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OUT WITH THE OPEN-TRANSACTION DOCTRINE: A NEW THEORY FOR TAXING CONTINGENT PAYMENT SALES

JEFFREY L. KWALL*

The open-transaction doctrine stems from Burnet v. Logan, *one of the most famous Supreme Court cases in the history of the tax law. For more than seven decades, this doctrine has wreaked havoc with the tax treatment of the seller and the buyer of a business whose purchase price is contingent on future profits. Contingent payment sales typically occur when the parties cannot agree on the value of the business. Professor Kwall argues that the open-transaction doctrine cannot be justified and that it is time for Congress to put the doctrine to rest. His Article advances a new system for taxing contingent payment sales. The courts have historically treated the seller's right to contingent payments as consideration provided by the buyer of the business. Professor Kwall argues that the seller's right to contingent payments should instead be conceptualized as a proprietary interest retained by the seller. This retained-interest theory provides a sound foundation for taxing contingent payment sales and fills a void that has existed with respect to these common business transactions since the origin of the income tax law.*

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> *The only indisputable conclusion that can be reached in wading through the plethora of case law dealing with the open-transaction approach is that little is clear and nothing is certain.*[1]

INTRODUCTION

The open-transaction doctrine is a common law creation, born out of the Supreme Court's famous *Burnet v. Logan* decision.[2] In 1916, a mere three years after the enactment of the "modern" income tax,[3] Edith Logan sold stock of a coal mining company for a cash payment and the right to receive a few cents for every ton of coal mined by an affiliate in subsequent years.[4] Due to the primitive state of the law governing realization of income, Mrs. Logan persuaded the

1. Edward Sair et al., *Treatment of Contingent Obligations in Stock or Asset Sales Uncertain After Repeal of Installment Method of Reporting for Accrual Method Taxpayers*, 27 J. CORP. TAX'N 203, 222 (2000).

2. Burnet v. Logan, 283 U.S. 404, 409–14 (1931).

3. In 1913, the Constitution was amended to allow a direct income tax without apportionment among the states. U.S. CONST. amend. XVI. The Sixteenth Amendment marks the advent of the "modern" income tax. For a discussion of earlier United States tax laws dating from the 1860s, see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 618 & nn.23–27 (1990).

4. *See Burnet*, 283 U.S. at 410.

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Supreme Court that any gain attributable to the right to contingent payments could not be measured until the contingent payments materialized and, therefore, was not realized in the year of sale.[5] The Court treated the sale as an "open transaction." As such, Mrs. Logan's gain was deferred until the total payments she received exceeded the tax basis of the stock she transferred.[6]

Mrs. Logan was not the last taxpayer to sell her business for consideration based on the future performance of the transferred business. Sales with contingent terms are quite common when the parties cannot agree on price.[7] Often, the seller of a business is far more optimistic about its future prospects than the buyer, and she will demand a higher price than the buyer is willing to pay. The buyer might pay the higher price if he were certain that the seller's expectations would materialize, but this will not be known until after the business is transferred. Making a part of the purchase price contingent on future profits bridges the gap—if the profits the seller anticipates materialize, the seller receives additional consideration; if the profits fail to materialize, the buyer's cost does not increase.[8]

To this day, *Burnet* is invoked by sellers to support the position that a right to contingent payments is not realized in the year of sale.[9]

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5. *See id.* at 412–13 ("When the profit, if any, is actually *realized*, the taxpayer will be required to respond." (emphasis added)).

6. *See id.* at 413. The cash payment Mrs. Logan received in the year of sale was less than the tax basis in her stock. The facts of *Burnet* are discussed in detail in Part I.

7. Dennis S. Karjala, *Taxing the Sale of Property*, 1980 DUKE L.J. 417, 485 ("[O]ne or both parties may be unwilling to assume the risk of being wrong in the assessment of value, and such unwillingness is often expressed in a ... contingent-price contract."); James C. Koenig & Craig M. Boise, *Contingent Consideration: The Taxation of Earnouts and Escrows*, MERGERS & ACQUISITIONS: MONTHLY TAX J., July 2001, at 3, 3 ("The past several years have seen a significant ongoing trend toward greater use of 'earnouts' in both stock and asset transactions. Earnouts have proven to be a valuable device for permitting a buyer and seller to reach agreement on a sale when the parties cannot agree on price.").

8. Michael D. Fernhoff & Jon E. Gelb, *Selling the Private Company*, 52 MAJOR TAX PLAN. ¶ 5A00, ¶ 5A03.2, at 5A-22 (2000) ("In many situations, the seller believes the company is worth more than the purchaser is willing to pay based on its current operating history. To bridge the gap, the purchaser may agree to pay additional consideration if the company meets certain performance milestones."). "Payment of an earnout might be contingent on any number of future events, including exceeding a specified gross revenue; net income; earnings before interest, taxes, depreciation, and amortization (EBITDA); or production amount." Koenig & Boise, *supra* note 7, at 3. For a recent example of a contingent payment sale, see Lisa Bannon & Nihkil Deogun, *Mattel Nears Sale of Learning Co. for a Share of Its Future Earnings*, WALL ST. J., Sept. 29, 2000, at A2.

9. *See, e.g.*, Bernice Patton Testamentary Trust v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,332 (Fed. Cl. Mar. 20, 2001) (involving a sale of stock for cash and a promissory note to be paid out of a percentage of post-sale profits), *available at* 2001 WL

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The government has long argued for "closed-transaction" treatment by claiming that the contingent element can and must be valued when the sale occurs.[10] According to the government's view, the contingent element is realized and taxed in the year of sale.[11] Bound by *Burnet*, however, the government has always conceded open-transaction treatment in those "rare and unusual cases" where the value of the contingent rights is "unascertainable."[12]

Unascertainable value has proved to be a slippery factual question and dozens of taxpayers have emerged victorious after arguing for open-transaction treatment in the courts.[13] Taxpayer victories subsequent to Mrs. Logan's have been even more costly to the government. Since 1921, Congress has imposed lighter tax burdens on capital gains than ordinary income.[14] With little analytical support, courts have extended the open-transaction doctrine to accord capital gains treatment to any gain that results when contingent payments materialize.[15] Surprisingly, the government conceded this issue with little fanfare.[16] By contrast, the courts have historically taxed as ordinary income any gain resulting from

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429809, *aff'd*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,277 (Fed. Cir. Feb. 27, 2002), *available at* 2002 WL 315269.

10. *See infra* note 96 and accompanying text.

11. *See* I.R.C. § 1001(b) (2000) (providing that the taxpayer's amount realized includes the fair market value of *all* property received).

12. *See, e.g.*, Likins-Foster Honolulu Corp. v. Comm'r, 840 F.2d 642, 650 (9th Cir. 1988) (involving an exchange of subsidiary stock for rights in the outcome of continuing litigation); Vestal v. United States, 498 F.2d 487, 493–94 (8th Cir. 1974) (involving a transfer of an investment opportunity in exchange for a partnership interest); Cassat v. Comm'r, 137 F.2d 745, 748 (3d Cir. 1943) (involving a sale of a brokerage house in exchange for the right to twenty-five percent of future profits for six years); Imperial Type Metal Co. v. Comm'r, 106 F.2d 302, 304 (3d Cir. 1939) (involving a sale of assets in exchange for five percent of future profits until five years after seller's death); Grudberg v. Comm'r, 34 T.C.M. (CCH) 669, 673–74 (1975) (involving the sale of a company for promissory notes, the payment of which were conditioned on future events).

13. *See infra* note 91. The cost to the Treasury of income deferral should not be underestimated. The time at which income is taxed is often as economically significant as the amount of income that is subject to tax. *See* Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565, 565–70 (1983).

14. *See* Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233 (codified as amended at I.R.C. § 1(h) (West 2002)). Under current law, capital gains of an individual generally are taxed at a maximum rate of 20% whereas ordinary income is taxed at rates as high as 38.6%. I.R.C. § 1(a), (h), (i) (West 2002).

15. *See infra* note 75 and accompanying text.

16. *See* Rev. Rul. 58-402, 1958-2 C.B. 15 ("[I]f the sale or exchange remains an open transaction, ... the subsequent payments received under the contract will be subject to the appropriate capital gains provisions in the statute....").

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contingent payments in a closed transaction.[17] Thus, open-transaction treatment now favors sellers from the standpoint of both the timing of income and its characterization.

In 1980, Congress attempted to reduce the frequency of open-transaction reporting by expanding the scope of the installment method of reporting gain to encompass contingent payment sales.[18] Under the installment method, when property is sold but payment of part of the purchase price is deferred to later years, the seller does not recognize her entire gain in the year of sale, but instead recognizes gain as payments are received.[19] Applying the installment method to contingent payment sales normally yields less favorable consequences to the seller than open-transaction reporting, but more favorable results than closed-transaction reporting.[20] Congress hoped that the certainty of this elective, middle-ground treatment would deter taxpayers from seeking the less certain, though generally more favorable, open-transaction treatment.[21]

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17. *See infra* note 116. Subsequent statutory amendments might now confer capital gains treatment on deferred gain in a closed transaction, but this is doubtful. *See infra* note 119. Gain occurs with respect to contingent payments in a closed transaction when the actual contingent payments exceed the estimated value of the right to contingent payments in the year of sale. *See infra* note 115.

18. *See* I.R.C. § 453(j)(2) (2000); S. REP. NO. 96-1000, at 24 (1980) ("[T]he effect of the new rules is to reduce substantially the justification for treating transactions as 'open' . . . ."), *reprinted in* 1980 U.S.C.C.A.N. 4696, 4719, *and in* 1980-2 C.B. 494, 506. For a discussion of the extension of the installment sale rules to contingent payment sales, see Martin D. Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 N.Y.U. ANN. INST. ON FED. TAX'N § 43.01, § 43.03 (1981); Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income from an Option to Acquire Property*, 48 TAX L. REV. 233, 264 (1993). For a summary of the law prior to 1980, see Dennis S. Karjala, *Sales of Property Outside Section 453*, 64 TAXES 153, 154 n.8 (1986). In 1999, Congress repealed the installment method for taxpayers using the accrual method of accounting but reinstated the rule in 2000. *See* Installment Tax Correction Act of 2000, Pub. L. No. 106-573, § 2(a), 114 Stat. 3061, 3061 (repealing § 536(a)(1) of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860, 1936); Sair et al., *supra* note 1, at 203.

19. I.R.C. § 453(a)–(c).

20. The installment method is generally *less* favorable to the seller than open-transaction treatment because only a portion of the basis in the transferred property offsets each payment under the installment method, whereas basis is applied dollar-for-dollar against each payment under open-transaction treatment. The installment method is generally *more* favorable to the seller, however, than closed-transaction treatment. Under the installment method, gain attributable to the right to contingent payments is not recognized until payments are received. By contrast, under closed-transaction treatment, gain attributable to the present value of the right to contingent payments is immediately recognized. For a comparison of the tax consequences of the installment method to open-transaction treatment and closed-transaction treatment, see *infra* Appendix.

21. *See* S. REP. NO. 96-1000, at 24 ("By providing an expanded statutory installment reporting option, the Committee believes that in the future there should be little incentive

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Extending installment reporting to contingent payment sales was, by Congress's own admission, an incomplete antidote to open-transaction reporting.[22] The installment method is an elective regime and aggressive taxpayers can continue to opt out of the installment method to utilize open-transaction treatment.[23] More significantly, the installment method applies to a contingent payment sale only if the right to contingent payments represents consideration received from the buyer. When the value of the contingency is unascertainable, it is dubious to treat the right to contingent payments as consideration flowing from the buyer. In these circumstances, the right to contingent payments should be regarded as an interest retained by the seller in the transferred property, a transaction to which the installment method does not apply.[24]

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to devise convoluted forms of deferred payment obligations to attempt to obtain [open-transaction] reporting."), *reprinted in* 1980 U.S.C.C.A.N. 4696, 4719, *and in* 1980-2 C.B. 494, 506.

22. *See id.* ("[I]t is the Committee's intent ... [that use of open-transaction reporting] be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained."), *reprinted in* 1980 U.S.C.C.A.N. 4696, 4719, *and in* 1980-2 C.B. 494, 506–07.

23. The installment method automatically applies to a sale in which at least one payment is to occur in a later year unless the taxpayer elects in the year of sale not to apply the installment method. I.R.C. § 453(d); Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (as amended in 1994). When the installment method is applied to contingent payment sales, arbitrary assumptions must be made that can yield highly irrational results. *See* Ginsburg, *supra* note 18, § 43.03, at 43-16 to 43-18 (illustrating circumstances in which basis recovery rules produce a severe mismatching of basis to payments received); Koenig & Boise, *supra* note 7, at 6–7 (demonstrating circumstances where application of the installment method to contingent payment sales "may produce anomalous outcomes," "may inappropriately accelerate recognition of gain or create timing and character issues," and may leave the seller "with a significant loss and little guidance on the deductibility, timing, or character of the loss"); Blake D. Rubin & William P. Cejudo, *Creative Tax Planning for the Disposition of Real Estate* (pt. 2), 28 J. REAL EST. TAX'N 319, 328–29 (2001) (discussing the problem of computing interest charges for certain contingent payment installment sales). It would be imprudent, therefore, for Congress to make the installment method of reporting gain mandatory for all contingent payment sales. Even an advocate of mandatory installment reporting for deferred, *fixed*-payment sales concedes elective treatment for contingent payment sales. *See* David F. Shores, *Closing the Open Transaction Loophole: Mandatory Installment Reporting*, 10 VA. TAX REV. 311, 356 (1990) ("Under this proposal open-transaction treatment would remain as an alternative to installment reporting only if the seller received a contingent payment obligation.").

24. Temp. Treas. Reg. § 15a.453-1(c)(1).

> The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions ....

Id.

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This Article argues that open-transaction treatment cannot be justified and that it is time for Congress to put the open-transaction doctrine to rest.[25] Closed-transaction treatment is not viable, however, when the seller receives a right to contingent payments with unascertainable value because it is impossible to quantify the seller's amount realized. Efforts to impose closed-transaction treatment in these circumstances yield confused and inconsistent tax consequences.[26]

This Article proposes a new theory for taxing contingent payment sales with unascertainable value; namely, that the right to contingent payments should be conceptualized as a proprietary interest retained by the seller in the transferred business.[27] The consequences of this retained-interest approach are a hybrid of open-transaction treatment and closed-transaction treatment. As to the timing of income, the retained-interest approach reflects an open-transaction view—the right to contingent payments is not realized in the year of sale because it does not represent consideration flowing from the buyer. Rather, the right to contingent payments reflects an interest retained by the seller who is taxed as the contingent payments materialize. As to characterization, however, the retained-interest approach more closely approximates closed-transaction treatment because the seller's deferred income is generally taxed as ordinary income.

Part I demonstrates that the open-transaction doctrine cannot be justified. It shows that *Burnet* weakly supports the doctrine because the year of sale was not before the Court, the Commissioner's position was inherently flawed, and the Court rested its holding on an

25. For additional commentary on the open-transaction doctrine, see generally Daniel S. Goldberg, *Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980*, 34 TAX LAW. 605 (1981) (examining tax consequences of deferred payment sales and concluding that open-transaction treatment remains available to a seller using the cash method of accounting in appropriate cases); Mathew A. Lykken, *Mrs. Logan Comes to a Sudden Realization: An Analysis of the Current State of the Open Transaction Doctrine*, 42 OKLA. L. REV. 581 (1989) (discussing the development of the open-transaction doctrine and concluding that the doctrine should be replaced by the installment sale rules and the general cash equivalency doctrine); Robert R. Wootton, *Mrs. Logan's Ghost: The Open Transaction Doctrine Today*, 71 TAXES 725 (1993) (opining that the open-transaction doctrine is in retreat and that the tax law is trending toward rules requiring current valuation subject to adjustment based on outcome).

26. *See infra* Part II.

27. The proposal advanced in this Article contemplates an asset sale by an individual. The implications of a sale of assets by a C Corporation, S Corporation, or unincorporated enterprise taxed as a partnership, and a sale of ownership interests in a business entity (stock or partnership interests) are beyond the scope of this Article. For some general observations on these other types of transactions, see *infra* note 206.

