Mrs. Logan Comes to a Sudden Realization: An Analysis of the Current State of the Open Transaction Doctrine

Matthew A. Lykken

Follow this and additional works at: https://digitalcommons.law.ou.edu/olr

Part of the Law Commons

Recommended Citation

This Article is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact darinfox@ou.edu.
MRS. LOGAN COMES TO A SUDDEN REALIZATION: AN ANALYSIS OF THE CURRENT STATE OF THE OPEN TRANSACTION DOCTRINE

MATTHEW A. LYKKEN*

In 1916, Mrs. Logan had a problem. She owned shares of stock in a steel company, which in turn had an interest in a mining company. The problem was that Mrs. Logan could only receive the profits from the mining company in the form of dividends from the steel company, which would be currently taxable in full. She solved this quandary by selling her stock for cash plus an ore royalty contract. In 1931, the United States Supreme Court ruled in Burnet v. Logan1 that the result of this sale was that Mrs. Logan’s March 1, 1913 basis2 in her stock (minus the cash she received at the time of the sale) carried over to the royalty contract, and that she could apply 100% of the royalty payments received under the contract against that basis until the basis was fully recovered.3 Thus, she not only was able to subtract her basis in the steel company stock from the proceeds she received, but was also able to defer taxation of her profit in excess of basis until some far future date.

Unfortunately, the Court was vague in defining the legal principle that justified this act of generosity. Yet, while the lower courts were uncertain as to what the Court had said, they had a duty to follow the Court. The open transaction doctrine (the “Doctrine”) thus born flowered into various rather disparate branches, the most pernicious of which were pruned away by the enactment of sections 453 and 483 of the Internal Revenue Code (the “IRC”).4 Yet, the tree of the Doctrine remains embedded in the tax

---

* B.A., University of Minnesota; J.D., Harvard University. Associate Attorney, Office of Chief Counsel, Internal Revenue Service, Dallas District. The content of this article is the opinion of the writer and does not necessarily represent the position of the Internal Revenue Service.

1. 283 U.S. 404 (1931).

2. The first modern income tax statute, the Tariff Act of 1913 § 2, 38 Stat. 166, imposed a tax on all income derived after March 1, 1913. With regard to capital gains, this initial date was implemented by granting all persons who held property on March 1, 1913, a basis in such property equal to its fair market value on that date. This was incorporated in the Revenue Act of 1918 § 202(a), 40 Stat. 1060. In Logan, this initial basis was estimated by the same discounted income projection that was rejected in estimating Mrs. Logan’s gain on the sale of her stock.

3. 283 U.S. at 412. The doctrine that receipt of certain income producing assets having “no ascertainable fair market value” may not result in current taxation, but rather that the taxpayer may defer taxation until the income from the asset is received, is generally known as the open transaction doctrine. As commonly construed, the doctrine permits taxpayers to further defer the recognition of any gain until their basis has been fully recovered, and to treat the receipts as flowing from the transaction by which the taxpayer acquired the asset.

4. I.R.C. § 453 (1986), applies in general to dispositions of property (other than sales of
law, and may soon take on new significance due to certain provisions of the Tax Reform Act of 1986. In particular, the Doctrine may raise various difficult questions of classification under the new passive loss provisions. If, for example, a taxpayer receives a limited partnership interest of uncertain value in exchange for services rendered, and the receipt of the partnership interest is held to be an "open transaction," is the income flowing from the partnership interest active or passive? If the taxpayer then receives an intangible asset as a distribution from the limited partnership in another "open transaction," is the taxpayer's income from the asset active, passive or portfolio income? The Doctrine also seems to create practical problems in regard to corporate liquidations after the repeal of the General Utilities doctrine, since theoretically a corporation could continue to receive "income" under some versions of the Doctrine for several years after the corporation becomes defunct.

These and other, similar problems warrant a re-evaluation of the Doctrine as it has evolved, in order to uncover its theoretical underpinnings and determine whether the Doctrine still serves any valid purpose, or should be replaced by a new construction. This article discusses the developments in the Doctrine and in related tax areas since Logan, and concludes that the Doctrine should, for the most part, be replaced by the principles of I.R.C. sections 453 and 483 and the general cash equivalency doctrine.

What Mrs. Logan Failed to Recognize

In Burnet v. Logan, the taxpayer, Mrs. Logan, owned one-sixteenth of the stock of Andrews & Hitchcock Iron Company ("A&H"), which in turn

personal property by dealers or dispositions of personal property of a kind which would be required to be kept in inventory by the taxpayer) where at least one payment is received after the year of disposition.

Section 453 generally provides that, with respect to such dispositions, each payment received is to be allocated to gross profit in a ratio equal to the ratio between total expected gross profit and the total contract price. Thus, the taxpayer is not generally permitted to recover his full basis before recognizing any income. Section 483 applies in general to deferred payments on account of the sale or exchange of property and allocates a portion of each such payment to interest, unless the contract otherwise provides for adequate interest charges. See I.R.C. § 483 (1986).

6. I.R.C. § 469 (1986). Generally, the passive loss rules divide income and losses into three baskets - passive, portfolio, and active - and provide that losses from passive activities may only be claimed to the extent of income from passive activities. The prototypical passive activity is an interest as a limited partner.
7. Portfolio income basically consists of dividends, interest, annuities, and royalties not derived in the ordinary course of a trade or business. See I.R.C. § 469(e)(1) (1986).
8. General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935). Section 631(c) of the Tax Reform Act of 1986 amended I.R.C. § 311 to reverse the long standing rule that a corporation was not taxable on the distribution of property with respect to its stock.
9. It should be noted that Congress has likewise expressed the view that I.R.C. sections 453 and 483 have made further use of the Logan doctrine, for the most part, unnecessary and undesirable. See S. Rep. No. 1000, 96th Cong., 2d Sess. at 24, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 4696, 4719; H. R. Rep. No. 1042, 96th Cong., 2d Sess. at 21.
The Open Transaction Doctrine

1989] THE OPEN TRANSACTION DOCTRINE 583

owned 12% of the stock of Mahoning Ore ("Mahoning"). Mahoning extracted amounts of ore ranging from 303,020 to 3,029,865 tons per year from a certain mine and distributed the ore pro rata to its stockholders, including A&H. In 1916, Youngstown Sheet & Tube ("Youngstown") bought all of the A&H stock from the A&H stockholders in exchange for cash plus a promise to pay 60¢ for each ton of ore distributed to A&H by Mahoning.

The Commissioner of Internal Revenue (the "Commissioner") attempted to tax Mrs. Logan on her sale of the A&H stock to Youngstown by the following method. First, he projected the total expected receipts of ore payments under the contract for all of the former A&H shareholders ($5,965,814), and discounted the amount to its present value at the time of sale ($1,942,111). The discounted value, plus the cash received, was determined to be less than the March 1, 1913 value of Mrs. Logan's stock, so there was no gain on the sale in 1916. The Commissioner then determined that Mrs. Logan's total basis in the ore payments contract was one-sixteenth of the $1,942,111 discounted value, and that she should recognize gain on the receipt of each ore payment based upon the ratio of her total basis (1/16 of $1,942,111) to the total expected receipts (1/16 of $5,965,814). The Supreme Court rejected this approach. The Court held that Mrs. Logan's basis in the ore payments contract was the March 1, 1913 value of her A&H stock less the cash she received in 1916 and that she was not required to recognize any income upon the receipt of the ore payments until that basis had been recovered.

