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Memorandum**

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subject:

This Chief Counsel Advice responds to your request for assistance in which you ask for help in determining whether a taxpayer's transfer of fishing rights is the sale of a capital asset and should be afforded long-term capital gain treatment. For the reasons described below, we conclude that the transfer of fishing rights is not a sale or exchange of a capital asset, and hence should not be taxed at long-term capital gain rates, but as ordinary income.

This advice may not be used or cited as precedent.

LEGEND

Taxpayer:

Transferee:

Sub:

Vessel:

State A:

State B:

Year 1:

Year 2:

Year 3:

Year 4:

Date 1:

Date 2:

Date 3:

Fish:

Area:

Act:

Cooperative 1:

Cooperative 2:

x:

y:

z:

### ISSUE

Whether amounts paid to Taxpayer for the right to use its Fish allocation rights under the Act for one year should be treated as gain from the sale of a capital asset held for more than one year.

### CONCLUSION

Taxpayer's transaction does not warrant long-term capital gain treatment. It merely provided the use of an asset for a limited time, with limited rights. It may have been a license of its allocation rights, rather than a disposition of a portion of those rights under § 1001 of the Internal Revenue Code; but even assuming it was a disposition, it was not a disposition of "property" under § 1221.

## FACTS

Taxpayer is a State A limited partnership, formed in Year 1. Transferee is a State A Corporation which owns and operates a fishing vessel. Taxpayer and Transferee have their ownership interests held by the same group of individuals.

Taxpayer originally owned Vessel, a fishing vessel. In Year 2, Taxpayer sold Vessel to Transferee, who in turn immediately contributed the vessel to its wholly-owned subsidiary, Sub, which is also a State A corporation. Under the terms and conditions of the sale of Vessel, Taxpayer retained ownership of Vessel's catch history and license limitation permit. Taxpayer and Transferee recognized that one or more of the fisheries that Vessel participated in might become subject to a limited entry system in the future. Limited entry systems divide current fishing rights based on catch history. Retention of catch history by Taxpayer meant that Taxpayer would take credit for all fish harvested by the vessel prior to the sale, in the event that a new limited entry system were put into effect in a fishery in which Vessel had participated prior to the sale of the vessel.

Since the sale of Vessel, the principal asset of Taxpayer has been the catch history and license limitation permit of Vessel. In Year 3, Taxpayer acquired other assets that it treats as investment assets.

One of the fisheries that Vessel participated in is the Fish fishery held in the Area. The Area is part of the U.S. exclusive economic zone off the cost of State B, where commercial fishing is regulated by the Secretary of Commerce, through the National Marine Fisheries Services (NMFS). Prior to Year 3, Fish fisheries in Area were open access fisheries. The NMFS determined fishing seasons and a total allowable catch for each district of Area.

The Act created a new limited entry system for Fish fisheries in Area. The Act created directed fishing allowances for catcher/processors and catcher vessels. Vessel's catch history played a role in determining its directed fishing allowance, which in turn determined the amount of Fish it could harvest in a given year. NMFS refused to recognize a divided catch history for purposes of the Act. Ultimately it was determined that Taxpayer would claim the fishing rights associated with Vessel under the Act.

Under the Act owners of vessels with fishing allowances may join together in a fishing cooperative, which enables members to divide the allowances among the vessels in any mutually agreeable way. Thus the directed fishing allowances are transferable to other vessels or catcher/processors eligible for the same directed fishing allowance.<sup>1</sup>

On Date 1, the owners of the catcher vessels listed in the Act formed Cooperative 1. Sub, not Taxpayer, was a party to Cooperative 1, since legal title to Vessel 1 had been

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<sup>1</sup> In addition to its original allocation, Taxpayer acquired a portion of another catcher/processor's allocation.

transferred to Sub by this time. On Date 2, Cooperative 1 entered into an agreement with Cooperative 2, which was made up of catcher/processors listed under the Act. The cooperative agreement set forth a joint harvest schedule and an apportionment of the total amount of Fish that could be harvested under the Act. The cooperative agreement further stipulated that any member of either Cooperative 1 or 2 could transfer their Fish allocation to members of either cooperative.

In Year 3, Taxpayer assigned its allocation for the Year 3 fishing seasons to Transferee, a member of Cooperative 2. Taxpayer assigned similar rights to Transferee in subsequent years.

With respect to the Year 4 transaction at issue, on Date 3, Transferee and Taxpayer agreed to the assignment of rights of Taxpayer under the Act for Year 4. The terms of the agreement were that Taxpayer assigned all of its allocated fishing rights for Year 4 under Act to Transferee, and in turn Transferee agreed to pay \$ x per metric ton during the first fishing season of Year 4 and \$ y per metric ton during the second season of Year 4. The amounts due were to be paid in cash at the close of each season, and the agreement related only to the Year 4 Fish seasons.

Taxpayer and Transferee understood that Taxpayer would own any future fishing rights awarded based on Fish harvested under the Year 4 allocation. If a new limited entry system were put into effect in the directed Fish fishery, and fishing rights were awarded in part based on catch history from Year 4, Taxpayer would be credited for all Fish harvested under the allocation, and Transferee would transfer to Taxpayer any future rights awarded. Since the creation of the Act Taxpayer and Transferee had entered into similar arrangements on a yearly basis.

Transferee paid Taxpayer \$ z for the amount of Fish caught in Year 4.