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erroneous conclusion. Most importantly, the Court's holding is inconsistent with current law. Accordingly, Congress should overrule the open-transaction doctrine.

Part II shows that contingent payment sales generally occur when the parties cannot agree on the value of the business and, therefore, that the value of the right to contingent payments is normally unascertainable. This Part then reveals the problems presented by closed-transaction treatment under current law and demonstrates that it is impossible to identify a conceptual framework that yields sensible and consistent tax consequences when closed-transaction principles are applied to most contingent payment sales. As such, a new approach for taxing contingent payment sales is needed.

Part III advances the novel approach of treating the contingent payment sale as a transfer of only a part of the seller's ownership interest when the value of the right to contingent payments is unascertainable. Under this theory, the right to contingent payments represents a proprietary interest retained by the seller in the transferred business. This retained interest gradually shifts from the seller to the buyer with the passage of time until the buyer owns the entire property when the term of the contingency expires. The retained-interest theory provides a sound foundation for taxing contingent payment sales, yielding sensible and consistent tax consequences to all parties.

I. OPEN-TRANSACTION TREATMENT CANNOT BE JUSTIFIED

The keystone support for open-transaction treatment is the Supreme Court's *Burnet* decision. Whenever a court permits deferred realization of gain in a contingent payment sale, *Burnet* is routinely cited as the principal, and generally the sole, authority for that result.[28] No subsequent authority provides conceptual support for deferred realization; rather, the holding of *Burnet* is simply accepted with blind faith.[29]

A careful examination of *Burnet* and the events that followed reveals that open-transaction treatment cannot be justified. As a threshold matter, the *Burnet* courts never confronted the issue they are credited with resolving; namely, the tax consequences in the year of sale. Mrs. Logan sold her stock in 1916 but the Commissioner refrained from challenging Mrs. Logan's position in the year of sale as

28. *See infra* note 91 and accompanying text.

29. *See infra* note 91 and accompanying text.

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the tax years at issue in the litigation were 1918 through 1920.[30] Moreover, the Commissioner advanced an inconsistent position and thereby precluded the courts from considering a logical alternative to Mrs. Logan's open-transaction view.[31] In addition, the Supreme Court justified its holding by finding that no costs were associated with a "wait-and-see" approach, a conclusion that is generally incorrect.[32] Most significantly, legislation subsequent to the events in *Burnet* eliminated statutory ambiguity that arguably accommodated Mrs. Logan's open-transaction position.[33] This Part will develop these observations and demonstrate that open-transaction treatment of contingent payment sales cannot be justified.

A. *Chronology of* Burnet v. Logan

On March 11, 1916, Edith Logan and the other shareholders of the Andrews & Hitchcock Iron Company ("A&H") sold their stock to the Youngstown Sheet & Tube Company for an aggregate of $2,200,000 and the right to $.60 for each ton of ore subsequently received by A&H from the Mahoning Ore & Steel Company.[34] Mrs. Logan received $137,500 of the 1916 cash payment and roughly $35,600 of the contingent payments made from 1917 to 1920 for a total of $173,100.[35] The parties stipulated that the tax basis in the stock Mrs. Logan sold exceeded the amount of consideration she had received through 1920.[36] Mrs. Logan reported no income from 1916

30. *See infra* text accompanying notes 56–57.

31. *See infra* notes 61–68 and accompanying text.

32. *See infra* notes 69–76 and accompanying text.

33. *See infra* notes 77–87 and accompanying text.

34. Burnet v. Logan, 283 U.S. 404, 410 (1931). A&H owned 12% of Mahoning and was contractually entitled to 12% of the ores mined by Mahoning. *See id.* at 409.

35. *Id.* at 410. Mrs. Logan owned 250 of the 4,000 outstanding shares of A&H, or 6.25%. Mrs. Logan's share (6.25%) of the 1916 cash payment ($2,200,000) was $137,500. Mrs. Logan received contingent payments of $9,900 in 1917, $11,250 in 1918, $8,995.50 in 1919, and $5,444.30 in 1920; totaling $35,589.80. Mrs. Logan also held the right to contingent payments for 550 shares previously owned by her deceased mother, with respect to which Mrs. Logan received $19,710.19 in 1919 and $11,977.49 in 1920. *Id.*

36. *Id.* at 411. Because Mrs. Logan acquired her stock prior to March 1, 1913, her tax basis in the stock was the fair market value of the stock on that date. Revenue Act of 1916, ch. 463, § 2(c), 39 Stat. 756, 758 ("For the purpose of ascertaining the gain derived from the sale or other disposition of property . . . acquired before [March 1, 1913], the fair market price or value of such property as of [March 1, 1913], shall be the basis . . . ."). Although the March 1, 1913, value of Mrs. Logan's stock is not revealed, the Court stated that that value "exceeded $173,089.80—the total of all sums actually received by her prior to 1921 from their sale ($137,500 cash in 1916, plus four annual payments amounting to $35,589.80)." *Burnet*, 283 U.S. at 411.

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to 1920 because her stock basis exceeded the monies she received during that period.[37]

As to the year of sale (1916), the Commissioner acknowledged that "no taxable income had been derived from the sale when made" because the consideration Mrs. Logan received did not exceed the basis of her stock.[38] With regard to 1917 through 1920, however, the Commissioner claimed that Mrs. Logan should have reported as gain roughly two-thirds of the contingent payments she received in each of those years.[39]

To arrive at the conclusion that two-thirds of each post-1916 payment represented taxable gain, the Commissioner began by projecting that the shareholders of A&H ultimately would receive roughly $6 million of contingent payments.[40] Mrs. Logan's share was approximately $375,000.[41] The Commissioner assumed arbitrarily that the $6 million of contingent payments would be received in level amounts over the forty-five year projected life of the mine and computed the present value of the payment stream to be roughly $2 million.[42] Mrs. Logan's share was approximately $125,000.[43] The Commissioner conceded that Mrs. Logan did not realize a gain in the year of sale because the sum of the cash payment she received ($137,500) and her share of the estimated present value of the right to contingent payments ($125,000) was less than the tax basis in the stock she transferred.[44] The Commissioner then determined that the right to contingent payments represented new property that

37. *Burnet*, 283 U.S. at 410.

38. Logan v. Comm'r, 42 F.2d 193, 194 (2d Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931).

39. Logan v. Comm'r, 12 B.T.A. 586, 599-600 (1928), *rev'd*, 42 F.2d 193 (2d Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931).

> The Commissioner ... has determined ... a portion of each payment under the contract was a return of capital and a portion represented gain. The Commissioner has determined ... that each payment, whether made one year after the agreement was made or 45 years thereafter, is made up [32.554] per cent return of principal and 67.446 per cent income.

Id.

40. *Id.* at 593. The Commissioner estimated the total reserves of the Mahoning mine at March 11, 1916, to be 82,858,535 tons. *Id.* A&H was entitled to $.60 per ton for 12% of the ores mined by Mahoning. *See supra* note 34 and accompanying text. The calculation is as follows: *82,858,535 tons x $.60 per ton x 12% = $5,965,814.52.*

41. Mrs. Logan owned 6.25% of the stock of A&H. *See supra* note 35. The calculation is as follows: *$6,000,000 x 6.25% = $375,000.*

42. *Logan*, 12 B.T.A. at 593.

43. Mrs. Logan owned 6.25% of the stock of A&H. *See supra* note 35. The calculation is as follows: *$2,000,000 x 6.25% = $125,000.*

44. Logan v. Comm'r, 42 F.2d 193, 195 (2d Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931).

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substituted for the stock Mrs. Logan sold. As a result, the Commissioner treated the $125,000 estimated present value of the right to contingent payments as the tax basis for determining the taxable portion of the deferred payments Mrs. Logan actually received.[45] Because Mrs. Logan's $125,000 basis represented roughly one-third of the $375,000 of deferred payments she was projected to receive, the Commissioner claimed that roughly two-thirds of each post-1916 payment should be taxed as gain.[46]

The Board of Tax Appeals agreed with the Commissioner.[47] The Second Circuit reversed and held that Mrs. Logan had no taxable gain until she received payments in excess of the tax basis in the stock she transferred.[48] The Second Circuit treated the right to contingent payments as property received in the year of sale by equating the contingent right to the receipt of an annuity.[49] The Second Circuit was bothered by the fact that the Commissioner's position deprived Mrs. Logan from recovering the part of the basis in her A&H stock that exceeded the sum of the cash payment she received and the estimated present value of the right to contingent payments.[50]

The Supreme Court affirmed the Second Circuit's decision.[51] The Court observed that no need existed to force valuation in an

45. *Id.* at 196.

46. If she received $375,000 of payments with respect to an interest in which she had a basis of $125,000, the gain would be $250,000 or two-thirds of each projected payment. *Logan*, 12 B.T.A. at 599–600 ("[E]ach payment, whether made one year after the agreement was made or 45 years thereafter, is made up [32.554] per cent return of principal and 67.446 per cent income.").

47. *Id.* at 605. The court disagreed, however, with the mechanics of the calculation. In lieu of treating a fixed percentage of each contingent payment as income, the Board of Tax Appeals favored full inclusion and a partially offsetting depletion deduction. *See id.* at 600–03.

48. *Logan*, 42 F.2d at 197.

49. The court stated: "Therefore, when this taxpayer sold her stock, in addition to receiving cash, she would obtain what substantially amounts to an annuity for a period of 45 years." *Id.* The tax consequences of a purchased annuity have been modified dramatically since *Burnet* was decided. At that time, sums received with respect to a purchased annuity were not treated as income until after the entire purchase price was recovered. *See* United States v. Bolster, 26 F.2d 760, 762–63 (1st Cir. 1928); Allen v. Brandeis, 29 F.2d 363, 364 (8th Cir. 1928); Warner v. Walsh, 15 F.2d 367, 368 (2d Cir. 1926). Under current law, however, the purchaser of an annuity must report a portion of each payment as income. *See* I.R.C. § 72 (West 2002) (requiring an annuity owner to amortize basis over the projected payment stream). Hence, if *Burnet* were decided today and the purchased annuity analogy applied, gain would be triggered before payments exceeded the seller's entire basis in the transferred property.

50. *Logan*, 42 F.2d at 196–97. For a more detailed discussion of this point, see *infra* notes 64–68 and accompanying text.

51. Burnet v. Logan, 283 U.S. 404, 414 (1931). The Supreme Court decision also applied to a companion case involving Mrs. Logan's sister, Julia Andrews Bruce. *See*

uncertain situation. Rather, by waiting until the payments materialized, the correct amount of income would ultimately be taxed.[52] The Court's comfort with this "wait-and-see" approach led to its sanction of deferred realization: "When the profit, if any, is actually *realized*, the taxpayer will be required to respond."[53] The Court bolstered its position by stating that the contingency "was in no proper sense the equivalent of cash" and "had no ascertainable fair market value."[54] The Court loosely embraced the Second Circuit's annuity analogy.[55]

B. *Government's Position Was Fatally Flawed*

The proper starting point for analyzing *Burnet* is 1916, the year Mrs. Logan sold her shares. Mrs. Logan reported no gain in 1916,[56] and the Commissioner did not challenge that reporting.[57] The interesting question is why Mrs. Logan did not claim a tax loss in the year of sale. Quite clearly, the cash Mrs. Logan received in 1916 was less than the basis in the shares she transferred.[58] Though one can only speculate as to why no loss was claimed, Mrs. Logan's 1916 reporting position is perfectly consistent with an open-transaction perspective. Her position reflects the view that the contingent element of the transaction had no ascertainable value—not that it had no value at all.[59] Thus, no loss would be realized until she knew with certainty that the total of all the payments she would ever receive was less than the tax basis in the stock she sold. This view of loss realization is consistent with Mrs. Logan's belief that she did not realize gain until the total payments received exceeded the tax basis in her stock, at which point it became inescapable that gain existed.[60]

In contrast to the logic of Mrs. Logan's open-transaction position, the Commissioner's version of closed-transaction treatment was inherently inconsistent. Normally, closed-transaction treatment

Bruce v. Comm'r, 42 F.2d 197 (2d Cir. 1930), *rev'g* 5 B.T.A. 300 (1926), *aff'd by* Burnet v. Logan, 283 U.S. 404 (1931).

52. *Burnet*, 283 U.S. at 412–13 ("The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation.").

53. *Id.* at 413 (emphasis added).

54. *Id.*

55. *Id.* at 413–14; *see supra* note 49 and accompanying text.

56. *See Burnet*, 283 U.S. at 410.

57. *See* Logan v. Comm'r, 42 F.2d 193, 194 (2d Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931).

58. *See Burnet*, 283 U.S. at 411; *supra* note 36 and accompanying text.

59. *See supra* note 37 and accompanying text.

60. *See Burnet*, 283 U.S. at 410.

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results in a taxable gain in the year of sale because the sum of the cash received and the present value of the right to contingent consideration exceeds the taxpayer's basis in the transferred property.[61] In these circumstances, the uncertainty associated with valuing the contingency is only relevant to the magnitude of the gain. In *Burnet*, however, asserting closed-transaction treatment in the year of sale would have triggered a tax loss.[62] Because Mrs. Logan did not report a tax loss in the year of sale, it is not surprising that the Commissioner refrained from challenging her tax reporting for that year.

Although the Commissioner did not question Mrs. Logan's failure to report a tax loss in 1916, he nevertheless claimed that Mrs. Logan's basis in the right to contingent payments was the estimated present value of those rights, an amount that was less than Mrs. Logan's basis in the stock she transferred.[63] The Second Circuit was concerned that the Commissioner's position precluded Mrs. Logan from recovering her entire basis in the stock she sold.[64] The deprivation occurred because the Commissioner determined that the right to contingent payments represented new property that substituted for the stock Mrs. Logan sold. As a result, the estimated present value of the contingent right became the basis for determining Mrs. Logan's gain with respect to future payments.[65] Because the estimated present value of the contingent right was less than the basis in the stock Mrs. Logan sold, she would never be able to apply all the tax basis in her stock against future gains.[66]

The fact that the Commissioner was mandating a "step-down" in basis without allowing a tax loss reveals a fatally flawed position.[67]

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61. *See* I.R.C. § 1001(a) (2000).

62. Loss would have resulted because the basis in Mrs. Logan's stock exceeded the sum of the cash she received in the year of sale and the estimated present value of the right to contingent payments. *See Logan*, 42 F.2d at 195.

63. *See id.* at 196.

64. *Id.*

> The respondent's determination deprived the petitioner of the benefit of that part of the March 1, 1913, value which is greater than the consideration received .... When he ascertained the gain from ... the contract right to receive future payments, he did not give credit to the taxpayer for any March 1, 1913, value, but began the base anew on the theory that the contract right to receive payments when reduced to cash is partly a return of contract right and partly income.

Id.

65. *Id.*; *see supra* text accompanying note 45; *see also* Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (Ct. Cl. 1954) (finding that the value of property received in a taxable exchange becomes the basis of that property).

66. *See supra* note 64 and accompanying text.

67. *Logan*, 42 F.2d at 196.

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The Second Circuit could not salvage the Commissioner's step-down in basis position by allowing Mrs. Logan a loss in the year of sale because 1916 reporting was not before the court.[68] As a result, Mrs. Logan's open-transaction position was the only logical choice.

Whether a different outcome would have resulted had the Court's initial foray into open-transaction reporting involved the year of sale cannot be known. But the fact remains that the Commissioner's position was inherently inconsistent and precluded the courts from evaluating two potentially viable alternatives. Thus, *Burnet* did not afford the Court the opportunity to evaluate the merits of open-transaction treatment.

C. *Supreme Court's "Wait-and-See" Rationale Is Invalid*

In light of the government's fatally flawed position, the Supreme Court had little choice but to affirm the Second Circuit. The Court compounded the error, however, by justifying its affirmance with an invalid rationale.

The Court's opinion consists primarily of conclusory statements. The principal justification for its affirmance is a cursory cost-benefit analysis. The Court essentially considered the inevitable inaccuracy that would result from valuing the contingent rights immediately and weighed this consideration against what it perceived to be the cost-free alternative of waiting until payments are made to compute gain with certainty.[69] In effect, the Court adopted a "wait-and-see approach" because it perceived no cost to this action.[70] This view would be quite compelling if, in fact, it cost nothing to wait. But due to the time value of money and characterization distinctions that emerged subsequent to the events in *Burnet*, significant costs are often associated with this wait-and-see approach.

