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Notes

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NOTES

DAMAGES RECOVERABLE FOR THE INFRINGEMENT OF A COPYRIGHT.—Where the work of a copyright proprietor has been infringed, his remedies under the present Copyright Act have been classified 1 as 1. Recovery of the profits made by the infringer; 2. Recovery of the actual damages in addition to such profits; and 3. Recovery in lieu of profits and actual damages, but not by way of penalty, designated sums within a minimum — maximum schedule. This paper concerns the recovery of damages, as distinguished from the profits realized by the infringer, whether they be actual damages or those recoverable solely by virtue of statutory provision.

Historical Background — The Common Law Copyright

Although the primary justification set forth by the courts in creating the so-called common law copyright was a recognition of the property right of the creator and the monetary return that might thereby accrue to him, an equally important basis was that of encouraging intellectual labor and thereby securing to society the beneficial products that might result. 2 This twofold reason underlying the social interest in copyright was recognized in the Federal Constitution wherein it was provided that:

"The Congress shall have power 3 . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." 4

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1 Wel on Copyright.
2 AN ENCYCLOPEDIA OF THE SOCIAL SCIENCES, Copyright, p. 401 (1930).
3 U. S. CONST., Art I, § 8.
4 U. S. CONST., Art. I, § 8 (8).
And the court decisions that followed, though using varying and different phraseology, reiterated this social interest as the reason supporting the principle. However comprehensive the law on this subject is today, it must be remembered that, as was the case with other phases of the law, it represents the imperceptible accretion over the years of the usage and interest of society in the intellectual labor of its members. And to correctly understand and estimate the importance of present statutory provisions it is necessary to examine the beginning — the common law copyright — and what influence, if any, it has at the present day.

At the outset it should be noticed that the common law copyright still exists independent of statute and is an actual and independent right, irrespective of whether statutory protection has been applied for. It "entitles the proprietor thereof to the exclusive use of the production before publication and the exclusive right to copy the production until he permits a general publication." Also defined as the right of first publication, it is an absolute property right capable of being transferred and recognizable as such where infringement or interference is threatened. However, the right itself must be distinguished from the material object which is the subject of the right. As was pointed out in a very recent case, "It is an intangible, incorporeal right in the nature of a privilege or franchise quite independent of any material substance such as the manuscript or the plates used for printing." And Judge Drummond speaking as early as 1870 stated that common law copyrights exist independent of any notwithstanding statutory enactments:

"The author of any literary or dramatic work is the sole proprietor of the manuscript and its contents and of copies of the same independent of legislation, so long as he does not publish it or part with the right of property. This is called a common law right and exists irrespective of copyright statutes."

It is in the nature of common law copyright that it can exist only in manuscripts and other unpublished works. But it is a different and independent right from that of ownership in an article of personal

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6 "The law undertakes to encourage the publication of works of this character." Wermmeister v. Springer Lithographing Co., 63 Fed. 808, 810 (C. C. S. D. 1894).
6 34 A. M. JUR., LITERARY PROPERTY AND COPYRIGHT, § 10.
8 Crowe v. Aiken, 2 Biss. 208, 6 Fed. Cas. 904, No. 3,441 (N. D. Ill. 1870).
9 Remick Music Corp. v. Interstate Hotel Co. of Nebraska, 58 F. Supp. 523, 542 (D. Neb. 1944).
10 Crowe v. Aiken, 2 Biss. 208, 6 Fed. Cas. 904, 905, No. 3,441 (N. D. Ill. 1870).
11 AMDUR, COPYRIGHT LAW AND PRACTICE, § 35 (1936).
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property, being in the nature of a privilege or franchise as heretofore noted. Though the common law and the statutory copyright cannot co-exist, it does not necessarily follow that by the enactment of statutory provision that the rights incident to and characteristic of the common law copyright are thereby extinguished. They continue to exist independent of all statutory enactments and have been recognized and excepted from the operation of the federal act by a specific reference therein. The reason underlying this mutual exclusiveness can best be appreciated by recourse to a definition of terms. Thus the common law copyright has been termed "copyright before publication" and is the exclusive right of first publishing any original material product of intellectual labor. On the other hand, statutory copyright has been defined as "copyright after publication" and is the right to multiply copies of a literary work to the exclusion of others and exists only by reason of specific statutory enactments. It is designed to protect the producer who complies with the mandatory requirements of the act. In return, although the common law right is thereby extinguished, he acquires a sort of monopoly for a limited period. A new and totally different property right is thereby effected and protected even after general publication, which publication would have obviated any further protection under the doctrine of common law copyright. Without further elaboration it can be seen that an abortive attempt to secure a statutory copyright may in some cases destroy all rights under the common law theory, and thus leave the proprietor remediless. The determining factor in such a situation is what constitutes a publication. In Jewelers Mercantile Agency v. Jewelers Weekly Publishing Co. it was held that the mere deposit of two copies of the manuscript with the Librarian of Congress as required by statute would constitute a publication thereof, irrespective of whether or not a copyright was secured, and destroyed all rights incident to the copyright at common law. However, in a very early case it was held that the filing of a copy of the title page of a drama manuscript preparatory to obtaining a copyright was not such a publication as would cause the author to lose his common law rights and thereby serve as a dedication of his work to the public.

19 155 N. Y. 241, 49 N. E. 872 (1898).
20 Jones v. Thorne, 1 N. Y. Legal Obs. 408 (1843).
Having ascertained the existence of the exclusive right in a manuscript prior to publication, our next consideration is how far and in what manner will the courts protect this common law right? That there is liability in damages for any unwarranted interference or infringement is uncontroverted, but the authorities are by no means agreed as to the correct measure to apply. Generally it may be said that:

"There is little authority on the question of the amount of damages recoverable in cases of invasion of common law rights in literary property. Determination of the amount seems to lie in the discretion of the jury upon consideration of the facts of the case, and the fundamental rule of awarding a fair compensation and indemnity for loss, apparently is applied." 21

The measure applied by the courts varies with the factual situation and apparently is adapted to meet the exigencies of each individual case. Thus where a carrier lost the baggage of one of its passengers which included an unpublished manuscript, the court though making no specific reference to the doctrine of common law copyright, recognized the manuscript as a thing of value, the exclusive property right which was vested in the party damaged. Therefore recovery was allowed, the measure being the cost of reproduction. 22 And where a manufacturer used ideas submitted at his request by an advertising agency but refused payment, the court applied the measure as being the value of the use of the idea to the infringing party, 23 stating that even though the ideas were submitted for consideration, there was, nevertheless, not such a publication as would defeat the common law right to first publication and so would not excuse subsequent use without permission or preclude liability therefor. So also in the case of State v. State Journal Co. 24 where the court, though refusing to predicate liability upon the grounds of an infringement of a common law copyright, nevertheless reached the same result by applying the value of the use measure and stating that should the use amount to a conversion then the measure would be the value of the property itself and not merely the value of the use thereof. Where, however, there has been a wanton and malicious disregard of the author's rights as was the case in Press Publishing Co. v. Monroe 25 and an infringement is knowingly and wilfully made, exemplary damages will be awarded and such award is not dependent upon the proof of actual pecuniary damage. In that case the author sold an ode she had composed for use in the dedicatory exercises at the World's Fair, reserving the copyright until

23 Ryan and Assoc. v. Century Brewing Assn., 185 Wash. 600, 55 P. (2d) 1053 (1936).
24 75 Neb. 275, 106 N. W. 434 (1905).
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a publication should be made in any one of a specified number of ways. Defendant newspaper published it without her permission after she had delivered it, though notified by their Chicago correspondent that it was copyrighted. The court in determining whether a common law copyright still existed said: "A reservation by the author 'subject to the concession herein made . . . of her copyright in the poem', imports a reservation of common law as well as statutory copyright." Relief can be procured by way of damages then, though different measures are applied. But what of the cases wherein it is impossible to prove actual pecuniary loss — what relief will the courts then afford?

Should the interference be a threatened one and not actually inflicted, recourse may be had to equity. Thus Pomeroy says:

"A jurisdiction has become well established by modern decisions to restrain the invasion or piracy of literary property in the product of intellectual labor, which still remains in the form of manuscript, or which, if printed, has not been published, and over which, as a consequence, no statutory copyright has been obtained." Of course the injunction is also available after infringements and damages resulting therefrom. But to all intents and purposes there is no remedy whereby a recovery may be had for the pecuniary loss previously sustained by reason of the infringement already committed. However, it has been held that where an unlawful use can be shown, a court of equity is authorized to grant an order for an accounting as well as an injunction. But this is adequate only where the profits actually realized from the infringement coincide with the damage inflicted. It is inconceivable that such a state of equilibrium will ever be reached. On the other hand, no recovery could be had under this theory where there was an infringement but no profits were made. To correct these manifest inequities, something in addition to the common law remedies was necessary.

Statutory Modification

At the common law, no relief was forthcoming in the absence of proof of actual damages inflicted. This defect was recognized at a very early date and statutes enacted in an attempt to rectify it. These statutes, however, were not in derogation of the common law copyright but were supplementary thereto and also afforded some protection to the copyright proprietor after publication had been made, provided of course that certain conditions precedent had been fulfilled. The historical basis for these statutes might be summarized as:

26 Id. at 198.
27 POMEROY, EQUITY JURISPRUDENCE (4th Ed. 1919).
28 French v. Kreling, 63 Fed. 621 (N. D. Cal. 1894).
"The right of an author, irrespective of statute, to his own productions and to a control of their publication, seems to have been recognized by the common law but to have been so ill-defined that from an early period legislation was adopted to regulate and limit such right."  

Such regulation of the common law right secured three heretofore unrealized advantages — rights after publication, award of damages where no actual damages could be shown to exist, and remedies for infringement. Until the passage of these statutes comprising the various Copyright Acts none of these benefits were obtainable, either because of the absence of such specific provisions at the common law or because the peculiar circumstances of the case were inadmissible as evidence. These statutory modifications were not a continuation of the common law right, however. They were a new, severable, and distinct right created by Congress in conformity with the provisions of the Federal Constitution. This distinction was recognized in an early Supreme Court case wherein it was pointed out:

"That an author at common law has a property in his manuscript, and may obtain redress against any one who endeavors to realize a profit by its publication cannot be doubted; but this is a very different right from that which asserts a perpetual and exclusive property in the future publication of the work, after the author shall have published it to the world."

These same principles were reiterated in a later Supreme Court case wherein the court sought to clarify the impression that the Copyright Act superseded the common law right by declaring:

"The contention of the plaintiff in error that the passage by Congress of the copyright statutes has abrogated the common law right of an author to his manuscript is unsupported by authority. These statutes secure and regulate the exclusive property in the future publication of the work after the author shall have published it to the world. "But this is a very different right from the ownership and control before publication."

The property right of exclusive use before publication, then, will be protected independent of and notwithstanding the copyright statutes. The point of departure, then, is the divestiture of the common law right and the substitution therefor of the common law copyright as well as correcting the discrepancies that existed therein. As was said in Bobbs-Merrill Co. v. Straus:

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29 Holmes v. Hurst, 174 U. S. 82, 84, 43 L. Ed. 904, 905 (1899).
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“The surrender of the perpetual right (of property under the doctrine of common law copyright) is a condition precedent to the enjoyment of statutory copyright. The common law right is lost by the general publication or unrestricted sale of a single copy. The statute protects the owner in the unrestricted publication and sale of all copies during the term of the copyright. The right to copyright which exists at common law, has been superseded by statute. Where the owner of the common law copyright elects to substitute the protection of the statute for that of the common law, he, upon publication, abandons or surrenders his common law rights, including said right of limited publication, in exchange for the statutory right, the exclusive right to multiply copies. He cannot have at the same time his benefit of the copyright statute and also retain his common law right. No proposition is better settled than that a statutory copyright operates to divest a party of the common law right.”

