gain, even though a part of the proceeds would have been attributable to the future rent payments due from the lease.157

In Lake, the taxpayer assigned only a portion of its ownership rights in a working interest of an oil and gas lease.158 The taxpayer owned a working interest, which was the underlying income-producing property, and possessed the right to receive the income produced by that interest.159 The transaction consisted of an assignment of a portion of this income attributable to the working interest.160 Since the taxpayer in Lake could convert the ordinary income into capital gains, the potential for abuse was present in that case as well. Therefore, determining in Lake that the interest was a horizontal slice was the proper result. If the taxpayer would have sold his entire ownership in the working interest, then the sale would have been vertical and the correct result would have been capital gains because the potential abuse would not be present.

Although Gillette can be considered a mere right to use case, the fundamental nature of the transaction was the transfer of a horizontal slice.161 Gillette did not transfer its entire interest in the vehicles; instead, it maintained ownership of the property and the government simply used the property.162 If Gillette transferred its

155. Shores, supra note 13, at 500–01.
157. See Chirelstein, supra note 27, ¶ 17.03, at 321–22. Most commentators view the transaction in Hort as constituting a carve-out properly resulting in the Court’s holding. However, Professor Chirelstein argues that the lease was a separate property interest and should be a capital asset because it was subject to the same market fluctuations as other capital assets. He analogized the cancellation with the sale of a bond. Id. at 321–22. This argument is examined later in this Comment.
159. Id.
160. Id.
162. Id. at 131. The fact that the transfer was involuntary does not affect this analysis.
entire interest in the vehicles, thereby divesting itself of any rights to future income from them, the amount received for the use would have been capital gains.\(^{163}\) However, since this was not the case, the potential for abuse was present and the amount received was properly classified as ordinary income.

2. **Limitation on the Right to Earn Income**

In addition to this carve-out limitation, a second boundary that should confine the application of the substitute-for-ordinary income doctrine is taken from *Dresser* mentioned above.\(^{164}\) This limit emphasizes the entitlement that the actual right sold or otherwise disposed of confers upon the owner. If the right sold was the mere right to collect future *earned* income, then the amount received in connection with this sale should be classified as ordinary income. However, if the sale involved the transfer of the future right to *earn* income, then the amount received should be treated as capital gains.\(^{165}\) The distinction between earned income and the future right to earn income is very important in defining the limits to the substitute-for-ordinary income doctrine.

Earned income conveys the concept that the income has already been earned and the holder of the right to this income only has to collect it. In other words, the owner of the right to earned income is entitled to the income merely by virtue of owning the property. Examples of this category are rental income, stock dividends, and, as will be discussed later in this Comment, rights to future lottery payments.

The right to earn income involves the idea that the holder of such right must do something further to earn the income. In other words, mere ownership of the right to earn income does not entitle the owner to income. An example of the rights under this category is a patent.

Although this distinction was noted and upheld by the court in *Dresser*, this limitation would have profound effects on other cases applying the substitute doctrine. For example, this idea would virtually turn the case law pertaining to the termination of employment contracts on its head.\(^{166}\) However, as shown below, the distinction is logically sound and would serve as an appropriate bright-line limit to the doctrine, guiding courts and taxpayers alike.

a. **Personal Services Contracts**

\(^{163}\) *Id.* at 135 (noting this alternative conclusion). *See supra* notes 117–19 and accompanying text.

\(^{164}\) United States v. Dresser Indus., Inc., 324 F.2d 56, 59 (5th Cir. 1963); *see also supra* notes 140–47 and accompanying text.

\(^{165}\) *See supra* notes 140–47 and accompanying text.

\(^{166}\) For a discussion of the line of cases dealing with termination of employment contracts, see Shores, *supra* note 13, at 490–95. *See, e.g.*, Holt v. Comm'r, 303 F.2d 687 (9th Cir. 1962) (holding that a lump sum payment received in consideration for future income based on percentage of sales was ordinary income and not capital gains); Flower v. Comm'r, 61 T.C. 140 (1973) (holding that amounts received in consideration for termination of a selling contract was ordinary income and not capital gains).
The substitute-for-ordinary income doctrine forms the basis and rationale for the decisions in personal services termination cases. Courts find the performance of personal services is considered ordinary income, therefore, the lump sum received for the termination of the contract should be ordinary as well. The idea that income received via the contractual property rights would have been ordinary had the contract not been sold or terminated is not conclusive for the treatment of the lump sum received to terminate these property rights. This idea is inherent in all income producing assets. For example, when Company A sells its inventory during the ordinary course of business, the amount received upon sale is taxed as ordinary income. However, assume Company A has run into some problems, is forced to liquidate its inventory, and sells it in bulk to Company B. In this situation, the lump sum received from Company B would be taxed at capital gains rates. Under these circumstances, the inventory’s income tax characterization changes depending on the timing or method of its sale. As a result, proceeds received for the normal sale of inventory would be ordinary income, but a lump sum payment for this same inventory may not require ordinary tax treatment. This distinction is necessary to understanding the theory for limiting the substitute-for-ordinary income doctrine.

Two strong arguments exist against the current ordinary income treatment of lump-sum payments as consideration for terminating personal services contracts. The first argument is based on the idea that the right to terminate or sell a contract has a separate value subject to appreciation. Courts rely on this ability to appreciate in holding that contract rights are not capital assets. They treat these rights as a substitute-for-ordinary income without a separate value by themselves. This is based on weak justifications for the preferential tax rates of capital gains. As mentioned throughout this Comment, these justifications are all subject to arguments undermining their validity and strength. Courts do utilize this rationale,

167. See Shores, supra note 13, at 490–95.
168. Id.
169. Id. at 494.
170. Id.
171. See Shores, supra note 13, 494.
172. Id.
173. This issue is distinct from the treatment of situations involving the sale of income for services already rendered, which are not included in this analysis. The reason for distinguishing this fact situation is the income has already been earned through performance of the labor, thus appropriately characterized as ordinary income. In this type of situation, the assignor renders the services, and earns the income, but the assignee collects the income. Id. Allowing this type of assignment undermines the basis for the progressive tax system. Id. Moreover, the exclusion of these situations serves as another example of distinguishing cases involving the right to earned income, which is where these cases would fall, and the right to earn income.
174. See, e.g., Holt v. Comm’r, 303 F.2d 687, 691 (9th Cir. 1962) (“The essence of a capital transaction . . . is that the sale or exchange of an asset results in a return of a capital investment coupled with realized gain or loss (as the case might be) which accrcues to the investment over a certain period of time.”); United States v. Woolsey, 326 F.2d 287, 290 (5th Cir. 1964) (stating that the term capital asset suggests “the investment of money in property with resulting appreciation” in the value of the property).
however, and for the purpose of this analysis, value appreciation is viewed as an appropriate consideration for the courts.