The Court overlooked the impact of the time value of money when it concluded that no costs were associated with a wait-and-see approach. Regardless of whether a contingent payment sale is treated as an open transaction or a closed transaction, the same amount of gain, in nominal terms, should ultimately be taxed. That gain represents the difference between the total payments actually received and the taxpayer's basis in the transferred property.[71]

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68. *See supra* text accompanying notes 56–57.

69. Burnet v. Logan, 283 U.S. 404, 412–13 (1931).

70. *See id.*

71. *See* I.R.C. § 1001(a) (2000). A portion of the deferred consideration may be recharacterized as interest, but that affects characterization and possibly timing, not the amount of income. *See id.* §§ 483(f)(1), 1271–1275.

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the confused and contradictory treatment of sale and exchange transactions from 1918 to 1924. Although the law was clarified in 1924 with the enactment of statutory language that still applies today, the remnants left in the wake of Congress's earlier struggles appear to have influenced the *Burnet* courts.

The Revenue Act of 1918 introduced a cash equivalence concept to realization. The Act states that "[w]hen property is exchanged for other property, the property received in the exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any."[79] In interpreting this rule, the Treasury tied cash equivalence to marketability. Specifically, the Treasury construed the statute to mean that property received would not be treated as the equivalent of cash unless it was readily marketable.[80] In 1921, Congress followed the Treasury's lead by conditioning recognition of gain or loss on marketability, stating that "on an exchange of property . . . for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value."[81] Under an interpretive Treasury Regulation, property had a realizable market value when it could "be readily converted into an amount of cash or its equivalent substantially equal to the fair market value of the property."[82] Although the *Burnet* courts appeared to pay little attention to the primitive statutes applicable to the events in that case, they logically could have concluded that the contingency in their case was not a cash equivalent under the 1918 Act because it was not readily marketable.[83] In any event, the deferred realization holdings of the Second Circuit and the Supreme Court were certainly not impeded by the law before 1924.

In 1924, Congress did an about face by enacting the definition of "amount realized" that still applies today: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."[84] The Committee Reports explained that the

79. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060.

80. Treas. Reg. § 1563 (1919).

81. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230.

82. Treas. Reg. § 1564 (1921).

83. *See* Logan v. Comm'r, 42 F.2d 193, 195 (2d Cir. 1930) (citing section 202(b) of the Revenue Act of 1918 for the proposition that for income to be derived, the consideration must be the equivalent of cash), *aff'd sub nom.* Burnet v. Logan 283 U.S. 404 (1931). Cash equivalency no longer impacts the timing of realization. *See infra* note 87.

84. Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 253, 256 (codified as amended at I.R.C. § 1001(b) (2000)).

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amendment was made because of the difficulty of determining whether property has a readily realizable fair market value, a difficulty that impeded applying the law with accuracy or consistency.[85] The House Report explicitly provides that "where income is measured in the form of property, the measure of the income is the fair market value of the property at the date of its receipt."[86] Neither the legislation nor the Committee Reports suggests any exception to realization for property with an unascertainable value.[87]

Notwithstanding the absence of legislative support for an exception to immediate realization when the value of property received is unascertainable, the regulations governing realization have long stated "the fair market value of property is a question of fact but only in rare and extraordinary cases will property be considered to have no fair market value."[88] Although the relevance of this statement is unclear, it should have no bearing on whether the receipt of property with an unascertainable value is included in the seller's amount realized. Since 1924, all property received in an exchange is immediately realized regardless of whether the value is ascertainable.[89] No statutory support exists for deferred realization.

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85. *See* H.R. REP. NO. 68-179, at 13 (1924), *reprinted in* J.S. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1861, at 686 (1938); S. REP. NO. 68-398, at 13–14 (1924), *reprinted in* SEIDMAN, *supra*, at 686–87.

86. *See* H.R. REP. NO. 68-179, at 13.

87. For some time, controversy existed as to whether the tax accounting rules superceded the realization of gain rules when a contingent payment sale occurred. During this time, a cash-method taxpayer arguably did not realize gain until cash payments actually materialized. *See, e.g.*, Goldberg, *supra* note 25, at 635–39 (exploring the ambiguous legislative history of the statutory provisions impacting the realization of gain); Karjala, *supra* note 7, at 451–56 (examining the case law that relied on the taxpayer's method of accounting to tax gain from the sale of property); Karjala, *supra* note 18, at 155–60 (exploring the historical tension between the disposition of property provisions and the tax accounting provisions). The realization rules are now generally regarded as taking priority over the tax accounting rules. *See* Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (as amended in 1994) ("A taxpayer using the cash receipts and disbursements method of accounting must report as an amount realized in the year of sale the fair market value of the contingent payment obligation.").

88. Treas. Reg. § 1.1001-1(a) (as amended in 1996). The earliest version appeared in 1928. *See* Treas. Reg. § 561 (1928).

89. The fact that it is impossible to quantify the value of property with an unascertainable value does not dictate an exception to realization. Rather, the error is in viewing a right to contingent payments with unascertainable value as consideration received from the buyer. Instead, that right should be regarded as an interest retained by the seller in the transferred property. *See infra* Part III.

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Although the same amount of nominal gain will be taxed in either case, the seller's tax cost in real terms is normally lower if open-transaction treatment is authorized. If open-transaction treatment is allowed, the seller is not taxed on the value of the right to contingent payments until payments materialize. Hence, the seller's tax is deferred in an open transaction. The taxpayer, rather than the government, earns a return on these tax dollars during the deferral period. By contrast, if the sale is taxed as a closed transaction, the seller is taxed on the estimated value of the right to contingent payments in the year of sale.[72] As such, the government enjoys the time value of the tax imposed on the estimated value of the contingency. In real terms, therefore, open-transaction treatment almost always yields less tax revenue than closed-transaction treatment.[73]

In addition to timing differences, characterization differences that have emerged subsequent to *Burnet* also increase the cost to the government of open-transaction treatment. *Burnet* involved tax years in which Congress drew no distinctions between capital gain and ordinary income. Since 1921, however, Congress has imposed lighter tax burdens on an individual's capital gains than on ordinary income.[74] With relatively weak analytical support, courts have extended the open-transaction doctrine to cause the seller's deferred income to be taxed as capital gain.[75] By contrast, deferred income

72. *See id.* § 1001(b). If the present value of the right to contingent payments is zero, the timing of income in a closed transaction will be the same as in an open transaction.

73. Of course, in a rare case like *Burnet* where closed-transaction treatment should have resulted in an immediate tax loss, open-transaction treatment would benefit the government from a time value of money standpoint. In these circumstances, open-transaction treatment would defer the tax loss (and the correspondent tax savings) until the payment stream ended. Even in a gain situation, open-transaction treatment might yield more tax revenue than closed-transaction treatment in real terms if tax rates increase after the year of sale. In this event, the additional cost resulting from imposition of a higher rate of tax on deferred payments might exceed the time value savings associated with deferral. *See generally* Alvin C. Warren, Jr., *The Timing of Taxes*, 39 NAT'L TAX J. 499 (1986) (explaining the time value of money impact of income taxes). Note that the taxpayer's basis in the transferred property is recovered in its entirety before any gain occurs under both open-transaction reporting and closed-transaction reporting. Hence, the timing difference relates to when the contingent payments are realized, not to the amount of basis in the transferred property.

74. *See* Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233 (codified as amended at I.R.C. § 1(h) (West 2002)). The same tax rates apply to capital gains and ordinary income of a C Corporation. *See* I.R.C. § 11.

75. *See, e.g.*, Steen v. United States, 509 F.2d 1398, 1403–04 (9th Cir. 1975) (characterizing contingent compensation as capital gain mechanically by viewing the agreement under which the compensation was paid as part of an "open" stock sale transaction); United States v. Yerger, 55 F. Supp. 521, 522 (E.D. Pa. 1994) (distinguishing

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resulting from a closed transaction has historically been taxed as ordinary income.[76] These characterization differences increase the cost of perpetuating the open-transaction doctrine.

D. Deferred Realization Violates Current Law

Even if the government had advanced a consistent closed-transaction position and the Supreme Court had not embraced its invalid "wait-and-see" rationale, Mrs. Logan's open-transaction treatment still might have been sanctioned by the courts. In 1916, when the events in *Burnet* transpired, Congress had not provided any tools for evaluating the income tax consequences of a sale or exchange of property. Now, the Internal Revenue Code mandates immediate realization of gain or loss when such a sale or exchange occurs.[77] Thus, open-transaction treatment stands in opposition to current law. This Section explores the evolution of the statutory prohibition on deferred realization.

Prior to 1918, the earliest Revenue Acts merely included "gain from sales or dealings in property" in the definition of income without any guidance as to when and how such gain was measured.[78] Even more damaging to the frame of reference of the *Burnet* courts is

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without justification contingent future profit payments normally viewed as ordinary income by allowing capital gain treatment when paid pursuant to an "open" stock sale transaction); Clement v. United States, 331 F. Supp. 877, 881 (E.D.N.C. 1971) (concluding without explanation that any gain with respect to contingent profit payments made under an "open" transaction is treated as capital gain in the year of receipt); McShain v. Comm'r, 71 T.C. 998, 1003 (1979) (affording capital gain treatment automatically for amounts received under a nonrecourse note by determining that the transaction under which the payments were received was "open"); Grudberg v. Comm'r, 34 T.C.M. (CCH) 669, 674 (1975) (characterizing the unpaid balance of worthless promissory notes mechanically as capital loss because the notes were issued in exchange for stock in an "open" transaction); Dorsey v. Comm'r, 49 T.C. 606, 628 (1968) (concluding without justification that payments received by shareholders under certificates distributed to them in liquidation were taxable as capital gains, finding that the liquidation was an "open" transaction); Rev. Rul. 58-402, 1958-2 C.B. 15 ("[I]f the sale or exchange remains an open transaction, ... the subsequent payments received under the contract will be subject to the appropriate capital gains provisions in the statute ...."). Interest could be imputed to deferred payments in an open transaction, thereby causing a part of those payments to be taxed as ordinary income. *See* I.R.C. § 483(f)(1).

76. *See infra* note 116 and accompanying text.

77. I.R.C. § 1001(a).

78. *See* Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757; Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167–68; *see also* Louis A. Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis*, 26 BUFF. L. REV. 219, 335–36 (1977) (analyzing deferred realization through a discussion of the legislative history of I.R.C. § 1001(b)); Karjala, *supra* note 7, at 427–38 (exploring the development of the statutory scheme of I.R.C. § 1000 and interpreting the statute's current framework).

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Thus, the statement in the regulations should be clarified in a manner that can be reconciled with current law.[90]

Although courts continue to confer open-transaction treatment on contingent payment sales, no decision has advanced a principled argument for this result—*Burnet* is simply cited as the controlling authority.[91] In light of the changes in the law that have occurred since *Burnet*, deferred realization of contingent payments cannot be justified and *Burnet* should be overruled.[92]

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90. The regulations governing realization should be clarified to provide that the transfer of property for a right to contingent payments with unascertainable value is normally indicative of a retained interest in the transferred property. *See infra* text accompanying notes 219–20.

91. *See, e.g.*, Steen v. United States, 509 F.2d 1398, 1403–04 (9th Cir. 1975) (involving a sale of corporate stock in exchange for cash and certain contingent future state tax payments); Aryton Metal Co. v. Comm'r, 299 F.2d 741, 751–52 (2d Cir. 1962) (involving a sale of rights in a joint venture in exchange for a share of future profits); Miller v. United States, 235 F.2d 553, 557 (6th Cir. 1956) (involving the distribution of second-mortgage notes from a corporation to its shareholder); Westover v. Smith, 173 F.2d 90, 92 (9th Cir. 1949) (involving the distribution of contract rights from a corporation to its shareholder); Comm'r v. Carter, 170 F.2d 911 (2d Cir. 1948) (involving the distribution of oil brokerage contracts from a corporation to its shareholder); Comm'r v. Hopkinson, 126 F.2d 406, 410 (2d Cir. 1942) (involving a sale of patents in exchange for a percentage of profits derived by the purchaser); Clement v. United States, 331 F. Supp. 877, 881 (E.D.N.C. 1971) (involving the sale of an insurance company in exchange for five percent of future profits for five years); Hill's Estate v. Maloney, 58 F. Supp. 164, 171 (D.N.J. 1944) (involving a sale of stock in exchange for cash and non-refundable life annuity contracts); United States v. Yerger, 55 F. Supp. 521, 522 (E.D. Pa. 1944) (involving the transfer of assets to a corporation in exchange for stock and a percentage of profits for five years); Cloward Instrument Co. v. Comm'r, 52 T.C.M. (CCH) 34, 41 (1986) (involving a sale of a trade name in exchange for ten percent of future royalties for ten years); Simmonds Precision Prods. Inc. v. Comm'r, 75 T.C. 103, 116–17 (1980) (involving a cancellation of indebtedness in exchange for unregistered stock options); Wiggins v. Comm'r, 72 T.C. 701, 708 (1979) (involving a sale of subdivision lots in exchange for promissory notes, the payment of which were contingent on future events); McShain v. Comm'r, 71 T.C. 998, 1003 (1979) (involving a sale of a leasehold interest in exchange for a non-recourse note); Bolles v. Comm'r, 69 T.C. 342, 354 (1977) (involving the sale of a corporation in exchange for stock and other consideration conditioned on future events within the acquiring corporation's control); Dorsey v. Comm'r, 49 T.C. 606, 628 (1968) (involving the distribution of contractual rights to future profits from a corporation to its shareholder); Underhill v. Comm'r, 45 T.C. 489, 492 (1966) (involving the collection of discounted notes by a purchaser); Bradford v. Comm'r, 22 T.C. 1057, 1073 (1954) (involving the distribution of contract rights from a corporation to its shareholder); Nicholson v. Comm'r, 3 T.C. 596, 601–02 (1944) (involving a sale of stock in exchange for contingent mineral rights).

92. Open-transaction treatment cannot be reconciled with current law if the contingent payment obligation is treated as property received by the seller because all property received by the seller is realized in the year of sale. The Second Circuit's annuity analogy confirms that the courts regarded Mrs. Logan as receiving property in the year of sale. *See supra* note 49 and accompanying text. The *Burnet* courts' notion of deferred realization could be reconciled with current law if Mrs. Logan's right to contingent payments had been equated to a retained interest in the transferred property, rather than part of the consideration received from the buyer. *See infra* Part III.

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Burnet never provided principled support for open-transaction treatment. Subsequent changes in the law have eroded whatever support may have existed for such treatment.[93] It is time for Congress to overrule *Burnet* and thereby eliminate the only authority that exists for applying the open-transaction doctrine to contingent payment sales. If *Burnet* were overruled, it would seem that closed-transaction treatment should result regardless of how difficult it might be to value the contingency.[94] As Part II will demonstrate, however, the matter is not that simple.

II. CLOSED-TRANSACTION TREATMENT IS PROBLEMATIC

The principal problem with taxing contingent payment sales as closed transactions is that the right to contingent payments must be valued and included in the seller's amount realized in the year of sale.[95] The government has long argued for "closed-transaction" treatment by claiming that the contingent element can and must be valued when the sale occurs.[96] Frequently, however, the value of the

93. For other commentators favoring the elimination of open-transaction treatment, see Karjala, *supra* note 18, at 155 ("[T]here is no longer any reason . . . for adhering to any form of open-transaction reporting based on the absence of an ascertainable fair market value . . . ."); Lykken, *supra* note 25, at 605 ("[*Burnet v.*] *Logan* . . . should not be regarded as the source of a separate ground for avoiding current taxation . . . .").

94. In the absence of an open-transaction alternative, closed-transaction treatment would result if the seller of property in a contingent payment sale elected not to report the sale under the installment method. *See supra* notes 18–23 and accompanying text. Part III argues that a right to contingent payments with unascertainable value should be treated as an interest retained by the seller, a transaction to which the installment method would not apply. *See infra* Part III; *supra* note 24 and accompanying text.

