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### The Tax Treatment of Advance Receipts

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# The Tax Treatment of Advance Receipts

DAVID HASEN\*

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## I. INTRODUCTION

The tax treatment of advance receipts, which include prepaid services income, loans, and deposits, remains a conceptually unsettled area of the law.<sup>1</sup> Commentators taking opposed positions have characterized current law, and those who interpret it, as “wrong,”<sup>2</sup> “misguided,”<sup>3</sup> “insufficiently conscious of . . . tax values,”<sup>4</sup> and guilty of “bad economics, bad accounting and bad tax law.”<sup>5</sup> The same long-standing principles, such as that loan proceeds are not an accession to wealth under a realization-based income tax or that one’s basis in services or property to be provided in the future is relevant to the amount of income one has on a present receipt, have been described as “basic”<sup>6</sup> and “demonstrably false,”<sup>7</sup> while articles by respected commentators that purport to transmit to judges and other legal actors principles that are “well understood”<sup>8</sup> within at least some quarters of tax academia advance ideas that other tax scholars hotly contest.<sup>9</sup>

On reflection, it is not entirely surprising that the treatment of advance receipts should lie in a state of confusion. For one thing, the actual rules seem to lack a basic rationale. In a word, they appear to be inconsistent. Amounts termed “deposits” generally are not taxable to the recipient,<sup>10</sup> whereas prepaid rent is.<sup>11</sup> Loan proceeds are not taxable to the recipient,<sup>12</sup> but prepaid services income almost always

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<sup>1</sup> See Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 Va. Tax Rev. 245, 274 (2007) (discussing the history of the taxation of debt).

<sup>2</sup> Calvin H. Johnson, *The Illegitimate “Earned” Requirement in Tax and Nontax Accounting*, 50 Tax L. Rev. 373, 379 (1995).

<sup>3</sup> William A. Klein, *Tailor to the Emperor with No Clothes: The Supreme Court’s Tax Rules for Deposits and Advance Payments*, 41 UCLA L. Rev. 1685, 1687 (1994). Klein makes a valiant effort to vindicate a result similar to the one that is advocated here, but his argument rests on assumptions that later theorists have rejected, such as that even loan proceeds should not be included in income. See, e.g., Klein, *supra*, at 1698 (assuming that interchangeability of advance payment with borrowing demonstrates no income in either case); see generally Dodge, note 1. As explicated below, the argument here seeks to justify these principles as well, purely in terms of the concept of income.

<sup>4</sup> Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 Am. J. Tax Pol’y 17, 20 (1998).

<sup>5</sup> Johnson, note 2, at 379.

<sup>6</sup> Dodge, note 1, at 253 n.34.

<sup>7</sup> Klein, note 3, at 1687.

<sup>8</sup> Geier, note 4, at 25.

<sup>9</sup> Compare, e.g., Geier, note 4, at 22 and *passim* (arguing that the matching principle is not a “tax value”), with Klein, note 3, at 1691 and *passim* (advocating a position closely related to the matching principle).

<sup>10</sup> *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

<sup>11</sup> Reg. § 1.61-8(b).

<sup>12</sup> Klein notes that the exclusion of loan proceeds from gross income “has been regarded as so self-evidently correct that the only authority for it is case law on whether particular

is.<sup>13</sup> In many cases, the distinctions among these types of receipts appear to be purely formal. At the same time, however, it is not at all clear how the rules can be made consistent without violating deep-seated intuitions about proper outcomes in particular cases. For example, if loan proceeds were taxed on receipt and deducted on repayment, it would become unclear why (at least some portion of the value of) rental property also should not be taxed on transfer to the renter (and possibly deductible on its return). However attractive a goal consistency in the rules may be, the taxation of renters on receipt of rental property seems too high a price to pay.

Second, the formality of the rules means that they are subject to manipulation. It is easy enough to convert a deposit into prepaid rent and vice-versa without changing the underlying economics of the transaction.<sup>14</sup> Likewise, the similarities between an ordinary loan from a third-party lender and an employer's advance against future salary income suggest that distinct tax treatment of the two arrangements is inappropriate. If the rules are formal, then tax electivity is easy. The question becomes how to draft the papers, not how to structure the economic transaction.

Under these circumstances, it is easy to understand why the aspiration for a theory that would identify and tax the income generated in advance payment situations becomes particularly powerful, and why the theory itself has proved elusive. A regime that would better track the underlying realities of advance payments would remedy the arbitrariness and electivity of current law; by the same token, if it seems that any set of rules that would tax advance payments on the basis of their substance yields unacceptable results, the theory itself seems unattainable.

This Article makes three points that clarify why the problem of taxing advance receipts has remained intractable and why apparently inconsistent rules in this area may make sense. The first is that there has been a general failure to recognize the significance of questions of tax administration to the formulation of appropriate rules. Thus, it is helpful to distinguish the basic questions of when and whether someone in receipt of an advance receipt has true economic income from timing questions relevant for purposes of tax administration. Advance payments raise two timing questions, each of which is associated with its own "tax values." The first concerns the actual time at which

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transactions are in fact loans or on the consequences of a loan transaction." Klein, note 3, at 1691 (footnotes omitted).

<sup>13</sup> See, e.g., *Schlude v. Commissioner*, 372 U.S. 128 (1963) (prepayments for dance lessons includible). But see *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968) (prepayments for parking at baseball games not includible). These cases are discussed below.

<sup>14</sup> See Klein, note 3, at 1696-97.

a taxpayer can be said to have income; the second is the related administrative question of the appropriate time to tax the taxpayer. The latter has to do with the practicalities of collecting tax, whereas the former has to do with the income concept itself. The rules that courts and the Service have developed for particular types of payments are, for the most part, answers to the second question, and they are generally reasonable. But looking for analytical cogency from these rules, as many commentators have done, is bound to be fruitless if the rules are thought to embody a coherent income concept. The rules do not hew to any definition of income but make sense, to the extent they do, in light of the importance of collecting tax when it seems a tax will arise and a fund is available to pay it.