With this background we can now proceed to a consideration of the terms of the statute, its interpretation, and the difference in protection afforded the author under the code as compared to the meager protection which we have seen is available at the common law.

In determining what effect and interpretation shall be given the express terms of the statute, recourse must be had to legislative intent. Judicial determination of this intent in the application of the provisions of a statute to a given case is a cardinal rule of statutory construction. What then, was the purpose of Congress in passing the Copyright Act? As was succinctly stated in a recent Federal case:

“The Copyright Statute, 17 U. S. C. A. section 1 et seq., was enacted for the protection of property rights and not for the purpose of providing a means by which a penalty could be collected in the nature of damages.”

As to what effect should therefore be given its provisions, the statement made by Justice Day in the early case of American Tobacco Co. v. Werckmeister has been, and still is, quoted as paramount authority:

34 147 Fed. 15, 19 (C. C. A. 2d, 1906); affirmed 210 U. S. 339, 52 L. Ed. 1086 (1908); 52 Fed. 1086 (1908) citing Dorne ON COPYRIGHT at page 346; “As the law is now expounded, there are important differences between the statutory and the common law right. The former exists only in works which have been published within the meaning of the statute, and the latter only in works which have not been so published. In the former case, ownership is limited to a term of years; in the latter, it is perpetual. The rights do not co-exist in the same composition; when the statutory right begins, the common law right ends. Both may be defeated by publication. Thus, when a work is published in print, the owner’s common law rights are lost and, unless the publication be in accordance with the requirements of the statute, the statutory right is not secured.”

35 2 SUTHERLAND, STATUTORY CONSTRUCTION (3rd Ed. 1943) 176.


37 207 U. S. 284, 291, 52 L. Ed. 208, 214 (1907).
“Under this grant of authority (as contained in the provisions of the Federal Constitution) a series of statutes have been passed, having for their object the protection of the property which the author has in the right to publish his production, the purpose of the statute being to protect this right in such manner that the author may have the benefit of this property for a limited term of years. These statutes should be given a fair and reasonable construction with a view to effecting such purpose.”

In applying these tests of purpose and construction to the Copyright Act, recourse must be had not only to that section dealing with damages recoverable but also to those parts of the Act which define and limit the interferences constituting damage. Before the measure of damages may be ascertained, the question of what is damage under the Copyright Act must be resolved. Section 25 provides the penalties that will be assessed, “If any person shall infringe the copyright in any work protected under the copyright laws of the United States.” Answering the question, what is infringement, then, is tantamount to determining what constitutes damage under the Copyright Act.

**Infringement**

The word “infringe” is derived from the Latin *infringere*, meaning to break. Bouvier defines an infringement as:

“A word used to denote the act of trespassing upon the incorporeal right secured by a patent or copyright... for which damages may be recovered at law by an action on the case, or which may be remedied by a bill in equity for an injunction and an account.”

Thus the Latin source, in addition to defining in a general way the nature of the interference also prescribes the remedy because an action of trespass on the case is one wherein there has been a breaking and entering upon the possession of another with results in an indirect as distinguished from an immediate and direct injury. In the case of Copyright, that right of possession, depending upon whether it was common law or statutory copyright, would be the exclusive right of the proprietor to the product of his labors, and the interference though working no immediate ascertainable injury, might impair future earnings and profits by reason of the unauthorized publication.

Although numerous cases have reiterated the principle that there is no distinction between an infringement at common law and under the copyright statute, nevertheless the problem is somewhat complicated

38 U. S. Const., Art I, § 8.
40 BOUVIER'S LAW DICTIONARY, Rawle's Third Revision (1914).
41 Notes ( ) 51 L. R. A. 278.
by continued references to "infringement" in the specific wording of
the present Act, but with no specific definition of the term therein.
The English Act on the other hand provides that:

"Copyright in any work shall be deemed to be infringed by
any person who, without the consent of the owner of the copyright
does anything the sole right to do which is by this act conferred
on the owner of the copyright."

In spite of the absence of an express definition in the American Statute,
a perusal of the Act as a whole indicates that a definition of a sort
can be dissected therefrom. As to the process to be followed in achieving
this desirable result, attention should first of all be called to the
initial sentence of the Statute: "Any person entitled thereto, upon
complying with the provisions of this title, shall have the exclusive
right:"

Thereupon are listed the specific rights protected by the
statute. By implication, therefore, it may be concluded that any action in derogation of the provisions shall constitute an infringement.
That such was in the contemplation of Congress when the statute was
enacted can be determined from the provisions of the Act which are
there set out, providing for specific relief where the provisions of the
Act are disregarded. This is also readily discernible from the fact
that no definition as such was incorporated into the otherwise com-
prehensive provisions of the Act, thus evidencing the intention of Con-
gress that the construction as herein made should control.

What the statutes assume in a general way, the established decisions
interpret to a point beyond which further refinement is unnecessary.
Thus it has been held that the intention to infringe is not an essential
attribute of the offense. Once the fact of infringement has been
established a cause of action is presented because the intent to in-
fringe is immaterial. The result and not the intention at the time
the deed was done controls. As was said in a recent Federal case,
"Assuming that the defendant did not intend to infringe, the lack of
intention does not affect the fact of liability. The result and not the
intention determine the question of infringement." How great an
invasion of the rights of another must it be to constitute an infringe-
ment? It has been decided that substantial portions of the copyrighted
matter must be appropriated so that it definitely appears that the

42 17 U. S. C. A., § 1 et seq.
43 Fenning Film Service v. Wolverhampton, Walsall, and District Cinemas
(1914) 3 K. B. 1171.
45 Italics those of this writer.
work of the proprietor has been used.\textsuperscript{51} It is that conduct, “whether being one act or many, which constitutes a connected and fairly unitary invasion of the proprietor’s rights.”\textsuperscript{62}

Insofar as actual copying is concerned, there again it must be substantial even though it constitutes but a small portion of the entire work.\textsuperscript{53} A quite recent decision interpreted copying as being something more than merely transcribing from one work to another:

“Copying is not confined to a literary repetition, but includes various modes in which the matter of any publication may be adapted, colorable alteration.”\textsuperscript{54}

In that case a lecturer appropriated to his own use a manner of presentation and a combination of ideas on the subject of memory aids and the court decided that this constituted copying sufficient to justify a finding of infringement. Inasmuch as an exact copying is not essential, it would seem logical that paraphrasing would also constitute an infringement. And it has been so held.\textsuperscript{55} Similarly, the playing of musical compositions without the consent of the copyright holders is an infringement,\textsuperscript{56} coming within the provisions of section 1 of the Act.\textsuperscript{57} And the fact that the presence of the orchestra is merely incidental to the main purpose for which the business is conducted is beside the point for it has been definitely stated that, “Whether it pays or not, the purpose of employing it is profit, and that is enough.”\textsuperscript{58} From the foregoing, it can be seen that the infringement of a copyright is an actionable wrong — a tort\textsuperscript{60} — the burden of proof of which is on the party seeking to establish the fact of infringement — the party plaintiff.

Various tests have been formulated to determine whether the facts of a particular case constitute an infringement. Thus there is no liability unless “the whole or a part of the copyrighted work has been copied, either in \textit{haec verba} or by colorable variation.”\textsuperscript{60} Or, as was said in the case of \textit{Simonton v. Gordon}:\textsuperscript{61}

\begin{itemize}
  \item \textsuperscript{51} Roe-Lawton v. Hal E. Roach Studios, 18 F. (2d) 126 (S. D. Cal. 1927).
  \item \textsuperscript{52} Westermann Co. v. Dispatch Printing Co., 233 Fed. 609, 615 (C. C. A. 6th, 1916).
  \item \textsuperscript{53} Towle v. Ross, 32 F. Supp. 125 (D. Ore. 1940).
  \item \textsuperscript{54} Nutt v. Nat’l Institute for Improvement of Memory, 31 F. (2d) 236, 238 (C. C. A. 2d, 1929).
  \item \textsuperscript{55} Borden v. General Motors Corp., 28 F. Supp. 330 (S. D. N. Y. 1939).
  \item \textsuperscript{56} Buck v. Dacier, 26 F. Supp. 37 (D. Mass. 1938).
  \item \textsuperscript{57} 17 U. S. C. A. § 1 — giving the exclusive right “To perform the copyrighted work publicly for profit if it be a musical composition.”
  \item \textsuperscript{58} Herbert v. Shanley Co., 242 U. S. 591, 595, 61 L. Ed. 511, 514 (1916).
  \item \textsuperscript{59} Frankel v. Irwin, 34 Fed. (2d) 142 (S. D. N. Y. 1918).
  \item \textsuperscript{60} Edward Thompson Co. v. American Law Book Co., 122 Fed. 922, 923 (C. C. A. 2d, 1903).
  \item \textsuperscript{61} 12 F. (2d) 116, 124 (S. D. N. Y. 1925).
\end{itemize}
"Whether the similarities existing . . . are mere coincidences arising because of the development . . . of a central idea taken from a common source, or whether these similarities are such as to . . . reveal plagiarism, and further, if there was not piracy, was there such an unintentional infringement of complainant's copyright as to justify the equitable relief which complainant seeks?"

Mere likeness, then, is not the real test, rather, "The finding that the second 'work' is not an original treatment of a subject open alike to treatment by both, but is a copy more or less servile of the first." 

Where it requires "dissection rather than observation to discern any resemblance," there is no infringement. To apply such a test would engrat too rigorous a restriction upon the author and would serve to permit the copyrighting of what has been recognized as the common source. Substantial appropriation to that extent, then, is not enough. Capability of apprehension by the so-called reasonable man is in addition necessary.

Before leaving the question as to what constitutes an infringement, a reference in passing should be made to the question of what constitutes a subsequent infringement. Although the topic will be considered more fully under the damages section of this paper, there is one phase of the problem that is more closely related to what constitutes infringement than to what damages to assess. For as we have seen, in order to have any measure of damages we must first of all ascertain if there has been an infringement. The chief diversity of judicial opinion has centered around the field of radio and the specific question as to whether or not rebroadcast constitutes any infringement.

The divergence of judicial opinion on this subject is probably attributable to the comparative ignorance of all save experts as to what the technicalities of radio were and just what was involved in the process of broadcasting and subsequent reception. Nor was there a keen appreciation of the possibilities of radio and the manifold and varied uses to which it could be put. Consequently, the dangers and extent of infringements of copyrights were not too readily perceived nor could the extent of the influence of radio in future years be readily estimated. Thus in an early Missouri case the court held that a hotel proprietor in receiving a radio broadcast on a master set and subsequently disseminating it throughout the hotel, both to its public and private rooms, did not infringe the proprietor's copyright because:

"The waves thrown out upon the ether are not a record of the original performance. They are the original performance. Their

reception is not a reproduction but a hearing, of the original performance. The reception of a musical composition on a radio receiver is not a performance at all."

