12 T.C. 320 (1949)

Payments received as a substitute for lost profits, arising from a contract modification that reduced those profits, are considered ordinary income for tax purposes, not capital gains.

Summary

Charles E. McCartney received a payment from Lomita Gasoline Co. in exchange for releasing a contract entitling him to a percentage of Lomita's gas sales to Petrolane, a corporation co-owned by McCartney. The original contract was created to compensate McCartney for agreeing to a price increase in Lomita's gas sales to Petrolane, which would reduce McCartney's profits from Petrolane. The Tax Court held that the payment McCartney received for releasing the contract was ordinary income because it represented a substitute for lost profits, not the sale of a capital asset.

Facts

McCartney developed a process for using liquefied petroleum gas. He contracted with Lomita for gas supply. McCartney and Lomita formed Petrolane, with McCartney owning 30% and Lomita 70%. Lomita supplied gas to Petrolane at favorable prices. Later, Lomita wanted to increase the gas price to Petrolane. To compensate McCartney for the anticipated reduction in Petrolane's profits (and thus his dividends), Lomita agreed to pay McCartney 15% of gas sales revenue from Petrolane. In 1944, Lomita paid McCartney $69,300 to release his rights under the 1935 contract.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in McCartney's income tax for 1944, arguing the $69,300 payment was ordinary income. McCartney argued it was a long-term capital gain. The Tax Court ruled in favor of the Commissioner.

Issue(s)

Whether the payment received by Charles E. McCartney in 1944 for the release of his contract with Lomita Gasoline Co. should be treated as capital gain or ordinary income for tax purposes.

Holding

No, because the payment represented a substitute for lost profits, which would have been taxed as ordinary income, and because the release of the contract did not constitute a 'sale or exchange' of a capital asset.

Court’s Reasoning

The Tax Court reasoned that McCartney’s 1935 contract was designed to replace profits he would lose due to the increased gas price charged to Petrolane. The court stated, “The payments provided by the contract, being a substitute for profits, which are income, were ordinary income and not capital gain.” The court also rejected McCartney’s argument that he sold a capital asset. The court emphasized, “The contract here was not sold, it was extinguished. Lomita acquired no exchangeable asset. The transaction, although in form a sale, was a release of the obligation.” Since there was no “sale or exchange” of a capital asset, the payment was deemed ordinary income.

Practical Implications

This case illustrates the principle that payments intended as substitutes for what would otherwise be ordinary income are taxed as ordinary income, even if received in a lump sum. This impacts how settlements, buyouts, and other transactions are structured and taxed. Legal practitioners must carefully analyze the underlying nature of a payment to determine its proper tax treatment. The case highlights that simply labeling a transaction as a “sale” does not automatically qualify it for capital gains treatment; the substance of the transaction must involve the transfer of a capital asset. Later cases distinguish situations where an actual asset is sold versus when an obligation is merely extinguished.