Consider the situation in which X and Y enter into a contract and X agrees to perform certain services for Y at a predetermined rate for a specified period of time.175 As X performs the services, Y pays him the set amount and X includes this amount, in ordinary income. Now, assume services that are similar to those that X is providing are being charged at a decreased amount in the marketplace. The value of X's services under the contract with Y has appreciated, and the services are worth more because if he was providing the same services to a new party he would receive a lower amount.176 The converse holds true if services similar to those X was providing to Y are charged at a higher amount in the marketplace. In this situation, the value that Y receives from the services has appreciated.177

This example demonstrates that personal services contracts have an inherent value that is subject to market appreciation. Each party is taking a risk on the market value for the contracted services, another factor the courts consider indicative of a capital asset.178 If the ability to appreciate is determinative of whether an asset is capital or ordinary, some of the cases concerning personal services contracts may have been decided incorrectly. By disregarding this characteristic, courts have erroneously held that these rights are merely substitutes for what would otherwise be ordinary income.179

The second argument against ordinary income treatment of consideration for the termination of personal services contracts is courts fail to recognize the difference between the right to earned income and the right to earn income. Separate treatment of these rights is necessary to define an appropriate limit to the substitute-for-ordinary income doctrine. Consider the example from above. As X performs the services, Y pays him the set amount, and X includes this amount in ordinary income. If X sells his right to income he has already earned but not yet received from Y, then the Code characterizes this as a sale of an account receivable, an ordinary asset subject to ordinary income tax rates.180 This is an example in which X possesses the right to earned income.

Now, assume the contract is detrimental to one of the parties and they negotiate a deal relieving X of his obligation to perform and Y of his obligation to continue making payments. The amount X receives as consideration for cancelling the contract constitutes his right to earn income, which is distinguishable from the right to earn income. The difference is that in the earned income situation, X performs the services, sells his right to the earned income, and the purchaser of this right merely collects the income. However, in the right to earn income example, where the parties terminate the entire interest in the contract, the amount that X receives

176. Id.
177. Id.
178. Id. at 29.
179. Id. at 26–29.
is the present value of the right to earn future income, which is inherent in all income-producing property.

Without drawing this distinction, the substitute-for-ordinary income doctrine engulfs the Code's capital gains provisions. Furthermore, the major justification for this doctrine is preventing taxpayers from converting their ordinary income derived from a property right into capital gains while maintaining the ability to earn ordinary income from that right. By severing his ability to earn future income from the same property right, the taxpayer has eliminated this potential for abuse. Upon sale, X's property rights in the contract are terminated and X would be free to perform the same services for others customers in the marketplace. This second argument is the analog of the treatment when the taxpayer sells a carved-out interest as opposed to his entire interest.

A separate but related issue arises when termination is accompanied by a covenant not to compete. A situation in which these may arise occurs when someone terminates a personal services contract and the previous employer wants to prevent that party from performing the same services for a specified period of time in a certain geographic area. In essence, the parties negotiate a new contract in conjunction with the termination of the old contract, and the previous employee gets paid for not performing the same services for a new employer for the specified term within the agreed upon locale. The Code treats the amount received in consideration of the covenant not to compete as ordinary income. Therefore, these agreements are not treated as property rights for tax purposes, and do not qualify for capital asset status.

Arguably, a covenant not to compete is the same as a termination of a personal services contract. Since the previous employee is getting paid to stop working for that employer, it is the same as terminating his rights under the personal services contract. If the covenant is viewed in this manner, as an additional payment received to terminate the personal services contract, then the amount received in consideration for giving up the right to work for that employer should be capital gains because a complete termination of the employee's right to earn income from that employer has occurred.

However, another view of a covenant not to compete is as a separate contract right. The employee receives a payment that is essentially the present value of his services had he remained working for the employer. Under this view, since the income would have been ordinary if the employee remained working, courts would likely characterize the payment for the covenant not to compete as ordinary income under the substitute-for-ordinary income doctrine. Therefore, even without the statute, courts would treat the amount received for these agreements as ordinary income.

To reiterate, courts have consistently found a lump sum payment received for the termination of a personal services contract gives rise to ordinary income. Moreover, the Code expressly treats covenants not to compete as ordinary income.

181. Id. § 83.
182. See supra note 166 and accompanying text.
income. The arguments discussed above supporting capital asset treatment for amounts received in consideration of termination of personal services contracts are persuasive and based on logical principles, but are yet to find favor in the courts or the Code. Perhaps, given the consistent treatment by courts and statutory treatment of covenants not to compete, the limitations suggested in this Comment should arguably apply to all situations, subject to a narrow exception for the termination of personal services contracts.

The fact remains, however, that these personal services contracts are subject to the same market fluctuations that characterize other capital assets. Also, the termination of interest in these contracts prevents the abuse that the substitute-for-ordinary income doctrine was designed to address. In fact, "the sale of a right to future income, not yet earned or accrued, reflects the very image of a capital gain." This statement encompasses the foundation for the proposed second limitation to the substitute-for-ordinary income doctrine. When applied as a bright-line test, courts could provide uniformity in their decisions and prevent the inconsistencies that have plagued this area of law.

3. Limitations Analysis

The second limitation, distinguishing between the right to earn income and the right to earned income, can be used simultaneously with the analysis of whether the right sold was a carved-out interest. Other times it can be used as a separate boundary of the substitute doctrine. Therefore, the two proposed boundaries should be viewed as disjunctive rather than conjunctive.