The second point is that both authorities and commentators have occasionally subsumed the timing question to the "matching" question. "Matching" refers to the principle of associating a particular income item with the costs the taxpayer incurs in order to earn it.<sup>15</sup> Frequently, amounts received in a prior period that will not be earned until a future period will not result in the taxpayer's incurring of associated expenditures until the future period either. Under generally accepted accounting principles, it typically is inappropriate to treat such a receipt as income until the associated expenses have been incurred or at least accounted for.<sup>16</sup> Commentators have observed that while this rule makes sense from a financial accounting perspective, the values that underlie the accounting treatment do not necessarily support deferral for tax purposes.<sup>17</sup> On occasion they then have gone on to conclude that the rejection of the matching principle for tax accounting suggests that current taxation of advance receipts is correct after all.<sup>18</sup> While I concur in the judgment that the matching principle ought not determine the timing of inclusions for tax purposes, I do not agree that current inclusion of advance receipts thereby follows. Conceptually, tax inclusion or deferral turns upon considerations that arise on the income side, not the deduction side. The issue is whether the activities that support inclusion have occurred, not whether expenses that will or may be incurred in connection with performance arise now or in a future period. Typically, in the case of an advance receipt, some or all of the activities that discharge or retire the recipient's obligation do not occur on receipt. It is this nondischarge, and

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<sup>15</sup> Geier, note 4, at 18-19.

<sup>16</sup> *Id.* at 28.

<sup>17</sup> See, e.g., Alan Gunn, *Matching of Costs and Resources as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1, 12 (1984).

<sup>18</sup> See, e.g., Geier, note 4, at 114. This is the position consistently taken by the Commissioner. See, e.g., Gunn, note 17, at 20 (observing that "the Commissioner has been content to exercise . . . discretion [to reject deferral] without justifying his choice").

not the fact of looming rather than current associated expenditures, that justifies deferral in many advance receipt contexts.

Finally, all parties—courts, the government, and commentators—have improperly imported cash flow taxation concepts into their analyses of advance payments. The result has been to apply income tax criteria to some types of advance payments and wealth or consumption tax criteria to others. Not surprisingly, such disparately motivated efforts have yielded inconsistent results, because an income tax frequently will apply at a different time and for different reasons than will a consumption or a wealth tax.<sup>19</sup> While there may be sound administrative reasons to adopt cash flow tax rules for a variety of advance payments under the income tax, conceptual clarity will never be attained by failing to recognize that that is what one is doing. Thus, concepts such as control over the receipt or the type of use (business or personal) to which the receipt is put may have a bearing on workable income tax rules, but they should not be enlisted in an effort to support a view about when a taxpayer economically has income or a loss. From a purely conceptual standpoint, control and use are relevant to wealth and consumption taxation but not to income taxation.

Part II sets the stage for the analysis by describing current law for a variety of advance payments and identifying differences in their tax treatments. Part III examines the underlying issue of when an individual can be said to have income under established income concepts. Part IV returns to the particular kinds of advance payments discussed in Part II, examining them in light of established income concepts and with a focus on tax administration.

## II. ADVANCE RECEIPTS

For purposes of the following discussion, I define advance receipts broadly to include any amount received, in money or kind or even services, in exchange for the provision in some future period of money or services, or for the promise to return the amount or some portion thereof that was transferred.<sup>20</sup> For example, a service recipient may pay a service provider for next year's work this year (prepaid services income),<sup>21</sup> or a lessee may prepay rent. Loans and deposits also are

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<sup>19</sup> See, e.g., Daniel N. Shaviro, *When Rules Change* (2000) (discussing the real and administrative differences between income and consumption taxes).

<sup>20</sup> I do not discuss property sale transactions such as forward and future contracts, which are the subject of an extensive literature. See, e.g., David Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 *Fla. Tax Rev.* 471 (1997).

<sup>21</sup> See, e.g., *Am. Auto. Ass'n v. Commissioner*, 367 U.S. 687 (1961) (subjecting such income to tax when received).

advance receipts. In a loan, the lender transfers loan proceeds to the borrower, who incurs an offsetting obligation to repay the amount in the future as well as, typically, an ongoing obligation to pay interest on outstanding principal. In a deposit, the recipient may hold the money for or on behalf of the depositor as a reserve against future fixed or contingent obligations; often the deposit is held as a fund to cover payment for the provision of future services to the depositor or against possible claims the holder may have against the depositor.<sup>22</sup> At the limit, even a lessee may be said to have an advance receipt on taking possession of rental property, the offsetting obligations being rent and the transfer of the leased property back to the lessor at the end of the lease term.

The rules applicable to many kinds of advance receipts are settled (if seemingly contradictory), while in other instances they are less clear. For example, it is well established that the proceeds of an ordinary, fixed-rate loan are neither includible in income when received nor deductible from income when repaid;<sup>23</sup> if a loan obligation is canceled, then the borrower typically has income to the extent of the canceled obligation,<sup>24</sup> subject to relief in certain cases.<sup>25</sup> The lender has a bad debt deduction or a deductible loss.<sup>26</sup> Similarly, it is undisputed that prepaid rent is includible in gross income of the recipient<sup>27</sup> and, if it is a business expenditure, amortizable or deductible to the renter.<sup>28</sup> By contrast, advance payments received by accrual method taxpayers in exchange for future services may or may not be includible on receipt, depending upon how tightly the recipient can tie the sum received to the provision of specific services at a specific time. Where it is possible to associate the payments closely enough with the services, income recognition is deferred until the service is provided;<sup>29</sup> in most

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<sup>22</sup> See Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 105.5 (2005).

<sup>23</sup> Klein, note 3, at 1691; see also text at nn.121-23.

<sup>24</sup> IRC § 61(a)(12); see also *Commissioner v. Tufts*, 461 U.S. 300, 317 (holding that cancellation of nonrecourse debt in excess of fair market value of property secured thereby results in increased amount realized on disposition of property).

<sup>25</sup> IRC § 108(a). Exceptions to inclusion include insolvency, cancellations of debt with respect to items that would be deductible if paid, as well as cancellation of qualified home acquisition indebtedness.

<sup>26</sup> IRC § 166 (bad debts), § 165 (losses).

<sup>27</sup> Reg. § 1.61-8(b). Section 467 overrides the standard treatment of prepaid (and postpaid) rent in the case of certain "section 467 rental agreements," which generally include agreements providing for pre- or postpaid rent where the total rental payments under the agreement exceed \$250,000 and other conditions are satisfied. See Bittker & Lokken, note 22, ¶ 105.7. Notably, the statute tracks what I argue below are the real items of income and expense associated with prepayments.

