Foote v. Commissioner, 81 T. C. 930 (1983)

Tenure at a university does not constitute a capital asset for tax purposes, and payments received for resigning a tenured position are taxable as ordinary income.

Summary

Merrill J. Foote, a tenured professor at Southern Methodist University, resigned his position and relinquished his tenure in exchange for a negotiated payment. The issue before the U. S. Tax Court was whether this payment should be taxed as capital gain or ordinary income. The court held that tenure is not a capital asset, and the payment received was taxable as ordinary income. The court reasoned that tenure does not meet the statutory definition of a capital asset and that the payment was essentially a substitute for future ordinary income that Foote would have earned had he continued teaching.

Facts

In 1968, Merrill J. Foote joined Southern Methodist University (SMU) as an assistant professor and was promoted to associate professor in 1971. In 1972, SMU recognized Foote's tenure status, which he received through de facto tenure due to his prior teaching experience. Tenure at SMU provided lifetime employment security and allowed more freedom for scholarly and professional activities. In 1977, due to friction with the administration and his focus on outside business activities, Foote resigned his tenured position in exchange for $45,640, to be paid in monthly installments throughout 1977 and 1978. Foote reported these payments as long-term capital gain on his tax returns, while the Commissioner of Internal Revenue asserted they were ordinary income.

Procedural History

Foote filed a petition in the U. S. Tax Court after receiving a notice of deficiency from the Commissioner for the tax years 1977 and 1978. The Tax Court heard the case and issued its opinion on December 7, 1983, deciding in favor of the Commissioner.

Issue(s)

1. Whether the payments received by Foote from SMU for resigning his tenured position are taxable as long-term capital gain or as ordinary income?

Holding

1. No, because tenure is not a capital asset within the meaning of sections 1221 and 1222 of the Internal Revenue Code, and the payment received was a substitute for future ordinary income.

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Court’s Reasoning

The court applied the statutory definition of a capital asset from section 1221 of the Internal Revenue Code, which excludes property held primarily for sale to customers or depreciable property used in trade or business. The court determined that tenure did not meet this definition because it is a personal right that cannot be transferred or sold to another person. The court cited numerous cases, such as Commissioner v. Gillette Motor Transport, Inc. , to support the principle that payments received for the termination of contract rights to perform personal services are taxable as ordinary income. The court rejected Foote’s economic argument that tenure could be considered a capital asset, emphasizing that the payment was a substitute for future salary and other income he would have earned. The court also noted that there was no sale or exchange of tenure, as it simply ceased to exist upon resignation. The court concluded that the payments must be reported as ordinary income.

Practical Implications

This decision clarifies that payments received for resigning a tenured position at a university are not eligible for capital gains treatment. It impacts how similar cases involving the termination of employment contracts should be analyzed for tax purposes, emphasizing that such payments are generally taxable as ordinary income. The ruling may influence negotiations between universities and tenured faculty members contemplating resignation, as it removes the potential tax advantage of treating such payments as capital gains. This case has been cited in subsequent decisions involving the tax treatment of payments for the termination of employment contracts, reinforcing the principle that such payments are not capital gains.

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