An additional factor courts consider to characterize an asset as either capital or ordinary is whether investment in that asset carries investment risk. Generally, a lack of investment risk weighs more heavily towards treatment as ordinary instead of capital gains. For example, in noting in particular that the payout under consideration in Lake "could have been estimated with reasonable accuracy," the Court placed great weight on this lack of risk factor in its determination that the oil payments carved-out of a larger interest were ordinary and not capital. This illustrates that the speculative nature of an asset, even if carved-out of a larger interest, can be a determinative factor in finding that the asset sold was capital and not ordinary. Without risk, the payment appears more like the future right to earned income because the holder of the right would only need to collect the income.

183. I.R.C. § 83.
184. See Chirelstein, supra note 175, at 19.
186. Id.
187. Id. at 265.
188. See, e.g., United States v. Foster, 324 F.2d 702, 706, 708 (5th Cir. 1963) (stating that Lake did not establish a rule that requires all carve-outs to be taxed as ordinary income, and that the speculative nature of a carved-out oil payment should be taken into consideration).
Another factor was considered in Commissioner v. Ferrer. In referring to cases in which capital asset status was upheld, the court stated that "[i]n all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income." This statement is similar to a lack of investment risk. In order to obtain capital gain status, the amount received must be more than a right to collect payments that would otherwise have been ordinary income.

However, these two additional considerations are not appropriate further limitations to the substitute-for-ordinary income doctrine. Rather they are based on vulnerable justifications for the preferential tax rates of capital gains. In fact, the Ferrer court acknowledged that the statute does not mention bunching as a justification. This also indicates a willingness to focus on congressional intent and then formulate ideas and phrases that are used to further this elusive idea of intent. Accordingly, Congress needs to eliminate some of the confusion, but this does not mean that courts should continue relying on intent as the source for their authority when, in effect, it is subject to criticism that calls it into question. By employing the two suggested limitations from this Comment, courts will develop a more consistent and logical area of case law that Congress, unfortunately, seems content in avoiding.

IV. APPLYING THE SUBSTITUTE-FOR-ORDINARY INCOME DOCTRINE TO THE SALE OF LOTTERY RIGHTS

A. Davis v. Commissioner

The sale of lottery rights has been the subject of several cases within the past two years. In each, the court’s decision was based on the substitute-for-ordinary income doctrine. The Tax Court faced this decision first in Davis v. Commissioner. Davis won $13,580,000 in the California State Lottery, to be paid in twenty annual installments of $679,000. Davis entered into an agreement with Singer Finance Co. to assign his rights to a portion of the annual payments from 1997 through 2007 for a lump sum of $1,040,000. For tax year 1997, Davis reported the lump-sum payment as a long-term capital gain. The Commissioner, however, determined that the amount received was "ordinary income because rights to future annual lottery payments [did] not meet the definition of a capital asset."
The Commissioner applied the substitute-for-ordinary income doctrine, relying on the reasoning from *Hort, Lake, Gillette, and Midland-Ross*.\textsuperscript{197} Davis argued the lottery rights were property under Section 1221 claiming that *Arkansas Best* overruled the cases relied on by the Commissioner. In stating that *Arkansas Best* did not overrule these cases, the court noted the language in footnote 5 of the *Arkansas Best* opinion, which stated, "[t]his line of cases, based on the premise that § 1221 'property' does not include claims or rights to ordinary income, has no application in the present context."\textsuperscript{198} The court also quoted the language from *Gillette* asserting that not everything considered property and outside the statutory exclusions falls under the definition of a capital asset.\textsuperscript{199} In concluding that the income was properly taxed as ordinary and not capital gains, the court held the amount paid to Davis was "for the right to receive such future ordinary income, and not for an increase in value of income-producing property."\textsuperscript{200} Furthermore, rights to receive future lottery payments were not within the definition of a capital asset under Section 1221.\textsuperscript{201}

**B. Boehme v. Commissioner**

The next case involving the sale or assignment of lottery rights was *Boehme v. Commissioner*.\textsuperscript{202} Mrs. Boehme won $1.5 million in the Colorado State Lottery payable in twenty-five annual installments.\textsuperscript{203} In 1995 and 1996, she pledged twelve of her remaining twenty future payments as collateral for four loans.\textsuperscript{204} Later in 1996, she assigned the same twelve payments to Woodbridge Financial Corporation for $400,000, to pay off the loans she incurred with the balance going to her.\textsuperscript{205} Initially, the Boehmes reported a $264,000 capital loss by taking the total amount they would have received, $664,000, and subtracting the amount actually received, $400,000.\textsuperscript{206} The Commissioner issued a notice of deficiency and included the lump-sum payment in ordinary income.\textsuperscript{207} At a hearing, the Boehmes admitted that the $400,000 was gross income but argued it was a capital gain and not ordinary income.\textsuperscript{208}

The court did not spend much time analyzing whether the lump sum payment constituted a capital asset. It simply referred to its prior decision in *Davis* and held

\begin{itemize}
\item \textsuperscript{197} *Id.* at 5–7.
\item \textsuperscript{199} *Id.* at 7 (quoting *Comm'r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960)).
\item \textsuperscript{200} *Id.*
\item \textsuperscript{201} *Id.*
\item \textsuperscript{202} 85 T.C.M. (CCH) 1039 (2003).
\item \textsuperscript{203} *Id.* at 1040.
\item \textsuperscript{204} *Id.*
\item \textsuperscript{205} *Id.* at 1040–41.
\item \textsuperscript{206} *Id.* at 1041.
\item \textsuperscript{207} *Id.*
\item \textsuperscript{208} *Boehme v. Comm'r*, 85 T.C.M. (CCH) 1039, 1041 (2003). This case also discusses the deductibility of interest from the loans that were paid off from the proceeds of the assignment. This part will not be discussed as it is beyond the scope of this Comment.
that the amount received was ordinary income and not a capital gain.\textsuperscript{209} The court pointed out that \textit{Davis} involved the assignment of only a portion of each of the eleven remaining fourteen payments whereas the Boehmes assigned all of the payments over twelve of the remaining twenty years.\textsuperscript{210} However, this difference was deemed immaterial and thus did not change the character of the lottery payment right as ordinary income.\textsuperscript{211}

