ARTICLES

The Sale of Donors' Eggs: A Case Study of Why Congress Must Modify the Capital Asset Definition

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INTRODUCTION

Female infertility plagues a large segment of the reproductive population.[1] In response to this problem, doctors have developed several techniques to fertilize and implant eggs into women that cannot produce their own.[2] These techniques have heightened the demand for donors' eggs. Infertility clinics now offer donors lucrative financial incentives to sell their eggs.[3]

During the egg retrieval process, donors must dedicate several hours of their time and endure some physical discomfort.[4] For political reasons, infertility clinics assert that they compensate donors' for their services, rather than their eggs.[5] Consistent with

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[1] *See* Howard W. Jones, Jr., M.D. & James P. Toner, M.D., Ph.D., *The Infertile Couple*, 329 NEW ENG. J. MED. 1710, 1710 (1993) (estimating that approximately 25% of women have episode of infertility at some point during their reproductive life); Kathryn Venturatos Lorio, *Alternative Means of Reproduction: Virgin Territory for Legislation*, 44 LA. L. REV. 1641, 1641 (1984) (estimating that approximately 17% of all couples of reproductive age are infertile); Maghelee M. Sebel, M.D., *A New Era in Reproductive Technology*, 318 NEW ENG. J. MED. 828, 828 (1988) (estimating that there are 2.8 million infertile couples in United States); Judith Lynn Bick Rice, Note, *The Need for Statutes Regulating Artificial Insemination by Donors*, 46 OHIO ST. L.J. 1055, 1056-57 (1985) (estimating that 10% to 20% of all couples of reproductive age are incapable of traditional procreation).

[2] *See, e.g.*, Anne Reichman Schiff, *Solomonic Decisions in Egg Donation: Unscrambling the Conundrum of Legal Maternity*, 80 IOWA L. REV. 265, 269-70 (1995); Zev Rosenwaks, M.D., *Donor Eggs: Their Application in Modern Reproductive Technologies*, 47 FERTILITY & STERILITY 895, 895 (1987).

[3] *See* Gina Kolata, *Price Soars for Eggs, Setting Off a Debate on a Clinic's Ethics*, N.Y. TIMES, Feb. 25, 1998, at A1. The intense demand for donors' eggs has caused infertility clinics and donees to consider recovery of eggs from unusual sources. *See* Gina Kolata, *$50,000 Offered to Tall, Smart Egg Donor*, N.Y. TIMES, Mar. 3, 1999, at A10 (discussing advertisement offering $50,000 to egg donor when offers usually range from $5000 to $7000); Eugene Robinson, *Furor over Fertility Options: Should Eggs from Fetuses or Cadavers Be Used to Help Women Become Pregnant?*, WASH. POST, Jan. 11, 1994, at Z6. It is difficult to know how far people may eventually go to get donor eggs; sometimes organs are even stolen from "donors." *See India Holds 10 in Plot to Steal Kidneys*, N.Y. TIMES, May 12, 1998, at A8 (describing arrest of individuals suspected of robbing peoples' kidneys and reselling them for cash).

[4] To produce eggs, donors must inject themselves with hormones for about two weeks. *See* NATIONAL ADVISORY BOARD ON ETHICS IN REPRODUCTION, NEW WAYS OF MAKING BABIES: THE CASE OF EGG DONATION 272, 273 (Cynthia B. Cohen ed., 1996) [hereinafter NEW WAYS OF MAKING BABIES]; OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, INFERTILITY: MEDICAL AND SOCIAL CHOICES 123 (1988). The hormones cause donors' ovaries to swell and simultaneously form a cluster of eggs to ripen. *See id.* 123. When ripe, donors' eggs are "harvested" by doctors who use a thin needle, inserted into the donor's vagina, to suction out the eggs. *See id.* During the entire process, doctors monitor donors and their ovaries using blood tests and ultrasound examinations. *See id.*

[5] Physicians at infertility clinics are fearful that the public might associate the sale of eggs with the sale of babies. *See* RUTH MACKLIN, Ph.D., *What Is Wrong with Commodification?*, *in* NEW WAYS OF MAKING BABIES, *supra* note 4, at 106-21. Another objection to the "sale" of eggs is that it commodifies women's bodies. *See id.*; John A. Robertson, *Technology and Moth-*

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their political position, infertility clinics issue tax information returns to donors indicating that the donors' role is service oriented.[6]

A more compelling argument can be made, however, that infertility clinics compensate donors not for their services, but for their eggs.[7] Because eggs constitute property, donors thus experience a gain when they sell their eggs.[8] This gain qualifies for preferential tax treatment because donors' eggs fall squarely within the broad scope of the "capital asset" definition provided under the Internal Revenue Code ("Code").[9] Based upon its policy objectives, however, Congress would likely not sanction this outcome.[10]

Like donors' eggs, many other assets that do not warrant capital asset status are nevertheless so classified.[11] Using donors' eggs as a case study, this Article evaluates the capital asset definition under the Code and concludes that Congress should modify the definition to align it more closely with the policy objectives of capital gain taxation and to limit the kinds of assets that are accorded capital asset status.

In the discussion that follows, Part I demonstrates that egg donors sell property, not services. Because donors' eggs are property and the Code defines the term "capital asset" broadly, Part II finds that donors' eggs fall squarely within the scope of the capital asset definition. This classification permits gains on the sale of donors' eggs to qualify for preferential tax treatment. Part III outlines the general policy objectives associated with preferential tax treatment for capital gains and evaluates the merits of

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erhood: Legal and Ethical Issues in Human Egg Donation, 39 CASE W. RES. L. REV. 1, 30 (1988-1989).

[6] Donors receive Form 1099-MISC (Miscellaneous Income). *See* I.R.C. § 6050 (1994).

[7] *See infra* Part I.

[8] Whether a donor has a tax basis in her body is debatable. *See generally* Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 F.L. TAX REV. 327, 343-44 (1995) (finding it unlikely that taxpayers have tax basis in their body parts). Even if a donor could determine a tax basis in her body, she would likely have no way to allocate such tax basis to her eggs. *See id.* The donor's basis in her eggs would, therefore, be deemed to be zero. *See* Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944) (stating that recovery for destruction of business and goodwill is fully taxable due to taxpayer's failure to establish tax basis in these assets). Any money she received upon the sale of her eggs would thus constitute a gain equal to the amount realized. *See* I.R.C. § 1001 (1994).

[9] *See infra* Part II.

[10] *See infra* Part III.

[11] *See infra* Part III.

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classifying donors' eggs, as well as other kinds of property, as capital assets. Part IV recommends changes to the capital asset definition to align it more closely with the policy grounds that justify preferential capital gains taxation. The Article concludes with observations about the effects of Congress's failure to modify the capital asset definition.

I. THE SALE OF DONORS' EGGS CONSTITUTES THE SALE OF PROPERTY, NOT SERVICES

The process of egg retrieval is complex. The harvesting process involves constant physician monitoring, drug-induced stimulation of donors' ovaries, and the use of needles to retrieve microscopic eggs.[12] To encourage donor participation in this process, infertility clinics entice donors with rich financial rewards.[13] Although there is some support for the position that donors are compensated for their services,[14] more compelling authority exists for the proposition that infertility clinics compensate donors for their eggs.

There are three sources of authority for the proposition that eggs are property. They are the charitable context, the tax accounting method context, and the installment sales context. In each context, courts have addressed whether a transfer between interested parties constituted an exchange of property or services.

A. *Charitable Giving and the Concept of "Coalescence"*

Subject to limitations, Code section 170 allows a deduction from gross income for any "charitable contribution" made within the taxable year.[15] A charitable contribution is defined as a contribution or gift of property to or for the use of specific classes of organizations.[16] The regulations promulgated under Code section 170 add that "[n]o deduction is allowable for a contribution of services."[17]

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[12] *See supra* note 4 and accompanying text (discussing egg retrieval process).

[13] *See supra* note 3 and accompanying text (noting financial incentive for egg donors).

[14] *See, e.g.*, Rev. Rul. 162, 1953-2 C.B. 127 (stating that donation of blood constitutes performance of service rather than contribution of property; therefore, no charitable deduction is allowed).

[15] *See* I.R.C. § 170(a) (1994).

[16] *See id.*

[17] See Treas. Reg. § 1.170A-2(a)(2) (1972).

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On the basis of this distinction between property and services, the Internal Revenue Service ("Service") has contested many taxpayers' charitable deductions.[18] In *Holmes v. Commissioner*,[19] for example, the taxpayer was an independent film producer. Among other projects, he spent substantial time and personal initiative producing two documentaries.[20] Upon their completion, the taxpayer contributed one documentary to one qualified charity and the other documentary to another qualified charity.[21] On his personal income tax return, the taxpayer claimed a charitable deduction under Code section 170 for the fair market value of these two documentaries.[22] The Service, however, disallowed the taxpayer's deduction, claiming that the taxpayer had contributed his services, rather than property, to the two qualified charities.[23]

In making the distinction between property and services, the Tax Court turned to *Webster's Dictionary* for assistance. The court noted that the dictionary defined the term "property" as "something that is or may be owned or possessed," "the exclusive right to possess, enjoy, and dispose of a thing," and "something to which a person has legal title."[24] In contrast, the dictionary defined the term "services" as "acts done for the benefit or at the command of another," "actions that further some end or purpose," conduct "that assists or benefits someone or something," and "deeds useful or instrumental to some object."[25] In examining the differences between the two definitions, the court concluded that "property is something which may be physically owned or possessed, while services, because of their inherently ephemeral nature, are incapable of being so held."[26]

These dictionary definitions aligned with the court's own observations on the issue. The court acknowledged that the taxpayer's services were central to the production of the donated

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[18] In the Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a), 83 Stat. 487, 549 (1969), Congress limited the deductibility of certain kinds of appreciated property, including so-called "ordinary income" property. In the case of charitable contributions of such property, the Code now allows a charitable deduction equal to the property's adjusted basis, rather than its fair market value. *See* I.R.C. § 170(e).

[19] 57 T.C. 430, 430 (1971).

[20] *See id.* at 431.

[21] *See id.* at 432.

[22] *See id.* at 433-34.

[23] *See id.* at 435.

[24] *Id.* at 436.

[25] *See id.*

[26] *See id.*

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documentaries.[27] These services, however, had, in the words of the court, "coalesced" with the unprocessed film to "form something different from both the taxpayer's services and the unprocessed film."[28] This coalescence process resulted in the production of a tangible commodity. This commodity could be physically owned and possessed. These observations, combined with the dictionary definitions of "property" and "services," led the court to rule in favor of the taxpayer.

In analyzing similar cases, other courts have followed the lead set by the Tax Court in *Holmes*.[29] While courts acknowledge the conceptual difficulties of making property/service distinctions, they recognize that taxpayers' efforts may produce a product which supersedes the taxpayers' services. In these situations, taxpayers have prevailed in their court battles with the Service. In other words, when taxpayers' labors have borne fruit, the contribution of this fruit to qualified charities has yielded allowable deductions.

B. Combined Sales of Merchandise and Services

Taxpayers that provide services may use the cash method of reporting while those taxpayers that sell merchandise must use the accrual method of reporting.[30] There are instances, however, when taxpayers sell both merchandise and services, sometimes charging a single price for the combined offering.[31] In limited situations, when the merchandise component of the transaction is incidental and the service component substantial, the entire transaction is cast as a sale of services and the taxpayer may report income using

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[27] *See id.*

[28] *Id.*

[29] *See* Cupler v. Commissioner, 64 T.C. 946, 954 (1975) (finding heart-lung machine designed by taxpayer held to be property rather than services); Jarre v. Commissioner, 64 T.C. 183, 183 (1975) (holding that music manuscripts are property rather than services); Goss v. Commissioner, 59 T.C. 594, 596 (1973) (finding completed essays formed something different from taxpayer's services and blank paper on which they were printed); Orchard v. Commissioner, 34 T.C.M. (CCH) 205, 207 (1975) (holding that magnetic tape copies of opera recordings were property rather than services). *But see* Grant v. Commissioner, 84 T.C. 809, 816-17 (1985), *aff'd per curium*, 800 F.2d 260 (4th Cir. 1986) (finding that legal services did not "coalesce" into property, even though legal briefs and memorandum resulted from rendering of services).

[30] *See* I.R.C. § 446(c) (1994); Treas. Reg. § 1.446-1(c)(2)(i) (1972) (stating that "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used").

[31] *See* STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING 6.05[1][d] (2d ed. 1993).