95. *See* I.R.C. § 1001(b) (2000).

96. *See, e.g.*, *Miller*, 235 F.2d at 557 (involving the distribution of second-mortgage notes from a corporation to its shareholder); *Westover*, 173 F.2d at 92 (involving the distribution of contract rights from a corporation to its shareholder); *Clement*, 331 F. Supp. at 881 (involving the sale of an insurance company in exchange for five percent of future profits for five years); McDonald v. United States, 181 F. Supp. 332, 333 (W.D. Wash. 1960) (involving the liquidation of corporate assets including pending custom duty refund claims); *Yerger*, 55 F. Supp. at 521–22 (involving the transfer of assets to a corporation in exchange for stock and a percentage of profits for five years); *Cloward Instrument Co.*, 52 T.C.M. (CCH) at 41 (involving the sale of a trade name in exchange for ten percent of future royalties for ten years); *Simmonds Precision Prods. Inc.*, 75 T.C. at 116–17 (involving a cancellation of indebtedness in exchange for unregistered stock options); *Wiggins*, 72 T.C. at 709 (involving the sale of subdivision lots in exchange for promissory notes, the payment of which were contingent on future events); *McShain*, 71 T.C. at 1003 (involving the sale of a leasehold interest in exchange for a non-recourse note); *Bolles*, 69 T.C. at 354 (involving the sale of a corporation in exchange for stock and other consideration conditioned on future events within the acquiring corporation's control); *Dorsey*, 49 T.C. at 628 (involving the distribution of contractual rights to future profits from a corporation to its shareholder); *Underhill*, 45 T.C. at 496–97 (involving the collection of discounted notes by a purchaser); Carter v. Comm'r, 9 T.C. 364, 368–69

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right to contingent payments is unascertainable.[97] Indeed, a disagreement as to the value of the underlying business is normally the reason that the parties opt for a contingent payment arrangement in the first place.[98]

When a sale of a business is negotiated, the primary reason for using a right to contingent payments is to bridge the gap between a seller who believes the business is worth more than the prospective buyer.[99] For example, assume the seller believes the annual income-producing capacity of the business is $2 million and values the business at $10 million.[100] The buyer, on the other hand, anticipates that the business will generate only $1.5 million of annual income and therefore values the business at only $7.5 million.[101] If the parties represent the proverbial "willing seller" and "willing buyer," the value of the business is unascertainable.[102] Indeed, if these parties were confined to using fixed-payment terms, an impasse would result. But by resorting to a contingent payment arrangement, terms can be devised that accommodate what appear to be irreconcilable views.

In the situation set forth above, the respective views of both parties can be accommodated by setting the price at $7.5 million plus 100% of the profits in excess of $1.5 million for five years after the sale. The seller would expect to derive $2.5 million from the contingency in light of her belief that the business will generate $2 million per year.[103] From the buyer's perspective, however, the

(1947) (involving the distribution of contractual rights to commissions from a corporation to its shareholder); Rocky Mountain Dev. Co. v. Comm'r, 38 B.T.A. 1303, 1304 (1938) (involving the sale of oil well equipment in exchange for a percentage of future profits).

97. *See supra* note 91.

98. *See supra* note 7 and accompanying text.

99. *See supra* notes 7–8 and accompanying text.

100. If the value of the business is based on future returns, anticipated future returns divided by an appropriate capitalization rate yields the business's value. In the example, the seller is implicitly using a twenty percent capitalization rate to value the business: *$2,000,000 annual income stream ÷ 20% capitalization rate = $10,000,000. See generally* Rev. Rul. 59-60, 1959-1 C.B. 237 (listing factors to consider in valuing the stock of a closely-held corporation); J. FRED WESTON & EUGENE F. BRIGHAM, MANAGERIAL FINANCE 227–39 (7th ed. 1981) (illustrating the mechanics of discounting a future income stream to present value).

101. Like the seller, the buyer is implicitly using a twenty percent capitalization rate to value the business: *$1,500,000 annual income stream ÷ 20% capitalization rate = $7,500,000.. See supra* note 100.

102. The gift tax regulations provide the classic definition of value: "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1 (as amended in 1992).

103. The seller's anticipated benefit is as follows: *($2,000,000 anticipated annual profits – $1,500,000 floor amount) x 5 years = $2,500,000.* For the seller to receive $2,500,000 in

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contingency imposes no apparent cost because the buyer anticipates that profits will not exceed the $1.5 million floor above which the contingency applies.[104] Thus, by utilizing the right to contingent payments, the seller thinks she is receiving $10 million for the business while the buyer believes he is paying only $7.5 million. The parties effectuate a sale of the business by using a right to contingent payments with unascertainable value.

Closed-transaction treatment of contingent payment sales, such as the one illustrated above, has resulted in ambiguous, confusing, and inconsistent law.[105] This Part explores the problems that exist under current law and demonstrates the impossibility of devising a closed-transaction system that would yield sensible and consistent tax consequences.

A. *Current Law Is Confused and Treats Parties Inconsistently*

The current treatment of a contingent payment sale taxed as a closed transaction stems from completely different views of the seller and the buyer both in the year of sale and in subsequent years when contingent payments materialize. Because the seller is regarded as transferring her entire ownership interest in exchange for both fixed payments and the right to any contingent payments, she must realize both the fixed consideration and the value of the contingent rights in the year of sale.[106] This principle applies regardless of whether the

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present value terms, the buyer would have to pay interest on the deferred payments. The interest factor is ignored for purposes of the illustration.

104. The buyer's anticipated cost is as follows: *($1,500,000 anticipated annual profits – $1,500,000 floor amount) x 5 years = 0.*

105. *See, e.g.*, Hibler v. Comm'r, 46 T.C. 663, 670 (1966). In *Hibler*, the court stated:

> Sometimes the line of demarcation between the decided cases has been exceedingly thin or shadowy, and no single factor has been used by the courts in reaching their determinations. No doubt an inordinate amount of judicial time has been devoted to solving the problems arising from [contingent payment sale] cases in an effort to reach a general consensus of what the law is, not to mention what it ought to be. However, out of the decisional law there have evolved some seemingly conflicting views which are difficult to reconcile.

Id.

106. I.R.C. § 1001(b) (2000) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."); Treas. Reg. § 1.1001-1(g)(2) (as amended in 1996) (stating that when a contingent payment debt instrument is received in exchange for property and gain is not reported under the installment method, the seller's amount realized is the issue price of the debt instrument increased by the fair market value of the contingent payments).

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value of the right to contingent payments is ascertainable. Immediate realization is dictated by statute.[107]

The flip-side of the seller's realization is the buyer's "cost" of the property. This determination controls the amount of tax basis allowed to the buyer in the year of the purchase.[108] The basis, in turn, determines the buyer's annual depreciation and amortization deductions.[109] The rule is quite simple: under current law, the buyer is allowed basis only for fixed payments. The buyer is not allowed basis in the year of purchase for contingent obligations, even if the value of the contingency is ascertainable.[110] The buyer does not receive basis for a contingent obligation until payments are actually made.[111]

Notwithstanding the inconsistency of taxing the seller on the value of the contingent right while denying the buyer basis for the contingent obligation, the differences in effect are often smaller than one might expect. If the value of the right to contingent payments is unascertainable, then, by definition, the seller cannot quantify the contingency with any degree of confidence.[112] In these circumstances,

107. The regulations imply an exception to realization for a right to contingent payments with unascertainable value, but those regulations are ambiguous and should be clarified in a manner that can be reconciled with current law. *See supra* notes 88–90 and accompanying text.

108. I.R.C. § 1012.

109. *Id.* § 167; *id.* § 168 (West Supp. 1A 2002).

110. Treas. Reg. § 1.1012-1(g)(1) (as amended in 1996) (stating that the cost of property acquired with a debt instrument is limited to the issue price of the debt instrument, which excludes any obligation to make contingent payments); *see* Denver & Rio Grande W. R.R. v. United States, 505 F.2d 1266, 1269–70 (Ct. Cl. 1974) (denying the buyer basis for contingent liabilities); Ferris v. Comm'r, 27 T.C.M. (CCH) 937, 939 (1968) (denying the buyer basis for contract payments contingent on future sales); Albany Car Wheel Co. v. Comm'r, 40 T.C. 831, 839 (1963) (denying the buyer basis for a contingent obligation under a union contract), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964).

111. 1 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND LEVERAGED BUYOUTS ¶ 403.5 (June 2001 ed.) ("Where [Buyer] makes future contingent payments to [Seller] in an asset sale ... [Buyer] is entitled to additional basis for the [acquired] assets as and when its contingent liability becomes fixed and determinable.").

112. The tax law generally insists that property rights be valued on receipt, but exceptions exist. *See, e.g.*, Treas. Reg. § 1.83-7(a) (1978) (stating that options do not have a readily ascertainable fair market value unless they are traded on an established market); Rev. Proc. 93-27, 1993-2 C.B. 343 (finding that the right to a share of future partnership profits normally has no determinable fair market value at the time of receipt). Commentators have acknowledged that the value of a right to contingent payments may be unascertainable. *See, e.g.*, Ginsburg, *supra* note 18, § 43.07, at 43–46 ("Contingent payment sales present a more complex situation .... Without doubt, there are transactions in which fair market value 'cannot be readily ascertained.' "). Another commentator has noted:

> There are those who believe that everything can be valued and point in support of this belief to the fact that assets are sold, and debt instruments issued, at prices

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the contingent rights might be analogized to "at the money" stock options where "any value that might attach to the options would be speculative and would depend on the profits of [the issuing corporation] and on appreciation in the value of the underlying stock in subsequent years."[113] In light of the seller's uncertainty as to the value of the contingency and because the seller will normally be averse to paying tax on amounts that may never materialize, the seller generally places the lowest reasonable value on the right to contingent payments.[114] As a result, the value of the contingent right included in the seller's gain in the year of sale may not significantly exceed the zero basis allowed to the buyer for the contingent obligation. By minimizing the value of the right to contingent payments, however, the seller will be taxed on a greater amount when contingent payments materialize in subsequent years.[115]

When contingent payments materialize, closed-transaction treatment again reflects diametrically different views of the seller and the buyer. Contingent payments received by the seller in excess of the seller's original estimate of the contingency are generally taxed as

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> that reflect in every case an implicit valuation of the contingencies in the transaction. Developments in modern finance theory, together with the spread of personal computers and other technology, lend credence to this view. But clearly some contingencies are inestimable and others may not be reported properly on tax returns.

Wootton, *supra* note 25, at 742.

113. Custom Chrome Inc. v. Comm'r, 76 T.C.M. (CCH) 386, 393 (1998) (finding that the "time value" of an option incorporates the expectation that the value of the underlying stock will increase, but the court was not compelled to value the option), *rev'd on other grounds*, 217 F.3d 1117 (9th Cir. 2000) (finding that the court must value the option because the fact that "an option is 'at the money' does not render the option valueless"). A stock option is "at the money" when the price the option holder must pay to acquire stock is equal to the fair market value of the stock when the option is granted. *See* ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 476–78 (1989) (explaining the intricacies of options).

114. As Koenig and Boise explain:

> [I]n the absence of an agreement by the parties, the seller may unilaterally fix the value of the earnout based on its perception of the likelihood of receiving any future payments.... [T]his value may be very low.... [T]he seller may decide that the likelihood of receiving the payments is so remote or the amount of the payments is so speculative that they should be valued at zero.

Koenig & Boise, *supra* note 7, at 8.

115. If the seller's year of sale gain includes an estimate of the present value of the contingent rights, payments that materialize are not taxed until they exceed the amount included in the seller's year of sale gain. In other words, contingent payments are not taxed on receipt unless and until they exceed the amount included in the seller's year of sale gain. The smaller the amount included in the seller's year of sale gain, the greater the amount that will be taxed on receipt if payments do indeed materialize.

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ordinary income.[116] In contrast, gain recognized by the seller in the year of sale is generally taxed at a lower capital gains rate.[117] The justification for taxing the contingent payments as ordinary income generally reflects the view that the "sale or exchange" element necessary for capital gains is lacking when the contingent payments materialize.[118] Because the original sale transaction is closed, the contingent payments are divorced from the sale of the business and, therefore, taxed as ordinary income.[119]

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116. *See, e.g.*, Osenbach v. Comm'r, 198 F.2d 235, 237–38 (4th Cir. 1952) (determining that a shareholder's collections of contingent claims subsequent to a liquidation were independent transactions properly taxable as ordinary income); Chamberlin v. Comm'r, 32 T.C. 1098, 1107–08 (1959), *aff'd*, 286 F.2d 850 (1961) (characterizing payments received under a royalty contract as ordinary income notwithstanding that the contract was partial consideration for an earlier exchange for stock); O'Brien v. Comm'r, 25 T.C. 376, 385–86 (1955) (concluding that the value of film rights distributed to a shareholder in liquidation was ascertainable and that any amounts subsequently received were independent and taxable as ordinary income). Subsequent statutory amendments might now confer capital gains treatment on deferred gain in a closed transaction, but this is doubtful. *See infra* note 119. Gain occurs with respect to contingent payments in a closed transaction when the actual contingent payments exceed the estimated value of the right to contingent payments in the year of sale. A trade-off has long existed for the seller between the time value of money savings derived from deferral of gain and the cost of adverse characterization of the deferred gain. The seller will normally be more concerned with timing than characterization, however, because the contingent payments may never materialize.

117. This statement assumes that the transferred property is a capital asset or a § 1231 asset and that no recapture rule or other recharacterization device applies. *See* I.R.C. § 1221 (West Supp. 1A 2002); *id.* §§ 1222, 1231, 1239, 1245, 1250 (2000). If the seller is a C Corporation, the same tax rates apply to capital gain and ordinary income. *See id.* § 11.

118. *See* I.R.C. §§ 1222, 1231 (2000).

119. It has been argued that the common law "*Arrowsmith* doctrine" should permit a look-back to the original sale when characterizing gain resulting from contingent payments in a closed-transaction and result in capital gain treatment. *See, e.g.*, Joel Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX. L. REV. 85, 98 (1972) (arguing that *Arrowsmith* should be applied in closed-transaction cases). In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), shareholders who received a liquidating distribution taxed as capital gain were required to satisfy a corporate liability in a subsequent year. When the shareholders made the payment, they claimed an ordinary loss on the theory that no sale occurred. The Court, agreeing with the Internal Revenue Service, looked back to the liquidation to characterize the subsequent year's loss and concluded that payment of the liability resulted in a capital loss. *Id.* at 8. Courts have not extended the *Arrowsmith* doctrine to contingent payments received in a closed-transaction. *See supra* note 116 and accompanying text.

Provisions added to the Internal Revenue Code that deem a sale to have occurred on the termination of certain property rights and retirement of a debt instrument might provide the sale element for contingent payments received in a closed transaction. *See* I.R.C. § 1234A (West Supp. 1A 2002); *id.* § 1271(a) (2000). It is questionable, however, whether either provision applies as a technical matter. Section 1234A requires the "cancellation, lapse, expiration or termination" of a right. None of these events necessarily occurs when a contingent payment is received. Clearly, § 1234A was not

In contrast to treating the seller as receiving contingent payments divorced from the sale of the business, the tax law treats the buyer as making payments married to the original purchase. Consequently, when the buyer remits contingent amounts, he is allowed additional basis in the acquired business. From the buyer's perspective, the contingent payments are treated as an increase in the original purchase price.[120]

As can be seen, closed-transaction treatment of contingent payment sales exhibits a split personality in both the year of sale and when contingent payments materialize. In the year of sale, the seller must realize the right to contingent payments even if the value of that right is unascertainable, while the buyer is denied basis for the contingent obligation even if its value is ascertainable. When contingent payments materialize, the seller's tax treatment separates the contingent payments from the sale, while the buyer's tax treatment attaches the contingent payments to the original purchase. These inconsistent views result in disparate tax treatment as illustrated in the following example.