In that case, the radio studio was not licensed to broadcast the infringing composition and the only question was as to how far the liability should extend. But in a California case a Supreme Court decision which was an appeal of the Missouri case cited above and in which the decision of the District Court was reversed. In concluding that the rebroadcast was such a reproduction as would justify an award of damages where a copyright was thereby infringed, the court distinguished between a hearing and a reproduction so that a hearing could be effectuated:

"We are satisfied that the reception of a radio broadcast and its translation into audible sound is not a mere audition of the original program. It is essentially a reproduction. As to the general theory of radio transmission there is no disagreement. All sounds consist of waves of relatively low frequencies which ordinarily pass through the air and are locally audible. Thus music played at a distant broadcasting studio is not directly heard at the receiving set. In the microphone of the radio transmitter the sound waves are used to modulate electrical currents of relatively high frequencies which are broadcast through an entirely different medium, conventionally known as the 'ether.' These radio waves are not audible. In the receiving set they are rectified; that is, converted into direct currents which actuate the loud speaker to produce again in the air sound waves of audible frequencies. The modulation of the radio waves in the transmitting apparatus, by the audible sound waves is comparable to the manner in which the wax phonograph record is impressed by the same waves through the medium of a recording stylus. The transmitted radio waves require a receiving set for their detection and translation into audible sound waves, just as the record requires another mechanism for the reproduction of the recorded proposition. In neither case is the original program heard; and, in the former, complicated

66 Buck v. Debaum, 40 F. (2d) 734, 735 (S. D. Cal. 1929).
67 283 U. S. 191, 199, 75 L. Ed. 971, 977 (1931).
electrical instrumentalities are necessary for its adequate reception and distribution. Reproduction in both cases amounts to a performance."

And the fact that the broadcasting station has a license to perform does not enable the receiver to disseminate the composition for the public and for profit, it being held that "there is not any privity whatever between the broadcaster and the receiver" and so the question of infringement "Depends not on the broadcaster's rights but the receiver's rights." In construing the license as one solely for the performance given by the broadcasting company, the court dissipated the theory of such an act impliedly sanctioning a "pick-up" of the performance by all capable of doing so and using it as they saw fit. Such is the law as to rebroadcast constituting infringement as it exists today.

**Damages**

As we have already noticed, the shortcomings of the common law in protecting the copyright proprietor against infringements and in assessing damages for pecuniary loss actually proved, led to the enactment of statutory provisions to remedy these defects as well as to provide further incentive to the exercise of creative genius by securing exclusive rights after publication. As one authority on the subject has said:

"The sole justification for these statutory damages . . . is that they deter wilful infringements and to some extent compensate the copyright owner for his considerable expense in investigating, prosecuting, and protecting his copyright."  

It might be added that such compensation entails the award of damages, though actual, non-provable, at the common law.

That part of the Act which remedies these short-comings of the common law by allowing the so-called statutory damages specifically provides:

"If any person shall infringe the copyright in any work protected under the copyright laws of the United States, such person shall be liable: . . .

"To pay to the copyright proprietor such damages as the copyright proprietor may have suffered due to the infringement, . . . or in lieu of actual damages and profits, such damages as to the

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70 Shafter, Musical Copyright, 306 (2d Ed. 1939).
court shall appear just, and in assessing such damages the court may, in its discretion, allow the amounts as herein stated." (Thereupon follows a schedule of damages recoverable). "But the foregoing exceptions shall not deprive the copyright proprietor of any other remedy given him under this law, nor shall the limitations as to the amount of recovery apply to infringements occurring after the actual notice to a defendant, either by service of process in a suit or other written notice served upon him."

The copyright proprietor then, can 1. recover the actual damages suffered; 2. recover statutory damages within the minimum — maximum provisions; 3. recover according to a fixed scale; or 4. recover such damages as the court may think just. The system of remedies as thus enumerated are exclusive whenever the question is the determination of what damages to assess for the infringement of a copyright. The reason underlying this proposition is that by complying with the provisions necessary to secure a statutory copyright, the rights at common law are thereby forfeited and the remedies provided for by statute alone remain. The legislative intent was to thus provide for the situations wherein actual proof of the profits received or damages sustained was difficult to ascertain. Congress was motivated by:

"A desire to provide for the recovery by the proprietor of full compensation from the wrongdoer for the damages such proprietor has sustained from the wrongful act of the latter. In the fact of the difficulty of determining the amount of such damages in all cases, the statute provides a minimum sum for a recovery in any case, leaving it open for a larger recovery upon proof of greater damage in those cases where such proof can be made."

The fact of the provisions of this section being for *compensation* merely and not by way of a penalty for infringement cannot be too strongly stressed. As one text writer has observed:

"The imposition of the statutory or 'in lieu' damages deters wilful infringement, which otherwise would be encouraged, but its true basis lies not in penalty or punishment but rather in compensating the copyright owner where proof of damages or discovery of profits is difficult, if not impossible." Or, as the courts have expressed it, "The purpose . . . is to prevent unjust enrichment." The phraseology of the section was adopted

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72 Loew's, Inc. v. Superior Court of Los Angeles County, 18 Cal. (2d) 419 115 P. (2d) 983 (1941).
74 Brady v. Daly, 175 U. S. 148, 154, 44 L. Ed. 109, 112 (1899).
75 Shafter, Musical Copyright (2d Ed. 1939).
to avoid "strictness of construction" so the award of damages should be made under the provisions of the section only in the absence of proof of actual damages. And in no event should they be assessed on the theory of punishment. The courts have in some cases looked upon these statutory damages in the nature of penalties, but the present trend reflects a certain amount of reluctance to so decide, especially where the infringement is a technical and unintentional one.

As a general proposition it may be stated that where there are acts constituting an infringement of a copyright there is liability for damages under the statute. Disregarding for a time the measure of such damages, it becomes of importance to determine under what circumstances an infringement begins and when it may be said to end. For as has been seen in the case of radio, a rebroadcast by one receiving a program will constitute an infringement where this rebroadcast is for the public and for profit. And it will constitute an infringement separate and distinct from that committed by the broadcasting station itself. Therefore, evidence of separate or subsequent infringements, though really encompassed in the doing of a single act, become of paramount importance in assessing the amount of damages recoverable. Thus where a catalogue infringed three distinct copyrights and there were four separate issues published, none of which were identical, the court allowed damages for twelve rather than three infringements. Similarly, where a contract existed for the use of certain advertising materials, which contract was cancelled after one year, the subsequent use of the materials in five advertisements constituted a separate infringement for each publication, within the meaning of the statutory minimum damage clause. As applied to radio broadcasting, where a copyright owner's musical composition was performed on three separate occasions by a radio network with chain hook-ups on sixty-seven, sixty-six, and eighty-five stations, there were two hundred and eighteen infringements and not merely three.

Earlier cases under the Act of 1909 show a diversity of opinion and apparently proceed on a different theory — that the actual infringement is not in the printing but in the engraving of the plates and so the subsequent use thereof is immaterial. Such was the holding in

81 Buck v. LaSalle Realty Co., 283 U. S. 191, 75 L. Ed. 971 (1931).
Sauer v. Detroit Times Co.\textsuperscript{85} wherein the infringement was the publishing of a copyrighted map in two separate editions of a newspaper. In construing the statute the court said that inasmuch as the infringing party acted in good faith and ceased publication immediately upon notice that the court in its discretion could treat the acts as one rather than a separate infringement. On the other hand, as early as 1845\textsuperscript{86} the principle was enunciated that every printing for sale was a new infraction of the copyright, although the same plates were used each time. The present and to be preferred rule was established by the Supreme Court in 1919\textsuperscript{87} wherein it stated: "Each copyright is treated as a distinct entity, and the infringement of it as a distinct wrong, to be redressed through the enforcement of this liability." There, copyrights were held on each of six pictorial illustrations of styles in women’s apparel and there was one publication of each of five illustrations and two publications of the sixth. The court in deciding that there were seven separate and distinct infringements asserted:

"The statute says that the liability thus defined is imposed for infringing ‘the copyright in any’ copyrighted work. The words are in the singular, not the plural."\textsuperscript{88}

The wording of the present Act is likewise in the singular and the instant case has been cited as authority\textsuperscript{89} in rendering a similar interpretation of the section in question.\textsuperscript{90}

As to the measure and quantum of damages recoverable, attention is directed to the fact that the court by reason of the "in lieu of" clause in section 25 (b)\textsuperscript{91} has the power to award statutory damages even though actual damages can be proved. The court in such cases exercises its discretion when it appears that the actual damages are insufficient recompense for the injury inflicted. A more detailed treatment of this clause will be made when dealing with the general discretionary powers of the court under the statute. For the present it is sufficient to note the power and to examine the decisions in the light thereof. The damages under this section\textsuperscript{92} "shall in no . . . case exceed the sum of $5,000 nor be less than the sum of $250." And sc where the number of infringements was insufficient to justify a recovery of the minimum damages under the statute because the infringed subject matter came within the specific schedule set out in

\textsuperscript{86} Reed v. Carusi, 20 Fed. Cas. 431, No. 11,642 (D. Md. 1845).
\textsuperscript{87} Westermann Co. v. Dispatch Printing Co., 249 U. S. 100, 105, 63 L. Ed. 499, 502 (1919).
\textsuperscript{88} Westermann v. Dispatch Printing Co., 249 U. S. 100, 105, 63 L. Ed. 499, 502 (1919).
\textsuperscript{89} Notes 17 L. R. A. 760 (1922).
\textsuperscript{90} 17 U. S. C. A. § 1.
\textsuperscript{91} 17 U. S. C. A. § 25 (b).
\textsuperscript{92} 17 U. S. C. A. § 25 (b).
the Act, the court is empowered to disregard the actual measure and award $250 damages. In such a case the minimum award is mandatory. But where the measure will aggregate in excess of the minimum amount recoverable the measure as specified in the schedule shall prevail. Or where the copies of the infringing work are not of a nature to be valued at the specified schedule rate of $1, it has been held that proof of actual damage is so insufficient as to justify the court in awarding damages in its discretion. Otherwise the award would be in excess of the damage actually suffered. In this latter case there were 5,000 copies of an infringing road map sold but it did not appear that the business of the copyright owner was appreciably affected thereby. Therefore the court awarded $2,000 rather than $5,000 damages. So also where there were approximately 39,000 cards printed advertising the sale of dishes and a copyright thereon was thereby infringed. The court acted in its discretion and awarded $2,500 damages because the claims varied from $28,000 on the part of the plaintiff to a loss of $1,000 by the defendant. The justification for so holding was enunciated by the court in the case of Kraft v. Cohen, wherein it was said:

"While the statute fixes as damages the sum of $1 for every infringing copy, the provision is permissive merely, and the amount of damages under the circumstances of this case are left to the discretion of the court."

In the instant case 5,000 copies of a catalogue were printed in which there were used certain copyrighted photographs. The catalogue was not sold but was used merely as an advertising medium and at the time the suit was instituted there were still 2,000 copies in the possession of the defendant. The court awarded $750 instead of $3,000 as damages.

There have been a few cases wherein a profit has been made by the infringing party but the court nevertheless disregarded the provisions of the statute and applied neither the statutory minimum nor the measure of actual damages suffered. Thus where a motion picture company infringed a copyrighted dramatic production by incorporating a portion thereof into one of their movies, the court awarded the copyright owner one fifth of the net profits realized, saying:

"It is now settled that where a portion of the profits of an infringing work is attributable to the appropriated work, to avoid

97 20th Century-Fox Film Corp. v. Stonesifer, 140 F. (2d) 579 (C. C. A. 9th, 1944).
an unjust course by giving the originator all profits where the infringer's labor and artistry have also to an extent contributed to the ultimate result, there may be a reasonable approximation and apportionment by the court of the profits derived therefrom. We find no reason to disturb the award of damages."

And in the case of *Sammons v. Colonial Press* \(^{98}\) wherein the printer was sued as a co-infringer for the profits he realized in printing a book for an infringing publisher, the court denied recovery as against him and stated that:

"the measure of damages is the profits which the plaintiffs would have made upon additional sales of its copyrighted book, had not the infringing book been competing in the market."

and that:

"the amount of such profits (if any were actually made) will be the measure of recovery and it will no longer be permissible to decree statutory damages 'in lieu' of actual damages and profits."