<sup>28</sup> Rev. Rul. 74-589, 1974-2 C.B. 286; Reg. § 1.263(a)-4(d).

<sup>29</sup> See, e.g., *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968); *Collegiate Cap & Gown Co. v. Commissioner*, 37 T.C.M. 960 (1978); see also Rev. Proc. 2004-34, 2004-22

instances, however, the service recipient will be unable to establish the required nexus and the payments will be taxed on receipt.<sup>30</sup> The following discussion elaborates on the taxation of these arrangements.

### A. *Deposits Versus Prepaid Services Income*

Perhaps nowhere are the difficulties with the courts' and the Service's approach to advance receipts more obvious than in authorities dealing with deposits. As a general matter, an amount that qualifies as a deposit is treated as neither includible by the payee nor deductible by the payor, while prepaid services income or rent typically is included on receipt.<sup>31</sup> The rules for categorizing a receipt as one or the other have shifted over time and have varied across jurisdictions. Prior to the Supreme Court's decision in *Commissioner v. Indianapolis Power & Light Co.*,<sup>32</sup> the Tax Court employed a facts and circumstances, or "earmarks,"<sup>33</sup> test that sought to determine whether the recipient treated the amount as an item held on the payor's account, or instead as a down payment on a future expected income item.<sup>34</sup> Under the earmarks approach, the payee's reasons for collecting the prepayment are not generally relevant to whether the item is income on receipt. Some circuit courts, however, applied a "primary purpose" test under which the determinative factor was whether the payment was intended to secure a future income item (such as payment for services) or instead to secure a nonincome covenant (such as for possible damage to equipment).<sup>35</sup> Here it was not the features of the payment but the purpose of collecting it that determined its tax treatment.

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I.R.B. 991 (permitting up to one year of deferral for certain advance payments to the extent they are received for items (including services, property, certain warranties, and other items) not attributable to amounts either reflected on the taxpayer's financials for the year of receipt or "earned" in the year of receipt).

<sup>30</sup> See, e.g., *Am. Auto. Ass'n v. Commissioner*, 367 U.S. 687 (1961) (automobile club dues); *Schlude v. Commissioner*, 372 U.S. 128 (1963) (dance lessons). The Service has provided partial relief for certain advance payments in Revenue Procedure 71-21, 1971-2 C.B. 549. Amounts received in a year in respect of goods or services to be provided in a subsequent year may be deferred until the year after receipt (but not thereafter) if, among other things, the taxpayer defers the receipt until delivery of the goods or services under its normal method of accounting.

<sup>31</sup> Rev. Proc. 71-21, 1971-2 C.B. 549, modified and superseded by Rev. Proc. 2004-34, 2004-22 I.R.B. 991; Reg. § 1.61-8(b). But see IRC § 467 (putting lessors and lessees on accrual method in the case of certain "section 467 rental agreements" (generally those involving total rent in excess of \$250,000 where there is substantial pre- or post-payment of rent)).

<sup>32</sup> 493 U.S. 203 (1990).

<sup>33</sup> The term is Klein's. Klein, note 3, at 1714.

<sup>34</sup> *City Gas Co. of Florida v. Commissioner*, 74 T.C. 386 (1980), rev'd, 689 F.2d 943 (11th Cir. 1982).

<sup>35</sup> *City Gas Co.*, 689 F.2d 943.

The Supreme Court attempted to bring some clarity to the area in *Indianapolis Power*,<sup>36</sup> but the effort has been widely criticized as relying on formal distinctions that have no basis in economics or tax theory.<sup>37</sup> In *Indianapolis Power*, the question was whether amounts that an electric utility collected as security for payment against future services from customers who had a history of delinquent payments were nontaxable deposits or prepaid services income. The amounts were twice the expected monthly utility bill. Initially, the utility paid 3% interest on the sums held at least six months. Later it paid 6%, but only to the extent sums were held more than twelve months, with 0% paid prior thereto. Unclaimed amounts held for more than seven years escheated to the state. Customers could secure repayment by requesting it and demonstrating acceptable credit (or by terminating their service). The utility treated the amounts on its books as deposits belonging to the customers, though it did not segregate the deposits from its own funds. The utility's noninclusion of the amounts in income for accounting purposes was consistent with generally accepted accounting principles and applicable state law.

The Tax Court held the amounts were not income on receipt.<sup>38</sup> In the court's view, the question was whether the primary purpose of the payment was to acquire security for future services should they be provided, or instead to obtain income ahead of future services on the expectation that they would be provided. To answer that question, the court looked to the rights transferred to Indianapolis Power & Light and those retained by the depositor. The fact that the utility required the advance payments from only 5% of customers (those from whom it was reasonable to request security), the depositors retained ultimate control over disposition of the amounts, and the utility paid depositors interest all supported treatment of the amounts as security deposits rather than advance income.<sup>39</sup> The Seventh Circuit affirmed on essentially the same rationale.<sup>40</sup>

The Supreme Court ultimately affirmed, but its reasoning differed slightly.<sup>41</sup> Accepting that a material difference exists between a deposit (no inclusion on receipt) and a prepayment (immediate inclusion in most circumstances), the Court looked to the circumstances under which repayment, if any, would likely be forthcoming as a basis to distinguish between the two types of receipts. It concluded that legal

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<sup>36</sup> 493 U.S. 203.

<sup>37</sup> Geier and Klein criticize *Indianapolis Power & Light*, though on different grounds. See Geier, note 4, at 130-31; Klein, note 3, at 1718-23.

<sup>38</sup> *Indianapolis Power & Light Co. v. Commissioner*, 88 T.C. 964 (1980).

<sup>39</sup> *Id.* at 977.

<sup>40</sup> *Indianapolis Power & Light Co. v. Commissioner*, 857 F.2d 1152 (7th Cir. 1988).