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enacted with the sale of a business at a gain in mind. *See* S. REP NO. 97-144, at 170 (1981) ("The Committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains."), *reprinted in* 1981 U.S.C.C.A.N. 105, 266. As to § 1271(a), see DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS § 9, at 28 (4th ed. 2000) ("[A]n obligation to make a series of wholly contingent payments (which is typical in the case of sales of property for contingent amounts) probably is not a debt instrument under general tax principles and so cannot be subject to the Regulations under sections 1271–75."). Even if § 1271(a) were to apply, it leads down a tortuous statutory path that may convert the gain back to ordinary income. *See* I.R.C. §§ 1273(b)(4), 1276(a)(1) & (b), 1278(a)(1)(d) & (a)(3) (2000).

In light of the unwillingness of courts to apply the *Arrowsmith* doctrine and the doubts that subsequent statutory sale provisions apply, deferred contingent payments in a closed-transaction are still likely to be taxed as ordinary income. *See* Wolff v. Commissioner, 148 F.3d 186, 189 (2d Cir. 1998) (clarifying that unless a statutory sale or exchange provision like section 1234A or section 1271(a) applies, any gain or loss resulting from a vanishing right is ordinary because no sale or exchange occurs when a right simply disappears).

120. Treas. Reg. § 1.1060-1(e)(ii)(B) (2001); *see also* GINSBURG & LEVIN, *supra* note 111, ¶ 403.05 ("If additional basis is allocated to property subject to . . . depreciation, the additional basis is recovered over the remaining years in the property's recovery period."). Much of the buyer's deductions for contingent payments made within fifteen years after the sale will be deferred because these payments will generally be allocated to goodwill, which is amortizable over fifteen years. *See* I.R.C. § 197(a) (2000); Treas. Reg. § 1.197-2(f)(2) (as amended in 2001) (providing that the additional basis is amortized ratably over the remainder of the fifteen year period).

Example 1 (Closed-Transaction Treatment Under Current Law): Seller transfers her business for a fixed payment of $9 million in Year 1 and contingent payments equal to 20% of annual profits in Year 2 through Year 5. Assume the annual profits in Years 2–5 and the corresponding 20% contingent payments are as follows:

	Annual Profits	20% Contingent Payments
Year 2	$2,000,000	$400,000
Year 3	$4,000,000	$800,000
Year 4	$6,000,000	$1,200,000
Year 5	$8,000,000	$1,600,000
		$4,000,000

A total of $13 million of payments flows from Seller to Buyer over the five year period ($9 million fixed payment and $4 million of contingent payments[121]). Because closed-transaction treatment requires Seller to value the right to contingent payments in the year of sale, assume Seller values the right at $1 million.[122] In this situation, Seller's tax consequences reflect a total of $13 million ($10 million amount realized in Year 1[123] and $3 million of ordinary income in Years 2 through 5[124]), as do Buyer's tax consequences ($9 million basis in Year 1[125] and $4 million of additional basis in Years 2 through 5[126]).

Year 1: The parties are treated inconsistently in the year of sale. Specifically, Seller must include the $1 million estimated value of the

121. The sum of the contingent payments is as follows: *$400,000 + $800,000 + $1,200,000 + $1,600,000 = $4,000,000.*

122. The seller can normally be expected to place a relatively low value on the right to contingent payments. *See supra* notes 114–15 and accompanying text. One million dollars is used in the example because it proves to be a relatively low value that produces a clear illustration.

123. Seller's $10,000,000 amount realized consists of the $9,000,000 fixed payment and the $1,000,000 estimated value of the right to contingent payments. *See supra* note 106 and accompanying text. Because Example 1 is intended to highlight disparities in the treatment of Seller and Buyer, the focus is on Seller's amount realized and Buyer's basis, not Seller's net gain or loss. Thus, Seller's basis in the transferred business is irrelevant to this illustration and can be ignored.

124. Seller's $3,000,000 of ordinary income is the difference between the $4,000,000 of actual deferred payments and the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in year of sale. *See supra* notes 115–16 and accompanying text.

125. Buyer's basis is limited to the $9,000,000 fixed payment. No basis is allowed for the estimated future contingent payments. *See supra* note 110 and accompanying text.

126. Buyer's basis is increased to reflect the $4,000,000 of contingent payments as those payments are made. *See supra* note 120 and accompanying text.

right to contingent payments in income but Buyer is denied basis for that amount.

Years 2–5: The parties are also treated inconsistently in Years 2 through 5. Any amounts received by Seller that exceed the $1 million estimated value of the right to contingent payments are divorced from the sale and taxed as ordinary income. By contrast, from Buyer's perspective, the contingent payments are related to the purchase because Buyer is allowed additional basis as the contingent payments are made.

Results of Example 1

	Seller	Buyer
Year 1	$10,000,000 amount realized	$9,000,000 basis
Year 2	$0[127]	$400,000 basis
Year 3	$200,000 ordinary income[128]	$800,000 basis
Year 4	$1,200,000 ordinary income	$1,200,000 basis
Year 5	$1,600,000 ordinary income	$1,600,000 basis
Total	$13,000,000	$13,000,000

The sale of a business for contingent consideration with unascertainable value should be governed by a uniform view to ensure that the seller and the buyer are accorded symmetrical tax treatment. Symmetrical tax treatment of the parties to a transaction is an important goal because opportunities for inconsistent treatment can often be exploited by one or both of the parties.[129] The tax law now mandates uniform reporting by the seller and the buyer when a business is sold.[130] The tax consequences to seller and buyer should

127. Seller can treat the $400,000 received in Year 2 as part of the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in Year 1 and, therefore, Seller has no income in Year 2. *See supra* notes 115, 123.

128. Because Seller treated the $400,000 received in Year 2 as part of the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in Year 1, the $800,000 payment received in Year 3 can be offset by the remaining $600,000 reflected in Seller's Year 1 amount realized. As a result, $200,000 of the Year 3 payment is taxable. *See supra* note 127.

129. *See* David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 748–49 (1995) (demonstrating that symmetry is not only sufficient, but also necessary for any disparity from the treatment of unit bonds to be absorbed into the price of the instrument); Reed H. Shuldiner, *Consistency and the Taxation of Financial Products*, 70 TAXES 781, 786–87 (1992) (demonstrating how symmetry can be used to advance consistency).

130. *See* I.R.C. § 1060 (2000) (mandating that, when a business is sold, seller and buyer use a uniform method of allocating consideration among transferred assets to determine the amount and character of seller's gain or loss, and buyer's basis); Treas. Reg. § 1.338-6 (2001) (delineating mechanics of allocation process). Both seller and buyer are required

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also be symmetrical and any system for taxing contingent payment sales should be evaluated with that goal in mind. As the foregoing example confirms, current law falls far short of achieving that goal.

To reconcile the tax treatment of seller and buyer in a contingent payment sale, the nature of the right to contingent payments must be explored. As long as the seller is regarded as transferring her entire ownership interest in the year of sale, all realization occurs at that time and the right to contingent payments must be regarded as property received in the year of sale.[131] The nature of the property received by the seller in the form of the right to contingent payments, however, is far from clear. The *Burnet* courts treated the property received by Mrs. Logan as an income-producing property right divorced from the transferred business. If that view were consistently applied, the tax treatment of the parties would be even more askew.

B. Treating Contingency as Income-Producing Property Makes Matters Worse

The *Burnet* courts suggested that the property received by Mrs. Logan was analogous to a purchased annuity.[132] This suggestion, along with other dicta, implies that the courts viewed Mrs. Logan as receiving an income-producing right that effectively blossomed into income as contingent payments materialized.[133] The main problem with applying this potential theory to contingent payment sales is the

to report these allocations to the Internal Revenue Service. I.R.C. § 1060(b); Treas. Reg. § 1.1060-1(e) (2001); *see also* Wootton, *supra* note 25, at 727 (identifying the problematic nature of asymmetrical treatment by parties to an open transaction).

131. Logan v. Comm'r, 42 F.2d 193, 197 (2d Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931); Logan v. Comm'r, 12 B.T.A. 586, 601 (1928) ("What happened in 1916 was that certain stock was sold for $2,200,000 and a contract .... No one would seriously question that a contract was property."), *rev'd*, 42 F.2d 193 (2nd Cir. 1930), *aff'd sub nom.* Burnet v. Logan, 283 U.S. 404 (1931).

132. Burnet v. Logan 283 U.S. 404, 413–14 (1931); *Logan*, 42 F.2d at 197; *see supra* note 49 and accompanying text.

133. *See Logan*, 42 F.2d at 196 ("Therefore, when this taxpayer sold her stock, in addition to receiving cash, she would obtain what substantially amounts to an annuity for a period of 45 years."); *Logan*, 12 B.T.A. at 601 ("The contract in question was an income-producing asset in that under its terms the owners thereof were entitled to receive income to the extent of 60 cents a ton ...."); *see also* Warren v. United States, 171 F. Supp. 846, 849 (Ct. Cl. 1959). *Warren* involved the sale of stock of a corporation owning oil and gas properties in exchange for an overriding royalty treated under Texas law as a property interest that was unsusceptible of valuation. The court acknowledged that when a property interest received by the seller is in the form of income-producing property, "the government would get its revenue by taxing the income as received." *Warren*, 171 F. Supp. at 849.

absence of any connection between the income-producing property right and the buyer when contingent payments materialize.

Treating the right to contingent payments as an income-producing property right reconciles the tax consequences to the seller and the buyer in the year of sale. Because the seller's gain is measured by including all property received in the year of sale, the value of the income-producing property right must be included in the seller's amount realized.[134] Correspondingly, the value of that right should also be treated as a cost incurred by the buyer in the year of purchase and should be included in the buyer's basis at that time.[135] Thus, the buyer's tax treatment in the year of purchase should be consistent with the seller's under the income-producing property right analogy.[136]

When contingent payments materialize in subsequent years, the income-producing property right model rationalizes the current law's treatment of the seller as receiving ordinary income.[137] That model divorces the right to contingent payments from the transfer of the business. In effect, the seller acquires a property right that degenerates into a stream of ordinary income with the passage of time.[138]

When applied to the buyer, however, the income-producing property right model provides no mechanism for awarding basis or a deduction when contingent payments are made. Because a contingent payment sale is regarded as a sale of the seller's entire ownership interest,[139] the buyer acquired the entire property at the time the business was purchased. Nothing remains for the buyer to acquire when contingent payments are made. At that time, the buyer

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134. I.R.C. § 1001(b); *see supra* notes 106–07 and accompanying text.

135. Treas. Reg. § 1.1012-1(a) (as amended in 1996) (stating that "cost is amount paid for property in cash or other property").

136. The buyer may also recognize a taxable gain with respect to the property right at the time of purchase. If the buyer is treated as acquiring a $10,000,000 business in exchange for $9,000,000 and an income-producing property right with an estimated value of $1,000,000, the buyer would recognize a gain with respect to the property right unless the buyer had a $1,000,000 basis in the property right. *See* Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313 (2d Cir. 1943) (holding that an employer's transfer of appreciated property to its employees pursuant to a stock bonus plan resulted in a realized and recognized gain to the employer). The buyer's basis in this amorphous income-producing property right is unclear. For an analogous issue, see *infra* note 163.

137. *See supra* notes 116–19 and accompanying text.

138. *See* Estate of Stranahan v. Comm'r, 472 F.2d 867, 868–69 (6th Cir. 1973) (involving the purchase of a right to dividends for a specified time period that would degenerate into a stream of ordinary income).

139. *See supra* note 131 and accompanying text.

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is simply making payments for something he already owns. No justification exists, therefore, for granting the buyer additional basis or a deduction when the contingent payments are made.[140] Because the buyer is entirely divorced from the seller's deferred receipts, the income-producing property right model, as illustrated below in Example 2, yields even more absurd results than the current law.[141]

<u>Example 2 (Closed Transaction With Contingency Treated as Income-Producing Property Right)</u>: Same facts as Example 1. Seller transfers her business for a fixed payment of $9 million in Year 1 and contingent payments equal to 20% of annual profits in Years 2 through 5. Annual profits are assumed to be $2 million in Year 2, $4 million in Year 3, $6 million in Year 4, and $8 million in Year 5; resulting in 20% contingent payments of $400,000 in Year 2, $800,000 in Year 3, $1.2 million in Year 4, and $1.6 million in Year 5.

A total of $13 million of payments flows to Seller over the five-year period ($9 million fixed payment and $4 million of contingent payments[142]). The estimated value of the right to contingent payments is still assumed to be $1 million.[143] In this situation, Seller's tax consequences reflect a total of $13 million ($10 million amount realized in Year 1[144] and $3 million of ordinary income in Years 2 through 5[145]), but Buyer's tax consequences reflect only $10 million ($10 million basis received in Year 1[146]).

<u>Year 1</u>: The parties are treated consistently in the year of sale. Specifically, Seller must include the $1 million estimated value of the contingent payments in income and Buyer is awarded $1 million of

140. The buyer is precluded from claiming an immediate deduction for these payments because the payments are not within the scope of an allowance provision. *See* I.R.C. § 161 (2000) (no disbursement is deductible unless specifically allowed).

141. *See supra* notes 120–28 and accompanying text.

142. The sum of the contingent payments is as follows: *$400,000 + $800,000 + $1,200,000 + $1,600,000 = $4,000,000.*

143. *See supra* note 122.

144. Seller's $10,000,000 amount realized consists of the $9,000,000 fixed payment and the $1,000,000 estimated value of the right to contingent payments which is treated in Example 2 as an income-producing property right. *See supra* text accompanying note 134. For an explanation of why Seller's basis is ignored, see *supra* note 123.

145. Seller's $3,000,000 of deferred income is the difference between the $4,000,000 of actual deferred payments and the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in year of sale. *See supra* notes 115–16 and accompanying text.

146. Buyer's basis equals the sum of the $9,000,000 fixed payment and the $1,000,000 estimated cost of the right to contingent payments which is treated in Example 2 as an income-producing property right. *See supra* note 135 and accompanying text.

basis. Correspondingly, Buyer is treated as paying that amount in the form of income-producing property conveyed in the year of sale.[147]

Years 2–5: The inconsistent treatment in Years 2 through 5 is worse than that under current law. Seller's receipts are divorced from the transferred business and taxed as ordinary income. By contrast, Buyer is making payments for property he already owns and therefore is denied basis for the deferred payments.

Results of Example 2

	Seller	Buyer
Year 1	$10,000,000 amount realized	$10,000,000 basis
Year 2	0 gain[148]	0 basis/deduction
Year 3	$200,000 ordinary income[149]	0 basis/deduction
Year 4	$1,200,000 ordinary income	0 basis/deduction
Year 5	$1,600,000 ordinary income	0 basis/deduction
Total	$13,000,000	$10,000,000

C. *Treating Contingency as Proprietary Interest Mitigates the Disparate Treatment*

Rather than treating the right to contingent payments as an income-producing property right divorced from the transferred business, an alternative potential theory is to regard the contingency as a proprietary interest in the transferred business that the buyer returns to the seller. Specifically, the seller transfers her entire ownership interest to the buyer and the buyer pays the seller, in part, by returning an interest in the business. After the sale, the seller becomes a co-venturer in the enterprise and the profits attributable to the proprietary interest returned to the seller are taxed directly to the seller.[150] Although a buyer is normally taxed on all post-sale income, this model does not tax the buyer on the portion of the post-sale income attributed to the seller. Because the buyer is never taxed on the income captured by the right to contingent payments, this

147. Buyer might also recognize a taxable gain in the year of purchase. *See supra* note 136.

148. Seller can treat the $400,000 received in Year 2 as part of the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in Year 1 and, therefore, Seller has no income in Year 2. *See supra* notes 115, 144.

149. Because Seller treated the $400,000 received in Year 2 as part of the $1,000,000 estimated value of the right to contingent payments included in Seller's amount realized in Year 1, the $800,000 payment received in Year 3 can be offset by the remaining $600,000 reflected in Seller's Year 1 amount realized. As a result, $200,000 of the Year 3 payment is taxable. *See supra* note 148.