The essence of the Supreme Court's opinion in Logan is stated in one vague and rambling paragraph:

We are not dealing with royalties or deductions from gross income because of the depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments .... As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no fair sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup

11. During the tax year in question, there was no capital gains deduction. Thus, the classification of the income as gain rather than as contract income was descriptive rather than operative.
12. 283 U.S. at 411-12.
13. Id.
her capital investment from payments only conditionally promised.\textsuperscript{14}

It is difficult, in the abstract, to say what the Court meant by this quoted paragraph. The statement that the ore royalty contract "had no ascertainable fair market value" could, with equal plausibility, mean that the Court found the contract had no fair market value or merely that the Court could not determine the fair market value of the contract. This ambiguity is the key to understanding the Logan case and has been the source of much confusion among the lower courts and the Internal Revenue Service.

The Court's reasoning can best be understood by breaking Mrs. Logan's sales transaction into two parts, each with a separate issue for decision. First, Mrs. Logan exchanged her A&H stock for an intangible right to receive ore royalties. The first question presented is whether such an exchange should result in the current recognition of a gain or loss to the taxpayer. Second, Mrs. Logan actually received the ore payments. The second question presented is whether a taxpayer's basis in such a contract may be recovered before any gain is recognized, or whether each payment should be allocated between a return of capital and the projected profit.

A Cash Equivalency Analysis

The first question can be answered through a form of cash equivalency analysis, rooted in section 202(b) of the Revenue Act of 1918,\textsuperscript{15} the law that governed the transactions in Logan. Section 202, titled "Basis for Determining Gain or Loss," provided in subsection (b): "when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as equivalent to cash in the amount of its fair market value, if any . . . ." It is instructive to note that this statutory provision uses the word "shall," suggesting that Congress did not intend to provide discretion in the provision's application. Rather, property received in an exchange was to be treated as cash to the extent of the property's fair market value, if any.

The Second Circuit's opinion in Logan v. Commissioner of Internal Revenue,\textsuperscript{16} which was affirmed in Logan, flipped the statute's linkage between fair market value and cash equivalency. The Second Circuit appears to have begun with the proposition that if property cannot be sold at a reasonable price, then it is not equivalent to cash, because it is not, as a practical matter, liquid. The court then reconciled this proposition with the language of the statute by concluding that if property cannot be sold at a reasonable price, then it does not have a "fair market value," and so need not be treated as equivalent to cash because of the "if any" qualifier in the statute. The Second Circuit rationalized this conclusion by assuming that in some situations a reasonable seller would not be willing to part with

\textsuperscript{14} 283 U.S. at 412-13.
\textsuperscript{15} 40 Stat. 1060. Compare this provision with I.R.C. § 1001(b) (1986).
\textsuperscript{16} 42 F.2d 193 (2d Cir. 1930), aff'd sub nom., Burnet v. Logan, 283 U.S. 404 (1931).
property at any price that a reasonable buyer would be willing to offer, and therefore, there would be no market value that would be fair to both parties. In essence, the court replaced the statutory dictate that property having any fair market value be deemed to be equivalent to cash with a rule that property that is not equivalent to cash, in the sense that it cannot be liquidated, will be deemed to have no fair market value.

This analysis is clearly set forth in the Second Circuit's opinion. The court stated, "Before income can be derived, there must not only be some value to the consideration, but it must have an established or fair market value; it must be equivalent to cash."17 The Second Circuit then reiterated, "[t]here is no taxable gain and no deductible loss unless the property received has a value realizable in money's worth."18 In support of this latter statement the court cited Tsivoglou v. United States,19 a case in which a federal district court held that no profit or loss could be determined upon the receipt of stock which was not marketable.20 Plainly, then, the Second Circuit was concerned with whether the property could be transformed into cash at a reasonable price. If not, then the mandate of section 202(b) that the property be treated as equivalent to cash to the extent of its fair market value would be inapplicable.

It is equally important to note that the Second Circuit was not concerned with whether the intrinsic value of the asset was difficult to determine or speculative. As the court noted, "Where there has been no sale . . . [the fair market] value will be determined by the method which the prospective buyer or seller in the industry would use in arriving at the sale value of the property at the basic date."21 Hence, it appears that valuation according to an established industry formula would be proper, even for a speculative asset like the royalty contract. In the case before the court, however:

There was ample testimony that there was no market for the sale of the obligation to pay the 60 cents per ton for 45 years, and that it had no cash equivalent. Congress, by the phrase "fair market value" meant that, not only must the market price be ascertained by sales, but sales so made and the circumstances under which they were made were to be considered to determine whether such sales served to evidence . . . the fair price which Congress said should be the satisfactory start or base from which subsequent gain should be determined . . . . [U]nder the statute there is no taxable gain and no deductible loss unless the property has a value realizable in money's worth.22

17. Id. at 195 (quoting Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929)).
18. Id. See also Walls v. Commissioner, 60 F.2d 347, 350 (10th Cir. 1932) ("It appears that the term 'fair market value' was used in the income tax statutes to mean exchangeable value, for, if a person could not realize a sum of money from the sale of property received by him, it was not proper to consider it as profit.").
19. 27 F.2d 564 (D. Mass. 1928), aff'd, 31 F.2d 706 (1st Cir. 1929).
20. Id. at 567.
21. Logan, 42 F.2d at 195.
22. Id. The notion that an asset may not be saleable at a price to which both a willing
The issue, then, was not whether a fair price would have to be determined through the use of formulas or estimates, but rather whether the asset in question could be sold for a fair price at all.

By reconciling the vague language of the Supreme Court in Logan with the opinion of the Second Circuit, the following analysis emerges. While normally a taxpayer who receives property can immediately convert it into cash, and thus has a real, disposable gain, Mrs. Logan was not as fortunate. She could not sell her royalty contract right, but rather had to rely on the receipt of the ore royalties in order to make a profit, if any. Thus, it could be said that Mrs. Logan had not “realized” a profit until such time as she had received royalties in excess of her basis. If a tax had been imposed before the ore payments received exceeded her basis, she might have lacked the means to pay the tax. It should be noted that under the cash equivalency analysis of Tsivoglou, supra, Mrs. Logan likewise could not claim a loss based upon any shortfall between the value of the ore payments contract and her basis.

Even if it were possible to place a precise value on the ore royalty contract (as was apparently the case in Tsivoglou, where stock was appraised by the liquidation value of the underlying assets), the lack of liquidity of the contract would prevent taxing a cash basis taxpayer upon receipt of a contract. This analysis is merely a poor restatement of the familiar principle that a cash basis taxpayer need not recognize income upon the receipt of a note or other promise of future payments, unless such note or contract is marketable.

Does this first part of the Logan Court’s reasoning make sense? If the question had been solely whether Mrs. Logan should have been taxed on the discounted value of the entire projected gain at the time of the sale, the open transaction approach seems reasonable. If the discounted value of the projected payment stream had substantially exceeded Mrs. Logan’s basis, the Court then would have faced a choice between taxing a profit that could not be converted into cash, or allowing a loss based upon the negligible sale value of the asset. The former choice would have been inconsistent with the principle of taxing based upon the ability to pay; Mrs. Logan

---

buyer and a willing seller would agree has become so foreign in modern America that it might be helpful to analogize an unmarketable asset to a human hand. It has great value to its owner which can be estimated when necessary, as in a tort action. However, no one else would be willing to pay that price to obtain it. Of course, this analysis neglects the principle that fair market value is to be determined on the basis of what a hypothetical willing seller and buyer would agree to, rather than the object’s value to the current owner.

23. Even under the Commissioner’s analysis, Mrs. Logan did not make a profit in 1916 - her basis exceeded the discounted value of the projected payment stream. The discussion here simply mirrors the tone of the Court’s opinion. The real question was whether the transaction was of the sort where profit should be recognized, if there was any. If not, then as a matter of consistency loss recognition should be deferred.