C. Johns v. Commissioner

The next case involving the sale of lottery rights was \textit{Johns v. Commissioner}.\textsuperscript{212} In 1992, Johns purchased a lottery ticket for $1.00 and won $9,397,987.40 from the New Jersey State Lottery to be paid in twenty annual installments of $470,000.\textsuperscript{213} He assigned four of the twenty payments to Singer Asset Finance Co. for $1.5 million.\textsuperscript{214} He reported the lump sum payment as long-term capital gain, but the Commissioner determined the payments were ordinary income.\textsuperscript{215} Although Johns agreed that his situation was almost identical to the \textit{Davis} case, he presented a new argument not yet considered by the court.\textsuperscript{216} His argument asserted that the lottery ticket itself "[was] ‘property’ under section 1221 and a capital asset, that he sold a partial interest (20 percent) in the winning lottery ticket, and that the gain on this sale [was] long-term capital gain and not ordinary income."\textsuperscript{217} The court pointed out that Johns did not sell a partial interest in the ticket, rather "he obtained court approval for the assignment of his rights to receive four of the future annual lottery payments of $470,000 each . . . then assigned those rights to Singer for $1.5 million."\textsuperscript{218} This was the only discussion surrounding that argument, and the court followed it by a single sentence holding that \textit{Davis} controlled. Consequently, the amount received for the assignment was ordinary income.\textsuperscript{219}

D. Simpson v. Commissioner

The Tax Court's most recent decision in this line of lottery rights cases is \textit{Simpson v. Commissioner}.\textsuperscript{220} In 1992, Simpson won $15,740,000 to be paid in twenty annual installments of $787,000.\textsuperscript{221} Simpson assigned $140,000 of each of

\begin{thebibliography}{99}
\bibitem{209} \textit{Id.} at 1041 ("No purpose would be served by repeating the legal analysis in \textit{Davis}, and we refer to that analysis in support of our holding.").
\bibitem{210} \textit{Id.} at n.4.
\bibitem{211} \textit{Id.}
\bibitem{212} 85 T.C.M. (CCH) 1318 (2003).
\bibitem{213} \textit{Id.}
\bibitem{214} \textit{Id.} at 1319.
\bibitem{215} \textit{Id.}
\bibitem{216} \textit{Id.}
\bibitem{217} \textit{Id.}
\bibitem{218} Johns v. Comm'r, 85 T.C.M. (CCH) 1318, 1319 (2003).
\bibitem{219} \textit{Id.}
\bibitem{220} 85 T.C.M. (CCH) 1421 (2003).
\bibitem{221} \textit{Id.}
\end{thebibliography}
the twelve payments running from 1997 to 2008 to Singer Asset Finance Co.\(^{222}\) The remaining three installments were not assigned.\(^{223}\) He subsequently assigned the remaining portion of ten of the twelve previously assigned payments from 1999 to 2008 to Singer for $4,485,000.\(^{224}\) The lump-sum payment was reported as a long-term capital gain, but the Commissioner determined it was ordinary income.\(^{225}\)

The court elaborated on the argument from Johns regarding the lottery ticket as a capital asset.\(^{226}\) It stated that "[the Simpsons] did not assign the lottery ticket to Singer; rather, they relinquished the lottery ticket to the State of California in order to claim the lottery prize and secure the right to the 20 annual installments of $787,000."\(^{227}\) Therefore, Singer was not assigned the actual lottery ticket; instead, it received only a right to a portion of the annual installments in exchange for the lump sum.\(^{228}\) The court concluded that this situation was almost identical to the Davis case, thus holding that "the right to receive future annual lottery payments does not constitute a capital asset" and simply referred to the analysis and holding in Davis as applicable here with no further reasoning necessary.\(^{229}\)

E. United States v. Maginnis

Although the Tax Court faced this decision before and consistently held the sale of lottery rights is ordinary income, this type of case was new to the other federal courts. Since the Simpson decision, the Ninth Circuit Court of Appeals decided a case, United States v. Maginnis, involving the sale of lottery rights that presented a new fact pattern.\(^{230}\) In 1991, Maginnis and his family won the Oregon State Lottery.\(^{231}\) His share of the winnings was $9,000,000 to be paid in twenty annual installments of $450,000.\(^{232}\) After five payments, Maginnis assigned his right to receive the remaining fifteen annual payments to a third-party for a lump-sum payment of $3,950,000.\(^{233}\) Maginnis originally reported the lump-sum payment as ordinary income; however, he later amended his return and reclassified the amount as a long-term capital gain.\(^{234}\) He requested a refund of $305,043.00,

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222. Id.
223. Id.
224. Id. at 1421–22.
225. Id.
227. Id. at 1422–23 n.5.
228. Id.
230. 356 F.3d 1179 (9th Cir. 2004). The District Court of Oregon decided this case about a month before the Davis decision, but before this Comment was completed, the Ninth Circuit decided it on appeal. To view the District Court's opinion, see United States v. Maginnis, No. 01-368-KI, 2002 U.S. Dist. LEXIS 11539, at *1 (D. Or. May 28, 2002).
231. Maginnis, 356 F.3d at 1180.
232. Id.
233. Id. at 1181.
234. Id.
plus interest, which the Service granted and issued a refund check.\textsuperscript{235} The government filed this suit to recover the refund.\textsuperscript{236}

The court began its discussion by referring to congressional intent as a guideline for not extending the capital asset definition beyond its purpose and noted the potential for abuse that could result by such an extension.\textsuperscript{237} The court then introduced the substitute-for-ordinary income doctrine as an appropriate technique for curtailing this abuse, quoting the language from \textit{Gillette} indicating that not everything considered property qualifies as a capital asset.\textsuperscript{238} On the other hand, the court pointed out that limits exist to the substitute-for-ordinary income doctrine, stating:

\begin{quote}
Many assets, including common stock, are typically valued on the basis of the present value of their future income stream, so an approach that took the substitute for ordinary income doctrine too far, and defined the term capital asset too narrowly, would hold that no sale of an asset that produces revenue, even common stock, could be taxed as a capital gain.\textsuperscript{239}
\end{quote}