<sup>41</sup> *Indianapolis Power & Light Co. v. Commissioner*, 493 U.S. 203 (1990).

entitlement to demand a repayment in cash more likely signals a deposit; where, however, cash is available to the payor merely as a remedy for the recipient's failure to perform, the amount generally is includible on receipt.<sup>42</sup>

Commentators have rightly pointed to the incoherence of the Court's reasoning as a matter of economics or tax theory. In an extended discussion, William Klein argues that the asserted distinction between a loan, to which the Court likens a deposit, and advance services income is essentially nil: The method by which the recipient of the amount finances the receipt is irrelevant to the economic consequences of the receipt.<sup>43</sup> In both cases the recipient receives the right to use a payment for a period of time prior to the date she discharges her obligation. Either both should be included on receipt, or neither should.<sup>44</sup> Joseph Dodge, advocating a cash flow approach to prepayments generally, reaches the same conclusion on the question of consistency: There is no basis for treating the two kinds of receipts differently.<sup>45</sup>

As to which rule is correct, disagreement prevails. Klein takes the position that the offsetting liability rationale that precludes inclusion in income of loan proceeds on receipt (and, correspondingly, prevents deduction of principal as it is repaid) is the correct rule generally for advance receipts of all kinds.<sup>46</sup> Dodge, by contrast, asserts that the question is whether the taxpayer enjoys an accession to wealth during the tax period. Recognizing that a pure accrual-based income tax would not necessarily support this approach, Dodge argues that under our realization-based tax system, rules parallel to those for built-in gain or loss on the asset side of the ledger ought to apply to liabilities. According to Dodge, as a general matter a realization-based income tax should disregard future obligations to the extent they are "unrealized," which is to say that payment is not due in the current period. From this perspective, the receipt is not offset by an obligation, and therefore it constitutes an accession to wealth.<sup>47</sup>

Deborah Geier suggests a third position that would accurately tax the loan element implicit in the arrangement, without necessarily taxing the entire deposit on receipt.<sup>48</sup> Recognizing, however, that bifurcating such a receipt may be difficult in particular cases, she suggests a

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<sup>42</sup> *Id.* at 207-08.

<sup>43</sup> Klein, note 3, at 1713-23.

<sup>44</sup> *Id.*

<sup>45</sup> Dodge, note 1, at 256-65.

<sup>46</sup> Klein, note 3, at 1730. The offsetting obligation rationale is discussed in detail in Section II.C.

<sup>47</sup> Dodge, note 1, at 265-71.

<sup>48</sup> Geier, note 4, at 133.

rule of full taxation or not, depending on whether the interest element constitutes more than half of the deposit.<sup>49</sup> Like Klein and Dodge, as well as a number of other commentators,<sup>50</sup> she views the Court's effort in *Indianapolis Power* as misbegotten.<sup>51</sup>

### B. *Prepaid Services Income*

There is similar disagreement with respect to advance payments for services where no fund amounting to a deposit is maintained or asserted. In terms of standard tax doctrine, such amounts differ from deposits because, unlike deposits, they are considered to be income to the recipient on receipt, and the only question that arises is whether the period of receipt, rather than some other period, is the appropriate time to levy tax.<sup>52</sup> In the majority of cases, amounts received as payment during the year in exchange for services to be performed in a later year are included on receipt.<sup>53</sup> The operation of this rule for cash method taxpayers has always been relatively unproblematic, but the rules for accrual method taxpayers remain somewhat unsettled. In a trilogy of cases decided by the Supreme Court in the 1950's and 1960's, the general rule emerged that even accrual method taxpayers must include on receipt amounts received for future services.<sup>54</sup> In each case, the taxpayer received an amount in a year prior to the year in which the taxpayer would be called upon to provide services, and in each case the quantity of services (but not the amount of the payment to which the taxpayer was entitled) that the taxpayer would be called upon to provide was uncertain.

These decisions seem to reflect a rejection of the "matching principle" as a basis for tax accounting. Under the matching principle, amounts are not treated as income for financial accounting purposes until the period in which the expenses associated with the right to retain the income are incurred.<sup>55</sup> The taxpayers in these cases generally argued that the accrual method of accounting for income tax purposes embodies the same principle. The accrual method is designed to provide an accurate measure of income, but if they were required to include prepayments without taking into account the costs of earning the prepayment, the tax law would provide an inaccurate measure of

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<sup>49</sup> Id. at 136.

<sup>50</sup> Yin, note 37, at 469; see note 37.

<sup>51</sup> Geier, note 4, at 128-29.

<sup>52</sup> See generally § 451(a); Reg. § 1.451-1.

<sup>53</sup> See Reg. § 1.451-1(a) (cash method taxpayers); *Schlude v. Commissioner*, 372 U.S. 128 (1963) (accrual method taxpayers).

<sup>54</sup> *Auto. Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *Am. Auto Ass'n v. Commissioner*, 367 U.S. 687 (1961); *Schlude*, 372 U.S. 128.

<sup>55</sup> Geier, note 4, at 28.

income. They also argued that it was inappropriate to require them to treat such amounts as taxable income if they were precluded from treating the amounts as income for financial accounting purposes. The Supreme Court rejected these arguments. It acknowledged that the matching of income and expense is a tax value,<sup>56</sup> but declined to permit deferral on that basis in the absence of a sufficiently determinate showing of the future expenses. Rather, the Court concluded that where the timing or amount of those expenses was uncertain, the matching principle gave way to the Commissioner's determination that deferral does not provide a "clear reflection of income," as required by § 446(b).<sup>57</sup>

Because the Court seemed to accept the notion that matching of income and expense, where possible, provides a more accurate measure of income than does their separate treatment, the trilogy left open the possibility for an exception to the immediate inclusion rule "where the time and extent of performance of future services"<sup>58</sup> associated with the advance payment are sufficiently certain. *Artnell v. Commissioner*<sup>59</sup> is one of a handful of cases that have acknowledged the exception. The taxpayer in *Artnell*, the Chicago White Sox, deferred the portion of season ticket revenues it received from season ticket holders that were allocable to games to be played in the subsequent tax year. Because the taxpayer could associate the precise portion of the prepayment to each game to be played, it was possible to determine the extent to which any particular portion of the amount received would represent profit or loss once the game was played. The Seventh Circuit concluded that deferral in this circumstance did not fail to clearly reflect income, and therefore that it was an abuse of the Commissioner's discretion under § 446 to require current inclusion. The court distinguished the Supreme Court trilogy on the basis that the timing and amount of the associated services were less certain in those cases, while the right to the payment was fixed.<sup>60</sup> Other lower

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<sup>56</sup> *Id.* at 120 (stating that acceptance of the matching principle pervades the majorities' and dissents' opinions in both *Automobile Club of Michigan* and *Schlude*).