24. Tsivoglou, 27 F.2d at 567.

could have sold her ore royalty contract and still have fallen far short of the funds needed to pay the tax on her hypothetical profit. Allowing the loss, on the other hand, seems contrary to common sense, since it seemed probable that she would eventually make a healthy profit on the transaction. Thus, the Court decided that the contract, while perhaps technically transferrable, was not marketable, and then applied basic principles of cash basis accounting. To this extent, then, Logan remains valid, although it adds little or nothing to general tax accounting principles.

The Annuity Analogy

In the Logan case, the realization of a gain or loss occurred on the receipt of the cash ore payments. The question thus became whether Mrs. Logan should be allowed to recover her basis before recognizing any gain, or whether she should recognize some gain as each ore payment was received. Oddly, the Supreme Court did not directly address this question with respect to the future royalty payments to be received in exchange for Mrs. Logan's own stock. Instead, the Court addressed the question by looking at the royalty contract Mrs. Logan had inherited from her mother.

With regards to the royalty contract inherited from Mrs. Logan's mother, the Court applied an annuity analysis. The Court reasoned that the estate had been taxed as though the ore payment contract had been converted into some $277,164.50 in cash. If that cash had been invested in an annuity contract under the tax laws as they then stood, the contract holder would have been entitled to recover 100% of her basis before recognizing any income from the annuity payments. Like an annuity, the royalty contract was essentially a promise to pay a sum of money over a period of years. Thus, Mrs. Logan should likewise be able to recoup her basis in the inherited ore royalty contract before recognizing any income. Apparently, the Court applied a similar analysis to the ore payments contract that Mrs. Logan received in exchange for her own stock, as did the Second Circuit.

Viewed from the perspective of the tax law as it then stood, treating the ore royalty contract like an annuity seems reasonable. If anyone purchasing a $5,965,814, forty-five year annuity for $1,942,111 could postpone any recognition of income until they had recovered their basis, it would seem fair to allow Mrs. Logan the same treatment as if she had purchased the royalty contract for cash.

Today, of course, the tax code is not so generous. I.R.C. section 72 would require Mrs. Logan to amortize her basis in an annuity over the

27. Id. at 410. Previously, Mrs. Logan's mother, who owned one-eighth of the A&H stock, had died and left Mrs. Logan a right to receive another one-eighth of the ore payments. The Commissioner had determined a fair market value for the mother's interest for estate tax purposes by discounting the estimated future income stream to be generated from the royalty contract.
28. 283 U.S. at 414.
29. Logan, 42 F.2d at 197.
annuity’s projected payment stream in order to match cost with income. I.R.C. section 453 provides similar treatment for an installment sale. By today’s tax standards, the treatment proposed by the Commissioner in Logan seems entirely fair, especially considering the treatment that would have been accorded such payments had the sale not occurred. It is highly probable that this part of Logan, which allowed full recovery of basis before recognition of gain, would not be decided the same way today, and it appears that this part of the Court’s opinion should be considered obsolete.

It might be argued, however, that the Logan Court was concerned with a straight valuation question, that is, whether it was proper to allocate the ore payments between capital recovery and gain based upon a hypothetical projection of the total value of the contract. If so, the Court was inconsistent at best. Mrs. Logan’s basis in her stock was its value as of March 1, 1913. As has been discussed above, the Commissioner calculated Mrs. Logan’s basis (1/16 of the $1,942,111) by discounting the total projected receipts from the royalty contract, so that the amount of her basis as so calculated would track any change in the estimated total projected receipts. So long as the assumptions regarding the pay-out period of the contract and the regularity of ore payments are accepted, it is actually irrelevant what overall value the Commissioner determined for the payment stream. Because the issue at hand was the ratio between Mrs. Logan’s total basis and the total expected receipts of ore payments, and because her basis would increase in direct proportion to any increase in the total expected receipts, the ratio of a 32.5% ($1,942,111/$5,965,814) basis recovery to a 67.5% gain would remain the same whether the expected receipts were projected to be $10,000 or $10,000,000.30

Thus, the Court’s statements that the “liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation” and that the contract “had no ascertainable fair market value”31 should not be construed as referring to valuation problems per se. Rather, the Court must have meant simply that it was inappropriate to treat the receipt of the royalty contract as a recognition event, based upon an estimated value, where the evidence showed that Mrs. Logan could not sell the ore royalty contract at such a value because of the absence of an appropriate market. The Court’s decision regarding the allocation of basis is best explained by its analogy to an annuity and not by a concern with difficulties of valuation.32

30. The net present value of $10,000 payable in 45 equal annual payments, discounted at six percent, is $3,434.63, which is some 34% of the $10,000 total payment stream. Likewise, the net present value of $10,000,000 under the same assumptions is $3,434,629.35, or approximately 34% of the $10,000,000 total payment stream. Thus, in either case the ratio of net present value to total payments is the same.
32. This valuation question may have a legitimate bearing upon the determination whether to allow front loaded basis recovery for that portion of each payment which represents receipts from the open transaction, as opposed to subsequent income. See infra notes 58-59 and accompanying text.
The original holding in Logan states a rather narrow doctrine: where a cash basis taxpayer receives an asset which, for some peculiar reason, cannot be liquidated at a price reflective of its fair value, the receipt of such asset shall not be deemed to be equivalent to the receipt of cash, and the transaction will not constitute a recognition event. Logan does not stand for the proposition that estimates and assumptions are inadequate bases for valuing an asset, but rather Logan rejects taxation based upon estimates and assumptions where such bases clearly fail to reflect the actual sale value of the asset.

Unanswered Questions

Logan left several important issues to be resolved by later cases. Initially, what is the tax effect of a transaction being held open? Logan was decided before the advent of the capital gains deduction, and did not address the question of whether the royalty payments, after Mrs. Logan's basis had been fully recovered, would constitute ordinary income or capital gains, or part capital gains and part imputed interest. Moreover, it was unclear whether the basis allocation rule used in Logan would apply to every open transaction, only certain open transactions, or would depend upon the normal treatment of annuities, or would be superseded by the installment sale rules. \(^{33}\)

Second, the Logan Court's vague language left a good deal of confusion as to what was required to trigger open transaction treatment. As previously discussed, it would appear that the Doctrine should only apply to the receipt of unmarketable assets by cash basis taxpayers. However, the Court did not state that the Doctrine would not apply to accrual basis taxpayers.

Further, the Logan Court made little effort to define the types of restrictions on or impediments to marketability that would trigger the Doctrine. This failure was aggravated by the Court's language suggesting that the Doctrine might be triggered any time an asset was especially difficult to value, or whenever the asset's valuation would depend upon mere estimates, assumptions, and speculation, even if the asset could be readily sold. \(^{34}\)

The Logan Court did not state whether there was any limitation on the types of assets, other than contingent rights to future money payments, that should be covered by the Doctrine. It would seem inappropriate, for example, to apply the Doctrine to assets that are, in substantial part, consumption goods, because with such goods the taxpayer realizes a benefit upon possession. But should it apply, for example, to real estate held for speculation, thus allowing an indefinite deferral of income? \(^{35}\) Should it apply

---

33. The original precursor to I.R.C. § 453, enacted by the Revenue Act of 1926 § 212(d), Pub. L. No. 69-20, on its face, seems to govern the allocation of basis in transactions such as Mrs. Logan's stock sale.

34. 283 U.S. at 412-13.

35. The open transaction doctrine does not, in fact, apply to real property. See infra text accompanying notes 103-06. Under I.R.C. § 1001(b) (1986), such property is included in the amount realized on a sale of property and would be currently taxable.
to tangible property at all? The only type of asset specifically referred to in Logan is a promise to pay an indeterminate sum of money.36 One might argue that with tangible property, all relevant contingencies and uncertainties are eliminated and the income is effectively realized once the property is in hand. The property may not be worth much, or its future worth may be dependent upon outside factors, but in the meantime it is indisputably real.