Due to the need to prevent the potential abuse of turning all capital gains into ordinary income, limits needed to be placed on the substitute-for-ordinary income doctrine.\textsuperscript{240} Accordingly, the court stated that each decision must be made on a case-by-case basis in determining whether the conversion of income rights into lump sum payments were the sale of a capital asset producing capital gain, or whether it produced ordinary income.\textsuperscript{241}

The court held that Maginnis’ right to future lottery payments was not a capital asset within the definition of Section 1221, therefore, the lump sum payment he received for the sale was ordinary income.\textsuperscript{242} The court considered two factors to be “crucial” in its decision, but noted that it did not hold that these factors would be dispositive in all cases.\textsuperscript{243} The two factors were “Maginnis (1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2)

\begin{itemize}
\item \textsuperscript{235} \textit{Id.}
\item \textsuperscript{236} United States v. Maginnis, 356 F.3d 1179, 1181 (9th Cir. 2004).
\item \textsuperscript{237} \textit{Id. at} 1181–82.
\item \textsuperscript{238} \textit{Id. at} 1182 (citing Comm’r v. Gillette Motor Transp., Inc., 364 U.S. 130, 134–35 (1960) as a basis for the substitute-for-ordinary income doctrine.).
\item \textsuperscript{239} \textit{Id.} (citing United States v. Dresser Indus., Inc., 24 F.2d 56 (5th Cir. 1963)).
\item \textsuperscript{240} \textit{Id.}
\item \textsuperscript{241} \textit{Id.} The court subsequently quoted BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 47.9.5 (3d ed. 2000): “Unless and until Congress establishes an arbitrary line on the otherwise seamless spectrum between [substitute-for-ordinary income] transactions and conventional capital gain transactions, the courts must locate the boundary case by case, a process that can yield few generalizations because there are so many relevant but imponderable criteria.”
\item \textsuperscript{242} United States v. Maginnis, 356 F.3d 1179, 1182 (9th Cir. 2004). The court cited the four recent Tax Court decisions discussed above—\textit{Davis, Boehme, Johns, and Simpson}. \textit{Id. at} 1183–84 n.3.
\item \textsuperscript{243} \textit{Id. at} 1183.
\end{itemize}
the sale of his right did not reflect an accretion in value over cost to any underlying asset Maginnis held.244

To further support these two factors, the court cited Hort, Lake, and Gillette, but not by using the usual overbroad language taken from them encompassing the substitute-for-ordinary income doctrine.245 The typical reference to these cases conveys the idea behind the doctrine that if income would have been treated as ordinary but for the sale or transfer of the right to such income, then the lump sum received in exchange for giving up that right should likewise be ordinary income. However, this court referred to language from these cases focusing on the lack of an investment and any accretion in value.246

With respect to the first factor, the court noted that the purchase of a lottery ticket was not a capital investment, which should give rise to capital gains.247 The court went on to state that lottery prizes are treated by the Code as gambling winnings, which are taxed as ordinary income; therefore, the purchase of a lottery ticket was analogous to a dollar bet on roulette, which cannot be argued to be an investment of capital.248 According to Oregon law, once Maginnis won the lottery, he needed to obtain judicial approval in order to transfer his lottery rights to a third-party.249 On this point, the court stated:

Because Maginnis had no right to an alienable lottery interest until he had already won the lottery, and because he made no capital investment before winning the lottery, no investment of capital was involved in creating the lottery right. Therefore, the assignment of the lottery right is better understood as the pure assignment of a gambling winning, rather than as the assignment of a capital asset.250

In analyzing the second factor, the court briefly noted that since, under the first factor, Maginnis had made no true capital investment, the lump sum he received cannot be characterized as an increase in value above the cost of an underlying capital asset.251 Therefore, the court stated that "the sale . . . lack[ed] the requisite

244. Id. To support the use of these two factors, the court quoted a case it had previously decided: The essence of a capital transaction within the tax statutes and decided cases is that the sale or exchange of an asset results in a return of a capital investment coupled with realized gain or loss (as the case might be) which accrues to the investment over a certain period of time.

Id. (quoting Holt v. Comm'r, 303 F.2d 687, 691 (9th Cir. 1962)).

245. Id. at 1183.

246. United States v. Maginnis, 356 F.3d 1179, 1183 (9th Cir. 2004).

247. Id.

248. Id.

249. Id. at 1183–84.

250. Id. at 1184.

251. Id.
realization of appreciation in value accrued over a substantial period of time’ that is typically necessary for capital gains treatment.”

After giving arguably persuasive reasons for its decision based on the two factors, the court continued by analyzing other possible considerations some of which were directly argued by Maginnis. First, the court stated that the present case was “almost indistinguishable” from the cases involving the assignment of future income from employment contracts for a lump sum. Although these cases are distinguishable on a factual basis, the court’s point was that income from employment is ordinary and so is a lump sum received for the assignment of the rights to such income; therefore, since the lottery winnings are treated as gambling winnings, which are taxed as ordinary income, then the sale of the rights to this income should retain their ordinary income status.

The next argument by the court was based on sound equity principles. The court stated that “treating the sale of Maginnis’ lottery right as a capital gain would reward lottery winners who elect to receive periodic payments in lieu of a direct lump-sum payment from the state, and then sell that payment right to a third party.” Taxpayers like Maginnis would receive a tax advantage unlike those taxpayers who chose originally to receive their lottery winnings in the form of lump sum payment. Moreover, the court noted that “[t]he purpose of narrowly construing the term capital asset under the substitute for ordinary income doctrine [was] to ‘protect the revenue against artful devices’ that undermine the Revenue Code’s standard treatment of ordinary income and capital gains . . . [which was] precisely what Maginnis ha[d] attempted here.”