150. For a discussion of the nature of this interest, see *infra* note 206.

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approach obviates the need for the buyer to be allowed basis or a deduction when the seller receives contingent payments. As such, the problems presented by the prior approach when contingent payments materialize are not shared by this approach.[151]

Problematic tax consequences occur in the year of sale, however, if the right to contingent payments is treated as a proprietary interest conveyed by the buyer to the seller. Because the seller's gain is measured by including all property received in the year of sale, the estimated value of the proprietary interest must be included in the seller's amount realized.[152] Consequently, this model taxes the seller twice on this amount: first in the year of sale and again when the seller's share of post-sale profits materializes.[153] With regard to the buyer, the value of the proprietary interest conveyed to the seller is a cost incurred by the buyer in the year of purchase and included in the buyer's basis at that time.[154] As a result, the buyer receives basis for a portion of the post-sale profits that will be taxed directly to the seller. The buyer does not appear to deserve this basis.[155] As illustrated in Example 3, treating the right to contingent payments as a proprietary interest conveyed by the buyer appears at first blush to overtax the seller and undertax the buyer.

<u>Example 3 (Closed-Transaction with Contingency Treated as Proprietary Interest)</u>: Same facts as Example 1. Seller transfers her business for a fixed payment of $9 million in Year 1 and contingent payments equal to 20% of annual profits in Year 2 through Year 5. Annual profits are assumed to be $2 million in Year 2, $4 million in Year 3, $6 million in Year 4, and $8 million in Year 5; resulting in

151. *See supra* text accompanying notes 139–41.

152. I.R.C. § 1001(b) (2000); *see supra* notes 106–07 and accompanying text.

153. The same double taxation issue occurs when a service partner who receives an interest in future profits is taxed on the value of that interest as compensation in the year of sale:

> If a partner is taxed on the determinable market value of a profit-share at the time it is created in his favor, and is also taxed on his full share of earnings as realized, there will arguably be double taxation, avoidable by permitting him to amortize the value which was originally treated as income.

Diamond v. Comm'r, 492 F.2d 286, 290 (7th Cir. 1974). For the possibility that the double taxation may be partially neutralized through amortization deductions, see *infra* note 161 and accompanying text.

154. Treas. Reg. § 1.1012-1(a) (as amended in 1996) (stating that "cost is amount paid for property in cash or other property").

155. The buyer's apparently undeserved basis may come at the cost of a tax to the buyer in the year of purchase. *See infra* text accompanying note 163.

20% contingent payments of $400,000 in Year 2, $800,000 in Year 3, $1.2 million in Year 4, and $1.6 million in Year 5.

A total of $13 million still flows to Seller over the five-year period ($9 million in Year 1 and $4 million in Years 2 through 5). The estimated value of the right to contingent payments is still assumed to be $1 million.[156] The consequences to Seller and Buyer appear to be consistent but problems remain. Notwithstanding that only $13 million flows to seller, Seller is taxed on $14 million ($10 million in Year 1[157] and $4 million in Years 2 through 5[158]). Correspondingly, Buyer gets "credit" for $14 million ($10 million basis in Year 1[159] and shelter from $4 million of business income in Years 2 through 5[160]).

Results of Example 3

	Seller	Buyer
Year 1	$10,000,000 amount realized	$10,000,000 basis
Year 2	$400,000 business income	$400,000 sheltered
Year 3	$800,000 business income	$800,000 sheltered
Year 4	$1,200,000 business income	$1,200,000 sheltered
Year 5	$1,600,000 business income	$1,600,000 sheltered
Total	$14,000,000	$14,000,000

The results of Example 3 are somewhat misleading because of further consequences that may moderate the apparent overtaxation of the seller and undertaxation of the buyer. Although the seller is taxed on the $1,000,000 value of the right to contingent payments in the year of sale, the seller should be permitted to amortize the basis

156. *See supra* note 122.

157. Seller's $10,000,000 amount realized consists of the $9,000,000 fixed payment and the $1,000,000 estimated value of the right to contingent payments, which is treated in Example 3 as a proprietary interest conveyed by Buyer. *See supra* text accompanying note 134. For an explanation of why Seller's basis is ignored, see *supra* note 123.

158. The $4,000,000 of deferred payments represent Seller's share of the post-sale income and yields $4,000,000 of gross income to Seller. I.R.C. § 61(a)(2) (2000). For the possibility that Seller might amortize her $1,000,000 basis in the proprietary interest against this income, see *infra* note 161 and accompanying text.

159. Buyer's basis equals the sum of the $9,000,000 fixed payment and the $1,000,000 estimated cost of the right to contingent payments which is treated in Example 3 as a proprietary interest in the business. *See supra* text accompanying note 154. For a discussion of the possibility that Buyer also has a taxable gain, see *infra* note 163 and accompanying text.

160. The business generates $20,000,000 in Years 2 through 5, but Buyer is taxed on only $16,000,000 because $4,000,000 is taxed directly to Seller. Thus, treating the right to contingent payments as a proprietary interest transferred to Seller shelters Buyer from tax on $4,000,000. The shelter results from a reduction in Buyer's gross income but the effect is equivalent to income inclusion and an equivalent business-expense deduction.

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associated with this element of gain against future income.[161] It is unlikely, however, that these future deductions will neutralize the seller's accelerated income.[162] Turning to the buyer, who appears to receive $1,000,000 of extra basis in the acquired business, that additional basis likely comes at the cost of a taxable gain to the buyer in the year of purchase. The buyer is using a proprietary interest to acquire $1,000,000 of property from the seller which will result in the buyer recognizing up to $1,000,000 of gain.[163] This taxable gain and the buyer's extra basis are unlikely to neutralize each other. Even if these additional consequences to the seller and the buyer were to eliminate the disparities that occur when the right to contingent payments is treated as a proprietary interest conveyed by the buyer, the resulting system is very complex. A far simpler and more direct means to this end is to treat the seller as retaining an interest in the transferred business, rather than receiving that interest as consideration from the buyer.

The problems illustrated in this Part occur because current law clings to the premise that the seller transfers her entire ownership interest in a contingent payment sale. The law should reject that premise when the value of the seller's right to contingent payments is

161. *See* Gordon v. Comm'r, 85 T.C. 309, 322 (1985) (noting in dicta that amortization of a purchased present interest would be allowed over the duration of the term). *See generally* Jeffrey L. Kwall, *The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space*, 49 OHIO ST. L.J. 1, 13–15, 26 (1988) (examining the ability of a holder of a present interest to amortize basis). There is no recognized procedure for this amortization deduction. *See* Diamond v. Comm'r, 492 F.2d 286, 290–91 (7th Cir. 1974) (acknowledging the absence of a recognized procedure for amortization under analogous circumstances).

162. It is unlikely the future deductions will neutralize the accelerated income due to differences in timing and characterization. The seller's gain is taxed in the year of sale and will likely be characterized as capital gain. *See supra* notes 106, 117 and accompanying text. The amortization deductions will offset income (and reduce taxes) in future years and will likely be characterized as ordinary deductions. *See supra* note 120.

163. If the buyer is treated as acquiring a $10,000,000 business in exchange for $9,000,000 and a proprietary interest in that business with an estimated value of $1,000,000, the buyer would recognize gain to the extent the value of the proprietary interest ($1,000,000) exceeded his basis in the proprietary interest. *See* Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313 (2d Cir. 1943) (holding that an employer's transfer of appreciated property to its employees pursuant to a stock bonus plan resulted in a realized and recognized gain to the employer). It is unclear whether any portion of the buyer's cash payment could be allocated to the proprietary interest he reconveys to the seller as part of the purchase price for the transferred business. If none of the cash payment could be so allocated, buyer would have a $1,000,000 taxable gain in the year of purchase. If that were to occur, buyer would likely be overtaxed because the buyer would be relegated to recovering the basis received in the acquired business in the future, so timing differences would result. An analogous issue exists under the income-producing property right model. *See supra* note 136.

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unascertainable. Instead, the seller should be treated as retaining a proprietary interest in the transferred business, a solution explored in Part III.

III. RETAINED-INTEREST TREATMENT RESULTS IN A COHERENT SYSTEM

The sale of a business for a price contingent on future profits is essentially a middle-ground between an immediate transfer of the seller's entire ownership interest and a joint-venture between seller and buyer of indefinite duration. If the seller is regarded as transferring her entire ownership interest, the right to contingent payments represents part of the consideration received from the buyer in the year of sale. The buyer is then taxed on all income generated by the business after the sale. As demonstrated in Part II, conceptualizing the transaction in this manner is problematic due to the difficulty of valuing the right to contingent payments in the year of sale.

Rather than treating a contingent payment sale as a transfer of the seller's entire ownership interest, the seller should be viewed as retaining a proprietary interest in the transferred business in the form of the right to contingent payments. Under this view, the right to contingent payments is not part of the consideration provided by the buyer and, therefore, the seller does not realize the right to contingent payments in the year of sale. Rather, the contingency represents a proprietary interest retained by the seller that diminishes with the passage of time. Correspondingly, the buyer's ownership interest grows until the buyer enjoys full ownership when the seller's right to contingent payments expires.

This retained-interest approach avoids the problems created when a right to contingent payments with unascertainable value is realized in the year of sale. If the right to contingent payments represents an ownership interest retained by the seller, the contingency is not realized in the year of sale. Rather, this approach taxes any income derived from the retained interest to the seller if and when the conditions triggering the contingent payments are satisfied. As such, this approach taxes the post-sale income of the business attributable to the seller's retained interest directly to the seller and not to the buyer. This approach taxes the buyer only on the portion of the business's income not captured by the right to contingent payments.

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The consequences of this retained-interest approach are a hybrid of traditional open-transaction and closed-transaction treatments. As to the timing of income, the retained-interest approach reflects an open-transaction view. As to characterization, however, the retained-interest approach more closely approximates closed-transaction treatment. This Part will demonstrate that conceptualizing a contingent payment sale with unascertainable value as a retained interest results in a coherent system of rational tax consequences to both seller and buyer.[164]

A. *Merits of Treating Contingency as Retained Interest*

Courts have considered treating a right to contingent payments as a retained interest on many occasions and in a variety of contexts. The litigation typically focuses on determining whether the right to contingent payments represents property received from the buyer (deferred purchase price), in which case the transaction is taxed as a closed transaction as illustrated in Example 1,[165] or property retained by the seller (a retained interest).[166] The law distinguishing deferred purchase price from a retained interest is ambiguous and inconsistent.[167] The most principled approach to distinguishing deferred purchase price from a retained interest stems from a trilogy of early Supreme Court cases that focused on whether the seller or the buyer bore the risk of loss with respect to the contingent payments.[168] When the seller bore the risk of loss, the Court treated

164. The retained-interest proposal is a legal fiction created solely for income tax purposes. The proposed treatment would not affect ownership for state law purposes. It is not uncommon for a transaction to be viewed differently for federal income tax purposes and for state law purposes. *See, e.g.*, Richard E. Marsh, Jr., *Tax Ownership of Real Estate*, 39 TAX LAW. 563, 570 (1986) ("[T]he niceties of title for state law purposes clearly are not conclusive [for tax ownership of real estate].").

165. *Supra* text accompanying notes 121–28.

166. *See* Del Cotto, *supra* note 78, at 276–82 (discussing jurisprudence distinguishing deferred purchase price from retained interest); William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153, 171–74 (1983) (examining the application of the retained-interest doctrine); Note, *Taxing Deferred Return Upon Transfer of a Capital Asset*, 63 HARV. L. REV. 853, 859–61 (1950) (exploring the scope of retained-interest theory).

167. *See* Hibler v. Comm'r, 46 T.C. 663, 670 (1966) ("Sometimes the line of demarcation between the decided cases has been exceedingly thin or shadowy . . . . [O]ut of the decisional law there have evolved some seemingly conflicting views which are difficult to reconcile."); Popkin, *supra* note 166, at 172 ("[T]he retained interest doctrine has been inconsistently applied.").

168. *See* Del Cotto, *supra* note 78, at 276–78. It appears that the value of the right to contingent payments in all three Supreme Court cases was ascertainable. In each case, a fixed cash consideration was to be paid from all or part of the earnings of the transferred property. Comm'r v. Brown, 380 U.S. 563, 567 (1965); Anderson v. Helvering, 310 U.S.

her as retaining an interest in the transferred property. By contrast, when the buyer bore the risk of loss, the Court treated the right to contingent payments as deferred purchase price. If this risk of loss analysis were consistently applied to the sale of a business for a right to contingent payments with unascertainable value, retained-interest treatment would normally result.

In *Thomas v. Perkins*,[169] the first case in the trilogy, certain oil and gas leases were sold to Perkins for $155,000 in cash and notes and an additional $395,000 to be paid out of 25% of the oil produced from the land.[170] The Commissioner sought to tax the buyer (Perkins) on all the production payments, including the 25% attributable to the right to contingent payments. The Court rejected the Commissioner's effort to tax the buyer on the payments attributable to the right to contingent payments and held that the seller had retained an interest in the transferred property.[171] The fact that the seller's contingent rights were not secured was pivotal in reaching this conclusion:

> [T]he absence of any obligation of the assignee [buyer] to pay in oil or in money, and the failure of assignors [seller] to take any security by way of lien or otherwise unmistakably show that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and saved up to an amount sufficient when sold to yield $395,000.[172]

Because the seller received no assurance from the buyer that the seller would be paid if the oil production failed to materialize, the seller bore the risk of loss and thereby the Court deemed the seller to have retained an interest in the transferred property.

In *Anderson v. Helvering*,[173] certain oil and gas properties were sold to Anderson for $50,000 in cash and $110,000 payable out of 50% of the proceeds from oil and gas produced by the properties or from the resale of the properties conveyed.[174] The Commissioner again sought to tax the buyer (Anderson) on all the production payments

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404, 405–06 (1940); Thomas v. Perkins, 301 U.S. 655, 657 (1937). No indication exists that the parties doubted the properties would generate enough income to achieve the specified payment. By contrast, the typical right to contingent payments on the sale of a business is far more speculative. Even if a dollar cap on the payments exists, there is normally much uncertainty as to whether the cap will be reached. *See supra* notes 99–102 and accompanying text.

169. 301 U.S. 655 (1937).
170. *Id.* at 657.
171. *Id.* at 659.
172. *Id.*
173. 310 U.S. 404 (1940).
174. *Id.* at 405–06.

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including the 50% attributable to the right to contingent payments.[175] This time the Court agreed with the Commissioner and treated the production payments as deferred purchase price.[176] The Court distinguished *Perkins* by finding that in *Anderson*, the buyer essentially guaranteed that the seller would receive the deferred payments irrespective of the productivity of the oil and gas properties.[177] The Court found the transaction "similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall in all events equal the specified sum."[178] By equating the arrangement to one in which the seller would be paid regardless of the future productivity of the property, the Court readily concluded that the risk of loss had shifted to the buyer. The seller had transferred her entire interest in the property and the buyer, therefore, would be taxed on all post-sale income.[179]

The Court's famous *Clay Brown* case also reflects the application of a risk of loss analysis.[180] There, the principal shareholders of a lumber company sold their stock to charity for $1,300,000 to be paid within ten years from the earnings of the company's assets.[181] The buyer's obligation was secured by the corporation's assets and if payments failed to total $250,000 in any two years, the seller could demand full payment.[182] In contrast to the prior cases, the Commissioner attempted to tax the seller, rather than the buyer (a tax-exempt charity in this case) on the post-sale income of the

175. *Id.* at 407.

176. *Id.* at 413.

177. *Id.* at 412–13.

178. *Id.* The Court's resolution was largely influenced by a desire to find a "workable rule" that would avoid the need to allocate the depletion allowance. The Court noted:

> An extension of [Thomas v. Perkins] to cover the case at bar would create additional, and in our opinion unnecessary, difficulties to the allocation for income tax purposes of such payments and of the allowance for depletion between transferor and transferee. In the interests of a workable rule, Thomas v. Perkins must not be extended . . . .

Id. at 413.

179. In 1969, Congress enacted legislation mandating deferred purchase price treatment when a production payment is retained on the sale of a mineral property. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 503(a), 83 Stat. 487, 630 (codified as amended at I.R.C. § 636(b) (2000)). As Professor Del Cotto points out, "Such treatment . . . proceeds on the false premise that [the buyer of a remainder interest in mineral property] has an obligation to [the seller] that is being satisfied by the income payments, despite the complete lack of such obligation." Del Cotto, *supra* note 78, at 282.

180. Comm'r v. Brown, 380 U.S. 563 (1965).

181. *Id.* at 567.