Neither did the Logan Court state whether it made any difference if the asset exchanged had an ascertainable fair market value. Presumably, Mrs. Logan's A&H stock, having the ore dividend rights as its primary asset, was not much more marketable than the royalty contract rights themselves. The Court might have been much less sympathetic if Mrs. Logan could have sold her stock for a fixed amount of cash, but elected instead to receive the contingent payment stream. In such a case, she might be deemed to have received the cash and then used it to purchase the contingent interest. Likewise, if Mrs. Logan had sold stock traded in an established stock market in exchange for the royalty contract rights, the Court could have concluded that if she bought the royalty contract for stock worth $X$ dollars, then she could presumably sell it to someone else for the same price, and so the royalty contract had an ascertainable fair market value of $X$ dollars. Indeed, even if she had exchanged a royalty contract in a gold mine for the royalty contract in the Mahoning iron mine, the Court could have concluded that such a substantial change of position proved that there was some fair market price for the contract and left it to the Commissioner to determine the price.

Finally, the Logan Court did not clearly address the question of when it might be appropriate, even in the case of promises of future payments lacking an ascertainable fair market value, to nonetheless treat the transaction as a realization event. The Court noted that the estate tax, by its nature, did not allow for open transaction treatment, but did not address such situations as corporate liquidations or retransfers of assets by sale or gift.

The Effect of Open Transaction Treatment

**Income Characterization**

Logically, the only effects that open transaction treatment should have on a taxpayer are the deferral of income recognition and the preservation of the character of the income. The latter effect is simply a restatement of the principle that "an item of income cannot be converted into a capital asset, having a cost basis, until it is first taken into income."37 Reciprocally, where income results solely from the sale of a capital asset, it should be treated as capital gain even if, as was the case with Mrs. Logan, it is received in a form that would otherwise be ordinary income.

36. 283 U.S. at 413.
What the Court failed to address in Logan, however, is how to separate out a deferred return of capital and capital gains resulting from the open transaction and interest, additional gain, or something else. If Mrs. Logan had received only cash on the day she sold her stock, she probably would have received the $1,942,111 present value of the projected income stream. She would thus have had a return of capital in that amount. If she had used the proceeds from the sale to purchase the ore royalty contract, the ore payments received in excess of her basis would have been ordinary income. Likewise, her actual receipts under the royalty contract should have been regarded as $1,942,111 in return of capital or capital gain, with the remainder treated as interest or as ordinary income.

This approach to deferred payment sales has now been codified under I.R.C. section 483 and the regulations thereunder. Section 1.483-1 of the Treasury Regulations provides generally that in the case of a sale for deferred payments, each payment shall be allocated to interest in a ratio equal to one minus the estimated present value of the remaining payment stream over the total amount of the anticipated payments. Where the payments to be received are uncertain as to time, liability or amount, the rule is applied to each payment actually received as if it were the only payment due under the contract. Thus, each payment is discounted back to present value as of the time the sale was made, and the excess over that value is treated as interest. This approach should provide fair and satisfactory results in virtually all open transaction situations by giving the parties the benefit of hindsight. Moreover, it should provide equally satisfactory results where the open transaction involves compensation for services rendered rather than a sale and should be applied to such situations.

A further advantage of the section 483 approach is that it partially solves the question of how payments received in an open transaction should be treated under the passive loss rules. The deemed interest component will be treated like any other interest income and, under I.R.C. section 469(e), will generally be treated as portfolio income.

A more complex case is presented by the receipt of a partnership interest. For example, a taxpayer receives a limited partnership share as compensation for services rendered, in a partnership with virtually no capital other than goodwill. The partnership has a net taxable loss of $10,000 in year one, followed by net income of $5,000 per year in years two through eleven, with a $10,000 cash distribution in year five. The partnership liquidates at the end of year eleven, and the taxpayer receives $30,000 upon liquidation. What should the taxpayer’s tax liability be?

39. The ratio is calculated as follows:
1 - (Present value/Total payments).
41. However, as discussed infra, in certain cases it may be more appropriate to characterize these excess receipts according to their proximate source, e.g., as receipts from a partnership interest. Classification as interest is a default position.
To answer the question, start by asking what the tax effects would be if the taxpayer had received the services income as cash in year one, and used that cash to purchase the partnership interest.\textsuperscript{42} The present value of the partnership distributive income and loss at a 10\% discount rate is about $19,000.\textsuperscript{43} In year one, the taxpayer would have had $19,000 in income less a $10,000 loss, or net income of $9,000, $5,000 in income per year for the next ten years which equals $50,000, and would have a $19,000 capital loss in year eleven.\textsuperscript{44} This model should be reproduced.

There are four basic alternatives for taxing the hypothetical partnership transaction, assuming the present value of the partnership interest in year one is not taxed. First, the partnership could be ignored and the cash distributions could be taxed when received, resulting in taxable income of $10,000 in year five and $30,000 in year eleven, for a total of $40,000 in taxable income ("Alternative I"). Alternative I allows the taxpayer to defer taxation as long as the taxpayer's cash is kept in the partnership. Second, the taxpayer could be treated as though he had an unchangeable zero basis in the partnership. This would result in taxable income of $5,000 a year in years two through four and six through ten, $15,000 in year five and $35,000 in year eleven, for a total of $90,000 in taxable income ("Alternative II"). Third, the taxpayer could be treated as having an initial basis of zero, but otherwise allow adjustments to his basis in accordance with Subchapter K ("Alternative III").\textsuperscript{45} This alternative would result in taxable income of $5,000 a year in years four through eleven for a total of $40,000,\textsuperscript{46} with the resulting $40,000 basis being completely consumed by the distributions.

\textsuperscript{42} This discussion assumes that the "services income" equals the present value of the partnership income/loss rather than the present value of the cash received.
\textsuperscript{43} That is, the discounted value of the $10,000 loss in year one plus the income of $5,000 per year for the following ten years.
\textsuperscript{44} The initial contribution of $19,000 less $10,000 loss, plus $50,000 income less $40,000 in cash distributions equal a net unrecovered basis of $19,000.
\textsuperscript{45} Subchapter K, of the Internal Revenue Code, §§ 701-761, generally governs the taxation of partnership income and losses.
\textsuperscript{46} The income for years two and three would be absorbed by the first year loss. See Treas. Reg. § 1.704-1(d)(1)(as amended in 1988). Section 212(d) of the Internal Revenue Act of 1926, Pub. L. No. 69-20, provided as follows:
Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

This provision has been repeatedly amended and substantially altered in subsequent years.
Finally, an initial basis of $19,000 could be assigned (if such forecasts of income could be made), in which case the taxpayer's liability would be a $10,000 loss in year one, income of $5,000 a year for the next ten years, and a $19,000 capital loss in year eleven, for a total of $40,000 less a $19,000 capital loss ("Alternative IV").

Clearly, only Alternatives I and III approximate the tax effects of the model. However, even these alternatives move away from the model if the partnership income becomes capital gain, assuming that the pre-1986 60% capital gains deduction was still in effect.\(^47\) If the first year loss was ordinary, the model would then result in a total of $29,000 in taxable income, less a $19,000 capital loss.\(^48\) Alternative I would still result in taxable income of $40,000, and Alternative III would decrease taxable income to only $16,000.\(^49\) Thus, the Alternatives call for some modification.

A logical and equitable result can be reached by overlaying a modified version of the section 483 approach. This would, as to Alternative III, treat each year's net income, not considering the section 1202 deduction,\(^50\) as consisting of ordinary income in the amount of the present value as of the beginning of year one of such income, with the remaining income being capital gain or ordinary income according to the income's proximate source. Conceptually, this treats the present value of each year's net income as deferred compensation, and the remainder as income from investing that deferred compensation in the partnership. Under this approach, total taxable income is approximately $29,000, and thus is consistent with the model.\(^51\) Reciprocally, if the partnership interest was received for the sale of a capital asset, the portion of distributive income equivalent to the year one discounted value of such income would be deemed to be capital gain, with the remainder again being characterized according to the proximate source of such income.