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the cash method (e.g., a dentist who uses acrylic to fill cavities).[32] But when the merchandise component of the transaction is more significant, the entire transaction is cast as a sale of merchandise and the taxpayer must report income using the accrual method (e.g., a lapidary that sells gems which have been cut and polished).[33]

There is, however, no statutory or regulatory bright-line test to determine when taxpayers have sold sufficient merchandise (relative to the value of their services) to trigger accrual method reporting. Instead, courts have examined the facts and circumstances of each case. In *Wilkinson-Beane, Inc. v. Commissioner*,[34] a leading case in this area, a taxpayer operated a funeral home business. As part of the normal funeral "package," clients received complete burial services along with a casket for one price.[35] The taxpayer reported income using the cash method on the theory that it was a service provider.[36] The Service disagreed; it contended that because the funeral packages involved the sale of caskets, the taxpayer, as a purveyor of merchandise, should report income on the accrual method.[37]

The First Circuit agreed with the Service's position. It found that the sale of caskets was a dominant feature of the taxpayer's business, and the price of the caskets relative to the price of the entire funeral package was not insignificant.[38] As a result, the taxpayer was required to report income on the accrual method.[39]

In subsequent decisions, other courts have followed the *Wilkinson-Beane* lead. These cases have focused almost exclusively on whether merchandise was held for sale and transferred to the customer.[40] Courts have generally ignored whether the

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[32] Taxpayers, such as lawn maintenance operators, provide items (e.g., fertilizer) to their customers that are of relatively little value compared to the services they render (e.g., cutting grass). *See* Tech. Adv. Mem. 98-08-003 (Feb. 20, 1998). *See generally* GERTZMAN, *supra* note 31, § 6.05[1][d] (noting that in these instances, the entire charge is "traditionally treated as a charge for services").

[33] *See* Treas. Reg. § 1.471-1 (1972). In general, if the production, purchase, or sale of merchandise is an income-producing factor in a taxpayer's business, the taxpayer is required to maintain inventories and generally must use an accrual method of accounting. *See id.*

[34] 420 F.2d 352 (1st Cir. 1970).

[35] *See id.* at 353-54.

[36] *See id.* at 354.

[37] *See id.* at 353.

[38] *See id.* at 355

[39] *See id.*

[40] *See, e.g.*, Thompson Elec., Inc. v. Commissioner, 69 T.C.M. (CCH) 3045, 3049 (1995) (finding electrical contractor's wire, conduit, and electrical panels constitute merchandise);

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merchandise was displayed to customers or the public, separately invoiced, sold separately from the services, or selected by customers.[41] Courts have instead analyzed the value of the merchandise relative to that of the service.[42] Only when the former is inconsequential compared to that of the latter may taxpayers report income on the cash method.[43]

These decisions regarding tax accounting methods signify the courts' reluctance to ignore the property element of a transfer. This reluctance is particularly strong when one of the central reasons the parties engage in the transaction turns on the production, transfer, and receipt of a specific piece of property (e.g., a funeral package that includes a casket).

C. *Installment Method and the Disposition of Property*

Subject to limitations,[44] Code section 453 and the regulations promulgated thereunder provide that a taxpayer that sells or otherwise disposes of property in an installment sale must report income under the installment method.[45] A taxpayer that renders services does not qualify for installment method reporting, even if the taxpayer is paid for his services in installments.[46]

In many situations, however, it is unclear whether taxpayers are in the business of selling property or services. A question,

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J.P. Sheahan Assocs., Inc. v. Commissioner, 63 T.C.M. (CCH) 2842, 2844-45 (1992) (holding that contractor's roofing materials are merchandise); Surtronics, Inc. v. Commissioner, 50 T.C.M. (CCH) 99, 103 (1985) (determining that electroplating metals are merchandise).

[41] *See Thompson Elec.*, 69 T.C.M. (CCH) at 3048-49 (holding that taxpayer who used materials such as wiring, conduits, electrical panels, etc., in electrical contracting business had merchandise that was income producing even though taxpayer did not display material to customers or to public, material was not itemized on bids or invoices or separately charged to customer, taxpayer did not sell material separately from its services, and taxpayer's customers generally did not select materials to be used).

[42] *See* Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 790-91 (11th Cir. 1984); *Wilkinson-Beane*, 420 F.2d at 357-58; McGrath & Sons, Inc. v. United States, 549 F. Supp. 491, 493 (S.D.N.Y. 1982); *Thompson Elec.*, 69 T.C.M. (CCH) at 3048-49.

[43] *See supra* note 32 and accompanying text (discussing appropriate time to use cash method).

[44] *See* I.R.C. § 453(b)(2)(B) (1994) (stating that dispositions of inventory are not permitted to be reported on installment method).

[45] *See id.* § 453(a).

[46] *See* Town & Country Food Co. v. Commissioner, 51 T.C. 1049, 1055 (1969) (finding that installment method could not be used for reporting purposes because "[t]he sale of a life membership [entitling the purchaser to warranty protection and discounts on subsequent purchases] did not itself effect the sale by petitioner of any property whatsoever"), *acq. in result*, 1969-2 C.B. xxv; Tech. Adv. Mem. 80-19-009 (Jan. 24, 1980) (stating that breeding services did not qualify for installment method reporting).

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therefore, often arises whether taxpayers are required (or, under prior law,[47] were permitted) under Code section 453 to report income on the installment method. A case that illustrates the intricacies of the property/service distinction is *W.W. Pope v. Commissioner*.[48] In *Pope*, a taxpayer was in the home construction business.[49] A prospective purchaser would select a model home and choose upgrades. The taxpayer would then build the selected home on the purchaser's lot.[50] The taxpayer reported income receipt on the installment method.[51] The Service contended, however, that the installment method was not available to the taxpayer because payment was for the taxpayer's services rather than for property.[52] The issue before the court was whether the taxpayer sold homes (and could, therefore, use the installment method of reporting income) or whether the taxpayer was compensated instead for his services in building the home (and was thereby precluded from using the installment method of reporting income).

While acknowledging the conceptual difficulties of resolving this issue, the Tax Court held in the taxpayer's favor.[53] In reaching its conclusion, the court pointed out that the "amalgamation of petitioner's services, his architectural plans, his lumber and various other building materials and the preformation of subcontractors clearly produce dwelling houses which indisputably constitute a traditional form of property."[54] The court analogized the taxpayer's situation to that of a furniture manufacturer that produces standardized products that are subject to small modifications based upon purchasers' demands.[55] Such a furniture manufacturer is clearly in the business of selling property rather than services.[56] By extension, as long as the homes in question were not customized — subject to "the whims and fancies of

[47] Until 1980, taxpayers had to elect to have installment method accounting apply. *See* I.R.C. § 453(a), *repealed by* Installment Sales Revision Act of 1980, Pub. L. 96-471, 94 Stat. 224 (1980). Income from an installment sale must be reported under the installment method, unless a taxpayer elects otherwise. *See* I.R.C. § 453(a),(d).

[48] 24 T.C.M. (CCH) 1096 (1965).

[49] *See id.* at 1097.

[50] *See id.*

[51] *See id.*

[52] *See id.*

[53] *See id.* at 1098.

[54] *See id.*

[55] *See id.*

[56] *See id.*

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potential householders"[57] — the court held that the taxpayer was entitled to use the installment method for income tax reporting purposes.[58]

The installment method line of cases illustrates that courts understand that, except for raw land, virtually all property is the by-product or culmination of taxpayers' services. The right to report on the installment method, therefore, should not turn on whether some kinds of property (e.g., shell homes) necessitate the use of more services than the production of other kinds of property (e.g., machine-made chairs). The focus should be on whether the service element predominates over the property element of a transfer (e.g., customized homes).

D. *Summary of Property/Service Debate*

The courts' position in the property/service debate reflected in the charitable contribution, tax accounting method, and installment sale areas of the law provides persuasive evidence that donors' eggs are property.[59] Extrapolating from what courts have said, donors' eggs clearly constitute property. In the words of *Holmes* (where the taxpayer donated self-produced documentaries to charity), the donors' time and effort have coalesced into a product; namely, mature eggs that can be possessed and owned. In the words of *Wilkinson-Beane* (where the taxpayer provided customers with a funeral "package" that included a casket), the infertility clinic and donor would not have contracted with each other but for the transfer of the donors' eggs, indicating the significance of the donors' eggs relative to that of the donors' services. Finally, in the words of *W.W. Pope* (where the taxpayer sold shell homes), donors' harvested eggs, like other assets, result

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[57] *See id.*

[58] *See id. Compare* Rev. Rul. 73-437, 1973-2 C.B. 156 (noting that taxpayer engaged in selling standardized homes constructed by him on customers' lots from precut material that he furnishes, commonly referred to as "shell homes," is dealer in personal property under Code section 453(a) and may (under prior law) adopt installment method accounting), *with* Rev. Rul. 73-438, 1973-2 C.B. 156 (stating that builder of custom-built houses is not allowed to report receipt of income on installment method).

[59] Other areas of federal jurisprudence lend additional support to the proposition that donors' eggs are property. *See, e.g.*, Stafford v. United States, 611 F.2d 990, 995 n.6 (5th Cir. 1980) (holding that transfer to partnership of letter of intent with insurance company for financing of hotel constituted contribution of property, rather than services); *see also* United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964) (holding that contribution of self-created geological maps to partnership was contribution of property rather than services).

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from the amalgamation of property (the donors' eggs) and services (the donors' time and effort in the harvesting process). This observation, coupled with the fact that there is no customization of the product on the part of donors, qualifies donors' eggs as property.

In addition to federal tax cases which support the proposition that donors' eggs are property, state courts have long recognized that people have property rights in their body parts.[60] Consider, for example, the situation of a California man who committed suicide and willed his sperm stored in a sperm bank to his second wife.[61] The children of his first marriage wanted the sperm destroyed.[62] The California Court of Appeals, however, found that the decedent had a property interest in his sperm because his sperm fell within the broad scope of the California Probate Code's definition of property.[63] Therefore, the court ruled that the decedent could dispose of his sperm as he liked.[64]

If sperm and other body parts are considered property under state law, there is little reason why donors' eggs should not be accorded the same status under the Code. Several commentators share this perspective.[65]

Those that remain steadfast in their belief that egg donors sell services rather than property may point out that infertility clinics generally compensate donors whether or not the harvesting

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[60] *See, e.g.*, Hecht v. Superior Court, 16 Cal. App. 4th 838, 20 Cal. Rptr. 2d 275 (Ct. App. 1993); ALAN HYDE, BODIES OF LAW (1997); RUSSELL SCOTT, THE BODY AS PROPERTY (1981); William Boulier, Note, *Sperm, Spleens, and Other Valuables: The Need to Recognize Property Rights in Human Body Parts*, 23 HOFSTRA L. REV. 693 (1995).

[61] *See Hecht*, 16 Cal. App. 4th at 840-41, 20 Cal. Rptr. 2d at 276-77.

[62] *See id.* at 843, 20 Cal. Rptr. 2d at 278.

[63] *See id.* at 850, 20 Cal. Rptr. 2d at 283.

[64] *See id.*; *see also* Roy Hardiman, *Toward the Right of Commerciality: Recognizing Property Rights in the Commercial Value of Human Tissue*, 34 UCLA L. REV. 207, 219 (1986) (stating that "[i]n the biomedical marketplace, human tissue is commonly traded and sold and often is the subject of commercially valuable contracts. Such transferability for consideration indicates that human tissue is property."); Bonnie Steinbock, *Sperm as Property*, 6 STAN. L. & POL'Y REV. 57, 66 (1995) (noting that in "the absence of a compelling argument against posthumous reproduction, individual autonomy should prevail, and sperm is correctly regarded as property that can be bequeathed by will").

[65] *Compare* Ruth Colker, *Pregnant Men Revisited or Sperm Is Cheap, Eggs Are Not*, 47 HASTINGS L.J. 1063, 1065 (1996) (noting that courts should grant women custody of embryos after divorce), *with* Philippe Ducor, *The Legal Status of Human Materials*, 44 DRAKE L. REV. 195, 247-48 (1996) (stating that transfer of blood is usually artificially treated as sale of services rather than sale of commodity to avoid strict product liability rules applicable to sales of goods), *and* Robert Jansen, *Sperm and Ova as Property*, 11 J. MEDICAL ETHICS 123, 125 (1985) (classifying sperm and ova donation as service).

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process is successful.[66] This, they say, proves that donors receive compensation for their time and effort rather than for their eggs.

This line of reasoning, however, is not persuasive. A significant portion of article 2 of the Uniform Commercial Code discusses express and implicit warranties of goods.[67] Sometimes a transaction includes such warranties by the seller; other times, it does not.[68] Simply put, when donors sell their eggs, they make no express or implicit warranties regarding the quality of their eggs.