As heretofore noted, the maximum — minimum provisions of the statute are controlling whenever the court exercises its discretion under the authority of the 'in lieu of' clause.\(^{99}\) As has been said by the Supreme Court: \(^{100}\)

"The maximum and minimum provisions were intended to be applicable to all types of infringements except those for which the section makes other specific provision."

But in the absence of proof of actual damages the minimum award of $250 has been held to be mandatory.\(^{101}\) On the other hand, where there is satisfactory proof of the copyright owner's actual damage or of the infringer's actual profits, the court is not justified in exercising its discretion and awarding statutory damages under the "in lieu of" clause.\(^{102}\) The court in the case of *Westermann Co. v. Dispatch Printing Co.*\(^{103}\) summarized the applicability of the provisions of this section when it stated:

"The fact that these damages are to be 'in lieu of actual damages' shows that something other than actual damages is intended — that another measure is to be applied in making the assessment. There is no uncertainty as to what that measure is or as to its limitations. The statute says, first, that the damages are to be

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\(^{98}\) 126 F. (2d) 341, 344, 350 (C. C. A. 1st, 1942).


\(^{100}\) Jewell-LaSalle Realty Co. v. Buck, 283 U. S. 202, 206, 75 L. Ed. 978, 981 (1931).

\(^{101}\) Buck v. Bilkie, 63 F. (2d) 447 (C. C. A. 9th, 1933).

\(^{102}\) Sheldon v. Metro-Goldwyn Pictures Corp., 309 U. S. 390, 84 L. Ed. 825 (1940).

\(^{103}\) 249 U. S. 100, 106, 63 L. Ed. 499, 502 (1919).
such as to the court shall appear to be just; next, that the court may, in its discretion, allow the amounts named in the appended schedule; and finally, that in no case shall they be more than $5,000 nor less than $250, except that for a newspaper reproduction of a copyrighted photograph they shall not be more than $200 nor less than $50. In other words, the court's conception of what is just in a particular case, considering the nature of the copyright, the circumstances of the infringement, and the like, is made the measure of damages to be paid, but with the express qualification that in every case the assessment must be within the prescribed limitations; that is to say, neither more than the maximum nor less than the minimum. Within these limitations the court's discretion and sense of justice are controlling, but it has no discretion when proceeding under this provision to go outside of them."

Even though the statute provides for damages where no damages can be proved, does this necessarily mean that an infringer is liable irregardless of whether damages were suffered by the copyright proprietor? This question was answered in the negative in the case of Rudolf Lesch Fine Arts, Inc. v. Metal wherein all infringing reproductions of a painting were seized and impounded before any could be sold. The court concluded that no actual damages had been inflicted by reason of the infringement and assessed nominal damages of one dollar. But even where the damages are trivial the courts have assessed minimum statutory damages. Thus where the choruses of the song "The Sidewalks of New York" and "Let Me Call You Sweetheart" were copied and sold at a profit of $5.10, the court nevertheless awarded $250 damages, refuting the argument of the infringing publisher that the infringement "was technical only, wholly unintentional, and trivial in nature," and that recovery should be limited to the actual profit made on the transaction. Actual damage, however, had been suffered. Clearly distinguishable is the case of Washingtonian Publishing Co. v. Pearson wherein the infringers authors of a book incorporated therein an article for which they had paid the author, but without consent of the copyright proprietor who was a magazine publisher whose magazine ceased publication some two years before the infringement took place. The court refused to assess statutory damages, stating that no actual damage had been caused the copyright proprietor and all that he was possibly entitled to was an apportionment of the profits — in that case $15.41. The court stressed the provisions of the Copyright Act and cited verbatim the authority of the court to pay to the copyright proprietor "such damages as the

104 51 F. Supp. 69 (S. D. N. Y. 1943).
copyright proprietor may have suffered due to the infringement."

Inasmuch as no damages had been suffered, but the profits resulting therefrom had been proved, the court refused to exercise its discretion under the "in lieu of" clause. Thus the fact of no actual damages having been suffered, and the inability to prove the actual damages inflicted, must be distinguished. In the former case, nominal and not statutory damages are recoverable, whereas the latter situation comes within the purpose for which the statute was enacted — that is those cases wherein actual damages are not and cannot be proved.108

It has been intimated in some of the decisions previously cited that the statutory minimum — maximum provisions are not always controlling. The statute itself contains a schedule of the damages recoverable in certain cases of infringement,109 and the question to be determined is what measure shall be adopted where the aggregate amount recoverable in accordance with that schedule is not equal to the minimum or is in excess of the maximum allowances expressly provided for. In other words, will the measure control the statutory limitations, and if so, in what class of cases? As was seen in the case of Jewell LaSalle Realty Co. v. Buck110 the limitation provisions were intended to be controlling whenever the other specific statutory provisions were inapplicable. Thus, where an infringer after notice thereof continued his invasion of the copyright owner's exclusive right and published 8,000 books containing material constituting an infringement, damages were correctly assessed at $1 per copy and the plaintiff allowed to recover $8,000.111 But where evidence of actual damage as thus inflicted is either exorbitant or insufficiently established, the court will fall back on its broader powers of assessing "such damages as to the court shall appear to be just"112 under the circumstances. Thus where there were 7,000 infringing copies of a copyrighted song printed, the court refused to apply the measure of $1 per copy, it appearing that the song retailed for 15c per copy and the return to the copyright owner was approximately 8c per copy. In awarding damages of $560 the court stated:

"While the discretion of the court may be used to award damages where no proof of actual damages is offered, yet the award should have relation to such inferences as are reasonably deducible from the whole case of infringement."113

And where the profits of an infringing movie were $19,800, the copyright proprietor was nevertheless entitled to recover only $3,960, that

110  283 U. S. 202, 75 L. Ed. 978 (1931).
sum being the proportionate amount that his composition contributed to the finished product. And where 50,000 copies of a magazine were sold to the public which contained an infringing photograph, the copyright owner was nevertheless entitled to recover only $1,000, that being the amount determined by the court to be just in the absence of any proof of actual damages.

The election of the court whether or not to exercise its discretion in the award of statutory damages and what curbs there are to this quasi-equitable jurisdiction has been the basis for a good portion of the case law on copyrights. The authority of the court so to exercise its discretion is contained in the so-called "in lieu of" clause — "or in lieu of actual damages and profits, such damages as to the court shall appear to be just." This has been interpreted to mean:

"An election or discretionary choice between actual damages and profits on the one side and, on the other side, an assumed or somewhat arbitrary award of such damages as may be just." Thus, "it is for the court to decide what kind of damages best fits the case." and the specific provisions in the Act enumerating a definite measure to be utilized in certain cases has been construed to come within this discretionary power — the measure being merely permissive and thus leaving the amount to be awarded to the court's discretion. As was declared in a very recent case:

"The damages to be assessed are to be fixed by the trial court based upon the record. The amount is discretionary if within the statutory limits. This rule was established in order to give more than nominal damages where the amount was incapable of proof."

And where the power is exercised within the statutory limits, it is not subject to review on appeal. Also, where on trial no proof of actual damages is offered and no finding is made on the subject, the assessment of statutory rather than actual damages lies in the court's discretion and is not reviewable. As was said by the Supreme Court:

114 20th Century-Fox Film Corp. v. Stonesifer, 140 F. (2d) 579 (C. C. A. 9th, 1944).
121 Hartfield v. Peterson, 91 F. (2d) 998 (C. C. A. 2d, 1937).
"In other words, the employment of the statutory yardstick, within set limits, is committed solely to the court which hears the case and this fact takes the matter out of the ordinary rule with respect to abuse of discretion. This construction is required by the language and purpose of the statute."  

Judge Learned Hand, in attempting to interpret the provisions of section 25 (b), formulated a test of this discretion which has been consistently followed in subsequent decisions. He said:

"in place of the old penalties the court is to estimate damages, but to estimate them within the sums given, without the limitations of usual legal proof. I think the whole course of damages, and that, in substituting for rigid penalties the discretionary power of the court, we must assume that a plaintiff should not fail for lack of proof."  

This election as to what damages should be allowed — statutory or actual — is not a matter of choice with the plaintiff, however. It rests solely in the sound discretion of the court and cannot be demanded as a matter of right. Thus where a newspaper appropriated a copyrighted article from a magazine publisher who intended to print the same in his own magazine, and it was published by the newspaper within six days of the date it was scheduled to appear in the magazine in question, the plaintiff was indemnified on the basis of actual damages and profits rather than in accordance with the provisions of the statute, it appearing that the damages and profits resulting from the infringement were ascertainable, and the court electing to decide the case on that basis.

What then are the distinguishing features between the award of damages at the common law and those allowable under provisions of the statutes? As a general proposition it may be stated that at the common law there are no limits to the amount recoverable in case of infringement — provided, however, that the damage can be proved. Whereas under the statute the copyright owner may recover the full amount of actual damages where the actual damage is provable, and where there is an intentional infringement after notice, he may recover on the basis of the statutory schedule, even though in so doing the sum received exceeds the maximum allowable. Otherwise, where the proof of actual damages or profits is not ascertainable, he may recover on a sliding scale between the minimum — maximum limitations of $250 and $5,000. In no case however, may the award exceed

the maximum scale, save in the two exceptions noted — where there is proof of actual damage, or where there is an intentional infringement after notice.

It becomes important then to determine in a given case just what evidence of damage there is. But the task is complicated by two qualifying and conflicting tenets: 1. Frequently because of the circumstances of the case actual damage is impossible of determination; and 2. Once determined, it is frequently inadmissible at the trial of the cause because of the Rules of Evidence. Those cases coming within the twilight zone — that nebulous plane upon which meet the practicality of securing evidence and the theory of being able to present it — illustrate the difficulty of attempting to collect monetary compensation solely on the theory of damages without recourse to the provisions of the Act. Furthermore, they illustrate the purpose for which the Act was formulated and passed, and also serve to justify the liberal provisions allowing damages where no actual damages can be proved. Thus, in Turner & Dahnken v. Crowley, the damage inflicted was the amount the plaintiff would have made on the sale of a like number of copies, and in Sammons v. Colonial Press it was the profits he would have made had not the infringing book been competing upon the market. But where a magazine publisher had gone out of business and two years subsequent thereto there was an infringement of one of the articles which had appeared in his now defunct publication, the court found no evidence of damage and apportioned the value of the contribution of the article to the completed work and awarded damages in the form of a percentage of the profits. Generally, all that is required is to prove the facts constituting an infringement and that damage resulted, although incapable of being ascertained. These things being shown, relief may be had under the Act. The paucity of cases wherein recovery has been had outside the Act on the theory of damages, and not as a part of the profits so as to prevent unjust enrichment, illustrate the shortcomings of the recovery under the common law doctrine and the wisdom of the present statutory provisions.

An objection may be raised on the theory that due to the limitations on the maximum amount recoverable, the small time copyright owner is thereby precluded from securing relief because of the prohibitive expense of bringing a suit. And that once the litigation is finished, he may have asserted his paramount and exclusive right but the cost of instituting and maintaining a suit leave him with no recovery for the damage he has suffered by reason of the infringement. The

127 252 Fed. 749 (C. C. A. 9th, 1918).
128 126 F. (2d) 341 (C. C. A. 1st, 1942).
framers of the Act appreciated this difficulty and made special provision therefor:

"In all actions, suits, or proceedings under this title, except when brought by or against the United States or any officer thereof, full costs shall be allowed, and the court may award to the prevailing party a reasonable attorney's fee as part of the costs." 130

But the court is not required to award attorney's fees under this section. 131 To remedy this and other defects of the Act and assure to the small copyright holder his day in court — not only to assert his right but to recover compensation for whatever infringements may have been committed — the American Society of Composers, Authors, and Publishers was formed.