### LAW AND ANALYSIS

Section 1001 of the Internal Revenue Code provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis.

For purposes of federal income taxation, a sale occurs upon the transfer of the benefits and burdens of ownership. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981). For there to be a sale of intangible property, the taxpayer must have parted with all substantial rights with respect to the property. Bailey v. Commissioner, 90 T.C. 558, 607-14 (1988).

Under Act and the cooperative agreements, Taxpayer held transferable rights to harvest a certain percentage of the allowable catch of Fish in Area, a "limited entry" fishery. These allocation rights were intangible property in Taxpayer's hands. For Year 4, as in prior years, Taxpayer did not transfer all substantial rights and obligations in this property to Transferee. Instead, it granted Transferee the right to use the allocation

rights for the two fishing seasons of that year, retaining all future rights in the allocation, including the Year 4 “catch history.” Such a time-limited transfer is generally treated as a lease or license for federal tax purposes, not a disposition under § 1001. It is thus not a “sale or exchange” for purposes of § 1222, described below, and the income from the transaction is taxed as ordinary income, not capital gain.

Taxpayer argues that each fishing season was an “event,” and that the transfer of the right to use the allocation for each fishing season was a separate transfer of the right to use the allocation for that event, analogizing to the sale of a ticket by a taxpayer that holds multiple tickets to a sporting team’s games. This argument proves too much. Under this theory, the right to use real property for a year, or a month, could be characterized as an “event,” converting all rental agreements into a series of property sales; or the right to print one book could be viewed as a separate item of “property,” converting all copyright royalty agreements into a series of mini-sales. Taxpayer’s grant of the right to use its allocation for a year is more properly viewed as a license of its intangible property, the income from which is ordinary income.<sup>2</sup>

Even assuming the transaction was a disposition under § 1001, and thus a “sale or exchange” under § 1222, the income from the transaction would still be ordinary income, because the transferred rights were not “property,” as that term is used in defining a capital asset under § 1221.<sup>3</sup>

In order for proceeds from the disposition of an asset to qualify as long-term capital gain, the asset must be a capital asset as defined by § 1221, the disposition must be a “sale or exchange,” and the asset must have been held for more than one year. Section 1222.

Section 1221 defines the term “capital asset” as property held by the taxpayer, regardless of whether it is connected with the taxpayer’s trade or business, unless the property meets one of eight listed exceptions.

Taxpayer asserts that its allocation rights do not come within any of the listed exceptions in § 1221. In order for § 1221 to apply, however, the asset sold must constitute “property.” Although § 1221 appears to give broad meaning to this term, the Supreme Court has found it “evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of § 1221] qualifies as a capital asset”; rather, the term “capital asset” “is to be construed narrowly in

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<sup>2</sup> Although by itself it does not preclude sale treatment, the contingent payment feature of the arrangement, under which Transferee paid a certain amount per metric ton fished, is a common characteristic of a license/royalty transaction. See, e.g., Nassau Suffolk Lumber & Supply Corp. v. Commissioner, 53 T.C. 280 (1969), acq., 1970-2 C.B. XVIII.

<sup>3</sup> Thus, the income from the transfer is ordinary income whether the transaction is viewed as a license or a sale. However, basis would be allowed as an offset in the latter case. It presumably makes little difference which tax treatment applies in the present case, because Taxpayer had little or no basis in its allocation rights.

accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ... ." Commissioner v. Gillette Motor Transport Co., 364 U.S. 130, 134 (1960) (compensation for temporary seizure of business facilities is ordinary income).<sup>4</sup>

As discussed above, Taxpayer only transferred the right to fish in the Area on a yearly basis. What was transferred was a time-limited interest carved out from Taxpayer's allocation rights, the remainder of which it retained. Over time, appreciation in the value of the allocation rights, including the catch history, accrued to Taxpayer, not Transferee or other temporary users. As stated in Gillette, the term capital asset should be construed narrowly. What Taxpayer transferred was less than the whole directed allocation right stemming from the Act, Vessel's catch history, and the cooperative agreements. "[T]he right to use is not a capital asset, but simply an incident of the underlying ... property, the recompense for which is commonly regarded as rent." Gillette, 364 U.S. at 135.<sup>5</sup>

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<sup>4</sup> See also Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1941).

Taxpayer asserts that because, in its hands, the allocation rights were not used in a trade or business, they are a capital asset under § 1221, not an amortizable business-use asset under § 1231. The characterization turns on whether Taxpayer was in the business of licensing its allocation rights. Regardless of which provision applies, however, the answer is the same, because the restricted definition of "property" applies under both provisions. In Gillette, for example, the Court applied its reasoning to the statutory predecessors of both § 1221 and § 1231.

<sup>5</sup> The cases and rulings cited by Taxpayer in support of capital asset characterization -- such as United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963) (well-surveying patent); Gladden v. Commissioner, 112 T.C. 209 (1999) (water allocation rights); Kingsbury v. Commissioner, 65 T.C. 1068 (1976) (cardroom lease); Estate of Shea v. Commissioner, 57 T.C. 15 (1971) (shipping charter); Rev. Rul. 72-384, 1972-2 C.B. 479 (milk allocation rights); and Rev. Rul. 66-58, 1966-1 C.B. 186 (cotton acreage allotments) -- are distinguishable, generally because they refer to the totality of a taxpayer's rights in intangible property, not, as here, to the transfer of a time-limited right to use intangible property, carved out of a larger interest.