Maginnis argued that the substitute-for-ordinary income doctrine should not apply because Arkansas Best limited the doctrine to two situations. The first situation involved those cases in which the taxpayer sold or assigned only a carved-out interest, and the second situation involved those cases in which the taxpayer sold or assigned rights to future income from personal services.

With respect to the second situation, Maginnis argued that these cases “[were] not covered by the substitute for ordinary income doctrine at all but fall within § 1221’s exclusion of ‘inventory’ from the definition of a capital asset.” According to Maginnis’ reply brief, however, the court erred in stating that Maginnis argued the inventory exception found in Section 1221(a)(1) of the Code

253. Id. (citing Furrer v. Comm’r, 566 F.2d 1115 (9th Cir. 1977)).
254. For a discussion of the logic involved in these employment cases, see supra text following note 166.
255. Maginnis, 356 F.3d at 1184.
256. Id.
257. Id. at 1184–85 (quoting Comm’r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958)).
258. Id. at 1185.
259. United States v. Maginnis, 356 F.3d 1179, 1185 (9th Cir. 2004).
260. Id.
261. Reply Brief of Maginnis at 10–11, United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004) (No. 02-35664) [hereinafter Reply Brief].
as covering the personal services cases.\textsuperscript{262} In his reply brief, Maginnis argued that the receivables exclusion found in Section 1221(a)(4) was the applicable authority for disallowing capital asset treatment for the personal services cases.\textsuperscript{263} Section 1221(a)(4) states that the capital asset definition does not include "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered . . . .\textsuperscript{264} Since Maginnis' lottery rights were not acquired in the ordinary course of his trade or business for services rendered, Section 1221(a)(4) and all of the personal services cases were inapplicable.\textsuperscript{265} Maginnis based this interpretation on a broad reading of the receivables exception that he argued the Court in Arkansas Best would apply.\textsuperscript{266}

Although this argument by Maginnis was persuasive and the court applied the wrong Section 1221 exception, it apparently did not matter because of the court's interpretation of Arkansas Best. The court stated that Arkansas Best did not affect the constraints on the capital asset definition that the substitute-for-ordinary income doctrine imposes.\textsuperscript{267} The court also seemed to place constraints on the Arkansas Best decision as a whole when it noted that the case dealt with a different subject entirely and it merely rejected the motive test.\textsuperscript{268} In finding that the substitute-for-ordinary income doctrine was not affected by the Arkansas Best decision, the court quoted Arkansas Best:

[Arkansas Best Corporation] mistakenly relies on cases [such as United States v. Midland-Ross, Gillette, P.G. Lake, and Hort] in which this Court, in narrowly applying the general definition of capital asset, has "construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income," even though these items are property in the broad sense of the word . . . . This line of cases, based on the premise that § 1221 "property" does not include claims or rights to ordinary income, has no application in the present context.\textsuperscript{269}

This interpretation of the language in the footnote is probably accurate. If taxpayers such as Maginnis seek to classify a property interest as a capital asset, it

\begin{enumerate}
\item \textsuperscript{262} Id.
\item \textsuperscript{263} Id.
\item \textsuperscript{264} I.R.C. § 1221(a)(4).
\item \textsuperscript{265} Reply Brief, supra note 261, at 10-11. The personal services cases cited in the Brief are: Furrer v. Comm'r, 566 F.2d 1115 (9th Cir. 1977) (relied on in the Maginnis opinion); Holt v. Comm'r, 303 F.2d 687 (9th Cir. 1962) (also relied on by Maginnis); and United States v. Snow, 223 F.2d 103 (9th Cir. 1955).
\item \textsuperscript{266} Id.
\item \textsuperscript{267} Id. 356 F.3d at 1185.
\item \textsuperscript{268} Id. The scope of Arkansas Best is broader than interpreted by this court, but, aside from the discussion of the case earlier in this Comment, supra notes 43-58 and accompanying text, this topic will not be examined further.
\item \textsuperscript{269} Id. (quoting Ark. Best Corp. v. Comm'r, 485 U.S. 212, 217 n.5 (1988) (alteration in original) (citations omitted)).
\end{enumerate}
is clear that, before even reaching Section 1221’s definition and exclusions, the taxpayer must still satisfy the test that the substitute-for-ordinary income doctrine encompasses.

Next, the court analyzed the carve-out exception, which Maginnis argued confined the substitute-for-ordinary income doctrine. This case was different from the other lottery rights cases in that it involved the sale of a vertical slice, a complete sale of the entire interest of Maginnis’ interest, in the lottery rights. Maginnis argued that since he sold his entire interest and retained no reversion in the lottery rights, the lump sum received on the sale of these rights should be taxed as capital gains. The court rejected this argument holding that even though a taxpayer sells his entire interest in the property, the substitute-for-ordinary income doctrine may still be applied.

The court noted that the concept of characterizing vertical slices different than horizontal slices was found in another area of tax law involving the assignment of income doctrine. The court distinguished the cases applying the assignment of income doctrine from those applying the substitute-for-ordinary income on the basis that the issue in the assignment cases was which person should be taxed on the income. It noted, however, the issue in Maginnis was whether the income received should be ordinary income or capital gain. The court’s discussion of this distinction was misplaced and unnecessary because the difference between these slices is equally applicable to the substitute-for-ordinary income cases and provides an appropriate dividing line in deciding the status of the property sold.

In continuing with the discussion of the carve-out exception proposed by Maginnis, the court stated that the substitute-for-ordinary income doctrine was not limited to cases involving horizontal slices. The court noted two cases it previously decided in which the taxpayer made a vertical slice of the interest in the underlying property yet, the court denied treatment for capital gains. However, both of these cases can be distinguished from Maginnis. The Holt case involved a personal service contract, which is different from the present case. Also factually different, Hallcraft Homes involved the sale of future rights to receive a percentage of income received by the water company for water service contracts. Furthermore, the holding in Hallcraft Homes was qualified in a subsequent case.
Jamison v. United States. The district court stated that, in order to make Hallcraft Homes "understandable," the decision must be construed as not allowing the taxpayer to benefit from the capital asset status of the property sold because he already allocated the entire basis in the property. In other words, the decision was not necessarily based on the substitute-for-ordinary income doctrine, which means the Maginnis court's reliance on it was misapplied. The same court that decided Maginnis affirmed the decision per curiam and added only one statement: "If our decision means the broadening of loop holes in the tax laws, the remedy is by action by Congress and not by judicial fiat." 