Green v. Commissioner[69] lends a final judicial voice of authority to the proposition that donors' eggs are property. In *Green*, the Tax Court held that the sale of blood constituted the sale of property rather than the rendering of services.[70] In the words of the court:

> The rarity of petitioner's blood made the processing and packaging of her blood plasma a profitable undertaking, just as it is profitable for other entrepreneurs to purchase hen's eggs, bee's honey, cow's milk, or sheep's wool for processing and distribution. Although we recognize the traditional sanctity of the human body, we can find no reason to legally distinguish the sale of these raw products of nature from the sale of petitioner's blood plasma.[71]

The process of harvesting donors' eggs is undeniably more complex than the process of obtaining blood. Yet, the difference is not of sufficient magnitude to recharacterize the underlying nature

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[66] *See* DAVID H. BARAD & BRIAN L. COHEN, *Oocyte Donation Program at Montefiore Medical Center, Albert Einstein College of Medicine Bronx, New York, in* NEW WAYS OF MAKING BABIES, *supra* note 4, at 20 (discussing financial compensation to donors).

[67] *See, e.g.*, U.C.C. § 2-313 (1988) (covering express warranties); *id.* § 2-314 (1988) (covering implied warranty of merchantability).

[68] *See id.* § 2-316(1) (1988) (covering words and conduct regarding creating warranties); *id.* § 2-316(2) (covering modifications). *See generally* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, 387-428 (3d ed. 1988) (discussing treatment of warranties in UCC). A recent interview of an Austrian egg donor supports this point. When asked, "[h]ow much did you get paid per operation and how does the financial transaction take place?", the woman replied, "After the procedure I get os 10,000 (U.S. $800) no matter how many eggs they take out. . . . The doctors pay for the product 'egg.'" RUTH MACKLIN, *What Is Wrong with Commodification?, in* NEW WAYS OF MAKING BABIES, *supra* note 4, at 108.

[69] 74 T.C. 1229 (1980).

[70] *See id.* at 1233-34. Whether a transfer of blood is that of property or of services is an issue that other courts have left open. *See, e.g.*, Lary v. United States, 787 F.2d 1538, 1540 (11th Cir. 1986); United States v. Garber, 607 F.2d 92, 96-97 (5th Cir. 1979) (en banc). The Service has administratively ruled, however, that a transfer of blood constitutes a transfer of services. *See* Rev. Rul. 162, 1955-2 C.B. 127.

[71] *Green*, 74 T.C. at 1234.

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of the transaction from a sale of property to that of services.

Finally, at least three commentators have addressed tax issues concerning the sale of body parts and embryos. The conclusion that each draws is that the sale of body parts and embryos constitutes the sale of property, rather than that of services, and the character of the taxpayer's gain should be capital.[72]

Having proven that donors' sell property rather than render services, the next Part discusses the parameters of the current capital asset definition and explains why donors' eggs fall within its scope.

II. DONORS' EGGS ARE CAPITAL ASSETS

Under Code section 1221, capital assets are defined by a process of elimination. That is, capital assets include all "property held by the taxpayer" except those assets which fall within five specified exceptions:

> (1) stock in [the] trade of the taxpayer or . . . inventory of the taxpayer . . . , or property held by the taxpayer primarily for sale to customers in the ordinary course of business;[73]
> (2) property, used in a taxpayer's trade or business, of a character which is subject to the allowance for depreciation . . . , or real property used in a taxpayer's trade or business;[74]
> (3) a copyright, a literary, musical, or artistic composition, a letter memorandum, or similar property, held by a taxpayer whose personal efforts created such property . . . ;[75]
> (4) accounts or notes receivable acquired in the ordinary course of trade or business . . . ;[76] and
> (5) [various government publications].[77]

Donors' eggs are not the kind of assets that fall within the scope of these five exceptions. Comprised of cytoplasm and carrying

[72] *See* Paul J. Dostart, *Taxation of Human Body Parts*, 36 TAX LAW. 61, 79-82 (1982); Note, *Tax Consequences of Transfers of Bodily Parts*, 73 COLUM. L. REV. 842, 856-57; Note, *The Sale of Human Body Parts*, 72 Mich. L. REV. 1183, 1256-64 (1974).

[73] I.R.C. § 1221(1) (1994).

[74] *Id.* § 1221(2).

[75] *Id.* § 1221(3).

[76] *Id.* § 1221(4).

[77] *Id.* § 1221(5).

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genetic codes, donors' eggs are designed to meet sperm, develop into fetuses, and ultimately become babies. Given their inherent nature, donors' eggs clearly are not (1) depreciable property[78] nor real property (second exception); (2) an account or note receivable (fourth exception); or (3) a governmental publication (fifth exception).

This Article next demonstrates that donors' eggs do not fall within the scope of either the first or third exceptions to the capital asset definition. In addition, this Article illustrates that the Supreme Court's position is clear: the capital asset definition should be read literally and in a manner that bars judicially created exceptions.[79]

A. *Donors' Eggs Are Not Property Held by Donors Primarily for Sale to Customers in the Ordinary Course of Donors' Trade or Business*

The fundamental purpose behind Code section 1221(1) is to distinguish between profits that arise from the everyday course of business and investments in property that accrue in value over a significant period of time.[80] The kind of assets that give rise to noncapital business profits must possess three characteristics:[81] (1) the assets are held primarily for sale (2) to customers (3) in the ordinary course of the taxpayer's trade or business.[82]

Under current medical ethics standards, donors are discouraged from selling their eggs more than twice (or at most three times) during their lifetime.[83] Assuming donors abide by these standards,

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[78] Donors' eggs lack a determinate useful life. Accordingly, no deduction for depreciation is allowed. *See* Treas. Reg. § 1.167(a)-1(b) (1986) (providing for depreciation for exhaustion and wear on certain property). In addition, donors have no tax basis in their eggs. *See Kahn, supra* note 8, at 343-44.

[79] *See infra* Parts II.A, II.B, and II.C.

[80] *See* Malat v. Riddell, 383 U.S. 569, 572 (1966); *see also infra* Part III (finding that purpose of section 1221(1) is to differentiate between business and investment income).

[81] The statute excludes two additional categories of property from possible capital asset classification: (1) stock in trade, and (2) property of a kind that is properly included in a taxpayer's inventory. *See* I.R.C. § 1221(1). But these two categories of assets have been subsumed under the more encompassing category of property "held primarily for sale to customers in the ordinary course of a taxpayer's trade or business." *See* Wood v. Commissioner, 16 T.C. 213, 225-26 (1951), *acq. in result*, 1951-2 C.B. 4 (property cannot be considered as stock in trade or inventory without being held primarily for sale to customers in ordinary course of taxpayer's trade or business).

[82] *See* I.R.C. § 1221(1).

[83] *See, e.g.*, NANCY A. KLEIN, ET AL., *Donor Oocyte Program at University of Washington Medical Center, in* NEW WAYS OF MAKING BABIES, *supra* note 4, at 9; Andrea Braverman, Ph.D., *Survey Results in the Current Practice of Ovum Donation*, 59 FERTILITY & STERILITY 1216, 1219

the sale of eggs does not satisfy any of the three criteria set forth under the first exception to the capital asset definition.

1. "Primarily for Sale" Requirement

Property held "primarily" for sale is potentially excluded from being classified as a capital asset.[84] Courts have devised various factors to determine whether property is held primarily for sale.[85] The Sixth Circuit, for example, has enumerated the following eight factors to consider when categorizing the status of property: (1) the purpose for which the property was acquired; (2) the purpose for which the property was held; (3) the extent of improvements made to the property; (4) the frequency, number, and continuity of sales; (5) the nature and substantiality of the taxpayer's transactions; (6) the nature and extent of the taxpayer's dealings in similar property; (7) the extent of taxpayer's advertising to promote sales; and (8) whether the property was listed for sale either directly or through brokers.[86]

These factors help distinguish between property that is held primarily for sale from that which is not. Consider the situations of two hypothetical taxpayers. Taxpayer *A* is a real estate developer who buys large tracts of land, makes improvements thereto (e.g., puts in electric, sewer, and gas lines on the purchased property), employs brokers or uses other advertising techniques to sell the improved realty, and repeats this cycle on a regular basis. Taxpayer *B* is an investor who purchases undeveloped land, lets it lie fallow, and then resells it several years later. Courts analyzing similar fact patterns have held that Taxpayer *A* holds the land primarily for sale while Taxpayer *B* holds the land for its appreciation in value.[87]

(1993); Lawrence K. Altman, *Fertility Drugs Linked to Ovarian Cancer*, N.Y. TIMES, Sept. 22, 1994, at A22.

[84] *See* I.R.C. § 1221(1).

[85] Although the word "primarily" is not defined in either the Code or the regulations, the Supreme Court has held that it means "of first importance" or "principally." *See Malat*, 383 U.S. at 572; *see also* Robert A. Bernstein, *Primarily for Sale: A Semantic Snare*, 20 STAN. L. REV. 1093, 1095 (1968) (discussing *Malat* Court's interpretation of "primarily").

[86] *See* Case v. United States, 633 F.2d 1240, 1245 (6th Cir. 1980) (listing eight factors); *see also* Gartrell v. United States, 619 F.2d 1150, 1154 (6th Cir. 1980) (listing eight factors set out previously by Sixth Circuit); Broughton v. Commissioner, 333 F.2d 492, 495 (6th Cir. 1964) (reiterating eight factors).

[87] *Compare* Ferguson v. Commissioner, 53 T.C.M. (CCH) 864, 869 (1987) (holding that real estate developer's gain on sale of improved land was ordinary income), *with* Buono v. Commissioner, 74 T.C. 187, 207 (1980) (holding gain on sale of unimproved land owned by investors to be capital).

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Upon the sale of the land, Taxpayer *A* must recognize ordinary income, while Taxpayer *B* realizes a capital gain.

While not identical, the situation of donors that sell their eggs is more closely aligned with the investor than with the real estate developer. Donors do not acquire their eggs with the principal purpose of selling them, and do not engage in selling activities such as improving them, marketing them, and then repeating this cycle. To the contrary, donors passively hold their eggs, are solicited by infertility clinics, and sell their eggs only rarely. Like investors, donors do not hold their eggs primarily for sale; instead, they generally retain their eggs because they want to have children of their own.

The fact that donors are endowed at birth with their eggs further supports the position that donors do not hold their eggs primarily for sale. When taxpayers have acquired property by gift or inheritance, courts generally have hesitated to exclude the property from the capital asset definition.[88] These courts have reasoned that taxpayers that do not affirmatively acquire property are less likely to hold such property primarily for sale to customers.[89] Consistency with this position suggests that courts would exercise the same lenient approach in the case of donors' eggs which are not acquired, but rather constitute part of each donor's natural endowment.

2. "To Customers" Requirement

In 1934, Congress added the "to customers" provision to the capital asset definition.[90] Legislative history indicates that the purpose of this provision was to curtail stock speculators during the Great Depression from recognizing ordinary losses on their stock trades.[91] Whether this requirement applies outside of the stock trading arena, however, is not entirely clear.[92]

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[88] *See, e.g.*, Riedel v. Commissioner, 261 F.2d 371, 372 (5th Cir. 1958) (finding that taxpayer recognized capital gain upon disposition of property acquired by inheritance); Fahs v. Taylor, 239 F.2d 224, 226 (5th Cir. 1956) (holding character of gain to be capital in situation in which disposed of property was acquired by gift); *see also* Philip E. Harris, *When Is Grain a Capital Asset?*, 30 S.D. L. REV. 275, 278-80 (1985) (proposing that farmers gift harvested wheat to their children to transform character of gain from ordinary to capital).

[89] *See* Howard J. Rothman, *Capital Assets*, 561 TAX MGMT. (1994), at A-34 to A-35.

[90] *See* Revenue Act of 1934, Pub. L. No. 73-216, § 117(b), 48 Stat. 680, 714 (1934).

[91] *See* Burnett v. Commissioner, 40 B.T.A. 605, 609 (1939), *aff'd in part*, 118 F.2d 659 (5th Cir. 1941) (quoting REPORT OF CONFER. COMM. ON H.R. REP. NO. 73-1385., at 22).

[92] *See generally* William A. Friedlander, *"To Customers": The Forgotten Element in the Charac-*

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At least one court has defined customers as purchasers that expect and pay for "merchandising functions" on the part of sellers.[93] Merchandising functions include displaying products, demonstrating their use, and standing behind the product's quality. Car salespersons, for example, show cars, offer test drives, and warrant product satisfaction. Reference to car purchasers as customers is thus fitting. In contrast, security traders conduct none of the same merchandising functions with respect to their sales of stock. Reference to traders as buyers rather than customers is thus appropriate.