**Conclusion**

The foregoing is but a summation of one isolated measure of the legal and equitable relief accorded those who possess either a common law copyright or that accorded them by virtue of their conformity with the provisions of statute. Although no detailed treatment has been made of the provisions for accounting for profits nor that relating to equitable remedies, it was the manifest intention to exhaust the one subject of paramount importance to the small copyright proprietor — the recovery of money damages for the infringement committed. Although the remedies are adequate, they are by no means co-extensive with the varying situations presented whenever a copyright is infringed. But as was the case with the correction of defects in the common law copyright by legislative enactment, subsequent statutory provisions will undoubtedly provide for the loopholes in the law that now exist.

Undoubtedly, adequate legal machinery has been noted in the treatment of the cases, justice has been accorded those who have been wronged, whether that justice was meted out by reason of the specific statutory measures provided or the discretionary power vested in the court by reason of the Copyright Act.

*Robert E. Sullivan.*

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Closed Transactions in Sales of Personal Property.—One of the most important of the many controversial fields concerned with the taxability of income (and deductibility of similar items) is the determination of when any particular item becomes income or becomes deductible from income. In what particular taxable year these items

are returned or deducted necessarily involves the problem of "closed transactions." It is the purpose of this article to outline in brief some of the general principles relating to closed transactions, calling particular attention to those governing the recognition of gain from the sale of personal property.

Income taxes are concerned only with realized gain. Paper profits or estimated profits are not realized gain until the property is sold — that is, until the transaction is completed. Capital gain is ordinarily taxable income only if it results from a "sale" or an "exchange." This conclusion is reached by the application of two theories of the income tax law: that theory developed in the celebrated case of *Eisner v. Macomber* ¹ (there can be no taxable income until something is realized out of which to pay the tax), and that of the application of the concept of "closed transactions," which requires an event of a definite nature to substantiate the fact of gain in a particular taxable year. There must be a demonstrable fixing of a taxable gain, and like considerations are applicable to capital and ordinary losses. The Regulations ² provide that statutory deductions for losses "must be evidenced by closed and completed transactions, fixed by identifiable events," and "substance and not mere form will govern" in determining what losses are deductible. The closed transaction must determine the existence of and the amount of such loss.³ Where the identifiable event is a sale, the transaction must ordinarily be closed and completed in the year in which the deduction is taken.⁴ In general, as for gains, a taxpayer on the cash basis includes in gross income all taxable income actually or constructively received during the year in cash or its equivalent; if he is on the accrual basis he includes in gross income all taxable income that accrues during the year.⁵ Hence, we readily see the importance of determining when a particular transaction results in taxable gain or a deductible loss. If a disposition of property takes the form of a sale for a money consideration, the resulting profit or loss is "recognized" for tax purposes at the time when the sale is consummated. In other words, the taxable year in which this gain or loss arises is that in which the transaction causing it is closed. But the great question remains: when is a transaction closed?

The problem of when a transaction is closed is particularly troublesome, and the question of when an item becomes taxable income or a deductible loss remains today practically unanswered, but a reason-

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¹ 252 U. S. 189, 64 L. Ed. 521 (1919).
² Regulation 103—Income Tax, Sec. 19.23 (e)-1.
⁴ Shoenberg v. Commissioner, 77 F. (2d) 446, 448 (C. C. A. 8th, 1935).
⁵ I. R. C. Sec. 42.
ably satisfactory answer must be found. No longer can we solve the problem solely by reference to the accounting methods employed by the taxpayer, but there must be taken into consideration the limitations of the statute and recent broad concepts of income.\(^6\) There is no single controlling factor, no hard and fast rules of thumb that can be used to determine when a sale is consummated — the transaction closed and taxable income received or deductible losses sustained — but the transaction must be viewed as a whole and in the light of realism and practicality.\(^7\) Rulings and decisions are numerous and extensive as to when a transaction is closed, and there are statutory provisions and regulations as to methods of accounting and periods in which items of income are includible and losses sustained, but at most these are but concepts, leaving much to the discretion of the Commissioner, causing arbitrary tax results in many instances, and providing for no explicit rules of law by which a particular transaction may be determined. Numerous cases provide the taxpayer with tests to be applied to certain types of transactions, with contingencies which affect the sale to make it closed or not closed, with distinguishing situations, with important considerations to be taken into account, and with certain other guideposts, but with no clear-cut, absolute rules governing all sales of property.

The principles governing sales of personal property are in the most part also those governing the sale and exchange of real property. Speaking in general terms, there are two essential elements of a closed transaction: 1. a transfer from the seller to the buyer of title, possession, and burdens of ownership, and 2. payment of the purchase price to the seller.\(^8\) The primary question always to be determined is when the sale is made. This question can be answered only by subjecting each particular transaction to tests that have been laid out in court decisions, by the method of inclusion and exclusion — what a particular transaction is and what it is not. Following are several types of sales transactions of personal property showing criteria which have been applied in the courts to determine whether or not they were closed transactions.

Probably the most basic test, and one most often quoted, is that stated by the Circuit Court of Appeals for the Second Circuit, which is as follows: \(^9\)

"A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of a consideration and by which the purchaser secures immediate possession

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\(^6\) 2 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942), Sec. 12.01.
\(^7\) 1 PRENTICE-HALL 1947 FEDERAL TAX SERVICE, Sec. 6255.
\(^8\) Ibid, Sec. 6253.
and exercises all the rights of ownership. The delivery of a deed
may be postponed and payment of part of the purchase price may
be deferred by installment payments; but for taxing purposes it
is enough if the vendor obtains under the contract the unqualified
rights to recover the consideration."

Only a few general rules can be formulated, and none can be abso-
lutely depended upon to answer our question as to when the sale is
made. The ultimate question is not solely of law, but usually a mixed
question of law and fact. The transaction "... must have reached
the stage of reasonable certainty that the transaction will be carried out." 10
No substantial contingencies must exist; the taxpayer must be uncon-
deritionally liable, and the obligation of the purchaser must be absolute
and the appropriation by the seller irrevocable. As pointed out in the
previously quoted decision, the question resolves itself to this: when
have there been enforceable rights and obligations created? The terms
of the contract of sale taken as a whole should be determined in view
of the intention of the parties, their acts, and all surrounding cir-
cumstances when profits (or losses) on sales of property are taxable
(and deductible).

Very general principles as to when gain is recognized may be stated
as follows: 1. in case of a taxpayer on the cash basis there is a closed
transaction when the purchase price is received; 2. if the taxpayer is
on the accrual basis, the income from the sale of personal property
should be reported for the year in which title passes. Income accrues
when an enforceable right to title arises. If the transaction is a sale,
the income, it would seem, judging from the cases and on principle,
should be reported in the year in which there arises a binding agree-
ment to sell. But the cases and decisions are in hopeless conflict,
due to the variance in state laws on the sale of property and to the
particular exigencies of the individual case, as will be pointed out in
the illustrations to follow.

The most fundamental test and one of the most important and
conclusive circumstances determining that a transaction is closed is
that concerned with when title passes.11 Profits from a sale under a
contract whereby part of the purchase money is deposited in escrow
to await closing of the transaction is realized in the year that the
contract becomes executed by the transfer of title.12 Transactions on
the New York Stock Exchange become closed only when title passes,13
and delivery of the certificate is necessary for a transfer of title to stock.

Passage of title is not, however, an absolute test. If the taxpayer
is on the accrual basis, payment becomes income when it becomes a

10 2 MEITEN, LAW OF FEDERAL INCOME TAXATION (1942), Sec. 12.119.
"... present, fixed, and unqualified obligation of the purchaser, which... constitutes an accrued debt..." to the seller.\textsuperscript{14} On the other hand, retention of title does not preclude a closed transaction, providing dominion and control over the property have passed to the purchaser. So where the taxpayer sells certain rights to property, receiving payment in the year of the sale partly in cash and partly in notes due in later years, the transaction is taxable in the year the sale is made and not when the notes are paid.\textsuperscript{15}

It is essential that the passage of title be an accomplished fact to make the transaction closed; the seller's right of property must pass to the purchaser. In f.o.b. sales title passes when the property involved is delivered free on board. In determining when title passes, some courts have followed the principle of the Uniform Sales Act, which says title to goods sold passes when the parties intend that it shall pass.

Passage of title coupled with payment of the purchase price and transfer of possession may be decisive of a closed transaction. If, in the case of a corporation, the accrual basis of accounting is used, gain realized from a sale is taxable for the year the contract is executed, but not until the transaction is closed if it is on the cash basis, where there is an abatement of the agreed purchase price.\textsuperscript{16} The right to receive and the obligation to pay definite and fixed sums fix the date when the transaction is closed where the taxpayer keeps his books and makes his return on the accrual basis; the actual payment and actual receipt of the purchase price are not essential in such an instance.\textsuperscript{17}

In an executory contract when there exists an unconditional right in the purchaser to execution of documents transferring title and on the part of the seller an unconditional right to the balance of the purchase price the transaction is closed.\textsuperscript{18} In a contract for sale of shares of stock entered into in 1929 but not finally signed until 1930, which contract provided for the passing of title and the right to possession on payment of the first installment, the transaction was held closed in 1930, the year there was a final agreement as to all the details.\textsuperscript{19} Here it will be noted, however, that the title-passing test was not actually applied, the decision resting instead on the theory that a definite bargain had not been concluded in 1929 but in 1930. The court said: "Parties must come to an agreement as to all the details, or at least

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\textsuperscript{14} Evergreen Cemetery Ass'n v. Burnet, Commissioner, 45 F. (2d) 667 (App. D. C. 1930).
\textsuperscript{15} Appeal of S. A. Hinely, 2 B. T. A.: 1027 (1925).
\textsuperscript{17} U. S. v. Utah-Idaho Sugar Co., 96 F. (2d) 756 (C. C. A. 10th, 1938).
\textsuperscript{18} Commissioner v. Segall, 114 F. (2d) 706 (C. C. A. 8th, 1940).
\textsuperscript{19} U. S. Industrial Alcohol Co. v. Helvering, 137 F. (2d) 511 (C. C. A. 2d, 1943).
as to all except those without the settlement of which the bargain would nevertheless go through. Although they suppose that they have agreed, if in fact they have not, their supposition will not serve, and they are not bound. But the reasoning of this court must be modified in applying it to any particular situation according to the circumstances of the particular facts, and has been so modified in another case where the court said: "... in cases of ambiguity in contracts ... courts will lean towards the presumed intention of the parties ... and will so construe such contracts ... as to effectuate such intent ..."

Even in the application of the most basic test of when title passes the cases are in no way harmonious. In the often quoted case of Commissioner v. Union Pacific R. Co. the taxpayer sold lands by installment contracts under which the purchasers took immediate possession, insured and repaired the premises and paid the taxes; the purchase price was not definitely ascertainable until several years after the contract was made, although a minimum price was set, but final acceptance of the property was conditional upon approval of title. The taxpayer was on the accrual basis. The transaction was held to be closed when the contract was made, since that was the date the seller had an absolute and unconditional obligation to deliver a deed to the buyer upon the payment of the consideration, and, furthermore, since the buyer at that date secured immediate possession and exercised all the rights of ownership. In an earlier case it was similarly said that "... the consummation of a sale is not dependent upon delivery of a deed where ... the consideration was received and the benefits and burdens of ownership were transferred previously."

Contracts to sell are to be distinguished from contracts of sale. An agreement whereby a stockholder placed shares of stock in escrow for a prospective purchaser, who never bound himself to pay for them and to whom they were never transferred, together with an agreement by the corporation to convey its assets upon the payment of the purchase price evidenced by certain notes, did not constitute completed sales or a closed transaction in the year when the agreements were made, and hence the stockholder could not deduct from his taxable net income any losses sustained in that year from the sales of stock and assets. This was correctly held to be an agreement to sell and not a sale.