The court noted that it did draw a distinction between carve-out situations in an earlier case. However, it stated that Metropolitan Building did not suggest that the substitute for ordinary income doctrine should only apply to carve out transactions. Furthermore, the Maginnis court rejected the carve-out exception as a bright-line test, adopting an approach in which each transaction is analyzed and an independent assessment is made as to whether the substitute-for-ordinary income doctrine should apply. Therefore, the fact that Maginnis sold his entire interest in the lottery rights did not alter the application of the substitute-for-ordinary income doctrine and its effect of characterizing the payment as ordinary income.

Maginnis also argued that his future lottery rights were similar to an account receivable, which qualifies as a capital asset under Section 1221 because they were not received in exchange for services rendered. The court quickly rejected this argument as unsupported by Section 1221, especially since Section 1221 only mentions accounts receivable as an exception to capital asset treatment. Simply because the account receivable in question does not fall within the exception does not automatically constitute a capital asset. However, this is exactly what the statute suggests, and this conclusion is even clearer after Arkansas Best. Nevertheless, the court pointed out that some accounts receivable will be treated as capital assets and some will not be considered capital assets under the substitute doctrine. Although this conclusion by the court may prove to be an accurate one, this argument should have been given more attention and analysis. Instead, the court abruptly and in a conclusory fashion stated: "Assuming without deciding that Maginnis' lottery right was an account receivable, that fact does not affect our analysis."
Finally, Maginnis argued that his right to future lottery payments was essentially a debt instrument, which qualified for capital gain status upon sale.\textsuperscript{290} In comparing the lottery ticket to a state revenue bond, Maginnis argued that the lottery ticket itself was evidence of indebtedness because the state used a portion of the cost of the ticket for state purposes.\textsuperscript{291} In Oregon, some of the proceeds from lottery sales goes to the state while the remainder is prize money.\textsuperscript{292} Despite the level of persuasiveness this argument may possess, the court simply noted that Maginnis’ right to the lottery payments was a “prize, not as any compensation for the use or forbearance of money, and therefore the lottery right did not constitute evidence of an indebtedness from Oregon to Maginnis.”\textsuperscript{293} Based on all of the reasons discussed above, the court concluded that the sale of Maginnis’ lottery rights should be taxed as ordinary income.\textsuperscript{294}

Although the court’s final decision was correct, the analysis was flawed, and the decision still leaves questions regarding the scope of the substitute-for-ordinary income doctrine. For example, the court’s reliance on the investment and no capital appreciation aspects is really based on the justifications behind the preferential treatment of capital gains. Therefore, the use of these arguments is susceptible to the same criticism as the justifications, discussed earlier in this Comment.\textsuperscript{295} Moreover, the capital appreciation requirement imposed by the court in Maginnis is not a characteristic that all capital assets possess. For example, personal use automobiles are given capital asset status under Section 1221. However, cars are not types of assets that typically involve capital appreciation over a long period of time. In other words, the court’s use of capital appreciation is not well-founded as it is not necessary for an asset to gain capital asset status and is based on underlying capital gain justifications which have flaws and shortcomings.

Additionally, the requirement of an underlying capital investment leads to a further inquiry. How much investment is needed in order for the property to be a capital asset? The court offers no help in this respect except that the purchase of a one dollar lottery ticket was not considered an investment. However, consider the taxpayer who buys a share of stock for one dollar. If the value of that share increases, the taxpayer will receive capital gain treatment when that share is sold, assuming he holds the stock for longer than one year. For example, if the share sells for ten dollars, then the nine dollar gain would be capital. Therefore, the share of stock would be treated as a capital asset regardless of the mere one dollar investment.

Although this court and the Tax Court dismissed the idea of classifying the lottery ticket as a capital asset itself, the argument for this treatment is still persuasive and worth discussing. Could the ticket be compared to a share of stock? Obviously, taxpayers buy lottery tickets hoping that one of the tickets will be the winner, i.e., that it will increase in value and add to the taxpayer’s wealth.

\textsuperscript{290} Id. at 1187.
\textsuperscript{291} Reply Brief, supra note 261, at 13–15.
\textsuperscript{292} Id. (citing OR. REV. STAT. § 461.500(2)).
\textsuperscript{293} Maginnis, 356 F.3d at 1187.
\textsuperscript{294} Id.
\textsuperscript{295} See supra notes 12–23 and accompanying text.
Comparing this purpose to the taxpayer who purchases a share of stock, the idea and motivation is the same. The stock purchaser hopes that the company will be successful, more specifically, that the value of the stock will increase, allowing him to benefit from this appreciation. The taxpayer who purchases the stock is gambling on the management of the company, and the taxpayer who purchases the lottery ticket is gambling that his ticket numbers will match.

Furthermore, the purchase of stock is referred to as an investment. The term investment can be defined as when a person puts money into something with the expectation of getting a profit while trusting someone else to have control. In other words, the investor puts money into something hoping that he will get a higher return through the actions and efforts of someone or something else. A lottery ticket fits within this definition because the person purchases a lottery ticket with the expectation (or hope) that his ticket will win, while relying on the lottery machine or the person selecting the numbers. On its face, the definition of investment appears to include a lottery ticket. However, as long as the courts rely on the vulnerable justifications for granting property capital asset status, the term investment will be construed as property involving a substantial investment that appreciates in value over time. This judicial definition has excluded some assets that should be considered capital assets.