Donors that sell their eggs perform no merchandising functions. When selling their eggs, donors' behavior corresponds more with that of security traders than that of car salespersons. Specifically, prior to the harvesting process, donors do not "merchandise" their eggs: they do not show their eggs, allow the infertility clinic to conduct tests, or warrant the viability of their eggs. Due to the absence of any merchandising efforts on the part of donors, infertility clinics are more likely to be categorized as buyers than as customers.

3. "Trade or Business" Requirement

Even if property is held primarily for sale to customers, gain recognized upon its sale may still qualify as capital rather than ordinary income if the property sold is not held for sale in the "ordinary course of the taxpayer's trade or business."[94] What constitutes a taxpayer's trade or business is often difficult to determine.[95] Courts analyzing this issue focus primarily on (1) the

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terization of Gains on Sales of Real Property, 39 TAX L. REV. 31, 35-36 (1983) (stating that phrase "to customers" was given without limitations or qualifications).

[93] *See* Kemon v. Commissioner, 16 T.C. 1026, 1032-33 (1951) (employing merchant analogy to phrase "to customers").

[94] *See generally* E. John Lopez, Comment, *Defining "Trade or Business" Under the Internal Revenue Code: A Survey of Relevant Cases*, 11 FLA. ST. U. L. REV. 949, 949 (1984) (stating trade or business is not defined in regulations or Code); Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. CIN. L. REV. 1199, 1199 (1986) (stating "trade or business" frequently used but words have no particular meaning); John M. Saunders, *"Trade or Business," Its Meaning Under the Internal Revenue Code*, 1960 SO. CALIF. TAX INST. 693, 693 (1960) (discussing importance of classifying gain on property as trade or business).

[95] *See* Royster v. Commissioner, 49 T.C.M. (CCH) 1594, 1610 (1985), *aff'd*, 820 F.2d 1156 (11th Cir. 1987) (explaining that question of whether primarily for sale to customers is factual and must be determined on case-by-case basis); Gartrell v. United States, 619 F.2d 1150, 1152-53 (6th Cir. 1980) (stating that factual inquiry is proper for held "primarily for sale to customers" standard); Suburban Realty Co. v. United States, 615 F.2d 171, 178 (5th

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number, frequency, substantiality, and continuity of sales[96] and (2) the taxpayer's participation in the economic activity.[97] Although these are not the only factors courts consider,[98] they appear to be weighted more heavily than others.[99]

To illustrate how courts employ these factors, consider the plight of the following two taxpayers. Taxpayer *A*, who has historically bought and sold real estate, purchased several large tracts of land. The taxpayer improved these tracts of land by adding streets, drainage, sewerage, and utilities. To market the land, Taxpayer *A*, through his own efforts and those of his brokers, promoted the sales of homes built on these tracts of land. Taxpayer *B*, an accountant, purchased real estate, but other than applying for and obtaining subdivision approval, Taxpayer *B* made no other

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Cir. 1980) (stating that frequency and substantiality of sales are most important factors); Biedenharn Realty Co. v. United States, 526 F.2d 409, 411 (5th Cir. 1976) (noting substantial number of improved lots sold over 40 year period); Rockwell v. Commissioner, 512 F.2d 882, 866 (9th Cir. 1975) (finding that factual inquiry is proper); Goodman v. United States, 390 F.2d 915, 919 (Ct. Cl. 1968) (considering such factors as soliciting, advertising, development, and improvement to indicate property held for sale); Estate of Segal v. Commissioner, 370 F.2d 107, 108 (2d Cir. 1966) (listing factors to consider in deciding if property is held primarily for sale to customers in trade or business); Wineberg v. Commissioner, 326 F.2d 157, 163 (9th Cir. 1963) (finding lack of advertisement not controlling in issue of property held primarily for sale, when taxpayer could sell without advertising); Rollingwood Corp. v. Commissioner, 190 F.2d 263, 266 (9th Cir. 1951) (finding while purpose for which property was purchased is helpful in determining character, most important question is purpose for which property is held); Guardian Indust. Corp. v. Commissioner, 97 T.C. 308, 316 (1991) (finding that whether asset is held primarily for sale in trade or business is question of fact); Major Realty Corp. v. Commissioner, 42 T.C.M. (CCH) 373, 381 (1981), *aff'd in part, rev'd in part*, 749 F.2d 1483 (11th Cir. 1985) (citing factors helpful to determine if property is held primarily for sale or business).

[96] *See Suburban*, 615 F.2d at 178 (noting that frequency and substantiality of sales are highly probative factors).

[97] *See, e.g.*, Bush v. Commissioner, 610 F.2d 426, 427 (6th Cir. 1979); Gates v. Commissioner, 52 T.C. 898, 905 (1969); Bynum v. Commissioner, 46 T.C. 295, 299-300 (1966); Harder v. Commissioner, 60 T.C.M. (CCH) 179, 181-82 (1990).

[98] In *United States v. Winthrop*, the Fifth Circuit enumerated the following additional factors:

> (1) the nature and purpose of the acquisition of the property and duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.

417 F.2d 905, 910 (5th Cir. 1969).

[99] *See Suburban*, 615 F.2d at 178 (emphasizing that frequency and substantiality of sales are most important factors for determining whether taxpayer is engaged in real estate business).

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improvements to the purchased property. While maintaining her accounting practice, Taxpayer *B* sold the property intact to one purchaser. Taxpayer *A*'s gains were characterized as ordinary income because he was held to be engaged in the real estate business.[100] In contrast, Taxpayer *B*'s gains were characterized as capital in nature because she was held to be a real estate investor.[101]

This example lends support to the proposition that donors' sales of eggs do not constitute a trade or business. First, most donors that sell their eggs do so only once or twice during their lifetimes.[102] Second, during the harvesting process, donors ordinarily maintain their careers and derive most of their income from alternative sources.[103] Third, the eggs are not developed or improved upon by the donor prior to their sale. These facts bear a striking similarity to those surrounding Taxpayer *B*'s investment in land. Donors are thus not in the trade or business of selling their eggs.[104] Accordingly, gains on the sale of a donor's eggs should qualify for preferential tax treatment.[105]

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[100] *See Biedenharn*, 526 F.2d at 423-24 (holding that gains derived by person involved in real estate business are ordinary income and not capital gains).

[101] *See* Buono v. Commissioner, 74 T.C. 187, 206-07 (1980).

[102] *See generally supra* note 64 (noting that human tissue is often subject of commercially valuable contracts). This fact bolsters the donors' position that their egg sales do not constitute a trade or business because courts have generally held that isolated sales do not constitute a trade or business. In *Reese v. Commissioner*, 615 F.2d 226, 230-31 (5th Cir. 1980), the Fifth Circuit stated:

> [W]hile there may perhaps be extraordinary circumstances in which a taxpayer's devotion of time and resources to a non-recurring venture constitutes a trade or business, a single transaction ordinarily will not constitute a trade or business when the taxpayer enters into the transaction with no expectation of continuing in the field of endeavor.

Id.

[103] *See, e.g.*, Snell v. Commissioner, 97 F.2d 891, 892 (5th Cir. 1938) (stating that "[t]he word [business], notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation"); Thompson Lumber Co. v. Commissioner, 43 B.T.A. 726, 729-31 (1941) (finding that losses sustained were capital because taxpayer's real estate activities were only "incidental" to its lumber business and were not of sufficient magnitude to constitute additional business).

[104] On several occasions courts have confirmed that a taxpayer whose activities involve isolated sales are not engaged in a trade or business. *Compare Reese*, 615 F.2d at 230 (holding that isolated sales of real estate do not amount to trade or business), *and* Commissioner v. Williams, 256 F.2d 152, 155 (5th Cir. 1958) (holding that isolated sale of vessel is not in ordinary course of trade or business), *with* S & H, Inc. v. Commissioner, 78 T.C. 234, 245 (1982) (holding that taxpayer who agreed to construct warehouse for purchaser was held to be in trade or business because there was preexisting arrangement to sell property).

[105] The outcome, of course, would likely be different if a donor ignored medical guidelines and sold her eggs on a regular basis. If that were the case, a court would likely point out that the donor was in the trade or business of selling her eggs and that the donor's eggs,

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In sum, the first exception to the capital asset definition specifies that (1) the asset is held primarily for sale (2) to customers (3) in the ordinary course of the taxpayer's trade or business. In the case of donors selling their eggs, none of these requirements are met.

B. Donors' Eggs Are Not a Copyright, a Literary, Musical, or Artistic Composition, a Letter or Memorandum, or Similar Property, Held by a Taxpayer Whose Personal Efforts Created Such Property

Congress incorporated this exception to the capital asset definition in order to eliminate the tax disparities that had arisen between professional and amateur authors, composers, and artists. In the case of professionals, their work efforts led to the creation of property that the courts deemed to be held for sale to customers in the ordinary course of the professionals' trade or business. Consequently, their profits were not eligible for capital gains treatment.[106] In contrast, amateurs' work products did not to fall within the scope of the same exception; therefore, their profits were eligible for capital gains treatment.[107] In 1950, Congress added Code section 1221(3) to the capital asset definition to ensure that profits earned by professionals and amateurs alike would be treated consistently under the Code.[108]

The narrow purpose that led Congress to add this exception, combined with the narrow fashion in which it was drafted, severely

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as such, were the inventory of the business. *See* Green v. Commissioner, 74 T.C. 1229, 1235 (1980). The court stated:

> [P]etitioner was actively engaged in the continual and regular process of producing and selling blood plasma to the lab for profit . . . [and] held herself out as engaged in the sale of blood plasma to the lab upon its acceptance. Upon the facts, we find the petitioner was in the trade or business of selling blood plasma.

Id. (citations omitted).

[106] *See, e.g.*, Fields v. Commissioner, 14 T.C. 1202, 1216 (1950), *acq. in result*, 1950-2 C.B. 21, *aff'd*, 189 F.2d 950 (2d Cir. 1951) (holding that proceeds from transfer of motion picture rights are included in ordinary income); Goldsmith v. Commissioner, 1 T.C. 711, 716 (1943), *aff'd*, 143 F.2d 466 (2d Cir. 1944) (holding that taxpayer used copyright of play in his trade or business and, therefore, it is not capital asset).

[107] *See, e.g.*, Herwig v. United States, 105 F. Supp. 384, 391-92 (Ct. Cl. 1952); Telinde v. Commissioner, 18 T.C. 91 (1952).

[108] *See* Revenue Act of 1950, Pub. L. No. 81-814, § 210, 64 Stat. 906, 932-33 (1950). Both the Senate and House committee reports indicate that Congress acted when it learned that General Eisenhower had sold all of the rights to his memoirs for $635,000 and he received a Treasury ruling that the gain was subject to capital gains rates. *See* S. REP. NO. 2375, 81st Cong., 2d Sess. 43, 83-84 (1950); H.R. REP. NO. 2319, 81st Cong. 2d Sess. 54, 91-92 (1950).

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limits its application.[109] This exception to the capital asset definition contains two aspects. The first aspect applies only to literary musical and artistic works,[110] and the second applies only to letters and memoranda.[111] Even the phrase "similar property" only marginally extends the breadth of this exception.[112] Finally, this exception requires either an affirmative contribution on the part of the taxpayer or, in the case of letters and memoranda, preparation by others that are under the administrative control of the taxpayer.[113]

Donors' eggs may be many things to many people, but they are not a literary musical or artistic work, a letter, a memorandum, or similar property. This observation, in conjunction with the fact that donors do not make an affirmative contribution to the production of their own eggs, negates any possible application this exception might have to a donor's gains upon the sale of her eggs.

C. *Courts Construe the Capital Asset Definition Narrowly in the Aftermath of the* Arkansas Best *Decision*

Having concluded that donors' eggs do not fall within any of the enumerated exceptions of the capital asset definition, one might argue that the courts should take it upon themselves to exclude donors' eggs as capital assets. Until the United States Supreme Court rendered *Arkansas Best v. Commissioner*,[114] such an argument

[109] *Compare* Commissioner v. Ferrer, 304 F.2d 125, 132 (2d Cir. 1962) (declaring that I.R.C. § 1221(3) should be narrowly confined to situations in which authors, artists, composers, and the like created such property), *with* Holt v. Commissioner, 303 F.2d 687, 690 (9th Cir. 1962) (adopting slightly broader perspective of when I.R.C. § 1221(3) may apply).

[110] *See* Treas. Reg. § 1.1221-1(c)(1) (1960). If the property in question cannot be classified as either being artistic or literary in nature, the character of the gain will be capital. *See, e.g.*, *Ferrer*, 304 F.2d at 132.

[111] *See* Treas. Reg. § 1.1221-1(c)(2).