<sup>57</sup> That is, the receipt is taken as an accession to wealth the inclusion of which may be deferred if the taxpayer can show that some of the wealth is phantom in the sense that future expenditures will need to be made to earn it. Where the showing cannot be made with sufficient certainty, the item is treated as current income. See Geier, note 4, at 118.

<sup>58</sup> *Artnell Co. v. Commissioner*, 400 F.2d 981, 983-84 (7th Cir. 1968).

<sup>59</sup> *Id.* at 981.

<sup>60</sup> *Id.* at 983-84.

courts occasionally have applied the *Artnell* rule,<sup>61</sup> although the rule is generally construed narrowly.<sup>62</sup>

A number of positions have been staked out in the literature on the treatment of prepaid services income. Dodge and Klein each advance a rule consistent with the rules they propose in the case of deposits: For Klein, prepaid services income generally should be deferred, because it is not earned until the associated obligation has been discharged. However the obligation is discharged—whether with future services or a future cash payment—the recipient taxpayer has no income on receipt.<sup>63</sup> For Dodge, the prepayment should be included on receipt because he views the receipt of cash in the current period as an accession to wealth that is not properly offset by an as-yet unrealized obligation due in a future period.<sup>64</sup>

Calvin Johnson advances an intermediate position. He would tax prepayments on the basis of the presumptive source of cancellation of the offsetting obligation.<sup>65</sup> According to Johnson, the decisive difference between loan receipts or other kinds of refundable payments and prepaid services income lies in the fact that prepaid services income, though it is not owned free and clear in an economic sense, is expected to be discharged with services having zero basis to the service provider. Thus there is no tax “cost” associated with satisfaction of the recipient’s obligation to the payor.<sup>66</sup> From a tax perspective, it is free. Loan proceeds and other kinds of refundable deposits, by contrast, presumptively will be repaid with after-tax amounts. For example, if *Borrower* repays *Lender* with salary income received from *Employer*, *Borrower* will pay tax on the salary income as earned, and only after-tax proceeds will be remitted to *Lender*. Hence, the offsetting liability attaches to an amount in which *Borrower* will have basis.

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<sup>61</sup> See *Collegiate Cap & Gown Co.*, 37 T.C.M. 960 (1978); *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976) (upholding the taxpayer’s consistently applied rule of including payments for engineering services in income when the services were provided, which sometimes was before and sometimes was after payment, rather than on the payment date). The Service has acquiesced in deferral in a wider array of cases, but only for up to one year. See Rev. Proc. 71-21, 1971-2 C.B. 549 (permitting up to one year of deferral for certain items of prepaid services income).

<sup>62</sup> See Rev. Proc. 2004-34, 2004-22 I.R.B. 991, § 5.01 (current inclusion), § 5.02 (deferral for up to one year if consistent with taxpayer’s method of financial accounting).

<sup>63</sup> Klein, note 3, at 1709-10 (noting that prepaid services income, loans, and deposits are economic substitutes for one another).

<sup>64</sup> Dodge, note 1, at 260-61.

<sup>65</sup> Johnson, note 2, at 385.

<sup>66</sup> *Id.* (“[L] gets no exclusion with respect to the \$1 million cash receipt, because [L] has no basis and will get no basis for the services.”); see also *id.* at 408 (“For all objective appearances, [L] is like someone who has just made a million dollars. . . . There is nothing about [L]’s \$1 million that makes it look like a loaned \$1 million or distinguishes it from an earned \$1 million.”).

Geier offers yet another view. She argues that as in the deposit case, the application of the matching principle to prepaid services income represents a misguided attempt to import accounting values into the income tax. The matching principle, which is a product of the accounting profession's attempt to determine the real source and extent of an enterprise's business health over the long term,<sup>67</sup> "should not be considered a value at all in a system that seeks to collect revenue, and to do so based on 'income.'"<sup>68</sup> In her view, instances of associating income and expense items that one finds in the Code do not exemplify a commitment to the matching principle but rather rest on other tax values, such as ensuring that taxpayers do not take inappropriate advantage of loss positions or use noneconomic depreciation to shelter ordinary compensation income.<sup>69</sup> The matching principle, while it may have a place in the income tax, should give way to the extent it conflicts with the principle of currently taxing amounts that represent genuine income now.<sup>70</sup> Geier refers to this principle as the "income tax value."<sup>71</sup> Thus, for example, she criticizes the Supreme Court's willingness to defer to the Service's insistence on postponing recognition of future contingent liabilities<sup>72</sup> but to permit the taxpayer to override the Service's insistence where the future liability is fixed.<sup>73</sup> In her view, it is not the contingency of the future obligation that justifies immediate inclusion but the fact that it is a future obligation—a feature equally true of future fixed liabilities.<sup>74</sup> Thus, neither fixed nor contingent future liabilities associated with a current receipt should entitle the taxpayer to defer inclusion.

To illustrate the point, Geier uses the example of a florist who is paid \$100,000 in Year 1 for flowers to be delivered in Year 16,<sup>75</sup> at which time the florist will incur \$100,000 of expenses to deliver the flowers under the contract. Failure to tax the \$100,000 until Year 16 is

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<sup>67</sup> Geier, note 4, at 27-29 (noting that the objective of the matching principle is to associate revenue items with expenses that they entail so that the true economic benefit or cost of the revenue is known).

<sup>68</sup> *Id.* at 22.

<sup>69</sup> Among the provisions she identifies are § 163(d) (investment interest rule), § 465 (at-risk rules), § 469 (passive activity rules), and § 1092 (straddle rules). Geier, note 4, at 19.

<sup>70</sup> Geier, note 4, at 91; see also Dodge, note 1, at 319-20 (rejecting the matching principle on similar grounds).

<sup>71</sup> Geier, note 4, at 44.

<sup>72</sup> See, e.g., *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934).

<sup>73</sup> *American Nat'l Co. v. United States*, 274 U.S. 99 (1927).