Alternative III, as thus modified, seems superior to Alternative I in that Alternative III avoids granting the taxpayer additional tax deferral, while recognizing that part of the income properly results from his partnership

\(^{47}\) Former I.R.C. § 1202 (1982), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2216, provided a deduction in the amount of 60% - the amount of the taxpayer's net capital gain.

\(^{48}\) That is, $19,000 in services income in year one less a $10,000 ordinary loss for a net of $9,000, plus income of $2,000 a year ($5,000 capital gain less the 60% capital gain deduction) in each of the next ten years for a total of $20,000, or $29,000 altogether. The $19,000 capital loss remains unchanged, because partnership basis is increased by the full amount of capital gain, not the net after the section 1202 deduction.

\(^{49}\) Alternative I, which treats the cash distributions as services income, ignores the nature of the partnership income. Alternative III would tax $2,000 per year, $5,000 gain less the 60% capital gain deduction) for each of years four through eleven - a total of $16,000.

\(^{50}\) As noted *infra* at note 47, I.R.C. § 1202 was repealed by the Tax Reform Act of 1986.

\(^{51}\) The following provides an illustration: The present value as of year one of the $5,000 in partnership income would be $4,132, which would be ordinary income. This leaves $686 in capital gain ($5,000-$4,132), to which the section 1202 deduction would apply for a taxable net of some $347, or $4,479 in total taxable income for the year. The actual total for all years is approximately $27,000, or roughly 7% less than the model.
investment rather than from his initial services. This method of allocation is admittedly imperfect in that it uses what amounts to a flat rate of return on the partnership investment in allocating the income, rather than actual results of partnership operations, but it seems to be the best available approximation that can be made without resorting to the unworkable income projections required by the model.

As applied to the passive loss rules, the effect of a modified Alternative III approach would be that the deemed compensation component would be active income. The income deemed to flow from the limited partnership investment, namely the excess of the net income over the year one discounted value of such income, would be passive income. All losses would be passive losses.

While the approach suggested here seems equitable and should be reasonably easy to administer, there is authority, primarily from the period prior to the enactment of I.R.C. section 483, for the proposition that Logan requires 100% of the receipts from an open capital gain type transaction to be treated as capital gain.52 As has been discussed previously, Logan requires no such thing. The question of capital gain versus ordinary income treatment was not in issue in Logan. To permit taxpayers who receive unmarketable assets not only the privilege of deferral, but also a benefit of income conversion that would not have been available had they received cash, is unnecessary and inequitable. These old cases should now be considered obsolete.53

Basis Allocation

Again, it seems that the Court's opinion in Logan was wrong as to the question of allocation of basis, at least given its failure to apply a section 483 type of allocation between ordinary income and capital gain. It is not at all clear that even the Logan Court would decide the case the same way today. As has been discussed previously,54 the Court reasoned by analogy to what was then the treatment for an annuity. Today, I.R.C. section 72 provides that a taxpayer's basis in an annuity is to be allocated by projecting the total amount of the payment stream, taking a ratio of the taxpayer's basis to that projected total, and then multiplying each payment received by that ratio to determine the portion allocable to a return of capital. I.R.C. section 453 now provides an equivalent method for allocating basis among payments received in an installment sale. The regulations under section 45355 provide four methods for allocating basis in the case of a contingent payment sale. Where a maximum selling price is stated in the

52. See, e.g., Westover v. Smith, 173 F.2d 90 (9th Cir. 1949); Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948); Dorsey v. Commissioner, 49 T.C. 606 (1968); Lentz v. Commissioner, 28 T.C. 1157 (1957); Bradford v. Commissioner, 22 T.C. 1057 (1954), rev'd, 233 F.2d 935 (6th Cir. 1956).
54. See supra text accompanying notes 29-30.
sales agreement, or can be determined in the year of sale from the terms of the agreement, basis is to be allocated to the payments received using the ratio of total basis to the total maximum selling price. Where such a price cannot be determined, but the contingent payment obligation is for a fixed term, basis is to be allocated essentially pro rata to the payments received for each year of the agreement. Where there is no maximum selling price and no fixed term, basis is to be recovered in fifteen annual increments beginning with the year of sale. In appropriate circumstances, basis may be allocated using the income forecast method. Against this background, the front-loaded basis allocation allowed by the Logan Court appears out of step.

Front-loaded basis allocation is reasonable, however, where it is unclear whether the total payments received in a transaction (net of any deemed interest component or other portion not attributable to the original open transaction) will exceed the taxpayer’s basis. If the amount received by Mrs. Logan was considered to be the discounted value of the anticipated payment stream, this principle would apply in the Logan case itself. Because Mrs. Logan probably had no unrealized post-March 1, 1913 appreciation in the value of her stock, the fair market value of the consideration received was likely to equal her basis exactly; if she had sold the stock for cash, she would have had no profit. This may be what bothered the Court. Thus, aside from the deemed interest question, it was reasonable to regard the payments Mrs. Logan received as 100% return of capital unless or until events proved that she had a profit.

This front-loaded basis approach may be seen most clearly in the discount income cases. Where a taxpayer buys a note or other fixed obligation at a discount, there is generally no question as to the fair market value of the obligation - it is equal to what the taxpayer paid. A cash basis taxpayer, then, should not realize current income on such a transaction. When payments are subsequently made under the obligation, the treatment of such payments for tax purposes was held to depend upon the speculative nature of the note. Where it was highly questionable whether the payments would ever exceed the purchase price, the taxpayer was permitted to recover his basis before recognizing any income. Otherwise, the taxpayer was required to allocate each payment between a return of principal and discount income. This was a reasonable reflection of the two types of elements which result in a discount. Where the discount primarily reflects the time value of money, arguably it is proper to treat deferred payments as partly principal

56. This aspect of Logan is still viable as a matter of case law. See, e.g., Tribune Publishing Co. v. United States, 836 F.2d 1176, 1180 (9th Cir. 1988) (court limiting Burnet’s application and allowing front-loaded basis recovery “only if there is uncertainty as to whether the taxpayer will realize a profit from the transaction at issue . . .”)

57. The old line of discount income cases was rendered obsolete upon the enactment of I.R.C. § 483 by Pub. L. No. 88-272, 78 Stat. 77 (1964).

58. See, e.g., Commissioner v. Lif tin, 317 F.2d 234 (4th Cir. 1963); Willholt v. Commissioner, 308 F.2d 259 (9th Cir. 1962).

59. See, e.g., Willholt v. Commissioner, 308 F.2d 259, 263-64 (9th Cir. 1962).
and partly interest. Where the discount is based primarily upon a strong likelihood of default, on the other hand, the income is not earned in a practical sense until payments in excess of basis are received.

What the discount income cases failed to consider, however, was that the difference between speculative and nonspeculative obligations is a matter of degree. The discount on speculative obligations is primarily due to risk, but is also partly due to the time value of money. Likewise, the discount on nonspeculative obligations usually contains some element to account for risk of nonpayment. The solution, now incorporated into I.R.C. section 483, is to allocate a portion of the receipts on both speculative and nonspeculative obligations to interest income. If the projected receipts exceed the total amount paid for the obligation, plus the deemed interest component under I.R.C. section 483, the taxpayer will generally report discount income equal to that portion of each payment which the maximum amount receivable under the contract bears to the amount paid therefore plus the section 483 deemed interest component. Thus, the sharp dichotomy between speculative and nonspeculative obligations is reduced.