[112] The term "similar property" is defined separately with respect to each aspect of this exception. *See* Treas. Reg. § 1.1221-1(c)(1) to -1(c)(2). In the case of the first aspect (namely, literary, musical, and artistic works), "the phrase 'similar property' includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection." *Id.* § 1.1221-1(c)(1). In the case of the second aspect (namely, letters and memoranda), "the phrase 'similar property' includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, [or] a log or journal. . . ." *Id.* § 1.221-1 (c)(2).

[113] *See id.* § 1.1221-1(c)(3).

[114] 485 U.S. 212 (1988).

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might have been successful. However, in *Arkansas Best*, the Court clearly indicated that courts ought to read the capital asset definition literally.

By way of background, from the introduction of the capital asset definition in 1921,[115] courts promoted the idea that the definition of a capital asset be narrowly construed and its exclusions be broadly interpreted.[116] This construction of the capital asset definition received apparent endorsement by the Supreme Court in *Corn Products Refining Co. v. Commissioner*.[117] In this decision, the Court ostensibly declared that an asset would be denied capital asset status if assigning such status would thwart congressional intent. This would hold true even if the asset did not literally fall within one of the capital asset exceptions.

The pertinent facts of the *Corn Products* decision are as follows. The taxpayer manufactured and sold various corn products but lacked on-site storage capacity.[118] Therefore, whenever there were corn shortages on the open market, it faced potential production stoppages and severe price increases.[119] To protect itself from shortages and price fluctuations, the taxpayer invested in corn futures.[120] When corn was in short supply, the taxpayer exercised its corn futures. Conversely, when corn was plentiful, the taxpayer sold its corn futures.[121] The sale of these corn futures resulted in tax gains to the taxpayer.[122] At issue was the character of the taxpayer's gains.[123]

Both the Tax Court and the Second Circuit held that the taxpayer's sales resulted in the recognition of ordinary income.[124] The Tax Court found that the "practice of purchasing corn futures was an integral part of [the taxpayer's] manufacturing business" giving rise to ordinary income and loss.[125] While affirming the Tax

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[115] *See* Revenue Act of 1921, ch. 136, Pub. L. No. 67-98, § 206(a)(1), 42 Stat. 227, 232 (1921).

[116] *See, e.g.*, Gilbert v. Commissioner, 56 F.2d 361, 362 (1st Cir. 1932) (regarding engineering firm that received stock in corporation that it had accepted in return for constructing building; held, taxpayer recognized ordinary loss on sale of such stock because it was received in ordinary course of business).

[117] 350 U.S. 46 (1955).

[118] *See id.* at 48.

[119] *See id.*

[120] *See id.*

[121] *See id.*

[122] *See id.* at 49.

[123] *See id.*

[124] *See id.* at 50.

[125] *See* Corn Prods. Ref. Co. v. Commissioner, 11 T.C.M. (CCH) 721, 726 (1952).

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Court's opinion, the Second Circuit emphasized that the corn futures were "part of the inventory purchase system which [was] utilized solely for purpose of stabilizing inventory cost."[126] As a result, the Second Circuit ruled that the corn futures, as part of a hedging transaction, fell within the scope of the "business profits" exception to the capital asset definition.[127]

In analyzing the character of gain issue, the Supreme Court appeared to be more persuaded by the reasoning offered by the Tax Court than the Second Circuit. The Court focused on the taxpayer's motivation underlying its purchase of corn futures.[128] Finding that the taxpayer's motive was business rather than investment related, the Court held the gain to be ordinary.[129] It expressed its opinion as follows:

> The capital-asset provision of § 117 [now § 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. Congress intended that profits and losses arising from the everyday operation of a business to be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income.[130]

The outcome of the *Corn Products* decision led to an eruption of tax litigation.[131] To avoid capital loss limitations, taxpayers that ostensibly sold capital assets such as securities and recognized a loss often argued that a business purpose dictated their original decision to purchase and retain the assets in question.[132] If the facts supported the taxpayer's position, under what became known as the *Corn Products* doctrine,[133] courts ruled the character of the loss to be ordinary. This was true even though a literal reading of the capital asset definition would have dictated a different outcome.[134]

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[126] 215 F.2d 513, 516 (2d Cir. 1954).

[127] *See id.*

[128] *See Corn Prods.*, 350 U.S. at 50-51.

[129] *See id.* at 52-54.

[130] *Id.* at 52.

[131] *See* Howard J. Rothman, *Capital Assets*, 561 TAX MGMT. PORTFOLIO 87, 87-96 (1994).

[132] *See id.* at 88 (stating that taxpayers use *Corn Products* doctrine as vehicle to characterize capital asset losses as ordinary losses).

[133] For a detailed discussion of this doctrine, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (5th ed. 1987) at 4.20.

[134] For example, in each of the following decisions, the taxpayer sold securities at a loss

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The *Corn Products* doctrine remained vibrant until eclipsed some three decades later by *Arkansas Best v. Commissioner.*[135] In this later decision, the Supreme Court rejected the so-called *Corn Products* exception to the capital definition and declared that a business purpose was irrelevant in determining whether property had capital asset status.

In *Arkansas Best*, the taxpayer acquired stock in a bank for both business (i.e., facilitation of a future public offering) and investment (i.e., potential for great appreciation in value) reasons.[136] Some years later the bank stock declined in value and was sold at a loss by the taxpayer.[137] In rejecting the taxpayer's claim of an ordinary loss, the Supreme Court distanced itself from prior court rulings which relied on *Corn Products* as a means to expand the exceptions to the capital asset definition.[138] In reviewing the capital asset definition, the Court found no mention of a business purpose test.[139] It stated that its *Corn Products* decision had been misconstrued by the lower courts.[140] More specifically, the Supreme Court held that *Corn Products* was decided on the much narrower grounds that the corn futures in question were really an inventory substitute and, as such, fell within the literal scope of the first exception to the capital asset definition.[141]

Arkansas Best thus restricts the leeway courts have in interpreting the capital asset definition and determining its application. The capital asset definition bestows capital asset status to all property unless one of five specific exceptions apply. As articulated by the Supreme Court, the role of the judiciary is not to interpret the capital asset definition to comport with its policy objectives.[142]

and such loss was accorded ordinary, rather than capital treatment. *See* FS Servs., Inc. v. United States, 413 F.2d 548, 552-55 (Ct. Cl. 1969); Booth Newspapers, Inc. v. United States, 303 F.2d 916, 920-22 (Ct. Cl. 1962); Livesley v. Commissioner, 19 T.C.M. (CCH) 133, 141 (1960).

[135] 485 U.S. 212 (1988).

[136] *See id.* at 215.

[137] *See id.* at 214.

[138] *See id.* at 222-23.

[139] *See id.* at 223.

[140] *See id.* at 216 (noting that court decisions support petitioner's interpretation of *Corn Products*).

[141] *See id.* at 222.

[142] *See id.* at 217-18.

D. Summary

Donors' eggs are not the kind of property that falls within the scope of any of the exceptions set forth in the capital asset definition. This fact, coupled with the holding in *Arkansas Best*, signifies that donors' eggs should be classified as capital assets. Upon their sale, income recognized by donors should thus be characterized as long-term capital gain.[143]

Part III discusses the policy objectives that underlie preferential tax treatment for capital gains and examines whether such treatment is justifiable in the sale and exchange of donors' eggs, as well as other kinds of property that fall within the capital asset definition.

III. THE POLICIES UNDERLYING PREFERENTIAL CAPITAL GAIN TREATMENT DO NOT JUSTIFY ACCORDING CAPITAL ASSET STATUS TO DONORS' EGGS AND OTHER ASSETS

Assuming eggs are capital assets, donors should recognize long-term capital gains. The tax savings from such treatment are considerable. Consider a donor that has adjusted gross income of $300,000, exclusive of her egg sales. Suppose that in 1999 she sells some of her eggs to an infertility clinic for $10,000 and suppose further that she files a joint tax return. Rather than pay tax at a marginal rate of 39.6% or $3960 on the $10,000 gain generated from the sale of her eggs,[144] the donor will instead pay tax at a marginal rate of 20% or $2000.[145] Although the government in this instance, as well as in any capital asset transaction, forfeits a significant amount of revenue, policy objectives outwardly justify this tax rate reduction. This Part investigates the policy objectives behind capital asset status, and evaluates whether gains on the sales of donors' eggs, as well as on the sales of other kinds of capital assets, warrant a tax rate reduction.[146]

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[143] Donors are born with their eggs. This fact, combined with the fact that donors are generally required to be consenting adults when they donate their eggs, means that donors' eggs are assets that have been held long-term. Long-term means greater than 12 months. *See generally* I.R.C. § 1222(3) (1994).

[144] *See id.* § 1(a) (1994).

[145] *See id.* §§ 1(h), 1222.

[146] There is a lot of controversy regarding the merits of a tax rate reduction for capital gains. Many commentators attack the practice of according preferential tax treatment to capital assets. *See, e.g.*, THE CAPITAL GAINS CONTROVERSY: A TAX ANALYSTS READER (J. Andrew Hoerner ed., 1992); Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35

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A. *Policy Objectives*

As a preliminary matter, the capital asset definition is supposed to distinguish between income arising from investments and income arising from business or speculation.[147] Income derived from investments possesses attributes that, from an equity and economic perspective, ostensibly merit a tax rate reduction.[148] These attributes include the fact that (1) an investment gain may reflect past appreciation as well as future income potential, creating a "bunching" effect[149] and (2) a tax on investment gain may reduce after-tax reinvestment returns, creating a "lock-in" effect.[150] Congress also crafted the capital asset definition (in conjunction with the tax rate reduction) as a means to encourage risk taking; by encouraging risk taking, Congress sought to foster business development and generate job growth.[151]

TAXES 247 (1957); Joseph M. Dodge, *Restoring Preferential Capital Gains Treatment Under a Flat Rate Income Tax: Panacea or Placebo?*, 44 TAX NOTES 1133 (Sept. 4, 1989); Daniel Halperin, *Commentary: A Capital Gains Preference Is Not EVEN a Second-Best Solution*, 48 TAX L. REV. 381 (1993); Daniel N. Shaviro, *Commentary: Uneasiness and Capital Gains*, 48 TAX L. REV. 393 (1993). Other commentators support the practice of according preferential tax treatment to capital assets. *See, e.g.*, Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Constantine N. Katsoris, *In Defense of Capital Gains*, 42 FORDHAM L. REV. 1 (1973). Engagement in this debate, however, is beyond the scope of this Article.

[147] *See* Cunningham & Schenk, *supra* note 146, at 340-44 (describing effects of capital gains preference on investment behavior); John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 10-21 (1995) (describing arguments of proponents and opponents of capital gains cut); William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153, 153-55 (1983) (explaining basic justifications for capital gains preference).

[148] *See generally* Peter Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation: I*, 59 YALE L.J. 837, 838-40 (1950) (distinguishing "investment" from other types of profit-making activity); Peter Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation: II*, 59 YALE L.J. 1057, 1057-68 (1950) (discussing special treatment of investment gains).

[149] *See* Blum, *supra* note 146, at 255 (discussing how capital gains reflect inflation).

[150] One commentator's sentiments capture the nature of the "lock-in" effect problem:

> [A] high capital gains tax is definitely a deterrent to realization. How great it is, is another question, but certainly if I have a security which is paying me dividends, and if when I sell it I am going to pay in tax half the proceeds and have only half to reinvest, I shall not be able to get the same income I had and, therefore, I shall be torn between the desire on the one hand to keep my income up, and on the other, to sell the stock before it begins to reach the top; so there is some deterrent.

TAX INSTITUTE, CAPITAL GAINS TAXATION 15 (1946) (quoting Eustace Seligman, attorney participating in Tax Institute Symposium of 1945).

[151] *See* AMERICAN LAW INSTITUTE, DISCUSSION DRAFT OF A STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 189, 189-91 (1960) (discussing positive incentives

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To illustrate the dynamics of the bunching effect, consider Taxpayer *X*, who is in the 15% tax bracket and purchases one hundred shares of AT&T stock for $10,000. Assume that ten years later the one hundred shares are worth $110,000, and assume further that this price reflects anticipated income flow from the stock. If Taxpayer *X* sold the stock, she would have to recognize a gain of $100,000. Assuming this gain was taxed at a rate of 39.6%, there would be a resulting tax of $39,600.