<sup>74</sup> Geier, note 4, at 91 ("Viewed from the perspective of the individual taxpayer, a current deduction for a payment that will certainly be made but not until some point in the future results in a violation of tax values.") (internal footnote omitted). The basis for the Supreme Court's differing rules for fixed and contingent liabilities is that the contingency of the liability brings the receipt under the claim of right doctrine. See *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932).

<sup>75</sup> Geier, note 4, at 113-15.

equivalent to providing a Year 1 deduction to the florist of \$100,000, which is to say it is equivalent to consumption tax treatment.<sup>76</sup> The size of the tax liability at issue can be illustrated by simple elaboration on Geier's example. Suppose the discount rate at all times is 10% compounded annually and the florist's marginal tax rate at all times is 30%. The present value of an obligation to pay \$100,000 in sixteen years is \$33,873, assuming an after-tax rate of 7%. If the florist invests the \$100,000 in Year 1 at 7%, it will grow to \$295,217 by Year 16, at which time she will have a \$100,000 liability, leaving her with \$195,217 on an initial investment of \$66,127.<sup>77</sup> In effect, the florist will be able to invest \$66,127 on a pretax basis. If she had been taxed properly on the \$66,127, she would have been left, instead, with \$46,289, which would have grown to \$136,652 at 7%. She thus ends up with an additional \$58,565 as a result of the failure to tax the \$100,000 up front. Preservation of the income tax value therefore requires current inclusion of the \$100,000.

Geier's point is well and good, but the problem she identifies is proper application of time-value-of-money principles, not the matching principle. In other words, the problem is not that the matching principle permits deferral of the inclusion until the associated expenses are incurred, but the deferral itself. Geier's example obscures the issue by assuming that no profit arises apart from the fact that payment occurs before the liability becomes due—that is, she stipulates that the florist will incur \$100,000 in expenses in Year 16 to satisfy her contractual obligation. But suppose the florist would incur just \$90,000 of expenses to satisfy the obligation, so that if the contract were completed in Year 1, she would clear \$10,000 of taxable income. Suppose further that the florist prepays the present value of \$90,000 in Year 1, or \$30,486, but that she cannot account for the expense for tax purposes until Year 16, when the \$100,000 will be included. Now income and expense occur in the same year, but both are deferred. The analysis does not change: The florist still has the benefit of the net profit to which she would have been entitled, but she has received it fifteen years early.<sup>78</sup> The timing of the expenses is not relevant. The question is when the income is earned.

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<sup>76</sup> See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* (1948), discussed in Geier, note 4, at 42-43.

<sup>77</sup> That amount is what is left of the \$100,000 the florist receives in Year 1 after she sets aside enough to pay the \$100,000 liability in Year 16. The florist also would have a \$30,000 tax liability on inclusion of the \$100,000 in income, but it would be offset by the \$100,000 of expense in supplying the flowers.

<sup>78</sup> The florist has \$69,514.30 that she can invest at 7% on an after-tax basis. In Year 16 she would have \$191,792. At that time she records both the \$100,000 inclusion and the \$90,000 expense, leaving \$101,792 after taxes.

Application of ordinary substance over form principles would eliminate the abuse Geier identifies, because it would address the inclusion side of the ledger. A customer's payment of \$100,000 today for flowers that will cost \$100,000 in sixteen years can only be understood as two separate transactions, inasmuch as the present value of a right to receive \$100,000 in fifteen years under these assumptions is just \$33,873 (on an after-tax basis), and parties dealing at arm's length do not give value for nothing. The proper tax analysis, before one gets to the question of whether to include the advance receipt in income or not, is therefore to determine why the purchaser would give an additional \$66,127 for the florist's services.<sup>79</sup> Whatever the reason, the advance receipt is the \$33,873 difference between the \$100,000 paid and the additional amount, which should be characterized and taxed according to its substance.<sup>80</sup> If the advance receipt portion is deferred, the florist receives the benefits of interest income without having paid tax on the invested amount. Of course, the florist also has an offsetting obligation to furnish \$100,000 of services fifteen years down the road. The arrangement is functionally indistinguishable from an original issue discount (OID) debt instrument issued by the florist to the customer.<sup>81</sup> The only difference is that payment is in goods and services rather than money. Like any borrower, the issuer of an OID debt instrument does not include the amount received in income. The difference from an ordinary debt instrument is that unpaid interest is treated as accruing during the life of the loan, and the parties are taxed accordingly.

### *C. Loans*

#### *1. The Offsetting Obligation Theory*

As a general matter, no income arises for the borrower on receipt of loan proceeds, and no deduction is available on repayment of principal.<sup>82</sup> (Hereinafter, I refer to this treatment as the "accrual model.")

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<sup>79</sup> See, e.g., *Custom Chrome v. Commissioner*, 217 F.3d 1117 (9th Cir. 2000), in which the court required the taxpayer to bifurcate payment received for a loan together with an option in order to determine the proper tax consequences of the transaction.

<sup>80</sup> As examples, the payment may be compensation income, a dividend, or a gift. See IRC § 7872, discussed in Part III below.

<sup>81</sup> The rules for OID debt instruments are set forth at §§ 1272-1275. Simplifying greatly, they generally require that the lender and the borrower account for the discount over the life of the OID debt instrument. The discount is treated as interest and is generally deductible to the borrower under § 163 and includible by the lender under § 1272, in each case without regard to when interest is actually paid.

<sup>82</sup> See Glen Arlen Kohl, *The Identification Theory of Basis*, 40 Tax L. Rev. 623, 634 (1985) ("Borrowing money at a market rate of interest does not constitute receipt of gross income.").