182. *Id.*

business.[183] The Court rejected the Commissioner's argument that the right to contingent payments represented an interest retained by the seller and held instead that it represented deferred purchase price. As a result, the buyer was taxed on all post-sale income. In reaching its conclusion, the Court focused on the fact that the seller was virtually assured of receiving payments under the purported right to contingent payments. The Court found that the seller "not only had rights against income, but if the income failed to amount to $250,000 in any two consecutive years, the entire amount could be declared due, which was secured by a lien on the real and personal properties of the company."[184] Thus, in *Clay Brown*, the risk of loss with respect to the right to contingent payments had passed to the buyer. As such, the right to contingent payments was treated as deferred purchase price, rather than as a retained interest.[185]

In these early Supreme Court cases, the buyer bore the risk of loss with respect to the right to contingent payments only if the buyer provided assurance that the seller would collect the contingent consideration without regard to the productivity of the transferred property.[186] If the buyer merely promised to remit amounts to which the seller was entitled when the events triggering contingent payments actually occurred, the seller continued to bear the risk of loss and was treated as retaining an interest in the transferred property.[187] Thus, a buyer's contractual obligation to pay over amounts due the seller when post-sale profits in fact surpass the

183. *Id.* at 568. The government's principal focus in cases distinguishing deferred purchase price from a retained interest has been to ensure that the buyer reports all post-sale income by pressing the view that the entire property has been sold and any contingent payout represents income of the buyer used to pay a deferred purchase price. *See* Del Cotto, *supra* note 78, at 281–82. The Commissioner took the opposite tack in the *Clay Brown* case and argued that the seller retained an interest in the transferred property because the buyer was a tax-exempt charity. *Brown*, 380 U.S. at 579. The government has advanced a retained-interest position in other cases. *See, e.g.*, Hamme v. Comm'r, 209 F.2d 29, 34–35 (4th Cir. 1953) (involving the conveyance of a leasehold in exchange for royalties based on net sales); United States v. Jones, 194 F.2d 783, 785 (10th Cir. 1952) (involving the transfer of franchises in exchange for income from a lease); Nassau Suffolk Lumber & Supply Corp. v. Comm'r, 53 T.C. 280, 285–86 (1969) (involving the sale of a fuel business in exchange for an annual license royalty determined by the annual sales volume of the fuel business).

184. *Brown*, 380 U.S. at 577.

185. Congress amended the Internal Revenue Code in 1969 to preclude tax-exempt organizations from exploiting the *Clay Brown* decision. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 121(d)(1), (d)(3)(A)–(B), 83 Stat. 487, 543, 548 (codified as amended at I.R.C. § 514 (2000)) (treating rental income of tax-exempt organization derived from debt-financed property as unrelated business income that is subject to taxation).

186. *See supra* text accompanying notes 177–79, 184–85.

187. *See supra* text accompanying notes 171–72.

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requisite level that triggers the contingent payments is not the type of obligation that shifts the risk of loss for the contingent payments to the buyer. A contractual obligation of this type does not shift the risk of loss to the buyer even if the transferred property secures the buyer's obligation to pay these amounts to the seller.[188] By contrast, if the buyer were obligated to make payments to the seller regardless of whether the condition triggering the contingent payments was satisfied, the risk of loss would have shifted to the buyer.[189] In such a case, the contingency would be treated as deferred purchase price.

If this risk of loss standard were applied to the sale of a business for a share of future profits with unascertainable value, retained-interest treatment would generally result. As previously explained, contingent payment arrangements are typically used when the seller believes the business has a greater future income-producing capacity than the buyer.[190] The buyer is motivated to agree to the contingent arrangement because the buyer does not believe that the profits anticipated by the seller will materialize. Under these circumstances, it would defy logic for the buyer to secure the arrangement in a manner that guaranteed the seller's return regardless of the future productivity of the enterprise. Rather, the only assurance that a rational buyer would provide is a commitment to remit the seller's share of any post-sale profits that materialize.[191] Hence, if risk of loss were the universal standard for distinguishing deferred purchase price from a retained interest, the presence of a contingency with unascertainable value would generally be characterized as a retained interest.[192]

188. *See* Anderson v. Helvering, 310 U.S. 404, 412 (1940) ("[R]etention of a lien ... upon the oil and gas production, and nothing more, would not make [the seller] any the less dependent upon such production for payment of the amounts reserved.").

189. *See supra* notes 177–79, 184–85 and accompanying text.

190. *See supra* text accompanying notes 99–104.

191. The buyer's ability to provide security may be further constrained if the purchase of the business is financed by an outside lender. In these circumstances the buyer's lender is likely to object to allowing the seller to retain a security interest in the transferred business.

192. In some cases, a contingent sale agreement may provide for a specified fixed payment to the seller in the event the business is sold before the term for contingent payments expires. When this occurs, the risk of loss does not appear to remain with the seller. *See Anderson*, 310 U.S. at 412 (rejecting a retained-interest argument in part because purportedly contingent amounts "may be derived from sales of the fee title to the land conveyed"). The presence of a guaranteed fixed payment in the event of a sale of the business suggests that the value of the right to contingent payments is ascertainable, in which case it would be realized and recognized in the year of sale, unless the installment method applied. *See supra* notes 18–24 and accompanying text.

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Unfortunately, the jurisprudence distinguishing deferred purchase price from a retained interest fails to embrace consistently a risk of loss standard.[193] Lower court cases involving the sale of a business for a right to future profits are confusing and inconsistent.[194] Courts sometimes treat the contingent rights as a retained interest.[195] Other courts treat the contingent rights as deferred purchase price.[196] Indeed, a risk of loss analysis has been specifically rejected by some

193. *See* Del Cotto, *supra* note 78, at 278–82; Popkin, *supra* note 166, at 171–73.

194. *See supra* note 167 and accompanying text.

195. *See* Cent. Life Assurance Soc'y v. Comm'r, 51 F.2d 939, 941 (8th Cir. 1931) (conferring retained-interest treatment where assets of a stock life insurance company were sold to a mutual life insurance company subject to the buyer's obligation to pay the seller all earnings from non-participating policies for twenty-two years); Fellows Sales Co. v. United States, 200 F. Supp. 347, 352–53 (D.S.D. 1961) (treating contingent rights as a retained interest where a widow sold her lumber-brokerage business to her children but reserved a life estate in five percent of gross receipts); Heminway v. Comm'r, 44 T.C. 96, 101–03 (1965) (involving the sale of stock to a sibling where the seller retained a life estate to dividends and the court held that the dividends were taxable to the seller rather than the buyer under agency theory); Collins v. Comm'r, 14 T.C. 301, 305–06 (1950) (treating contingent rights as retained interest where a mother sold her partnership interest in a department store to her son for cash and the right to five percent of annual profits for her life).

196. *See* Hibler v. Comm'r, 46 T.C. 663, 666, 669–70 (1966) (treating contingent payments as deferred purchase price in a case involving the sale of an insurance agency with fifty percent of commissions on renewal business reserved for an unlimited term but capped at $70,000); Vt. Transit Co. v. Comm'r, 19 T.C. 1040, 1044 (1953) (treating contingency as deferred purchase price in a case involving the sale of bus line franchises where, after the buyer recovered costs, the seller received one-cent per mile traveled in operation of routes and fifty percent of remaining profits for five years after sale), *aff'd*, 218 F.2d 468 (2d Cir. 1955). Other cases rejecting retained-interest treatment involve fact patterns where no dispute existed as to the value of the transferred property. *See* Bryant v. Comm'r, 399 F.2d 800, 801–02 (5th Cir. 1968); Alstores Realty Corp. v. Comm'r, 46 T.C. 363, 365–66 (1966); *see also* DHL Corp. v. Comm'r, 76 T.C.M. (CCH) 1122, 1159–60 (1998) (confirming that *Alstores*'s holding does not apply when value is at issue), *rev'd on other grounds*, 285 F.3d 1210 (9th Cir. 2002); Del Cotto, *supra* note 78, at 277–79 (identifying valuation distinction). If the value of the transferred property is determinable, the value of the right to contingent payments can be quantified and included in the amount realized in the year of sale. *See* Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954) (suggesting that when value of only one property to an exchange is determinable, other property normally has equivalent value).

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courts.[197] In certain areas, a risk of loss analysis has been superceded by legislation.[198]

Existing law is muddled when it comes to distinguishing between deferred purchase price and a retained interest. Nevertheless, treating the seller's right to contingent payments with unascertainable value as a retained interest can generally be reconciled with the most principled approach used by the courts to distinguish a retained interest from deferred purchase price. This risk of loss approach should be applied to contingent payment sales.

B. *Retained-Interest Treatment Yields Sensible and Consistent Tax Consequences*

If a risk of loss analysis were applied to contingent payment sales, retained-interest treatment would frequently result.[199] The tax consequences are clear when a right to contingent payments is treated as a retained interest. The sale of the business constitutes a realization event.[200] The seller's amount realized can easily be quantified because it consists only of fixed payments.[201] The right to contingent payments is not part of the consideration received in the year of sale but instead reflects an ownership interest retained by the seller. Thus, the value of the right to contingent payments is not included in the seller's amount realized. The seller's basis in the transferred business offsets the amount realized.[202] Gain results to the

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197. *See Hibler*, 46 T.C. at 669–70 (treating contingency as deferred purchase price notwithstanding the absence of a personal obligation on the part of the buyer); *Vt. Transit Co.*, 19 T.C. at 1044 (treating contingency as deferred purchase price after stating, "[n]or should it make a difference that the payments were payable only from the revenues from the rights and that there was no personal obligation of the buyer"). *But see* Ellison v. Comm'r, 80 T.C. 378, 388 (1983) (treating contingency as deferred purchase price and bolstering this holding with a finding that the seller's risk of loss was "very slight").

198. *See supra* notes 179, 185; *see also* I.R.C. § 1235 (2000) (taxing the transfer of a patent with retained rights as a sale); *id.* § 1253(c) (taxing a transfer of franchises, trademarks, and trade names contingent on future use as retained interest).

199. *See supra* text accompanying notes 190–92.

200. *See* I.R.C. § 1001(a).

201. *See id.* § 1001(b).

202. Technically, the basis should be allocated between the interest transferred and the interest retained. Treas. Reg. § 1.61-6(a) (1957). If the value of the retained interest is unascertainable, however, there is little choice but to allocate the entire basis to the transferred property. *See* Kwall, *supra* note 161, at 10–12 (exploring the basis allocation issue on the sale of a remainder interest); Popkin, *supra* note 166, at 173 n.79 ("Allocating basis between the sale and retained income elements of a transaction creates another potential problem. The simplest method is to allocate basis entirely to the sale . . . ."). If allocating no basis to the retained interest would result in a loss, however, that loss should not be allowed as a deduction. *See infra* note 203.

extent the amount realized exceeds the seller's basis in the business.[203] That realized gain is recognized in the year of sale[204] and generally will be characterized as capital gain.[205]

If, subsequent to the sale, the seller receives a share of business profits under the right to contingent payments, those profits are taxed directly to the seller, normally as ordinary income.[206] The seller's

203. If the seller's basis in the business exceeds her amount realized (like the situation in *Burnet*, *supra* text accompanying note 58), a loss should not be allowed in the year of sale because it is not clear that a loss has been sustained. *See* I.R.C. § 165(a) (West 2002) (requiring that a loss be sustained before a deduction is allowed); *see also* Schmidt v. Comm'r, 55 T.C. 335, 341 (1970) (denying capital loss to a shareholder of a liquidating corporation until the final distribution was made). The uncertainty that a loss has been sustained stems from the difficulty of determining how much of the seller's basis should be allocated to the retained interest. *See supra* note 202. The difficult task of allocating basis justifies allowing the seller to apply her entire basis against the payments received in the year of sale when a gain results. It is not necessary, however, to permit full recovery of basis in the year of sale when a loss would result. Instead, any basis that would otherwise yield a current loss should be allocated to the retained interest. That basis could then be applied dollar-for-dollar against any post year of sale receipts. If the seller has not recovered all basis allocated to the retained interest when the right to contingent payments expires, a loss could then be allowed.

204. *See* I.R.C. § 1001(c) (2000).

205. *See id.* § 1221 (West Supp. 1A 2002); *id.* §§ 1222, 1231 (2000); *supra* note 117.

206. The seller's retained interest would generally be taxed like an interest in the profits of a partnership. *See* I.R.C. § 702(a) (2000) (providing that a partner is to include in her personal return her distributive share of all items of partnership income). *See generally* Diamond v. Comm'r, 492 F.2d 286 (7th Cir. 1974) (involving the receipt of partnership profits interest by a service partner followed by the subsequent sale of that interest); Rev. Proc. 93-27, 1993-2 C.B. 343 (ruling that the recipient of an interest in partnership profits will normally not be taxed on receipt). Hence, the character of the seller's income would depend on the nature of the underlying income of the enterprise. *See* I.R.C. § 702(b) (providing that partnership items retain their original characterization when allocated to the partners).

The seller's tax treatment would also depend on the form of the transferred business. The proposal advanced in this Article contemplates an asset sale by an individual. The implications of a sale of assets by a C Corporation, S Corporation, or unincorporated enterprise taxed as a partnership, and a sale of ownership interests in a business entity (stock or partnership interests) are beyond the scope of this Article. Some general observations can nevertheless be made. Retained-interest treatment could apply to an asset sale by a business entity but a subsequent liquidation of that entity before the term of the right to contingent payments expires presents complex issues. It should also be feasible to apply retained-interest treatment to a transferred proprietary interest in a "pass-through entity" (an S Corporation or an unincorporated enterprise taxed as a partnership). Although stock of a C Corporation can be sold for a right to a share of future corporate profits, it would not be appropriate to tax a share of the corporation's profits directly to the seller in these circumstances because the seller never previously had a direct interest in the profits of the C Corporation. When C Corporation stock is sold for contingent payments, it would appear that the payments must be treated as deferred purchase price even when the value of the right to contingent payments is unascertainable. *But see* Fellows Sales Co. v. United States, 200 F. Supp. 347, 352–53 (D.S.D. 1962)

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retained interest deteriorates as the right to contingent payments elapses. Ultimately, the right to contingent payments expires with no further tax consequences to the seller.[207]

Turning to the buyer, treating the right to contingent payments as an interest retained by the seller eliminates the problem of quantifying the basis allowed to the buyer for the right to contingent payments.[208] The buyer receives no basis for the right to contingent payments because the buyer is not regarded as purchasing the part of the property encompassed by the contingent rights.[209] Thus, the buyer's basis at the time of purchase is limited to consideration that is readily quantifiable.

The tax consequences to the buyer when payments materialize under the right to contingent payments are also straightforward. Because the right to contingent payments is treated as an interest retained by the seller, the seller continues to own the proprietary interest generating such income for the term of the contingency. During that period, the share of the income attributable to the retained interest is taxed directly to the seller.[210] Thus, the seller's share of post-sale income captured by the right to contingent payments reduces the amount of post-sale income that would otherwise be taxed to the buyer.[211]

Treating the right to contingent payments as an interest retained by the seller yields sensible and consistent results to both parties. The parties are treated sensibly in the year of sale because the right to contingent payments yields no tax cost or tax benefit to either party. When the contingent payments materialize, the seller is taxed directly

(allowing the seller of stock who reserved a life estate in five percent of corporate gross receipts to bear the sole tax burden on those receipts).

207. Permitting the seller to recover her entire basis in the year of sale avoids the complexity of determining whether amortization deductions or a loss on expiration is allowed with respect to any basis allocated to the retained interest. *See supra* note 202. If the seller is denied recovery of her entire basis in the year of sale because a loss would result, however, the remaining basis is allocated to the retained interest and a loss would be allowed for any unrecovered basis when the right to contingent payments expires. *See supra* note 203.

208. *See supra* notes 108–11 and accompanying text.

209. To avoid inconsistent positions by seller and buyer, the reporting requirements imposed by Code section 1060 should be expanded to require both parties to disclose that the right to contingent payments is being treated as a retained interest. *See* I.R.C. § 1060(b); Treas. Reg. § 1.1060-1(e) (2001).

210. *See supra* note 206 and accompanying text.