Insofar as open transactions are concerned, it would be appropriate to adopt a similar approach. First, a section 483 type of analysis could be applied to allocate each payment received between post-transaction income (whether interest income, partnership income, or any other type of income) and receipts attributable to the open transaction. Then the taxpayer would be required to allocate basis according to the pattern provided by I.R.C. section 453. If there was no indication that the contract or other property received in the open transaction had a value in excess of the taxpayer's basis, however, then front-loading of basis recovery might be used in place of the section 453 rules.

What Triggers Open Transaction Treatment

There are five primary factors affecting the decision whether to apply open transaction treatment. These are: 1) the accounting method of the taxpayer; 2) the liquidity of the asset; 3) the difficulty of valuing the asset; 4) whether the item exchanged for the asset has a determinable market value; and 5) the type of asset involved.

Accounting Method

Logan was based primarily on a cash equivalency analysis. Cash equivalency is primarily an issue with respect to cash basis taxpayers, not accrual basis taxpayers. Open transaction treatment may be proper for accrual basis taxpayers insofar as it relates to whether the receipt of the asset in question renders the taxpayers' income from the transaction fixed and determinable,

but the scope of the Doctrine is properly narrower as applied to accrual method taxpayers.\textsuperscript{61}

In particular, an accrual method taxpayer should not be entitled to claim open transaction treatment simply because the asset received, though having an estimable value, is not currently marketable. Liquidity is not a prerequisite to recognition of income by an accrual basis taxpayer.\textsuperscript{62} However, where the value of the obligation or contract received in the transaction is truly dependent upon the occurrence or nonoccurrence of some contingency, it may be appropriate under a standard accrual analysis to defer recognition of income until the contingency occurs. Where recognition is deferred, the previously discussed principles may apply to the treatment of the payments eventually obtained.

\textit{Liquidity of the Asset}

This factor is properly the primary consideration in regard to open transaction treatment. Where an asset may be instantly transformed into cash at a price to which both buyer and seller would be amenable, there is no good reason for deferring recognition of the income.\textsuperscript{63} In such a case, it is purely the recipients' election to retain the asset rather than to transform it into cash, so there is no need to give them more favorable treatment than a taxpayer who receives cash in the first instance.

Moreover, if an asset is marketable then any difficulties in valuing it are not insurmountable. Presumably buyers would not be willing to bid for an asset unless they had some method for determining the assets value, and likewise sellers would be unwilling to part with their assets unless they had some assurance that they would receive an appropriate price. If there is a method for valuing the assets, and if a market does exist for the assets, then any difficulties of valuation are within the range of those difficulties with which reasonable businesspeople contend.\textsuperscript{64}

\textsuperscript{61} See Lentz v. Commissioner, 28 T.C. 1157, 1163 (1957) (distinguishing Jud Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946) and United States v. Lynch, 192 F.2d 718 (9th Cir. 1951), as involving, respectively, completed contracts method and accrual method taxpayers). See also Estate of Weeden v. Commissioner, 685 F.2d 1160, 1161 (9th Cir. 1982) (leading into open transaction discussion by noting "the cash basis taxpayer must report income received in the form of property only if the property is the equivalent of cash . . . ").

\textsuperscript{62} See Treas. Reg. § 1.451-1(a) (1986), which provides, in relevant part, that "[u]nder an accrual method of accounting, income is includable in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

\textsuperscript{63} Cf. Commissioner v. Swenson, 56 F.2d 544, 547 (5th Cir. 1932), cert. denied, 287 U.S. 618 (1932) (court noting that "though a venture is as speculative as a lottery, a chance or interest in it may be readily saleable . . . [and] [t]he law does not forbid the recognition of the proved exchangeable value of an asset" because of its speculative nature).

\textsuperscript{64} Cf. Grinsten v. Commissioner, T.C.M. (P-H) ¶ 64,051, at 434 (1964) (court stating it "may determine tax liability on the basis of assumptions when those assumptions are merely the ordinary ones reasonable men must necessarily make in their everyday business affairs if commerce is not to cease entirely").
While ready marketability may preclude application of the Doctrine, on the other hand, not every form of restriction on liquidity will justify the application of the Doctrine. The exact type of restrictions which may lead to open transaction treatment seem to depend upon the other factors here discussed: the nature of the asset, the circumstances under which the asset was received,65 and the accounting method of the taxpayer. In addition to these influences, however, there are three main factors likely to affect a determination as to whether an asset is marketable. First, an asset is more likely to be found to lack a fair market value if it is especially speculative or if it is subject to a substantial contingency that may result in little or no further income being received; indeed, today such a contingency may be a necessary prerequisite to open transaction treatment. Second, an asset is likely to be found marketable if it is of a sort which is commonly traded, even if the particular asset in question is unusually speculative. Finally, the courts and Congress are likely to be unimpressed by any contractual restriction on marketability that appears as though the restriction might be purposefully designed to trigger open transaction treatment.

An otherwise unmarketable asset may be subject to open transaction treatment if it is "contingent upon facts and circumstances not possible to foretell with anything like fair certainty."66 This is a factual determination. The following assets have, under the facts of the cases involved, been found to meet the quoted standard: (1) various notes, judgments, and accounts receivable remaining unliquidated after nine years of collection efforts;67 (2) second mortgages subject to prior 90% equity interests;68 (3) commissions on mortgage commitments, subject to completion of the mortgage transactions by others;69 (4) a right to certain payments effectively contingent upon certain highly optimistic sales projections for a novel product;70 (5) a right to 25% of the commissions on brokerage sales from a certain client list, dependent upon sales being made;71 (6) a right to commissions on future sales of oil, if any, between a named seller and a named buyer;72 (7) a right to 2% of the gross payments for ore from an unproven mine, valid only so long as a woman unrelated to either party owned the mine;73 and (8) a

65. Intrafamily transactions tend to be accorded open transaction treatment where such treatment would be detrimental to the taxpayer. See, e.g., Estate of Weeden v. Commissioner, 685 F.2d 1160 (9th Cir. 1982) (promise by donee nephews to pay the gift taxes owed by their donor uncle had no ascertainable market value); Baumer v. United States, 685 F.2d 1318 (11th Cir. 1982) (grant of real estate option from father’s corporation to son).
70. Altorfer v. Commissioner, T.C.M. (P-H) ¶ 6,148 (1961) (court’s decision apparently influenced by desire to relieve the taxpayer from an ill-advised stipulation as to value).
71. Cassatt v. Commissioner, 137 F.2d 745 (10th Cir. 1943).
72. Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948).
73. Ayrton Metal Co. v. Commissioner, 299 F.2d 741 (2d Cir. 1962).
right to payments dependent upon a favorable judicial decision on a novel question of state law.74

Logically, the impact of any contingency or risk will be greater as the factual situation moves towards the standard accrual trigger of a fixed and determinable right to income. In other words, where the purchaser or employer is the obligor and the asset in question is essentially only a right to future money payments, it can be argued that under standard accrual accounting any substantial contingency or uncertainty would prevent recognition of the income, and so there would certainly be no recognition on the part of a cash basis taxpayer. In such a situation, open transaction treatment may apply unless there is evidence that the asset in question was somehow more marketable than a mere nonnegotiable promise to pay. If a third party is the obligor or the asset in question consists of stock, patent rights, or a similar capital-participatory type of asset, it becomes more incumbent upon the taxpayer to show that the receipt of such an asset should not result in recognition of income because the asset cannot be sold.75 Indeed, in such cases it appears that courts may presume that the asset is marketable so long as there is some reasonable method available by which willing buyers and sellers could agree upon a fair price for the contingent or speculative asset.76

In the in-between cases, such as the receipt of mortgage interests or accounts receivable, open transaction treatment may apply where there is other evidence that the asset was not liquid. Thus, in Miller v. United States,77 the receipt of second mortgage notes was held not to be currently taxable where the distributing corporation had tried repeatedly to sell the notes without success.78 Likewise, in Union Commerce Bank v. Commissioner,79 an interest in various securities, notes, accounts receivable and judgment claims was held not to be currently taxable where the prior owner had been trying to liquidate the assets for nine years prior to the distribution.80 On the other hand, evidence of marketability may make the receipt of similar assets taxable. For example, in Estate of Goldstein v.