Similarly, the lender has no deduction or inclusion on the transfer or the later return, respectively, of principal. Interest generally is taxable<sup>83</sup> on receipt or when earned and, if it is paid in connection with the conduct of a trade or business or for the production of income, deductible by the payor.<sup>84</sup> When amounts originally disregarded under this regime are subsequently determined by the lender to be uncollectible, the borrower usually has income from the discharge of indebtedness,<sup>85</sup> subject to possible limitation if the debtor is insolvent,<sup>86</sup> while the lender typically has a bad debt deduction.<sup>87</sup>

The traditional justification for the accrual model has been the offsetting obligation theory. Under this theory, no tax arises on receipt of loan proceeds because the borrower is considered to be no wealthier by reason of the receipt of the proceeds than she was before she entered into the loan transaction. Because the burden of the obligation to repay precisely offsets the value of the outstanding principal amount, the loan transaction is viewed as an economic wash.<sup>88</sup> Moreover, as principal is repaid, a pro tanto reduction in the size of the benefit of the previous receipt occurs, so that at all times the net value of the loan proceeds plus the obligation is zero. Similarly, the lender has no deduction on payout of the loan proceeds because the borrower's note is an asset of equal value exchanged therefor. It is a straightforward exchange of value for value.<sup>89</sup>

The accrual model has many virtues, not least of which is its simplicity: The acts of borrowing and repayment of principal can be disregarded for income tax purposes. It also is not necessary to account for loans depending on whether the principal amount is contingent for some portion of the life of the loan, or on whether the loan is business or personal in nature.<sup>90</sup> Moreover, the accrual model is compatible with the principal purpose of most loan transactions, which is to acquire liquidity. Viewing borrowing as a purchase of liquidity, the accrual model keeps the income tax from working at cross purposes to the loan because the act of borrowing does not itself create liquidity-

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<sup>83</sup> IRC § 61(a)(4).

<sup>84</sup> IRC § 163(a). If the interest is paid in connection with the production of income but not in connection with the conduct of a trade or business of the taxpayer, the deduction may be subject to phase-out, see IRC § 68(a), and to the limits on deduction for investment interest. IRC § 163(d).

<sup>85</sup> IRC § 61(a)(12).

<sup>86</sup> IRC § 108(a).

<sup>87</sup> IRC § 166.

<sup>88</sup> See Johnson, note 2, at 384; Klein, note 3, at 1691; Kohl, note 82, at 634; see also Dodge, note 1, at 253-54 (stating but not agreeing with the theory).

<sup>89</sup> See IRC § 1001; Reg. § 1.1001-3. Note that Dodge agrees with this principle. Dodge, note 1, at 258-59.

<sup>90</sup> The points raised here do not apply to interest, the deductibility of which depends on a variety of factors.

impairing tax liabilities. Hence, liquidity is more readily available than it would be under the cash flow model, which would tax the proceeds on receipt and provide a deduction on repayment.<sup>91</sup> Finally, there appears to be a reasonable logical basis for treating the proceeds of borrowing differently from unrestricted receipts. It seems correct to say that a taxpayer in receipt of an item that comes with a corresponding liability does not enjoy the same accession to wealth that someone does who receives the item free and clear.

## 2. *Dodge's Criticisms of the Offsetting Obligation Theory*

Although the accrual model is well established and widely accepted among tax scholars as legally correct (at least for true market-rate loans),<sup>92</sup> Dodge recently has argued that the accrual model is incorrect under a realization-based income tax such as ours.<sup>93</sup> He claims, in the first place, that the offsetting obligation theory is inconsistent with the tax treatment of other kinds of advance receipts also associated with offsetting future obligations already discussed, such as prepaid services income. Second, he notes that it is similarly in tension with the denial of a deduction for future liabilities, even if they are fixed in amount, until no earlier than the time the taxpayer pays for (or, in the case of accrual method taxpayers, bears the real economic burden of)<sup>94</sup> the liability. In this connection he observes that these rules generally are not considered inappropriate, and indeed contrary rules would tend to invite arrangements that most would regard as abusive. For example, it appears that if taxpayers could defer inclusion of prepaid services income until economic performance occurred, then

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<sup>91</sup> One would expect market effects to compensate, at least in part, for the added cost of borrowing if loan principal were taxable on receipt. If the transfer of loan proceeds were, correspondingly, deductible to the lender, interest rates would be expected to drop by the precise amount necessary to enable borrowers to borrow enough more than they do currently to cover the tax liability associated with the loan receipt, setting aside differences in marginal rates, limitations on losses, and other ancillary issues. If, however, no deduction were available to the lender (as seems correct from an income standpoint), one would expect the economic incidence of the tax burden associated with receipt to be divided between borrowers and lenders. See e.g., Bradley J. Ruffly, *Tax and Subsidy Incidence Equivalence Theories: Experimental Evidence from Competitive Markets*, 89 J. Pub. Econ. 1519, 1525 (2005). Concomitantly, a tax advantage to equity financing would result in an overall decline in debt financing. See Klein, note 3, at 1711 (noting distortions arising from inaccurate tax rules). Whether the shift toward equity financing would represent the introduction of a distortion or a correction of a pre-existing one depends on one's view of the appropriate baseline against which to measure the distortion.

<sup>92</sup> For example, Geier, Johnson, and Klein all accept the borrowing exclusion as correct.

<sup>93</sup> Dodge, note 1, at 323.

<sup>94</sup> See IRC § 461(h) (requiring "economic performance" associated with an otherwise accrued liability to have taken place before the liability is deductible by an accrual method taxpayer).

through the expedient of prepaid employment contracts they could reduce the real burden of their tax liabilities while enjoying the economic benefit of the associated receipts. Similarly, the ability of accrual method taxpayers to deduct the full amount of an accrued but unpaid liability would permit them to deduct the face amount of a liability, the true value of which would be its discounted present value. This perceived abuse led Congress to enact § 461(h), which precludes any deduction for such liabilities until the economic performance associated with the liability takes place.<sup>95</sup>

Third, and most significantly, Dodge argues that most forms of borrowing should be taxable on receipt and deductible on repayment, because the receipt of loan proceeds represents a real accession to wealth that is not matched by an offsetting liability under a realization-based income tax. Although the liability is real, Dodge argues that it should not be accounted for until the period in which it actually becomes due.<sup>96</sup> Prior to that period, it is appropriate to leave the tax liability out of the tax base, just as unrealized gains and losses on the asset side of the ledger are omitted from the tax base.<sup>97</sup>

Dodge argues that the result would seem to follow under the Haig-Simons conception of income that is widely accepted as the normative benchmark for the actual income tax.<sup>98</sup> Haig-Simons income is defined as the net increase in wealth (including values spent on consumption) during the relevant tax period.<sup>99</sup> When the repayment obligation arises in a period later than the period in which receipt occurs, it would seem that the obligor on the loan has income to the full extent of the receipt, because the realization rule precludes taking current account of any reduction in her wealth during the period by reason of the future obligation.<sup>100</sup> If *Borrower* receives \$100,000 in Year 1 in exchange for her note to *Lender*, payable in full in Year 10 with

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<sup>95</sup> See H.R. Rep. No. 98-432, pt. 2, at 1254-55 (1984); see also Martin J. McMahon, Jr., *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 St. Louis U. L.J. 1029 (1985). Note, however, a more accurate remedy than adoption of the economic performance test would have been to require discounting of the amount of the deduction to its present value. See, e.g., Geier, note 4, at 101 (noting that § 461(h) is a compromise provision).