The courts have applied statements of Williston on Sales to show the distinction between a contract to sell and a sale as follows:

23 Stiver v. Commissioner, 90 F. (2d) 505 (C. C. A. 8th, 1937).
“A contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price.”

“A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price.”

The distinction is often expressed by the terms “executory” and “executed” sales.

Besides distinguishing between agreements to sell and sales, distinctions are to be made between a sale and a consignment, and a loan and a sale.

A contract for sale of voting trust certificates, representing capital stock of a corporation, has been held to be an effectuated transfer thereof, rendering taxable gain during the year the contract was entered into. This principle comes from the case in which, for example, a contract was executed on December 20, 1921, but the taxpayer contended that the contract would not become effective until March 28, 1922, the parties contracting for the “purchase to be consummated and said purchase price paid on the 28th day of March, 1922.” Under the terms of the contract the taxpayer neither retained title to the certificate nor reserved any power with respect thereto, but delivered actual possession to the purchaser, and properly endorsed the certificate in blank; and, by giving the purchaser irrevocable proxy and power of attorney, invested him with authority to do all that he himself as absolute owner would do had the agreement not been executed, with the sole exception of having the transfer certificates noted on the trustees’ records. In consideration of this, the taxpayer had the purchaser’s absolute promise to pay secured by collateral of fair value in excess of the total price of the certificate. The court said that in interpreting an equivocal transaction, motives may be considered as bearing on the real nature of the transaction, although primary consideration will be had of what was actually done and the legal effect thereof. It was presumed by the court that the motive was to avoid heavier income tax in the year the transaction was entered into.

Where the terms of a sale are complete although the subject matter has not been delivered, nevertheless there may be a closed transaction and a completed sale if it was the intention of the parties that it was to take place as of a certain date. It is not necessary that a sale of personal property be accompanied by delivery if “the obligation to deliver is so fixed that the loss (or gain) is reasonably certain in fact and ascertainable in amount.”

25 1 Williston on Sales, (2d Ed. 1924), Sec. 1.
27 Brunton v. Commissioner, 42 F. (2d) 81 (C. C. A. 9th, 1930).
28 Stanton v. Commissioner, 98 F. (2d) 739 (C. C. A. 7th, 1938).
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may not hastily divest himself of title to property, taking in exchange a pledge to carry out an agreement to deliver in exchange certain other property or securities and thereby evade tax liability for the year in which the terms of the exchange were actually arrived at and carried out. Mere postponement of delivery does not, however, mean that an actual sale has not been consummated. Nor does delay in the payment of the purchase price negative a present sale if the parties agreed to a delay in payment, providing, however, the transaction was bona fide and not in evasion of taxation.

What is meant to be an absolute sale may be classified by the Commissioner as a partial return of capital, as can be seen in the following situation. In two succeeding years shares of stock were sold to a syndicate in consideration partly of cash payments and partly of payments under non-refundable life annuity contracts. It was held that the sales were not closed transactions, but the cash payments and annuity payments received in the years in which the sale was made were treated as return of capital to the extent that they represented cash to the seller, and the amount received by him over and above his cost of the stock should be computed as taxable gain in the year in which he received it, for the reason that the promise to make the payments under the annuity contract had no ascertainable market value for purposes of taxation in the year in which they were made.

These few illustrations, brief statements of principles, tests and rules outlined in this article are not, of course, comprehensive, and were not meant to be so. They cannot serve to solve the taxpayer's intricate and individually peculiar problems, but they are intended to help guide him, if only by pointing out the importance of the problem together with showing him some of the many considerations he must take into account in determining when to include income or take allowable deductions.

Frederick N. Hoover.

TAXATION — PARTNERSHIP BUSINESS INSURANCE.—"What tragic irony for able men to spend precious years in building a successful business only to have it collapse in ruin when a partner dies . . . because they 'Did Not Know.'" These are indeed powerful words and yet they are the exact words of the life underwriter as he makes

1 Gravengaard, How to Preserve Your Partnership, The Diamond Life Bulletins.
his approach to a client. What is the life insurance salesman going to tell the lawyer's partnership clients that is going to affect him as an attorney? He will explain to the partners the basis of their legal existence as a business. He will point out to them that they are working today as a "team." The salesman might present one of the partners with a previously prepared letter like this:

"Jones, I'm terribly sorry, but I've unexpectedly got to go away, and it's very doubtful that I'll ever be back. So, I wish you'd collect all outstanding accounts receivable — complete all of our present contracts — sell all our assets at public auction, or at a private sale, to anyone who will pay a fair price — pay off all of our creditors — and then give my wife half of what is left. I hope there'll be enough to clean up all of our obligations, Jones; otherwise I guess you'll have to make up the difference out of your own personal savings, because Mary and I haven't been able to accumulate anything more than we have in the business. I'm just awfully sorry, Jones, but I can't help it, so good-bye, and lots of good luck."

The salesman would undoubtedly follow this letter with the following words:

"Well, Mr. Jones, I suppose you'd think he was crazy; and yet that is really what you would have to do if word came to you today, that your partner had passed away. It would be a pretty tough break, wouldn't it? As you probably know, Mr. Jones, the death of your partner would immediately dissolve the partnership — that's the law. There are only four alternatives for your choice in a spot like that."  

What are Mr. Jones' alternatives? Under a plan of reorganization, he could buy the interest of the deceased partner and continue the business as a proprietorship. Obviously this is ideal, but there is no assurance that the heirs would sell at a reasonable price. The heirs have a legal right to insist on receiving cash in full or compel the partnership to liquidate. If the survivor is depending on his present credit rating based upon his partnership interest as a going concern to borrow money with which to pay the heirs, he will most likely find such credit greatly lessened as a result of his associate's death. Mr. Jones may be fortunate enough to locate a new partner who has the necessary business requisites in addition, of course, to enough cash to satisfy the heirs before the partnership creditors force liquidation. Another alternative is to take one of the heirs into the business as a partner. For reasons too numerous to mention, this arrangement seldom is successful. The last alternative is liquidation. This could

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be done by Mr. Jones's selling his interest in the business. Then Mr. Jones finds himself in the usually undesirable situation of being without a position and thus without income. Usually, one of the least desirable choices would be for Mr. Jones to liquidate the business and settle with the executor of the deceased partner. In this event much of the asset value is certain to be lost, and, in the case of assets such as good will, a total loss might result.

A considerable portion of these problems could have been avoided by a proper drawing of the articles of partnership. The basis and purposes of such articles might well find expression in the words of Benjamin Franklin. "Partnerships often finish in quarrels; but I was happy in this, that mine were all carried on and ended amicably owing, I think, a good deal to the precaution of having very explicitly settled in our Articles everything to be done by, or expected from, each partner, so there was nothing to dispute, which precaution I would therefore recommend to all who enter into partnerships." These basic problems for many years have fallen squarely upon the shoulders of the attorney, and now the life insurance field has created the new and modern answer to a large portion of the remaining difficulties arising from the partnership organization. The success or failure of the partnership insurance agreement lies within the providence of the practicing attorney. The numerous decisions of recent years on this legal proposition bear out the statement that, like most phases of the law, there are now in use by practicing attorneys agreements which have been proven to be bad, some of which can be classed as good, others as better, and still others as the best.

The partnership agreement must provide the right for the surviving partner to purchase the interest of the deceased partner at a fair value, and the method of arriving at such a value must be stated in the agreement. It must also provide for some type of financing plan whereby the funds will be immediately available to the survivor to make such purchase. The partnership insurance agreement presupposes the insurability of the partners; and, although it is proposed in this paper to proceed on the assumption that the partners are insurable, it should be noted that other types of financing plans based on the same general pattern have been designed in those instances where one or both of the partners are not insurable.

Let us assume the following facts in order to illustrate the mechanics of that which is considered the "best" plan. Mr. A and Mr. B are partners who are desirous of having their partnership problems solved by this new method of protection. The agreement should provide for A to purchase a life insurance contract on the life of B. A should pay the premiums and exercise complete control and ownership over this policy. B will reciprocate in precisely the same manner by purchasing a policy on the life of A. Mr. B dies and his estate will then contain
B's interest in the business plus B's life insurance policy on the life of A. The agreement must provide for A to purchase B's interest at a reasonable value which is determined by a previously agreed on formula, and for B's estate to sell this interest. A will take the proceeds from the policy which he held on the life of B and purchase B's interest. B's estate now has the cash for the business interest and in addition the policy on the life of A. The agreement will remedy this by providing for A to purchase this policy from the estate of B (usually based on the cash value of the policy).

Is the above plan "tax wise"? Let us see. The Internal Revenue Code states: "In computing net income no deduction shall in any case be allowed in respect of ... premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy." Quite obviously, in view of this section the premiums paid by the partners will not be deductible; however, it should be noted that where variations of this plan have been attempted to circumvent this result, the decisions have been the same. For example, in the Joseph Nussbaum case, A had insured his own life payable to B, and a reciprocal policy was being paid for by the latter. The court did not allow deduction as to the premiums paid. The premium payments failed to qualify as "ordinary and necessary business expenses" under the Code. Even if the deduction was not disallowed under the above two referenced sections of the code, it would still have to pass the limitations imposed by another section of the Code which pertains to deductions allowable to production of tax-exempt income.

Under section 22 (b) (1) of the Code, the proceeds will not represent taxable income. Even if the beneficiary were the partnership itself, the proceeds would not be taxable income. In this regard however, proper warning should issue as to a common plan whereby A would assign his policy to B and B would assign his policy to A. The Code covers this and similar transactions as follows: "In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph." The case of Harverty Realty & Investment Co. held

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3 INT. REV. CODE, § 24 (a) (4) (1938).
4 19 B. T. A. 868 (1930).
5 INT. REV. CODE, § 23 (a) (1938).
6 INT. REV. CODE, § 24 (a) (5) (1938).
7 2 RABIN AND JOHNSON (1946) I 2 § 6.
8 INT. REV. CODE, § 22 (b) (2) (1938).
9 3 T. C. 161 (1944).
that parol evidence may be introduced to disprove the recital of consideration in the instrument of transfer. Rabkin & Johnson,\textsuperscript{10} in referring to an amendment to the Code,\textsuperscript{11} interprets this section as providing that the "consideration" test is not applicable where "... such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor." The opinion refers to this section as a "new exception" which "would seem to be applicable to the proceeds of a policy taken out by one partner on the life of another, and then contributed to the partnership. Cf I. T. 2591, C. B. X-2, 123. The regulations point out, however, that the transferee of a policy in a non-taxable transfer may realize income upon the death proceeds where the transferor had acquired the policy by outright purchase. Reg. Sec. 29.22 (b) (2)-3, as amended by T. D. 5271 (June 14, 1943)." It should be noted that the original plan qualifies under an exception to the general rule. Where the policy had been acquired by the insured in an assignment or transfer for a consideration, the death proceeds are not taxable to the beneficiary.\textsuperscript{12} A had acquired the policy on his (A's) life from B's estate for a consideration, but since A was insured, the proceeds on that policy would not be income to A's heirs.

One of the most important tax advantages which arises in a "buy and sell" agreement is ably stated by Rabkin & Johnson\textsuperscript{13} as follows: "In these cases, the decedent's interest in the business is includible in his estate. For the purpose of valuing that interest, however, the selling agreement may be important, particularly in the case of ... a partnership interest where a high earning history might produce a correspondingly high estate tax 'value.' See Reg. Secs. 81.10 (c), (d). As in any other case in which ... a partnership interest is subject to a purchase option at the ... partner's death, the value of the decedent's business interest for estate tax is ordinarily limited to the price at which the survivor is privileged to buy it."