Suppose, on the other hand, Taxpayer *X* retained the stock and paid tax each year on the income generated by the stock during that year. Taxpayer *X* would continue to pay tax on each year's stock earnings at the lower marginal tax rate of 15%. The progressive income tax rate schedule accounts for the difference in outcomes between the first scenario (tax on a single year's gain) and the second scenario (tax on income spread over the life of the asset). The bunching effect, therefore, causes taxpayers that sell an asset to endure a higher aggregate tax than they would have to endure if, in contrast, they continued to hold the asset in question and recognized the same amount of income in smaller increments over several years.[152]

To illustrate the dynamics of the lock-in effect, consider again the situation of Taxpayer *X* who holds appreciated AT&T stock. If the stock had a dividend yield of 3%, the one hundred shares would produce an annual cash flow of $3300 ($110,000 x 3%). Even if Taxpayer *X* discovered a better investment yielding a higher return, say 4%, she might refrain from selling her AT&T stock. This is because if Taxpayer *X* reinvested her after-tax proceeds of $70,400 ($110,000 (proceeds) - ($100,000 (gain) x 39.6% (tax rate)) at a 4% annual return, the yield on the new investment would only be $2816 ($70,400 x 4%). Obviously, income taxes are an impediment to the flow of capital.[153]

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that lower capital gains tax rates provide to risk-taking investment) [hereinafter A.L.I. DRAFT]. More recently, during debate on the Taxpayer Relief Act of 1997, the Senate Finance Committee reiterated this view, stating that "[t]he Committee believes it is important to encourage risk taking and believes a reduction in the taxation of capital gains will have that effect." S. REP. NO. 105-33, at 33 (1997).

[152] *See* H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* 1939-1 C.B. 168, 176 (stating that "[t]he sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum . . . in the year in which the profit is realized"); *see also* S. REP. NO. 67-275, at 12 (1921), *reprinted in* 1939-1 C.B. 181, 189-90.

[153] The effect is exacerbated by I.R.C. § 1014(c) (1998), which accords assets with a tax basis equal to fair market value at the death of the taxpayer. It eliminates an appreciated

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To offer relief from the consequences of the bunching and lock-in effects, Congress formulated the capital asset definition. Once capital asset status is accorded and the sale or exchange requirement deemed to have been met,[154] the resulting gain is taxed at a reduced tax rate.[155] The capital gain tax rate is supposed to be more equitable and economically efficient than the imposition of ordinary income rates: the reduced tax rate attempts to compensate for the bunching effect and to offset to some degree the lock-in effect.[156]

Diminishing the bunching and lock-in effects is consistent with the notion that "the tax system as far as possible should be neutral and should not interfere with the operation of market mechanisms."[157] In contrast to its neutralizing effect, the preferential tax rates accorded capital assets are also intended to spur economic development. That is, the reduced tax rates are supposed "to direct economic activity along lines it might not follow if its direction were determined wholly by the operation of market mechanisms."[158]

The combination of these dual policy objectives — namely, to neutralize the distortive effect of income taxes and to function as a economic catalyst — form the central justifications for offering a capital gains tax reduction.[159] Sales of appreciated corporate stock and vacant land (so-called "classic capital assets") illustrate the pivotal role capital asset status plays in facilitating achievement of these policy objectives.[160] Upon the sale of either asset,

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asset's taxable gain, providing taxpayers with an added incentive to hold capital assets until death. *See id.*

[154] *See, e.g.*, *id.* § 1221 (1998) (describing sale or exchange requirement); *id.* § 165 (g)(1) (1998) (deemed sale or exchange upon disposition of worthless stock); *see also* Boris I. Bittker, *Capital Gains and Losses — The "Sale or Exchange" Requirement*, 32 HASTINGS L.J. 743 (1981) (interpreting section 1221).

[155] *See* I.R.C. § 1(h) (1998).

[156] *See* A.L.I. DRAFT, *supra* note 151, at 182 (describing policy goals of capital gain preference).

[157] *Id.* at 189.

[158] *Id.*

[159] The strength of this foundation is debatable. *See supra* note 146.

[160] Commentators and politicians have articulated other policy objectives for according capital asset status (e.g., consumption, not income, should be taxed). *See, e.g.*, Charles E. Walker & Mark A. Bloomfield, *The Case for the Restoration of a Capital Gains Tax Differential*, 43 TAX NOTES 1019 (1989). These other policy justifications, however, have largely been discredited. *See* Cunningham & Schenk, *supra* note 146, at 324-44.

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[a] ***bunching problem*** would be involved since the realization of gain, which could be indefinitely deferred by a continued holding, would be concentrated in a single year as a result of the sale; this bunching problem arises irrespective of the period during which the property had been held but might perhaps be more significant when the holding period was long in that a larger gain may have developed. The ***lock-in problem*** would be fully applicable; the useful life of the property is in each case indefinite and there would appear to be sound reasons of social and economic policy favoring unimpeded transfers of such property. The policy of ***encouraging risk-taking*** would be applicable inasmuch as acquisition of stock or land normally involves an outlay of funds or commitment of credit.[161]

B. *Evaluation of Donors' Eggs as Capital Assets*

There are several reasons why accepted policy objectives do not support capital asset status being accorded to donors' eggs. First, the bunching problem is a less serious concern with respect to donors' eggs than with other capital assets. Two components comprise the bunching effect: (1) past bunching, which reflects an asset's unrecognized prior appreciation, and (2) forward bunching, which reflects an asset's anticipated income flow.[162] An examination of price offerings for donors' eggs indicates that a donor recognizing gain upon the sale of her eggs may face the problem of past bunching.[163] Nevertheless, the nonincome-producing nature of eggs obviates the problem of forward bunching. Like the price of diamonds, the price of donors' eggs simply reflects the dynamics of market supply and demand. That being the case, relief from forward bunching is less justified with the sales of donors' eggs than with other capital assets such as corporate stock. Prices with respect to the latter reflect not only potential appreciation, but also an anticipated income stream.

Second, donors' eggs are assets of limited duration: donors must either use their eggs or lose them. This fact negates concerns

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[161] A.L.I. DRAFT, *supra* note 151, at 194.

[162] The severity of forward bunching will correspond to the amount of income an asset produces. *See id.* at 149-52 (describing relationship between locked-in effect and future life of asset).

[163] *See id.* (stating that inherent nature of asset is relevant in determining appropriateness of capital asset classification).

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regarding the lock-in effect. The lock-in effect has its greatest impact with respect to assets that may appreciate either over a significant number of years or for the indefinite future, such as land or corporate stock. This is because "[i]f an appreciated asset may yield income reflecting that appreciation for an indefinite future period . . . , a sale will precipitate the realization of appreciation or gain whose realization might otherwise have been indefinitely deferred by a continued holding."[164] Conversely, if an asset will yield income for only a limited period of time, there is less deterrence to the sale of the asset because "a sale will only accelerate the realization of income which would necessarily have been realized over the period of the remaining life of the asset if the taxpayer had continued to hold the asset."[165]

In order to illustrate the influence that asset longevity has on the lock-in effect, reconsider the case of Taxpayer *X*, who holds one hundred shares of appreciated AT&T stock with a basis of $10,000 and fair market value of $110,000. The right to defer the tax indefinitely is equal to the amount of the tax, namely $39,600 (i.e., 39.6% (tax rate) x $100,000 (gain)). In contrast, assume Taxpayer *X* develops a computer using $10,000 of materials and that the computer is worth $110,000. Assume further that the computer will maintain its value for two years and then, due to obsolescence, be worthless. The right to defer tax from year one to year two is equal to the amount of the tax ($39,600) times an interest factor corresponding to the time value of money, say 10%, or $3960. In other words, the power to defer taxes "is worth less in the case of short-lived assets than in the case of longer-lived assets and assets of indefinite life for the reason that the power to defer tax is more limited in time in the case of shorter-lived assets."[166] The greater the taxpayer's ability to defer taxes (which turns on the anticipated life span of the asset in question), the greater the lock-in effect.[167]

In the case of assets that have limited duration, the lock-in effect is relatively weak and, therefore, so is the case for according capital asset status. Indeed, a reduction of tax rates for gains recognized on such assets produces a "forced-out effect": reduced tax rates make it advantageous for taxpayers to sell such assets and pay less tax rather than retain these assets and pay tax on the income

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[164] *Id.*

[165] *Id.*

[166] *Id.*

[167] *See id.* at 152 (explaining relationship between asset life and lock-in effect).

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generated at ordinary income tax rates.[168] In light of these fairly well accepted tax principles, the lock-in effect offers little justification for according capital asset status to donors' eggs, which have limited longevity.

A third reason for not according donors' eggs capital asset status is that the acquisition by donors of their eggs does not involve an outlay of funds or the commitment of credit. Eggs are part of every donor's birthday package. In light of this fact, according preferential tax treatment on the sale of donors' eggs cannot be justified on the grounds of encouraging risk taking: donors do not refrain from consumption and invest their savings in their eggs (as might be said in the case of venture capital). The incentive aspect of the preferential tax rate thus operates suboptimally in the context of egg donors, offering financial awards to taxpayers that have failed to make any capital investment.

In conclusion, accepted policy objectives do not support the capital asset definition according capital asset status to donors' eggs. Donors' eggs are not unique in this respect; many other kinds of assets have capital asset status without sound grounds for the accordance of such classification.

C. *Evaluation of the Capital Status of Other Assets*

Donors' eggs represent just one example of the failure of the capital asset definition to adhere to its original vision. The capital asset definition accords capital status to many other kinds of assets that, in light of policy objectives, do not merit preferential tax treatment. Assets that have the definitional cloak of being capital but lack the grounds for being classified as such include, but are not limited to, certain equitable interests in property, self-produced assets, and life estates.

1. Equitable Interests in Property

In *Commissioner v. Ferrer*,[169] the Second Circuit, in an opinion by Judge Friendly, detailed the meaning of the phrase "equitable interest" and the tax consequences associated with this classification. In *Ferrer*, the taxpayer, a famous actor, entered into a

[168] *See id.* (describing reduction of lock-in effect in assets with limited durations).

[169] 304 F.2d 125 (2d Cir. 1962).

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contract with the author of a novel entitled *Moulin Rouge*.[170] As part of the contract package, the taxpayer was given (1) the exclusive right to produce a play based upon the novel; (2) a restraint against the author from selling film rights to the novel; and (3) upon any subsequent film release based upon the novel, a right to a percentage of the film's profits.[171]

Soon after entering into the contract and prior to the play's production, the taxpayer, in conjunction with the novel's author, sold all his rights under the contract to a production company.[172] This was done as part of an overall plan to expedite production of a novel-based film.[173] On his income tax return, the taxpayer took the position that the character of gain on the sale of his rights was capital.[174] Upon audit, the Commissioner claimed that the sale of these rights resulted in the recognition of ordinary income.[175]

In addressing the character of gain issue, Judge Friendly surveyed prior court decisions, analyzing analogous fact patterns.[176] His review of these decisions led him to make two important observations:

> (1) Taxpayers recognized ordinary income when they sold rights to periodic receipts of income.[177] Periodic receipts of income arise from (a) dealings with others,[178] (b) rendering services,[179] or (c) maintaining ownership of larger "estates."[180]
>
> (2) Taxpayers recognized capital gains when they sold equitable interests in property.[181] Equitable interests include (a) an "estate" in[182] (b) an encumbrance upon;[183] or (c) an option to[184]

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[170] *See id.* at 126 (noting that Ferrer contracted with author, Pierre LaMure, for stage production of play, based on novel).

[171] *See id.* at 126-28 (discussing terms of contract).

[172] *See id.* at 128 (explaining transfer of rights to John Huston's production agency).

[173] *See id.*

[174] *See id.* at 129 (reporting payments as "long-term" capital gain).

[175] *See id.*

[176] *See id.* at 130 (surveying judicial treatment of similar cases).

[177] *Id.*

[178] *See* Leh v. Commissioner, 260 F.2d 489, 494-95 (9th Cir. 1958); Commissioner v. Pittston Co., 252 F.2d 344, 348 (2nd Cir. 1958); General Artists Corp. v. Commissioner, 205 F.2d 360, 361 (2d Cir. 1953); Commissioner v. Starr Bros., 204 F.2d 673, 674 (2d Cir. 1953).

[179] *See* Holt v. Commissioner, 303 F.2d 687, 690-91 (9th Cir. 1962).

[180] *See* Hort v. Commissioner, 313 U.S. 28 (1941); Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

[181] *See Ferrer*, 304 F.2d at 130.

[182] *See* Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752, 753 (2d Cir.), *cert. denied*, 348 U.S. 829 (1954); Commissioner v. Golonsky, 200 F.2d 72, 74 (3d Cir. 1952); Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592, 594 (9th Cir. 1960).