74. In re Steen, 509 F.2d 1398 (9th Cir. 1975).
75. Cf. Commissioner v. Swenson, 56 F.2d 544, 548 (5th Cir. 1932); Holmes v. Commissioner, 55 T.C. 53 (1970) (distinguishing, under the version of section 453 applicable before October 19, 1980, third party obligations received in a sale from obligations of the purchaser received in a sale). The receipt of such obligations or assets is generally viewed as a more definite change in status, and a more definite realization of income than is the mere receipt of the purchaser's promise to pay. Thus, a court will be inclined to ask why shouldn't this income be recognized, rather than why should it be recognized.
76. See, e.g., Campbell v. United States, 661 F.2d 209, 215 (Cl. Cl. 1981); Victorson v. Commissioner, 326 F.2d 264, 267 (2d Cir. 1964) (unregistered stock in a new corporation, subject to certain restrictions on its transfer, held taxable on receipt where there was testimony that the stock could have been sold privately).
77. 235 F.2d 553 (6th Cir. 1956), on remand, 155 F. Supp. 767 (W.D. Ky. 1957), aff'd, 262 F.2d 584 (6th Cir. 1958).
78. Id. at 554-56.
**Commissioner** the receipt of rights to commissions contingent upon the renewal of certain insurance policies was held to be currently taxable where it was shown that certain individuals and banks commonly purchased such rights.82

This discussion also illustrates the point that commonly traded interests are more likely to be found taxable than are unique contract rights lacking an established market. Stock, even if unregistered, and the renewal commission rights in *Estate of Goldstein* are commonly traded by persons who have developed methods for valuing any risks or contingencies associated with the asset. Likewise, in *Warren Jones Co. v. Commissioner*,83 the Ninth Circuit held that the receipt of a contract for deed was a closed transaction where such contracts were commonly bought and sold in the area, even though the contract in question would have been subjected to a large discount.84 The receipt of other, more unique interests, however, has resulted in open transaction treatment.85

Where lack of marketability is due to a contractual agreement rather than to some characteristics of the asset, open transaction treatment will generally not be allowed unless the asset is otherwise contingent or speculative, and it appears that the restriction was the result of bona fide nontax motivations. Thus, the receipt of speculative stock subject to an agreement prohibiting its transfer for some period of time, due to securities law concerns or some other nontax motivation, may result in open transaction treatment.86 However, less than absolute restrictions on transfer may not trigger open transaction treatment.87 The largest category of tax motivated restrictions, the issuance of restricted stock in exchange for services, was eliminated by the passage of I.R.C. section 83, which provides generally that the receipt of such stock or other restricted property will be currently taxable unless it is subject to a substantial risk of forfeiture. Given the Congressional intention expressed by section 83, it seems probable that in the future the courts will likewise construe I.R.C. section 1001(b) to prohibit open transaction treatment where restrictions placed on assets received in nonservices transactions appear to be designed to defer recognition of income rather than to serve any legitimate nontax purpose.

**Difficulty of Valuation**

As has been noted, it seems unlikely that the *Logan* opinion was based upon any difficulty in valuing the contract rights there in issue, because the allocation method used by the Commissioner did not depend upon the actual

81. 33 T.C. 1032, 1038 (1960), aff'd, 340 F.2d 24 (2d Cir. 1965).
82. *Id.* at 1037.
83. 524 F.2d 788, 792 (9th Cir. 1975).
84. *Id.* at 794.
85. See cases cited *supra* notes 68-73.
86. *See* Helvering v. Tex-Penn Oil Co., 300 U.S. 481, 499 (1937); Victorson v. Commissioner, 326 F.2d 264, 266 (2d Cir. 1964).
87. *See* Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964).
value of the payment stream. Nonetheless, over the years many courts have focused on the "ascertainable fair market value" language in Logan as meaning determinable or specifiable, rather than perceptible or discoverable. For example, in Dennis v. Commissioner, the Fifth Circuit stated:

[T]he "open transaction" doctrine is a rule of fairness designed to ascertain with reasonable accuracy the amount of gain or loss realized upon an exchange, and, if appropriate, to defer recognition thereof until the correct amounts can be accurately determined . . . . When the note received in the exchange does not have a readily ascertainable fair market value at the time of its receipt, computation of gain on the exchange is impossible. As a result, the Courts have found it necessary to treat the exchange as an "open transaction" until the note is collected.

Similar statements are common, but the cases have rarely, if ever, turned upon such a standard. To the extent that the courts have considered difficulty of valuation in applying the Doctrine, either they have found that the asset did have a determinable fair market value, or there were substantial contingencies or other indications of lack of marketability in addition to the straight valuation problem.

Accordingly, I.R.C. section 1001(b) appears, on its face, to state that if an asset has a fair market value, that value must be treated as an amount realized, even if it is difficult to determine what may be the value. This interpretation is reinforced by the legislative history of I.R.C. section 453, the installment sales provision. The Senate Finance Committee report on section 453 stated that deferred payment contracts not qualifying for installment sale treatment "are to be regarded as the equivalent of cash if such obligations have a fair market value. Consequently, that portion of the initial payment and of the fair market value of such obligations which represents profits is to be returned as income as of the taxable year of the sale." Likewise, Treasury Regulation section 1.1001-1(a) provides, "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." Congress and the Treasury Department, then, view the issue as whether the property has a fair market value, and not as whether the amount of the fair market value is easy to determine.

However, it is appropriate to consider difficulty of valuation as a factor in determining whether an asset has a fair market value. For example, if a contingent or speculative asset can be valued according to a standard

88. 473 F.2d 274 (5th Cir. 1973).
89. Id. at 285.
90. See, e.g., Lentz v. Commissioner, 28 T.C. 1157 (1957) (commissions on mortgage commitments subject to completion of the mortgage contracts by others).
91. (1986).
industry formula, it is highly unlikely that it has no fair market value. The Court of Claims seems to have applied the valuation issue in this restrictive sense in Campbell v. United States, wherein the court, after observing that "open transaction treatment is not warranted every time securities are restricted, or operations are deemed speculative," stated that the Doctrine "is confined in its application to those situations that present elements of value so speculative in character as to prohibit any reasonably based projection of worth." Absent such a situation, it appears that even speculative assets are to be presumed to have a fair market value, and the courts are to assume responsibility for determining what that value may be.

On the other hand, the valuation issue may be used in an expansive sense. Assets of a type that normally would be marketable may be found to have no fair market value if a court determines that there is no rational basis upon which a buyer or seller could determine a fair market price. For example, in Union Commerce Bank v. Commissioner, the asset in question was an interest in a trust that held various securities, accounts receivable, notes and judgment claims. While normally such assets may be bought and sold in commerce, the particular assets in question had already proven resistant to liquidation, and it was highly uncertain how much revenue the assets might produce, when it could be collected, and how much it would cost to extract it. Under the circumstances, the court found that it was "impossible to believe that any willing buyer would have been prepared to offer in cash at that time a sum sufficiently high to induce a seller to part with his prospects of realizing a substantial collection, at least in the absence of any pressing need for cash which, of course, would be inconsistent with the recognized definition of fair market value." Such an approach, however, should be used with caution. Today, virtually everything can be valued and sold, and there is generally no reason to think that it is worth more to the possessor to keep an asset than it is worth to a buyer to acquire the asset. Absent other indications that the asset in question was not saleable, it should not be presumed that the asset lacked a fair market value.