Under the plan here proposed, it would seem perfectly clear that no part of the insurance proceeds would be includible in the estate of the deceased. The difficulty arises in the numerous variations of this plan. For example, assume that the partnership took out policies on the lives of A and B. The partnership would exercise complete control and ownership of the policies and would name itself as beneficiary. There would be an agreement whereby the partnership would purchase the interest of the decedent. "This plan has the obvious advantage of simplicity in operation where there are several ... partners.

\textsuperscript{10} 2 Rabkin and Johnson (1946) I 2 § 6.
\textsuperscript{11} Revenue Act of 1942, §110.
\textsuperscript{13} 2 Rabkin and Johnson (1946) I 2 § 6.
Under the present estate tax statute, however, this plan is potentially dangerous. Even though the decedent possessed none of the 'incidents of ownership' of the policy on his life, he may be held to have made an 'indirect' payment of the premiums, with the result that the proceeds would be wholly includible in his estate." \[14\] Although the case of Wilson v. Crooks,\[15\] disaffirms the above contention, there are recent cases which are applying the "premium" test which points to the trend as expressed above.

Another variation of the original plan which is almost certain to result in an undesirable estate valuation is that wherein A takes a policy on his own life, exercising control and paying the premiums, but makes B the beneficiary. B does the same. Under this arrangement upon the death of B, B's estate will contain both the insurance proceeds plus B's interest in the business. Inequitable? Yes, but easy to avoid.

There still remains one plan which is favored by some attorneys because of its apparent simplicity and directness. Of course these are desirable elements in any plan, but is it "tax wise"? Assume that A takes out a policy on his own life, pays premiums etc., and makes his estate the beneficiary under same. B makes a reciprocal arrangement. A and B then enter into an agreement whereby each declares that the proceeds from his respective policy shall be received by his estate in lieu of his respective business interests, and thus the decedent's interest will vest absolutely in the survivor without more being done. The results of such a plan will be this. Upon the death of B, B's estate will take up the amount of the proceeds as beneficiary under B's policy. See M. W. Dobrzensky.\[16\] Although B's interest in the business has been held not to be includible in B's estate under such an arrangement, it still remains that there is no estate tax advantage since the proceeds are includible. Furthermore, such an arrangement might conceivably become changed whereby the proceeds and the business interest would both be includible in the decedent's estate. For these reasons this plan is potentially dangerous.

If, by agreement, A's heir takes out the policy on A, and the heir exercises all the incidents of ownership, B having a like arrangement with his heir, and then A and B agree to have their respective heirs accept the proceeds from their respective policies in lieu of the decedent's business interest, an estate tax saving will have been accomplished. There would be no grounds for including either the business interest or the proceeds in the estate of the decedent. What is wrong with these last two variations? Nothing except that such a plan is perfect groundwork for penalizing the survivor. The case of Paul

\[14\] 2 Rabkin and Johnson (1946) I 2 § 6.
\[15\] 52 F. (2d) 692 (1931).
\[16\] 34 B. T. A. 305 (1936).
Legallet has laid down the rule that proceeds received under such an arrangement by the estate or family of the decedent are not to be included in the cost basis of the partnership to the survivor. The ultimate tax consequences become obvious and automatically eliminate the use of such a plan to the foresighted counselor.

When there are more than two partners, a different plan will have to be employed but the same principles will remain applicable. For an example, Mr. C now joins Mr. A and Mr. B as an equal member of the partnership. Let us assume that the partnership has assets fairly valued at $90,000.00. The plan should be set up whereby A takes out policies on the lives of B and C in the amount of $15,000.00 each. A will pay the premiums and otherwise exercise all incidents of ownership with A as beneficiary on these policies. B and C will reciprocate in a like manner. Let us assume that B dies. B's estate will contain B's policies on the lives of A and C. Under the provisions of the "buy and sell" agreement, A and C will take the proceeds from their respective policies on the life of B and use same to buy B's business interest from B's estate. A and C will also purchase the policies from the estate of B which B carried on A and C. A will take the policy B carried on C and C will take the policy which B carried on A. B's estate is now clear, so let us turn to the survivors, A and C. The partnership still has assets worth $90,000.00 and A and C now own a one-half interest each with a value of $45,000.00 apiece. A now has two life insurance policies on the life of C, each in the face amount of $15,000.00 for a grand total of $30,000.00. C has the same on the life of A. Obviously the totals are insufficient by the amount of $15,000.00 in order to cover the other's interest. Also it should be noted that the policies that each obtained from B's estate on the life of the other were obtained for a consideration and thus fall squarely within the "consideration" rule as stated above. If both A and C are still insurable, and, depending on extenuating circumstances (such as relationship of consideration paid to face value, etc.), it would probably be advisable for A and C to cash in the policies which they received from B's estate and in place thereof, each take out $30,000.00 policies on the life of the other. This would place them precisely in the same position as the partners in the original A and B partnership.

It is true that "partnerships often end in quarrels," but the "tax wise" attorneys can and must prevent these endings.

Robert Lowell Miller.

17 41 B. T. A. 294 (1940).
REPORTING GAINS AND LOSSES FROM LAND CONTRACTS.—"The Government in casting about for proper subjects of taxation," warned Justice Cardozo in *Burnet v. Wells*,¹ "is not confined by the traditional classification of interests or estates. It may tax not only ownership, but any right or privilege that is a constituent of ownership." Justice Cardozo's warning is helpful in explaining the position of the courts in regard to the recognition of gains and losses from the sale of property under land contracts, for the traditional rules of law governing contracts, equity and real property have not always been strictly adhered to in determining the year in which a capital gain or loss should be reported from such agreements.

As several courts have pointed out, there are a number of well-established principles bearing upon land contracts. Generally, an executory contract may be breached any time before it has been acted upon, but part performance makes it binding. As a result of this rule, a failure to complete an executory agreement after partial performance subjects the violator to an action for breach of contract and, if the legal remedy is inadequate, the injured party can go into equity and compel specific performance.² Since "land contracts" are executory agreements to purchase real estate, they are governed by these rules; however, a difficulty is projected into such agreements which is not present in other types of executory agreements: legal title to real estate passes only upon the proper execution and delivery of a deed.³ Thus, the vendee in a land contract acquires equitable title whenever he ventures to perform, while the legal title does not pass until execution and delivery of the deed.³ The dilemma which confronts the courts is whether title passes for tax purposes in the year in which the equitable interest passes, in the year in which the legal title passes, or at some undetermined time in between. In answering this question, they are often forced to choose between contradictory factors: the vendor should not be compelled to pay a tax on his profit until there is a reasonable certainty that he will realize a profit; yet the federal government should be permitted to tax income as soon as possible.⁴

Because these two factors are of equal importance, the courts have refused to set down a hard and fast rule to govern when sale is consummated under a land contract, for tax purposes. They attempt to

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⁴ Note, OPTIONS AND SALE CONTRACTS IN TAXATION, 46 Yale L. J. 272 (1936).
view each transaction as a whole and in the light of realism and practicability, having regard to the transfer of possession, the substantial performance of conditions, and the passing of legal title. It can be observed safely, however, that when a contract is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of the consideration and by which the buyer secures immediate possession and exercises all the rights of ownership, the sale is consummated for tax purposes. This is true even though the delivery of the deed is postponed and payment of part of the purchase price is deferred. It is enough if the vendor obtains under the contract the "unqualified right to recover the consideration." A general rule with alternative provisions can therefore be set out as follows: The sale occurs at the time a deed is executed and delivered to the vendee, or at the time the burdens and benefits of ownership are, from a practical standpoint, transferred to the buyer, whichever occurs first.

The examination of a few of the typical situations encountered by the courts will be of assistance in illustrating when the burdens and benefits of ownership are transferred from a practical standpoint. The simplest cases to determine were those in which the agreements were binding upon the vendor only. Although such agreements are technically "option agreements" they are included in many of the modern land contracts. The leading case of *Lucas v. North Texas Lumber Company* concerns an option agreement, but is often used as authority in the land contract cases. In the *Lucas* case, a Texas corporation for some time prior to 1917 operated a sawmill, selling lumber and buying and selling timber lands. On December 27, 1916, it gave the Southern Pine Company a 10-day option to buy its timber lands for a specified price. The Company was solvent and able to make the purchase on that date. On December 30, 1916, the Company notified the Texas corporation that it would exercise the option, and the corporation ceased operation on the land. The papers which were required to effect the transfer were delivered, the purchase price paid, and the transaction finally closed on January 5, 1917. The corporation attempted to report the gain from the sale in 1916, but the court in holding that it must report it in 1917, pointed out that the agree-

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8 1 PRENTICE-HALL 1947 FED. TAX SERV. § 6254.
9 281 U. S. 11, 74 L. Ed. 668, 50 Sup. Ct. 184, 8 A. F. T. R. 10276 (1930); Birch Ranch & Oil Co., 1944, P. H. T. C. MEMORANDUM DECISIONS § 44,128 (is the most recent authority for the ruling that the mere giving of an option does not constitute a taxable sale. In that case, the deed was required to be delivered only if and when the payments made pursuant to the option agreement aggregated a certain sum before a fixed date).
ment in 1916 was a mere option, and that the question of whether the income was to be received or not could not be determined until the deed was executed and a substantial portion of the purchase price was actually paid. Thus, substantial performance was held to be, by the dictum in the Lucas case, a transfer of the burdens and benefits of ownership for tax purposes.

In the Newago Portland Cement Company case there was a contract for the sale of land made in 1922 and a 10% down payment made. The vendor retained possession until the completion of payment in 1923. The Board of Tax Appeals held that title did not pass for practical purposes until 1923.

Sometimes the method of accounting, whether cash or accrual, will determine the year in which the sale is consummated. Helvering v. Nibley-Mimnaugh has an excellent discussion on this point. The parties in that case agreed upon the purchase price and more than 35% was paid by the vendee in 1923. The vendor agreed that the timber acreage would amount to at least 20,000 acres and that the title should be satisfactory. Both of these conditions were met in 1923, but another condition which provided for a proportionate reduction in the purchase price should the manufactured lumber and timber be less than the quantity agreed upon. This condition was not determined until January 15, 1924, when abatement of the purchase price was agreed upon and the title, deed, mortgage and secured notes were executed and delivered in February, 1924. The court held that the year in which the gain from such sale should be reported by the vendor depended upon whether the seller was on a cash or accrual basis, explaining their holding as follows: "If it (the vendor) was on an accrual basis, the facts shown are sufficient to accrue the entire purchase price in 1923, and that, too, without regard to the fact that the agreed price was conditionally subject to abatement. This is true, we think, because it amply appears that in 1923, in addition to the delivery of the property, the seller had otherwise complied with his contract, as the result of which there existed an unconditional obligation on the buyer to comply. But a different principle is applicable if the seller was on a cash basis, for it is unquestioned that the consideration (over and above the cost of the property to the seller) was not received until 1924." Thus, the transfer of the burdens and benefits of ownership from a tax standpoint depended upon the accounting method used.

The ordinary vendor of land under an executory agreement will have little difficulty in reporting his gains or losses from such land contracts in the proper year. Option agreements and the popular land contracts of today which spread the payments over a considerable

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10 27 B. T. A. 1097 (1933).
11 70 F. (2d) 843 (C. C. A. D. C., 1934).
number of years and make the execution of the deed dependent upon payment of all the installments need not be reported as gains or losses until the option is taken up or the payments are completed, whichever the case may be. It can be seen that the burdens and benefits of ownership are not transferred at the time of the agreements. It is hoped that the discussion and rules set out in this article will enable the taxpayer to determine the year in which he should report gains and losses in the more difficult cases in which a large percentage of the purchase price is paid in one year, but the completion of contract made in the following year. As was pointed out, possession, performance of condition, and the accounting method used are factors which swing the scales toward the time of passing of equitable title or legal title.