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property which, if itself held, would be a capital asset.[185]

Returning to the facts before him, Judge Friendly next determined that the taxpayer's right to produce the play (the first element of the contract) was an estate interest tantamount to a leasehold.[186] Second, the taxpayer's negative power to prevent any film release (the second element of the contract) constituted an encumbrance.[187] Third, the taxpayer's right to receive a percentage of the film's proceeds (the third element of the contract) constituted payment for services to be rendered.[188] On the basis of these findings, Judge Friendly held that the taxpayer recognized capital gain income upon the sale of the leasehold and encumbrance, and ordinary income upon the sale of his right to a percentage of the film's proceeds.[189] In accordance with these conclusions, the court remanded the case to the Tax Court to determine the portion of the sale price allocable to each element of the transfer.[190]

On a statutory basis and in the wake of prior cases, the logic of Judge Friendly's opinion appears beyond reproach.[191] Indeed, numerous other decisions have followed the intellectual path blazoned by Judge Friendly.[192] These decisions have extended even further the bounds of the capital asset definition.[193]

However, from a policy perspective, there is little reason to accord preferential tax treatment to the gains recognized by the taxpayer in *Ferrer* or the gains recognized by other similarly situated taxpayers. Although the gains upon the sale of both the right to produce the play (the leasehold) and the right to block any film release (the encumbrance) concededly resulted in the bunching of income, the lock-in effect likely had marginal, if any, bearing on

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[183] *See* Commissioner v. Ray, 210 F.2d 390, 392 (5th Cir. 1954).

[184] *See* Dorman v. United States, 296 F.2d 27, 31 (9th Cir. 1961).

[185] *See Ferrer*, 304 F.2d at 130.

[186] *See id.* at 131-32.

[187] *See id.* at 133.

[188] *See id.* 133-34.

[189] *See id.* at 132-34.

[190] *See id.* at 136.

[191] *See, e.g.*, Louis A. Del Cotto, *"Property" in the Capital Asset Definition: Influence of "Fruit and Tree"*, 15 BUFF. L. REV. 1 (1965); James S. Eustice, *Contract Rights, Capital Gain, and Assignment of Income — The* Ferrer *Case*, 20 TAX L. REV. 1 (1964).

[192] *See, e.g.*, Anderson v. United States, 468 F. Supp. 1085, 1097 (D. Minn. 1979); Commercial Solvents Corp. v. United States, 427 F.2d 749, 756-57 (Ct. Cl. 1970).

[193] *See Ferrer*, 304 F.2d at 132-33 (discussing terms of contract between Ferrer and LaMure).

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the taxpayer's decision to retain or to sell his rights. More specifically, both the leasehold and encumbrance lapsed after a short period.[194] As wasting assets, the taxpayer quickly had to exploit these rights or risk losing them. In light of this predicament, the thought of holding these rights in order to defer payment of tax and thereby maximize his returns (a clear manifestation of the lock-in effect) probably never crossed the taxpayer's mind.[195]

Even if the taxpayer in *Ferrer* was influenced by the lock-in effect, this would probably not justify capital gains treatment of his income. While Congress may want to facilitate the flow of capital, say in the case of corporate stock, by alleviating the lock-in effect, the unimpeded transfer of the taxpayer's leasehold and encumbrance rights are probably not sufficient importance to warrant preferential tax treatment.[196]

Beyond alleviating the bunching and lock-in effects, the preferential tax treatment accorded capital gains is supposed to provide taxpayers with an incentive to undertake investment risks.[197] However, the equitable interests secured under contract by the taxpayer in *Ferrer* involved a minimal outlay of funds.[198] The taxpayer's gain on the play's lease and encumbrance in *Ferrer* did not hinge upon whether the taxpayer made a good investment, but rather how adept the taxpayer ultimately was in producing the play.

2. Self-Produced Assets

Other assets that are unnecessarily accorded capital asset status include self-produced assets. Taxpayers may develop ideas or concepts that result in the creation of intangible or tangible assets

[194] *See* Ferrer v. Commissioner, 35 T.C. 617, 618-19 (1961), *rev'd in part*, 304 F.2d 125 (2d Cir. 1962).

[195] To the contrary, the taxpayer quickly sold his rights at a tremendous profit. The preferential tax rate, if anything, probably induced the taxpayer to sell his rights. The quick sale evidences what some commentators have described as the "forcing-out" effect preferential tax treatment may have when offered to assets that produce income over a limited duration. *See* A.L.I. DRAFT, *supra* note 151, at 149-52.

[196] An encumbrance on property restricts its alienability and, therefore, has a lock-in effect of its own. *See id.* That being the case, it is counterintuitive that gains upon the sale of such encumbrances would receive preferential tax treatment.

[197] *See supra* notes 159-61 and accompanying text.

[198] *See Ferrer*, 35 T.C. at 619 (discussing petitioner's advance of $1000 total in both 1965 and 1952).

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such as technical know-how, a trade secret, or, in the case of an amateur wood-carver, a piece of furniture. As long as no exception to the capital definition applies, these assets will be accorded capital asset status.

In the case of *Ofria v. Commissioner*,[199] for example, the taxpayer, an engineer, was paid by the United States Air Force for design improvements he made to a product known as a fuze bomb coupler. Although these design improvements were unpatented and were, in words of the court, the "fruit" of the taxpayer's labor,[200] they nevertheless were deemed to constitute property.[201] Because no statutory exception applied under Code section 1221, the court held that the taxpayer recognized capital gains upon the sale of these design improvements.[202]

Despite statutory support for the holding in *Ofria*, policy objectives strongly suggest that taxpayers should recognize ordinary income rather than capital gains upon the sale of self-produced assets. Although the sale of such assets may result in bunched income, taxpayers are often anxious to bring self-produced assets to market. Failure to do so frequently results in a loss of income; for example, an invention may become obsolete. The pressure to bring these assets to market marginalizes the lock-in effect and the tendency of taxpayers to hold appreciated property to maximize their returns.

In the majority of these cases taxpayers have invested a lot of time and creative energy, but not dollars, in the development of these assets. The success of these projects thus turn on the infusion of taxpayer's labor, not capital. By according capital asset status, congressional support of these endeavors appears at odds with the policy of encouraging the taxpayer to put risk capital at stake.

3. Life Estates

Life estates represent a final example of the kind of assets currently accorded capital asset status in apparent conflict with the policies underlying such treatment. *Black's Law Dictionary* defines a

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[199] 77 T.C. 524 (1981).

[200] *See id.* at 535.

[201] *See id.* at 540 (stating that value engineering proposals included property).

[202] *See id.* at 541 (concluding that though inventions were not shown as patentable they were economically beneficial improvements that resembled patentable inventions, thus qualifying under section 1221 as capital assets).

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"life estate" as "[a] legal arrangement whereby the beneficiary (i.e., the life tenant) is entitled to the income from the property for his or her life."[203] On numerous occasions, gains recognized upon the sale of a life estate have been held to be capital.[204] These courts often rely on the syllogism that a life estate constitutes property, the taxpayer had a life estate, and that life estates do not fall within any specified capital asset exclusion.[205]

Noticeably absent from these court decisions (except in dissenting opinions), however, is a discussion of whether tax policy supports according capital asset status to life estates. The sale or exchange of a life estate does involve a bunching problem, the size of which depends on the age of the life tenant. But the two other important grounds for according capital gain treatment are absent. The lock-in effect, particularly for an older life tenant, is minimal and the mobility of capital vis-à-vis life estates does not appear to be an important congressional concern.[206] From a policy perspective, too, there are no sound reasons to encourage investment in life estates because their establishment is not likely to spur economic development.

Reflecting on the policies underlying capital asset status, in an illuminating dissenting opinion, Judge Frank once aptly pointed out: "It may well be that, had Congress specifically thought about the problem [of how gains on life estates are taxed], it would explicitly so have defined 'capital assets' as to exclude such an interest."[207]

D. *Summary*

Upon examining the policy objectives that underlie capital asset status and evaluating the merits of according capital asset status to certain classes of assets, it is clear that the stated policy objectives for according capital asset status and the capital asset definition are

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[203] BLACK'S LAW DICTIONARY 924 (6th ed. 1990).

[204] *See* Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592, 592 (5th Cir. 1946); McAllister v. Commissioner, 157 F.2d 235, 236 (2d Cir. 1946); Bell's Estate v. Commissioner, 137 F.2d 454, 458 (8th Cir. 1943); Harman v. Commissioner, 4 T.C. 335, 347 (1944); Estate of Johnson N. Camden, 47 B.T.A. 926 (1942). By acquiescing in the Second Circuit's opinion in *McAllister*, the Service has now accepted that a life estate is property for purpose of Code section 1221. *See* Rev. Rul. 72-243, 1972-1 C.B. 233.

[205] *See, e.g., McAllister*, 157 F.2d at 236-37 (discussing life estate as property possessed by taxpayer).

[206] *See id.* at 239 (Frank J., dissenting).

[207] *See id.*

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not in sync. More specifically, a series of examples — ranging from donors' eggs to life estates — evidence the flaws in the capital asset definition.

IV. PROPOSALS TO BRIDGE THE GAP BETWEEN POLICY OBJECTIVES AND THE CAPITAL ASSET DEFINITION

The study of donor eggs, as well as other types of capital assets, illustrates the need to modify the capital asset definition. The central role of the capital asset definition should be to facilitate the three policy objectives which lead to a capital gains reduction:[208] (1) relief from the bunching problem, (2) a reduction of the lock-in effect, and (3) the establishment of a positive incentive for capital investment.[209] Recent commentary endorsing capital gain reductions continues to center on these three objectives.[210]

In reviewing the dynamics of income recognition (as described in further detail in the discussion which follows), it is clear that the capital asset definition is a poor mechanism to remedy the bunching effect. This leaves only the second and third objectives to guide Congress in the manner in which it should modify the capital asset definition. The modifications this analysis suggests are designed to narrow the scope and application of the capital asset definition.

A. *Congress Should Eliminate Reduction of the Bunching Effect from Capital Asset Status Consideration*

In determining capital asset status, Congress should eliminate the reduction of the bunching effect from consideration. In a progressive income tax rate environment, taxpayers will always confront a potential bunching effect whenever they have an amount of income in a particular tax year that deviates higher than their norm. This bunching effect exists whether the income is generated from an asset sale or from the performance of services. Consider, for example, the situation of a solo attorney who performs an extensive amount of work on a complex litigation case

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[208] *See supra* notes 147-51, and accompanying text.

[209] *See infra* Parts IV.A, IV.B, and IV.C (discussing proposals to modify capital asset distinction).

[210] *See* John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1 (1995).

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lasting for three years. Suppose the attorney prevails in the third year and is awarded substantial fees. The attorney's three years of service income will be bunched into a single tax year and taxed as ordinary income.[211] In contrast, suppose the same attorney had purchased securities and held such securities for three years. If these securities appreciated in value, gain on the sale of these securities would be capital.[212] The bunching effect is not a legitimate basis for different income tax characterizations; to the contrary, the bunching effect may beset income recognition of any kind.

Moreover, the passage of time often compounds the bunching effect. A taxpayer, for example, that purchases a share of stock that annually doubles in value will, upon the sale of such stock, have much more gain attributable to the later years than to the earlier years. Proper accounting for the bunching effect would require that the capital gains tax rate be reduced for each year the stock is held.[213] Instead, for reasons of administrative ease[214] and to alleviate the lock-in effect,[215] capital asset status accords a tax preference to any asset as long as a taxpayer's holding period for the asset is greater than one year.[216]

Finally, the bunching effect is a problem only if the receipt of a significant amount of income in a particular tax year temporarily thrusts a taxpayer into a higher marginal tax bracket. For example, imagine that a taxpayer that earns $30,000 and whose income is normally taxed at a rate of 15%, sells stock, recognizing a gain of $100,000. That gain, due to the Code's progressive rate structure,

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[211] *See id.* at 44-47.

[212] *See id.* at 52.

[213] During one point in the nation's history, capital gain status was specifically targeted to alleviate the bunching effect. As the holding period of an asset increased, there was a corresponding reduction in the percentage of gain included in income. *See* Revenue Act of 1934, ch. 277, § 117, 48 Stat. 680, 714. This attempt at income averaging was modified in 1938. *See* Revenue Act of 1938, ch. 289, § 117, 52 Stat. 447, 501, *repealed by* Revenue Act of 1942, ch. 619, § 150, 56 Stat. 798, 843.

[214] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311(a), 111 Stat. 778, 831 (1997). The 1997 Taxpayer Relief Act established 12-month and 18-month holding periods. The combination of just two holding periods resulted in such complexity. *See, e.g.*, Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998); Philip J. Harmelink & Phyllis V. Copeland, *More Complexity — But Less Tax — For Capital Asset Sales*, 60 TAX'N FOR ACCT. 196, 196 (1998) (noting that 1998 Tax Relief Act repealed two-tier holding period in favor of single holding period).

