22 T.C. 13 (1954)

A lump-sum payment received in lieu of future royalty payments retains the character of the original royalty income and is therefore taxed as ordinary income, not capital gain, especially when the payment represents accrued but unpaid royalties.

Summary

In 1942, Jesse L. Lasky received a lump-sum payment of $805,000 from United Artists, which represented the proceeds from his contractual interest in the earnings of the motion picture "Sergeant York." Lasky claimed this should be taxed as capital gains. The Tax Court, however, determined the payment constituted ordinary income, not capital gain. The Court focused on the nature of Lasky's original agreement with Warner Bros. where his income was based on a percentage of gross film rentals, which was considered royalty income. Because the lump sum was essentially a substitute for those royalties, it retained the same character, regardless of the form of the transaction (e.g., the involvement of United Artists). The Court looked beyond the mechanics of the transfer to the substance of the income source.

Facts

In 1940, Lasky acquired the motion picture rights to the life story of Sergeant York and assigned those rights to Warner Bros. In return, Lasky was to receive a percentage of the film's gross receipts, thus generating royalty income. Lasky received advance payments in 1941 against future royalties. In 1942, Lasky sought to terminate the agreement and, through an intermediary (United Artists), received a lump-sum payment of $805,000. Lasky then reported the $805,000 as long-term capital gain from the sale of a capital asset.

Procedural History

The Commissioner of Internal Revenue determined that the $805,000 was ordinary income. The Tax Court reviewed this determination in response to petitions filed by Lasky and his wife.

Issue(s)

Whether the $805,000 lump-sum payment received by Lasky in 1942 was properly taxable as ordinary income rather than capital gains.

Holding

Yes, because the payment was in lieu of, and derived from, the original royalty income structure, it was taxable as ordinary income.

Court's Reasoning

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The Tax Court emphasized that the substance of the transaction, not its form, governed the tax treatment. The Court looked at the nature of the original agreement, which established a royalty income stream. Lasky had originally received income in the form of royalties based on the film's gross receipts. The Court noted that the subsequent lump-sum payment, although structured as a sale to a third party, was merely a method to receive the accumulated, unpaid royalties. The Court cited the principle that the character of income follows its source. The Court stated that the

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