Robert M. Million.

The Incorporation of Partnerships.—Much has been said but very little precedent exists in actual decided cases on the recognition of a gain of loss upon the incorporation of a partnership, from the point of view of taxation. The pendulum of opinion has swung to find family partnerships and closely owned businesses desiring to incorporate instead of holding the fears concerning excess profits levied upon corporations evident in the war years. Many partnerships composed of husband and wife have been declared a nullity for income tax purposes and as a result the entire income of the partnership has been taxed to the husband or the party contributing the capital. This failure to establish a partnership has elevated the husband's income into a still higher income tax bracket. Another factor favoring incorporation is that many owners of closely owned businesses, existing under partnership agreement, find it necessary to obtain a larger working capital and by means of incorporation put themselves in a position for public financing. Thirdly, the lowered corporate tax rates make it definitely advantageous for a partnership to transfer to a corporate form. And lastly, partners are looking into the future and guarding against the possibility of any disagreement between the heirs upon dissolution of the partnership by death of a partner. The changing into a corporate form enables the administrator or executor to divide the property in question by the sale of stock. The death of one partner of a two-partner partnership will destroy a going concern while an incorporation will keep the company intact.

If a corporation is desired over a partnership, for any reason, the Internal Revenue Code has expressly provided for non-recognition of loss or gain on the transfer of property by a partnership to a corporation in return for stock or securities. The failure to comply with Sec-
Section 112 (b) (5) of the Internal Revenue Code can result in the obligation for payment of a large tax on recognized gain on the part of the transferors. The failure on the part of the advising attorney to draw a tax-exempt agreement of incorporation for the partners will undoubtedly result in the loss of a valuable client as well as cause irreparable damage to the reputation of the attorney.

What are the requirements for compliance with Section 112 (b) (5)? This section requires: (1) The transfer must be solely for "stock or securities". (2) The transferors must be in control of the corporation immediately after the transfer. "Control" is specifically defined in Section 112 (h) to mean the ownership of eighty per cent of the combined voting power of all classes of stock and eighty per cent of the total number of shares of all other classes of stock. (3) The stock and securities received by each transferor must be substantially in proportion to his interest in the property prior to the exchange.

Suppose that A and B were partners. A had a 63.4% interest in the partnership assets and B had a 36.6% interest in the partnership assets. A received a 39% interest in partnership profits while B received 61% of the interest in partnership profits. Upon incorporating, the corporation issued common stock, a first preferred, and a second preferred stock. Each of the partners receive a percentage of each class equal to his interest in the assets. The common stock represented about fifty-seven per cent of the capital of the company and the preferred stock the balance.

Some time prior to the incorporation, and during the negotiations immediately preceding it, B insisted that he be given sufficient stock in the contemplated corporation to assure his receiving a share of the corporation profits which he had been receiving under partnership agreement. A agreed to transfer to B from the stock which he was to receive a number of shares which would, in general, accomplish the desired result. Nine days after incorporation, A transferred to B a number of common shares which would give him a sixty-one per cent interest in the common stock. After this transfer, the common stock was divided in accordance with their shares in the profits. The preferred stock was divided in accordance with their interest in the assets.

Does the transaction comply with Section 112 (b) (5)?

In all probability the case does comply with the Code and no gain will be realized. A and B transferred the partnership's assets for stock or securities complying with the first requirement. A and B were in control of the corporation immediately after the transfer, and the stock and securities received by each transferor was substantially in proportion to his interest in the property prior to the exchange, fulfilling the second requirement. The only point which might be questioned would be the transfer of stock nine days after the incorporation. If the plan
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were preconceived, prior to the date of incorporation, it might be sufficient to render the transaction taxable.

Perhaps a safer way to arrange for the sharing of the profits, would have been for B to receive a higher salary, under contract, a salary equivalent to the amount of profits he would have received under the original partnership.

The facts, as outlined in our example are substantially those of Strouse, Adler Company v. Commissioner,¹ a memorandum decision by Judge Kern of the Tax Court, in 1944.

Judge Kern stated that "the theory of the section of the statute quoted is that if the interest of the transferors is continued without material change in the transferee corporation, no gain or loss will be recognized. Here the transferor partners were working out an arrangement whereby under the unusual circumstances their interests would be so continued. Under the peculiar facts of the instant case we are unable to come to the conclusion urged by petitioners, that the amount of stock received by each transferor was not substantially proportionate to his interest in the property prior the exchange". He then added, "We reach our decision the more readily because the transfer of stock from Louis (A) to Isaac (B) took place nine days after the transfer of their interests to petitioner corporation and was pursuant to an oral understanding between the two brothers which was indefinite as to method and time of execution, and which was no part of the formal plan of incorporation leading to the existence of petitioner".

The Strouse, Adler Company case could have escaped litigation on this point if the parties on incorporation had complied with the spirit of the law and had not changed their proportionate interests nine days after incorporation. The stock and securities received by each transferor could have remained substantially in proportion and a contract agreement for a higher salary to B would have satisfied his demands.

It will be difficult to ascertain what interpretation will be given to Section 112 (b) (5) in the future. It is certain, however, that with the great number of partnerships which are at present transferring to the corporate form, much litigation will be forthcoming. In a very recent case, In Mather and Company v. Commissioner² transfer of property to a corporation in exchange for stock qualified as a nontaxable exchange under Section 112 (b) (5) where the corporation issued common stock and non-voting preferred stock and assumed indebtedness of the transferors. The "proportion" requirement was satisfied when the aggregate value of the stock and debt assumption received by each transferor was proportionate to the value of the property transferred by him, even though the common stock, pre-

² 7 Tax Court 165 (1947).
ferred stock, and debt assumption were acquired in different proportions. The interests were found to be "proportionate" because there was a maximum discrepancy of three per cent in the percentages of aggregate gain or loss of the several transferors. This case should have a far reaching effect in the near future.

F. Gerard Feeney.

PROPOSED RULE CHANGES FOR THE TAXABILITY OF INCOME OF CERTAIN TRUSTS.—Certain changes in the regulations concerning the taxability of income of certain trusts have been proposed by the Commissioner of Internal Revenue. The proposed changes are to be issued under the authority of Section 62 of the Internal Revenue Code (53 Stat. 32, 26 U. S. C., 62) and will amend regulations 111 (26 CFR, Part 29) as follows:

Paragraph 1. Section 29.22 (a)-21, added by Treasury Decision 5488, approved December 29, 1945 (26 CFR 29.22 (a)-21), is amended as follows:

(A) By striking out the last sentence of paragraph (a) of such section and inserting in lieu thereof the following: "Such factors are set forth in general in paragraph (b) and in detail in paragraphs (c), (d) and (e), below."

(B) By striking out the words "subsection (a)", "subsection (c)", "subsection (d)", and "subsection (e)" wherever they appear in paragraph (b) of such section and inserting in lieu thereof "paragraph (a)", "paragraph (c)", "paragraph (d)" and paragraph (e)".

(C) By striking out of subparagraph (2) of paragraph (c) of such section the words: "or spouse living with the grantor," and inserting in lieu thereof the following: "or spouse (living with the grantor, and not having a substantial adverse interest in the corpus or income of the trust)."

(D) By striking out the second undesignated paragraph of paragraph (c) of such section beginning: "Where the grantor's reversionary interest is to take effect in possession or enjoyment" to and including subdivision (ii) and inserting in lieu thereof the following:

"Where the grantor's reversionary interest is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years, the trust income is nevertheless attributable to him if such event is the practical equivalent of the expiration of a period less than 10 to 15 years, as the case may be. For example, a grantor is taxable on the income of a trust if the corpus is to return
to him or his estate on the graduation from college or prior death of his son, who is 18 years of age at the date of the transfer in trust. Trust income is, however, not attributable to the grantor where such reversionary interest is to take effect in possession or enjoyment at the death of the person or persons to whom the income is payable”.

(E) By striking out the second sentence of the first undesignated paragraph of paragraph (d) of such section and inserting in lieu thereof the following: “The grantor is not taxable, however, if the power, whether exercisable with respect to corpus or income, may only affect the beneficial enjoyment of the income for a period commencing 10 years from the date of the transfer (or 15 years where any power of administration specified in paragraph (c) of this section is exercisable solely by the grantor, or spouse living with the grantor and not having a substantial adverse interest, or both, whether or not as trustee).”

(F) By striking out the last sentence of the first undesignated paragraph of paragraph (d) of such section and inserting in lieu thereof the following: “Where the income affected by the power is for a period beginning by reason of some event other than the expiration of a specific term of years, the grantor will be taxable if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be, in accordance with the criteria stated in paragraph (c) of this section.”

(G) By striking out exception (3) of paragraph (d) of such section and inserting in lieu thereof the following:

“(3) A power which merely enables the grantor or another person:

“(i) To distribute or apply income to or for a current income beneficiary or to accumulate such income for him, provided that any accumulated income must ultimately be payable to the beneficiary from whom distribution or application is withheld or to his estate, or, if payable upon the complete termination of the trust or in conjunction with a distribution of corpus which distribution is augmented by such accumulated income, is ultimately payable to current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive the date of distribution, the share of such deceased beneficiary is to be paid to one or more designated alternate takers, other than the grantor or the grantor’s estate, if such date may reasonably be expected to occur within the beneficiary’s lifetime and if the share of such alternate taker or the shares of such alternate takers have been irrevocably specified in the trust instrument; or

“(ii) Only during the minority of a current income beneficiary to distribute or apply income to or for such beneficiary or to accumulate and add such income to corpus.
(H) By striking out of exception (4) of paragraph (d) of such section the phrase: "For the requirements of such standard, see exception (5);" and inserting in lieu thereof the following:

"(5) A power to apportion income (whether by distribution or accumulation) to or within a class of beneficiaries, or a power to pay out corpus to or for a current income beneficiary, if such power is exercisable by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, and its exercise is not subject to the approval or consent of any person other than such trustee or trustees. However, if any of such trustees is the father, mother, issue, brother, sister, or employee of the grantor (or is an employee of a corporation in which the grantor is an executive or the stockholdings of the grantor and the trust are significant from the viewpoint of voting control), and if the class of beneficiaries designated to receive the income includes the wife or any child of the grantor, this exception shall apply only if the power is limited by some reasonably definite external standard. For the requirements of a reasonably definite external standard, see exception (4). A power to appoint within a class of beneficiaries does not fall within this exception if the trustee is enabled to add to or eliminate from the class of beneficiaries designated to receive the income except insofar as provision may be made for after-born children".

(J) By striking out paragraph (e) of such section in its entirety and inserting in lieu thereof the following:

"(e) Administrative control. Income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where:

"(1) A power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate and full consideration in money or money's worth; or

"(2) A power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate security or interest; or

"(3) The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year; or
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“(4) Any one of the following powers of administration over the trust corpus or income is exercisable by any person in a nonfiduciary capacity: A power to vote or direct the voting of stock or other securities, a power to control the investments or reinvestments or by vetoing proposed investments or reinvestments, a power to reacquire the trust corpus by substituting other property of an equivalent value, and a power which enables the grantor to borrow the corpus or income with adequate security and interests”.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. For example, where the trust corpus consists of diversified stocks or securities of corporations the stock of which is not closely held and in which the holdings of the trust, either by themselves or in conjunction with the holdings of the grantor, are of no significance from the viewpoint of voting control, a power with respect to such stocks or securities held by a person who is not a trustee will be regarded as exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.

The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money’s worth. On the other hand, such authority may be indicated by the actual administration of the trust.

Paragraph 2. Section 29.22 (a)-21 (26 CFR 29.22 (a)-21) as amended shall be applicable to taxable years beginning after December 31, 1945.

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