[215] When Congress experimented with a step holding period to alleviate the bunching effect, it inadvertently compounded the lock-in effect by creating an incentive for taxpayers to hold assets for longer periods of time. *See supra* note 151 and accompanying text.

[216] *See* I.R.C. § 1222(3) (1995).

may be taxed at a higher marginal tax rate, say 39.6%. But empirical studies indicate that the majority of capital gains are recognized by high income taxpayers.[217] This fact, if true, diminishes concerns regarding the bunching effect. Recognition of gains by high income taxpayers who are already at the "rate summit" do not subject their gains to higher marginal tax rates. For example, imagine that a taxpayer that earns $400,000 and whose income is already taxed at the top marginal tax rate of 39.6%, sells stock, recognizing a gain of $100,000. This taxpayer would not bear a higher marginal tax rate on such gain.

In sum, attempts to modify the capital asset definition based on the bunching effect are misplaced. Other measures, such as adopting a system of income averaging,[218] are far more refined tools to address the bunching effect. According capital asset status must, therefore, rest on policy grounds other than reduction of the bunching effect.

B. Congress Should Modify the Capital Asset Definition to Alleviate the Lock-in Effect

Congress should modify the capital asset definition to accord with the policy objective of alleviating the lock-in effect. The lock-in effect results from the fact that assets often appreciate in value. This appreciation may cause taxpayers, in light of taxes, to retain such assets.[219] Congress perceives it necessary to reduce the lock-in effect in order to increase the mobility of capital to its most efficient use[220] and to facilitate the recognition of income to

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[217] *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 1998: INDIVIDUAL INCOME TAX RETURNS 151 (1998) (reporting that 66% of net capital gains are reported by those with adjusted gross income exceeding $200,000); Leonard E. Burman & Peter D. Ricoy, *Capital Gains and the People Who Realize Them*, 50 NAT'L TAX J. 427, 427-51 (1977) (presenting data that indicates high income taxpayers realize overwhelming majority of capital gains); Allen D. Manvell, *Basic Statistics on Capital Gains*, CAPITAL GAINS READER (1992) (reporting similar patterns for prior tax years); George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity*, 48 TAX L. REV. 419, 492-93 (1993) (presenting studies which confirm this phenomenon).

[218] *See* I.R.C. §§ 1301-1305 (affording taxpayers in certain instances ability to average their income), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141(a), 100 Stat. 2085, 2117 (1986). Commentators have sharply criticized these provisions. *See, e.g.*, Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 524 (criticizing federal general income averaging provisions).

[219] *See supra* Part III.A.

[220] *See* Lee, *supra* note 210, at 13. In the legislative history to the Taxpayer Relief Act of 1997, the Senate Finance Committee reports echoes this sentiment:

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enhance revenue to the federal government.[221]

Congress should, however, accord capital asset status only to those assets where the lock-in effect is most powerful. Assets that have a limited life are poor candidates for capital asset status: the taxpayer must bring these assets to market or, over time, their worth eventually diminishes in value.[222] In these instances, accordance of preferential tax treatment to combat the lock-in effect is unwarranted. In few instances is this point more vivid than in the case of donors' eggs.

In contrast, assets that have an indefinite or an extraordinarily long life are far better candidates for capital asset status. This is because taxpayers have no immediate or long-term need to bring these assets to market. Under these circumstances, without capital asset status, taxpayers may retain their investments and thereby immobilize capital and frustrate the government's ability to raise revenue.

Assuming alleviation of the lock-in effect is an acceptable objective for according capital asset status,[223] the capital asset definition should incorporate this concept. At the outset, the capital asset definition should require that, to qualify, the measuring life of an asset be of significant duration. What the measuring life benchmark should be is a legislative decision that only Congress can make.[224]

> The Committee also believes that a reduction in the taxation of capital gains will improve the efficiency of the capital markets, because the taxation of capital gains upon realization encourages investors who have accrued past gains to keep their monies "locked in" to such investment even when better investment opportunities present themselves. A reduction in the taxation of capital gains should reduce this "lock in" effect.

S. REP. NO. 105-33, at 33 (1997).

[221] *Compare* Lee, *supra* note 210, at 56-82, *with Citizens for Tax Justice, Notes on the Budget Surplus and Capital Gains*, 80 TAX NOTES 129 (1998) (presenting study that indicates that reduction of capital gains tax rate does not result in increase in tax revenue).

[222] *See supra* note 195 and accompanying text.

[223] *See* Cunningham & Schenk, *supra* note 146.

[224] The suggestion to require that a capital asset be of significant duration was made almost four decades ago. *See* A.L.I. DRAFT, *supra* note 151, at 28. The report defines the term "limited duration asset" to mean an asset other than an asset which is of a character such that:

> (A) the future period during which the asset can reasonably be expected (at the time of its disposition) to have substantial value is not less than _____ years, or
>
> (B) the length of the future period during which the asset can reasonably be expected (at the time of its disposition) to have substantial value cannot be ascertained to be less than _____ years.

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C. Congress Should Use the Capital Asset Definition to Stimulate the Economy

Other modifications to the capital asset definition should focus on the policy objective of stimulating the economy. In part to stimulate the economy and to encourage new business ventures, Congress incorporated a preferential tax rate for capital gains.[225] Capital gain proponents argue that a tax rate preference stimulates the economy by producing higher returns for investors.[226] These higher returns compensate investors for the purported additional risk they assume in making their investments.[227]

If a capital gains preference is to operate as a legitimate economic stimulator that brings taxpayers to the market to invest and assume risk, two conditions must be met. First, capital asset status should be accorded only to assets that involve an initial outlay of funds or the commitment of credit.[228] Their absence signifies that a gain arose for reasons unrelated to market appreciation, a traditional bellwether of capital asset status.[229] In situations where there is an absence of an outlay of funds or commitment of credit, the current capital asset definition falls short of its mission of luring taxpayers to the market to invest.[230]

A second condition to secure capital asset status should be that the capital investment in property be substantial relative to its overall fair market value. The preferential tax rate for capital gains is supposed to infuse the economy with capital.[231] If the investment in capital is insubstantial, say in the development of an invention

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Id. The committee drafting the report deferred to Congress regarding the requisite number of years an asset had to be held in order for it to qualify for capital asset status. *See id.*

[225] *See supra* notes 147-51 and accompanying text.

[226] *See* Charles E. Walker & Mark A. Bloomfield, *The Case for the Restoration of a Capital Gains Tax Differential*, 43 TAX NOTES 1019, 1022 (May 22, 1989).

[227] *See id.*

[228] *See* A.L.I. DRAFT, *supra* note 151 at 179-80.

[229] To illustrate, consider again the case of the taxpayer in *Ofria* whose sale of know-how was accorded capital asset status. *See* Ofria v. Commissioner, 77 T.C. 524, 545 (1981). The taxpayer spent many hours developing the know-how. What the taxpayer risked in developing it was not capital, however, but rather the opportunity costs of developing other projects or engaging in leisure. *See id.* at 540.

[230] In each of the following cases, the taxpayer leased property from lessor, had made no capital investment, and subsequent events led the taxpayer to sell its leasehold rights at a gain. In each instance, despite the absence of economic risk, the taxpayer's gain was accorded preferential tax treatment. *See* Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592, 592-94 (9th Cir. 1960); Commissioner v. McCue Bros. & Drummon, Inc., 210 F.2d 752, 754 (2d Cir. 1952); Commissioner v. Golonsky, 200 F.2d 72, 74 (3d Cir. 1952).

[231] *See, e.g.*, *Ofria*, 77 T.C. at 540.

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or know-how,[232] market value is likely attributable instead to labor.

Capital asset status should therefore be accorded only in those instances in which the taxpayer has made a significant investment in property. The addition of a few statutory words to institute this standard would eliminate capital asset status in those investments in which taxpayers had little, if any, economic risk.[233]

D. *Summary*

Although relatively modest in nature, the suggested modifications to the capital asset definition would go a long way toward reconciling the capital asset definition with its objectives. The benefactors of these modifications would be the government, the courts, and the taxpayers. Targeting the capital asset definition to meet its objectives should lead to more government revenue generation, increased mobility of capital, and economic stimulation. Courts, which have historically found it difficult to decipher the cryptic legislative history surrounding the capital gains preference,[234] would have additional (and, hopefully, more comprehensible) guidance to orient their decisions on issues relating to gain characterization. Finally, taxpayers would be in a better position to plan their transactions in light of the clarity the new capital asset definition would offer.

CONCLUSION

> In this area the only statement one can make with conviction is that the present state of affairs is highly unsatisfactory, is steadily worsening, and therefore makes attempts at solution imperative.[235]

So Professor Stanley Surrey lamented over four decades ago

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[232] *See id.*

[233] *See* Calvin Johnson, *Seventeen Culls from Capital Gains*, 40 TAX NOTES 1285, 1288 (1990) (recommending that Congress amend Code section 1221 to read as follows: "[T]he term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), in which the taxpayer has a substantial capital investment . . . .").

[234] *See* Myron C. Grauer, *A Case for Congressional Facilitation of a Collaborative Model of Statutory Interpretation in the Tax Area: Lessons to Be Learned from the* Corn Products *and* Arkansas Best *Cases and the Historical Development of the Statutory Definition of "Capital Asset(s)"*, 84 KY. L.J. 1, 63-69 (1995-1996).

[235] Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 1019 (1956).

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regarding capital gain taxation. Were he alive today, Professor Surrey would be surprised to learn that few meaningful changes have been made in the capital asset definition.[236]

As a result, many assets are considered capital assets even though tax policy does not support this classification.[237] The issue of donor egg taxation exemplifies this problem: under the current tax regimen, donors' eggs are clearly capital assets; from a tax policy perspective, they clearly should not be.

In the Taxpayer Relief Act of 1997, Congress further enhanced preferential tax treatment offered to long-term capital gains.[238] To minimize their taxes, taxpayers have added incentive to figuratively fit and contort as much of their property as is possible within the purview of the capital asset definition. This exploitation of the capital asset definition likely diminishes revenue and places added tax burdens on other forms of income. Several studies indicate that preferential capital gain treatment primarily benefits the wealthy,[239] information that indicates the Code's generous capital asset definition retards the tax system's equity.[240]

Modifications to the capital asset definition would erase the incongruities between practice and policy. If such changes are not

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[236] If anything, Professor Surrey's concerns have been confirmed: tax practitioners are constantly developing new techniques to exploit the inadequacies of the capital asset definition and command preferential tax treatment. *See, e.g.*, James A. Fellows & Michael A. Yuhas, *Sales of Reality in an Era of Tax Reform: Capital Gains Versus Ordinary Income*, 25 REAL EST. L.J. 276 (Winter 1997); Shaya Schimel & Arthur J. Innamorato, *More Assets May Be Eligible for Capital Gain on Disposition than Is Apparent at First Glance*, 35 TAX'N FOR ACCT. 264 (1985); Laurence Goldfein & Lester Hochberg, *Use of Commodity Straddles Can Effect Impressive Tax Savings*, 29 J. TAX'N 342 (1968).

[237] Capital assets even include such unusual things as Mark McGuire's record-breaking home run baseball. *See* Bill Dedman, *Fan Snaring No. 62 Faces Big Tax Bite*, N.Y. TIMES, Sept. 7, 1998, at D4 (noting that "[a] fan who wants to sell the ball would be wise to keep it for at least a year. Then it becomes a long-term capital asset, subject to the maximum capital gains rate on collectibles of 28%, or $280,000 on $1 million.").

[238] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311(a), 111 Stat. 778, 831 (1997). This legislation reduced the highest marginal tax rate applicable to capital gains from 28% down to 20%. *See id.* In addition, beginning in the year 2000, the highest marginal tax rate for capital assets held for more than five years will be 18%. *See id.*

[239] *See* George R. Zodrow, *supra* note 217 at 491; Albert J. Davis, *Measuring the Distributional Effects of Tax Changes for the Congress*, 44 NAT'L TAX J. 257 (1991); Gerald E. Auten & Joseph J. Cordes, *Policy Watch: Cutting Capital Gains Taxes*, 5 J. ECON. PERSP. 181, 186-89 (1991).

[240] One commentator long ago observed that because "the great accumulations of wealth by individuals in this country have largely been the result of capital gains, and the salary of wage-earning classes might quite naturally feel that they were being unjustly discriminated against if they were taxed on their salaries or wages and the large capital gains of the very wealthy should escape taxation." George O. May, *The Taxation of Capital Gains*, 1 HARV. BUS. REV. 11, 12 (1922).

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instituted, tomorrow's litigation will undoubtedly focus on the capital status of donors' eggs.

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