Maginnis is actually the primary basis for this Comment because it is factually distinguishable from the other lottery cases applying the substitute-for-ordinary income doctrine, since it involved a vertical sale of the lottery rights. Although the Ninth Circuit Court of Appeals has already decided the case, the court did not provide any new guidelines for applying the substitute-for-ordinary income doctrine. Also, as mentioned above, the reasons offered by the court in reaching its decision are subject to criticism. This Comment's two suggested limits for the doctrine are applied below to the lottery cases. Although the previous results from these lottery cases are accurate, the limits would provide the same correct result while also placing appropriate boundaries on the substitute-for-ordinary income doctrine.

V. APPL YING THE PROPOSED LIMITATIONS OF THE SUBSTITUTE-FOR-ORDINARY INCOME DOCTRINE TO THE SALE OF LOTTERY RIGHTS

The first limitation to the substitute-for-ordinary income doctrine is to draw a line between those cases involving the sale of a carved-out interest and those in which the taxpayer sells his entire interest in the property. If the interest sold is carved-out of a larger interest, then the amount received for that interest would constitute ordinary income. By retaining ownership in the larger estate, the taxpayer still has the ability to manipulate the Code through converting ordinary income into capital gains. However, if the taxpayer sells his entire interest in the property, the potential for abuse is no longer present.

The first four lottery cases discussed above, Davis, Boehme, Johns, and Simpson, were all examples of carve-out sales. Although the carve-outs arose in

296. See supra notes 192–229 and accompanying text.
different situations, the fact remains that the taxpayer in each of the cases did not completely terminate his interest in his contract for the right to future lottery payments. Therefore, these cases could have been properly decided based on this limitation alone. However, *Maginnis* involved the sale of the taxpayer’s entire interest in the property, presenting a new situation for the courts. In order to decide this case, the court needed to look beyond the temporal division found in the other lottery cases.

The second limitation draws a distinction between property that represents the right to earned income and the right to earn income. The right to earned income should be taxed at ordinary rates, and the right to earn income should be taxed at capital gains rates. Because these two limitations can be used together, it is important to note that this second limitation properly decides all of the lottery cases despite any presence of a carved-out interest. Lottery rights can hardly be said to constitute the right to earn future income. In fact, the future rights to lottery payments themselves are based on a fixed amount to be paid each year predetermined by the total winnings and the associated interest rates assigned under the annuity contract. In other words, the holder of the future rights does not possess a right to earn future income; instead, he has already “earned” the income by virtue of his ticket being selected and his claim to the winnings. Since he is already entitled to the income and does not need to do anything further to earn the income, the lottery winner has in fact earned the income.

This fact distinguishes lottery rights from other property rights such as patents and royalties. Under ownership of those rights, the taxpayer or some other party must do something further to earn income from them. Merely owning those rights does not produce income, whereas with lottery rights, simple ownership constitutes the right to receive the income. In other words, the income has already been earned and the taxpayer only has to collect it. This distinction applies to all of these lottery cases including *Maginnis*. Therefore, by applying these two limitations, these decisions would have been resolved without reference to the overbroad language used for the substitute-for-ordinary income doctrine and the vulnerable justifications for the capital gain preferential rate.

VI. CONCLUSION

The substitute-for-ordinary income doctrine was designed to prevent the potential abuse by taxpayers of converting ordinary income into capital gains through the use of creative schemes. Essentially, taxpayers were transforming ordinary income into property rights and characterizing these rights as capital assets, thus claiming the preferential tax rate attributable to these assets. However, the Commissioner and the courts have denied such treatment through the development of the substitute doctrine.

The lottery cases have been the most recent application of this doctrine. Each of these cases were properly decided, even though the courts continued to use the overbroad language of the substitute doctrine and the vulnerable justifications for

297. *See supra* notes 270–85 and accompanying text.
capital gain preferences to reach the correct result. However, the need to refine the doctrine is still apparent and the two suggested limitations in this Comment should provide the courts with guidelines to reach the appropriate result. These boundaries prevent the extension of the doctrine into areas beyond its scope, while still avoiding the taxpayer’s usurpation of the Code through creative schemes.

After Arkansas Best, there appears to be a new judicial process for determining whether something that qualifies as property under state law will also satisfy the definition of property for federal tax purposes to be treated as a capital asset. The first step is that there must be a sale of property. Next, it is necessary to determine whether the property sold falls within the substitute-for-ordinary income per Hort, Lake, and Gillette. It is important to note that this is an intermediate hurdle that must be overcome before the Arkansas Best decision applies (arising by virtue of footnote five in that decision298). The final step, per the Arkansas Best decision, is that if the property sold falls outside specified exclusions in Section 1221, then it must be a capital asset. Again, the importance of this process is to realize that the statute governing the capital asset definition, Section 1221, never comes into play if the property comes under the substitute-for-ordinary income doctrine.

The cases involved in the development of this doctrine have made an important judicially-created principle into a complicated mess. The underlying theory is an important aspect in the tax law area and its premise is necessary to uphold the current tax system. The lower courts have added factors and other interpretations, resulting in inconsistent decisions and seemingly arbitrary applications of the doctrine. Major confusion has developed from the overbroad language of the doctrine and the vulnerable justifications that the courts have inferred to be congressional intent.

The ideas behind the two limits proposed in this Comment are not new or innovative. In fact, the distinctions that these limits entail have been noted in various court decisions, law review articles, and treatises, but the courts have never used them together to form an actual test to limit the scope of the substitute-for-ordinary income doctrine. By following the two suggested limitations, courts will develop a uniform body of case law that will apply the doctrine correctly by maintaining the important premise for which it is based without broadening the language to areas beyond its scope. Even though the application of these limits will cause reconsideration of areas of law, such as personal services contracts, these limitations are necessary to preserve the substitute-for-ordinary income doctrine and the appropriate treatment of these property rights governed by it.

Back to our favorite taxpayer from the beginning of the Comment. Charlie will now be able to predict how the courts would treat the lump sum payment for his rights to future lottery installments if he decides to sell them. Although this is definitely not what Charlie would like to see happen to his winnings, he may receive some comfort in knowing up front how the proceeds will be treated if he elects to receive annual payments and subsequently sell them for a lump sum. Now, he will be able to explore other tax planning strategies to ensure that the

government will get as little as possible and, more importantly, that Katherine receives most of everything he has.

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