211. From the buyer's perspective, taxing the seller directly on the income attributable to the right to contingent payments is the substantive equivalent of taxing the buyer on all post-sale income and allowing the buyer an immediate deduction when contingent payments are made.

on the profits allocable to the retained interest and the buyer is sheltered from tax on a like amount. As Example 4 illustrates, no anomalies or ambiguities exist with respect to the seller's income, the buyer's basis, or the tax treatment of the contingent payments.

Example 4 (Contingency Treated as Interest Retained by Seller): Same facts as Example 1. Seller transfers her business for a fixed payment of $9 million in Year 1 and contingent payments equal to 20% of annual profits in Year 2 through Year 5. Annual profits are assumed to be $2 million in Year 2, $4 million in Year 3, $6 million in Year 4 and $8 million in Year 5; resulting in 20% contingent payments of $400,000 in Year 2, $800,000 in Year 3, $1.2 million in Year 4, and $1.6 million in Year 5.

A total of $13 million of payments flows to Seller over the 5-year period ($9 million fixed payment and $4 million of contingent payments). Seller's tax consequences reflect the entire $13 million ($9 million amount realized in Year 1[212] and $4 million of business income in Years 2 through 5[213]). Buyer's tax consequences likewise reflect the entire $13 million ($9 million basis in Year 1[214] and Buyer is sheltered from tax on $4 million of business income taxed directly to Seller in Years 2 through 5[215]).

Results of Example 4

	Seller	Buyer
Year 1	$9,000,000 amount realized	$9,000,000 basis
Year 2	$400,000 business income	$400,000 sheltered
Year 3	$800,000 business income	$800,000 sheltered
Year 4	$1,200,000 business income	$1,200,000 sheltered
Year 5	$1,600,000 business income	$1,600,000 sheltered
Total	$13,000,000	$13,000,000

212. Seller's amount realized consists only of the $9,000,000 fixed payment because the right to contingent payments is regarded as an interest retained by Seller, rather than additional consideration provided by Buyer. For an explanation of why Seller's basis is ignored, see *supra* note 123.

213. Seller is taxed directly on the business income attributable to her retained interest. *See supra* note 206 and accompanying text.

214. Buyer's basis is limited to the $9,000,000 fixed payment. Buyer receives no basis for Seller's right to contingent payments because that right is regarded as an interest retained by Seller, not additional consideration provided by Buyer. *See supra* notes 208–09 and accompanying text.

215. The business generates $20,000,000 in Years 2 through 5, but Buyer is taxed on only $16,000,000 because $4,000,000 is taxed directly to Seller. *See supra* note 213 and accompanying text. Thus, treating the right to contingent payments as a proprietary interest retained by Seller shelters Buyer from tax on $4,000,000.

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This retained-interest approach is essentially a hybrid of traditional open-transaction treatment and closed-transaction treatment. As to the timing of income, the retained-interest approach reflects an open-transaction view—the right to contingent payments is not included in the seller's amount realized nor does the buyer receive basis for the contingent obligation in the year of sale.[216] Rather, the seller is taxed as the contingent payments materialize and the buyer is sheltered from tax on a like amount at that time.[217] As to characterization, however, the retained-interest approach more closely approximates closed-transaction treatment because the seller's deferred income is generally taxed as ordinary income.[218]

Retained-interest treatment yields sensible and consistent tax consequences to seller and buyer. If Congress overrules *Burnet v. Logan*,[219] a retained-interest approach could be implemented administratively. Specifically, the Treasury could clarify the realization regulations to provide that the transfer of property for a right to contingent payments with unascertainable value is normally indicative of a retained interest in the transferred property.[220]

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216. *See supra* text accompanying notes 3–6, 108–11.

217. *See supra* text accompanying notes 210–11. From the buyer's perspective, retained-interest treatment is generally superior to open-transaction treatment from a timing standpoint. When contingent payments are attributed to a retained interest, the amount of business income that would otherwise be taxed to the buyer is reduced immediately. By contrast, when contingent payments occur in an open transaction, the buyer's basis in the acquired property is increased, and the buyer's deductions are deferred. The additional basis is normally allocated to goodwill. *See* I.R.C. §§ 197, 1060 (2000); Treas. Reg. § 1.1060-1(e)(l)(ii)(B) (2001). When contingent payments are allocated to goodwill, any such payments materializing prior to fifteen years after the sale cannot be deducted in their entirety until the fifteen-year period elapses. *See supra* note 120.

218. *See supra* notes 116–18 and accompanying text.

219. *See supra* text accompanying notes 93–94.

220. *See supra* notes 88–90 and accompanying text. In addition to clarifying the realization regulations, the installment sale regulations must also be modified. The regulations governing installment sales state, "Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.' " Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (as amended in 1994). That language should be eliminated and the installment sale regulations should be clarified to provide that the receipt of a right to contingent payments with unascertainable value is normally indicative of a retained interest by the seller in the transferred property, a transaction to which the installment sale rules do not apply. *See supra* note 24 and accompanying text.

C. Scope Should be Limited Due to Tax Avoidance Potential

Although retained-interest treatment yields a coherent system for taxing contingent payment sales, its scope should be limited to instances where the value of the right to contingent payments is unascertainable. As a general matter, the aggregate tax cost of retained-interest treatment is lower than the cost of deferred purchase price treatment. In both cases, all post-sale income is subject to tax; retained-interest treatment divides the post-sale income between seller and buyer, whereas deferred purchase price treatment causes all post-sale income to be taxed to the buyer. Deferred purchase price treatment imposes an additional tax on the seller, however, because the contingent payments augment the gain recognized by the seller with respect to the sale of the business.[221] This additional tax cost is not present under a retained-interest theory—nor should it be because the buyer does not pay for the seller's retained interest. Instead, the retained interest simply shifts from the seller to the buyer as the period of the right to contingent payments elapses.

Although the buyer does not pay for the seller's retained interest, the buyer derives a benefit as time passes. As the seller's retained interest diminishes, that interest effectively shifts to the buyer through accretion of the buyer's ownership interest.[222] This accretion would seem to represent mere asset appreciation barred

221. As Example 1 illustrates, deferred purchase price treatment causes the seller to be taxed on the estimated present value of the right to contingent payments in the year of sale and on any actual deferred payments that exceed the estimated value of the right when the those deferred payments are received. *See supra* notes 123–24 and accompanying text. Thus, deferred purchase price treatment imposes a tax cost not imposed by retained-interest treatment, unless the seller's basis is high enough to offset all of these inclusions. Focusing only on the seller's additional tax exaggerates the difference in the tax cost of deferred purchase price treatment and retained-interest treatment. On the buyer's side of the ledger, deferred purchase price treatment yields a tax benefit that does not appear when retained-interest treatment applies. Specifically, the buyer derives additional basis in the acquired business to reflect the fact that the contingent payments represent additional purchase price on which the seller is taxed. *See supra* note 126 and accompanying text. The buyer's additional basis is normally allocable to goodwill subject to fifteen year amortization. *See supra* note 120. Thus, deferred purchase price treatment bestows a benefit on the buyer equal to the present value of the tax savings from the future deductions resulting from the additional basis. The present value of the buyer's tax savings will normally be less than the seller's immediate tax cost. Thus, the aggregate tax cost of deferred purchase price treatment is normally higher than the cost of retained-interest treatment.

222. *See* Kwall, *supra* note 161, at 17–19. This assumes that the underlying property is regenerating, rather than wasting, property.

from the tax base by the realization requirement.[223] The failure to tax this benefit as it accrues could create an incentive to use contingent payment arrangements to disguise known value.[224] Retained-interest treatment should not be conferred in these circumstances.

To ensure that the adoption of this retained-interest approach does not lead to tax avoidance, its application must be limited to contingent payment sales with unascertainable value. As previously explained, contingent payments are typically used precisely because the parties cannot agree on the value of the business.[225] Nevertheless, a contingent payment arrangement is not always indicative of unascertainable value. Instances may exist where contingent payments are used for other reasons.

Parties with identical views of the future might resort to a right to contingent payments as a mechanism for enhancing rewards or reducing risk. For example, a reluctant seller might be willing to gamble away a portion of a fixed price in the hope of reaping a windfall from unanticipated returns that might result from the skill or luck of the buyer. A less confident buyer might grasp the opportunity to reduce a fixed obligation by converting a portion of agreed value to a share of future profits.

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223. *See* I.R.C. § 1001(a) (2000). If the retained interest were regarded as a spatial interest rather than a temporal interest, the seller could be treated as receiving a discrete piece of property each year and be taxed on each deemed transfer. *See* Warren v. United States, 171 F. Supp. 846, 849 (Ct. Cl. 1959) (Jones, C.J., dissenting) ("It is as if the purchaser of the house or apartment in question has sold a 1/20 interest each year until the entire house or apartment had been disposed of."). Equating the sale of a business for a right to contingent payments to a spatial division is inappropriate, however, because full ownership will accrue to the buyer without any further action by the seller and irrespective of whether the seller receives any payments under the contingency.

224. An element of the annual accretion in the buyer's property interest represents compensation for deferred enjoyment of the portion of the property retained by the seller. *See* Del Cotto, *supra* note 78, at 281. This time value element is not insulated by the realization requirement and could be taxed to the buyer annually as interest if it could be quantified. *See generally* I.R.C. § 1272 (authorizing economic accrual of unstated interest). If the value of the business were unascertainable when the sale occurred, it would seem that the principal amount on which to compute an interest element is lacking. *See* Kwall, *supra* note 161, at 33. Interest could be computed if the contingent payments that ultimately materialize were used as a proxy for the principal amount. *See* Treas. Reg. § 1.1275-4 (as amended in 1999) (providing that when payments occur under a contingent payment debt instrument, the payments are discounted back to the time of transfer and the difference between the actual payment and the discounted present value is taxed as interest). No apparent relationship exists between the contingent payments received by the seller and the time value benefit derived by the buyer. Thus, interest should not be imputed to the buyer when the value of the right to contingent payments is unascertainable.

225. *See supra* text accompanying notes 99–102.

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The contingent element in these situations is not indicative of unascertainable value. In effect, the parties are merely transforming a portion of the agreed upon value from fixed terms to a right to contingent payments. In light of the possibility that tax savings may be derived from retained-interest treatment, it is important to be wary of taxpayers who might use a right to contingent payments to camouflage known value.[226] In these situations, retained-interest treatment should not be granted. Rather, the seller should realize the value of a right to contingent payments with an *ascertainable* value in the year of sale. These transactions should either be accorded deferred recognition under the installment method or be taxed as closed transactions when the installment method does not apply.[227]

CONCLUSION

The open-transaction doctrine cannot be justified. *Burnet v. Logan* presented a sympathetic case for deferred realization in light of the government's effort to rob Mrs. Logan of basis without allowing a tax loss. The Supreme Court's misguided opinion, however, cannot be reconciled with current law. Consequently, the time has arrived for Congress to put the open-transaction doctrine to rest.

The principal problem with taxing contingent payment sales as closed transactions is that the right to contingent payments must be valued in the year of sale. Frequently, however, the value of the right to contingent payments is unascertainable. Indeed, a disagreement as to the value of the underlying business is normally the reason that the parties opt for a contingent payment arrangement in the first place.

When unascertainable value exists, it is impossible to devise a coherent system for taxing the parties as long as the seller is regarded as transferring her entire ownership interest in exchange for consideration from the buyer that includes the right to contingent payments. No reason exists to adhere blindly to the view that the seller is transferring her entire ownership interest. Instead, the right to contingent payments should be regarded as an interest retained by the seller in the transferred business. Treating the right to contingent payments as a retained interest yields consistent and sensible tax consequences to both seller and buyer.

226. In any given case, whether the value of a right to contingent payments is ascertainable presents a question of fact. Disputes between taxpayers and the Internal Revenue Service would need to be resolved on an ad hoc basis.

227. *See supra* notes 18–24 and accompanying text.

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Although the retained-interest theory comports with the substance of many contingent payment sales, its application should be limited. Retained-interest treatment can be seen as undertaxing the parties because the accretion in the buyer's ownership interest is outside of the tax base. For this reason, the retained-interest approach should be confined to those instances where the value of the right to contingent payments is indeed unascertainable. With this limitation in place, the retained-interest theory provides a sound foundation for taxing contingent payment sales and fills a void that has existed with respect to these common transactions since the origin of the income tax law.

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APPENDIX

Comparison of Installment Sale Treatment to Open-Transaction Treatment and Closed-Transaction Treatment

The installment method, like the open-transaction doctrine, enables the seller to refrain from including the right to contingent payments in income in the year of sale. In contrast to the open-transaction doctrine, however, the installment method does not permit the seller to apply her entire basis against the payments she receives before recognizing any gain. Rather, the seller's basis is allocated over the period of years during which payments may be received and, therefore, only a portion of the seller's basis may be applied each year.[228] Because the seller's basis is spread over the entire payment period, less gain is deferred under the installment method than under open-transaction reporting. As to characterization, under the installment method all deferred payments other than an interest element are taxed as capital gain.[229]

A simple example will illustrate the middle-ground tax treatment achieved by the installment method. Consider the sale of a business where Seller receives a $2 million payment in the year of sale (Year 1) and the right to a percentage of post-sale profits payable in Year 2. Assume Seller has a basis in the business of $1 million. If Seller were compelled to estimate the value of the right to future profits at the time of sale (i.e., if closed-transaction treatment were mandated), assume Seller would estimate the value of that right to be $1 million.[230] Assume Seller's right to future profits actually yields $2

228. If a maximum payment term exists but there is no limit on the amount of contingent payments, basis is recovered ratably over the payment term. Temp. Treas. Reg. § 15a.453-1(c)(3) (as amended in 1994). If the amount of contingent payments is limited, the regulations assume that the maximum amount will be paid and basis is allocated among the projected payments. *Id.* § 15a.453-1(c)(2). If no maximum payment term exists, and no limit is imposed on the amount of contingent payments, basis generally is recovered ratably over fifteen years. *Id.* § 15a.453-1(c)(4).

229. Capital gain treatment assumes that the transferred assets are capital assets or assets used in a trade or business. *See* I.R.C. § 1221 (West Supp. 1A 2002); *id.* § 1231 (2000). For rules governing the imputation of interest, see Treas. Reg. §§ 1.1274-1 to 1.274-5 (1994); *id.* § 1.1275-4. The interest element is ignored for purposes of this illustration.

230. Any estimate of value can be selected. The $1,000,000 amount was chosen to produce a clear illustration of the installment method as a middle ground.

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million in Year 2. Seller's tax consequences under each treatment alternative are as follows:

	Year 1	Year 2
Open-Transaction Treatment	$1 million capital gain[231]	$2 million capital gain[232]
Installment Method	$1.5 million capital gain[233]	$1.5 million capital gain[234]
Closed-Transaction Treatment	$2 million capital gain[235]	$1 million ordinary income[236]

This example demonstrates that when the installment method applies, the seller's gain is generally accelerated relative to open-transaction treatment, but deferred and more favorably characterized relative to closed-transaction treatment.

231. The $2,000,000 Year 1 payment is offset by Seller's entire $1,000,000 basis in the business and the right to a contingent payment is not realized. *See supra* notes 5–6, 15 and accompanying text.

232. The $2,000,000 contingent payment is not offset by any basis because all basis was applied to the Year 1 payment. *See supra* note 231.

233. The right to contingent payments is not realized (akin to open transaction treatment) but the $2,000,000 cash payment is offset by only half of Seller's $1,000,000 basis because the other half is allocated to Year 2. *See* Temp. Treas. Reg. § 15a.453-1(c)(3); *supra* note 228.

234. The $2,000,000 contingent payment is offset by the $500,000 of basis that was allocated to Year 2, and the resulting income is taxed as capital gain with the exception of an imputed interest element. The interest element is ignored in the example. *See supra* notes 106–07 and accompanying text.

235. Seller realizes the estimated value of the contingent right in the year of sale. Thus, both the $2,000,000 cash payment and the $1,000,000 value of the right to contingent payments are realized but are offset by Seller's entire $1,000,000 basis. *See supra* notes 106–07 and accompanying text.

236. The part of the $2,000,000 contingent payment that exceeds the estimated $1,000,000 value that was realized in Year 1 is taxed as ordinary income. *See supra* notes 116–19 and accompanying text.

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