**Whether the Asset Exchanged Had a Determinable Market Value**

The bulk of the cases where open transaction treatment has been permitted involve corporate liquidations in which assets of the corporation are distributed to the stockholders. Most of the remainder of cases involve the

93. See, e.g., Slater v. Commissioner, 356 F.2d 668 (10th Cir. 1966); Grill v. United States, 303 F.2d 922 (Ct. Cl. 1962).
95. Id. at 215.
97. Id. See also Altorfer v. Commissioner, T.C.M. (P-H) ¶ 6,148 (1961).
98. Likins-Foster Honolulu Corp. v. Commissioner, 840 F.2d 642 (9th Cir. 1988); Miller v. United States, 235 F.2d 553 (6th Cir. 1956), on remand, 155 F. Supp. 767 (W.D. Ky. 1957), aff'd, 262 F.2d 584 (6th Cir. 1958); Westover v. Smith, 173 F.2d 90 (9th Cir. 1949); Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948); Dorsey v. Commissioner, 49 T.C. 606 (1968); Lentz v. Commissioner, 28 T.C. 1157 (1957); Bradford v. Commissioner, 22 T.C. 1057
exchange of one contingent or speculative asset for another asset.\footnote{99} It appears that the reason for this uniformity is that where the asset exchanged has a readily determinable fair market value, the valuation issue will be applied in the restrictive sense to prevent open transaction treatment. Thus, in \textit{Davis v. United States},\footnote{100} open transaction treatment was denied where the taxpayer received a release of his ex-wife’s inchoate marital rights in exchange for appreciated stock. The Supreme Court found that the inchoate marital rights had an ascertainable fair market value equal to the market value of the stock exchanged.\footnote{101} Since dower rights are not a normal item of trade and might be assumed to be essentially unmarketable, the Court’s decision appears to have been based upon the restrictive application of the valuation issue.

In cases such as \textit{Logan}, this approach is ineffective because the item exchanged (stock) has a value determined primarily by the value of the asset received (the distributed asset). Similarly, the exchange of a customer list for a percentage of the commissions therefrom, or the release of a debt in exchange for the only asset of the insolvent debtor, involves a change more in the form than in the substance of the asset held, and does not provide a basis for valuation of the asset received.\footnote{102}

\textit{The Type of Asset Involved}

\textit{Logan} involved a contingent promise of future money payments, the type of asset which traditionally is least likely to be treated as equivalent to cash or to be regarded as property.\footnote{103} While it might once have been possible to restrict the scope of the Doctrine to such assets, subsequent cases have expanded the scope to include assets ranging from mortgage notes\footnote{104} to stock.\footnote{105}

This is not to say that every type of asset can qualify for open transaction treatment, however. The Doctrine does not appear to apply to tangible property. Indeed, in one case\footnote{106} the Board of Tax Appeals drew a fine line


99. Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943) (sale of a customer list in exchange for right to 25\% of the commissions earned from customers on the list); Union Commerce Bank v. Commissioner, T.C.M. (P-H) ¶ 61,260 (1961) (release of debt claim upon insolvent debtor in exchange for debtor’s interest in a trust).

100. 370 U.S. 65 (1962).
101. \textit{Id.} at 72-74.
102. See cases cited \textit{supra} note 98.
105. \textit{E.g.}, Helvering v. Tex-Penn Oil Co., 300 U.S. 481, 499 (1937); MacSim Bar Paper Co., T.C.M. (P-H) ¶ 41,402 (1941).
106. Kimbell v. Commissioner, 41 B.T.A. 940 (1940). This appears to be the only case on}
between payment rights contingent upon production from an oil lease, which were granted open transaction treatment, and an actual oil lease interest, which was not granted open transaction treatment. As to the latter, the Board simply stated that "'[t]here was nothing contingent about this working interest . . . .'"107

There is obvious sense in this distinction. To begin with, most varieties of tangible property have some element of consumption value. A taxpayer receiving real estate, a portrait, or a letter signed by Thomas Jefferson might be happy just to keep the asset, never receive monetary income from it and never pay tax. Further, even where a tangible asset is used to produce income, there is a sense in which the receipt of such property is still more of a definite realization event than is the receipt of intangible property. A tangible object is real. It performs functions. A typical intangible, on the other hand, is basically just a right to receive cash. It does nothing, and has no intrinsic value, until the cash is received.108 Thus, intuitively, the receipt of tangible property may be viewed as realization per se.

In any event, it is unlikely that tangible property would ever be found to lack an ascertainable fair market value. Everything from post-modernist art to the sludge from municipal waste treatment plants to dead cats can be bought and sold in the American market. Even if a tangible asset was subject to absolute restrictions on transfer, it seems likely that the valuation issue could be applied in the restrictive sense to prevent open transaction treatment. In such a case, taxpayers would be restricted to arguing that because of the transfer restriction and the lack of any possessory value in the assets, they had not yet received the property within the meaning of the tax laws.

What Precludes Open Transaction Treatment

Logan involved one of the situations in which open transaction treatment will not be permitted, namely death. In cases involving estate tax valuation or the determination of March 1, 1913 values, there is a special need to "close the books," and make a final determination of value.109 Presumably, it would also be necessary to close a transaction insofar as the income tax liability of the estate is concerned, unless the estate is to be kept open indefinitely after the distribution of the assets to the heirs, filing returns of open transaction income every year.

the subject. Perhaps taxpayers have also felt that receipt of tangible property is realization per se, or they may simply not have been aggressive enough to claim that such property can lack a fair market value.

107. Id. at 952.

108. Granted, however, that often intangibles such as stock or patent rights may provide significant value through the control inherent in them, aside from the issuance of dividends or payment of royalties. Perhaps this accounts for the reluctance of the courts to grant open transaction treatment upon the receipt of such assets.

Likewise, with the repeal of the General Utilities\textsuperscript{110} doctrine under the I.R.C., it would be appropriate to deny open transaction treatment to a liquidating corporation. Allowing open transaction treatment would require that corporate returns continue to be filed for years after the corporation dissolves, and potentially for years after there ceases to be any officer authorized to file returns or otherwise act for the corporation, based upon information within the sole control of the former stockholder.

However, this may produce a rather incongruous result. If a corporation liquidates and distributes its sole asset to its stockholder, the stockholders may then be currently liable for the corporate tax on the estimated value of the assets as transferees, while taxation of their gain on liquidation is deferred as an open transaction. In such a case there would be two possible ways of treating the stockholders' liability. First, it might be assumed they received assets with a value estimated for corporate tax purposes, so that it would be proper to require them to pay the full corporate tax liability upon receipt. Alternatively, their transferee liability could be treated as an open transaction, so that they would pay both individual and corporate income tax as cash payments were received. This latter option, however, while perhaps more consistent, raises various problems involving basis and the statute of limitations that the Internal Revenue Service or a court would be inclined to avoid. The most likely result is that an estimated value would be applied to the asset for purposes of both corporate income tax liability and transferee liability.

\textit{Conclusion}

Currently, the Doctrine suffers from age, confusion and the lack of a clear theoretical structure. The Doctrine should be updated to reflect the changes in taxation of annuities and the enactment of I.R.C. sections 83, 453 and 483. The difficulty of valuation issue needs to be cut back to its appropriate role, namely as one factor to consider in deciding whether an asset has a fair market value. Finally, the Doctrine needs to be more firmly equated with the general doctrine of cash equivalency. Rightly viewed, \textit{Logan} is merely a case involving the consequences of a determination that the receipt of certain assets is not equivalent to the receipt of cash; it should not be regarded as the source of a separate ground for avoiding current taxation, or as a rationale for taxing transactions differently than logic and fairness would otherwise require.