<sup>96</sup> Dodge, note 1, at 263-65.

<sup>97</sup> See IRC § 1001 (tax is applied to gain or loss realized on sale or other disposition of property). There are some exceptions to the realization rule, but these are relatively narrow. See IRC § 475 (dealers in securities), § 1256 (certain forward, futures, and option contracts).

<sup>98</sup> Dodge, note 1, at 248-49.

<sup>99</sup> Henry Simons, *The Concept of Income* 50 (1938).

<sup>100</sup> "[T]he earliest time that a decrease in wealth can be said to occur is the date payment is due, that being the earliest time that the creditor has the right (and possibly the power) to cause the debtor's existing stock of wealth (if any) to be reduced, as well as being the earliest date on which interest can commence to run." Dodge, note 1, at 256-57.

adequate stated interest prior thereto, then *Borrower* appears to have \$100,000 income in Year 1 because of the loan. According to Dodge, the obligation to repay, while real, does not have any impact on *Borrower* in Year 1. Rather the impact occurs in the period or periods in which the loan becomes due, just as the recipient of prepaid income for services typically has income on receipt even though she has an obligation to provide the services in a future period.

Moreover, Dodge denies that the fact that a lender has no deduction on extension of the loan requires noninclusion by the borrower. He claims that while future repayment obligations are generally irrelevant to the measurement of income in the current period, repayment rights, because they are typically salable, represent an asset the value of which is approximately equal to the cash the lender surrenders on the loan.<sup>101</sup> It follows that on his view, the proper treatment of loan proceeds would effectively result in the creation of income as a result of the extension of the loan: No loss to the lender, but inclusion in income to the borrower at that time. Reconciliation occurs as the loan is repaid, at which time the borrower has a deduction but there is no corresponding inclusion to the lender.

#### D. *Claim of Right*

The final receipt examined here arises under the doctrine of claim of right, which I discuss by way of comparison to the typical advance receipt case. Like advance receipt cases, the claim of right doctrine applies to amounts that may or may not turn out to be income to the recipient, but unlike advance receipt cases, in many instances the claim of right relates to an item that is clearly income of someone at the time it is paid; the uncertainty relates to the identity of the owner.<sup>102</sup> Hence the cases in which the doctrine applies may differ in important but illustrative ways from the typical advance receipt case.

First articulated by the Supreme Court in *North American Consolidated Oil Co. v. Burnet*<sup>103</sup>, the doctrine covers the receipt of payments the ultimate disposition of which is subject to uncertainty. *North American* involved underlying litigation between the taxpayer and the federal government over beneficial ownership of oil-producing land during 1916 and of the profits from the land earned in that year. A receiver was appointed to hold the profits during the pendency of the

<sup>101</sup> Id. at 258-59.

<sup>102</sup> This is not always the case. In some claim of right cases the issue has been framed as one of timing—when is the amount income? See, e.g., *Schlude v. Commissioner*, 372 U.S. 128 (1963) (characterizing prepayments for dance lessons as income on receipt under a claim of right).

<sup>103</sup> 286 U.S. 417 (1932).

litigation. In 1917, the trial court decided for the taxpayer and the receiver distributed the 1916 profits to it. The federal government appealed,<sup>104</sup> and the Supreme Court ultimately affirmed the decision in 1922.<sup>105</sup>

The tax case involved the question of when North American had to include the 1916 profits in income. In an amended return for 1916, the company included the amounts in that year. The government determined on audit that the proper year was 1917, when the receiver turned over the 1916 profits to the company. Before the courts, the company argued that the proper year to report the income was 1922, the year in which the litigation was finally terminated. It also argued that if 1922 was not the proper year, 1916 was since that was the year the income was earned. The Court ruled in favor of the government. "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."<sup>106</sup> The Court noted that had the taxpayer lost the underlying litigation, it would have been entitled to a deduction in 1922.

Like the rules for loan proceeds and advance deposits, the claim of right rule has been criticized as incorrect or, even if correct, as based on faulty reasoning. Recognizing the practical virtue of the all-or-nothing rule for items received under a claim of right, Klein argues that the theoretically correct rule would discount the inclusion by the probability of its return.<sup>107</sup> Dodge argues that the only way to make sense of the claim of right rule, with which he presumably agrees, is to regard the repayment obligation as contingent because it is incapable of valuation and so as not "realized."<sup>108</sup> As I argue below, a claim of right, where it does not involve an offsetting deduction or loss to another party, technically presents a different question from the pure advance receipt case. Unlike an advance receipt, such an amount represents a current income item to someone; the only question is whom.<sup>109</sup> The rule that the Court articulated in *North American* is that the recipient is the presumptive owner of the income.

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<sup>104</sup> The Ninth Circuit affirmed, 264 F. 336 (9th Cir. 1920).

<sup>105</sup> 258 U.S. 633 (1922).

<sup>106</sup> *North American*, 286 U.S. at 424.

<sup>107</sup> Klein, note 3, at 1689-91.

<sup>108</sup> Dodge, note 1, at 277 (agreeing that the repayment obligation is not realized because it has not occurred in the present period); see also Geier, note 4, at 119-20 (suggesting that the claim of right doctrine masks the real problem in advance payments, which is failure to account for the time value of money).

<sup>109</sup> This is not always the case. A claim of right may apply to an item already taxed to someone, with the question being whether the recipient under the claim of right or another

The difference between such a case and the advance receipt case is that under a claim of right the question does not involve the treatment of an as-yet unrealized future income item or an expected income item, but rather who should be taxed on an item that should be registered by the system as a genuine increase in wealth now.<sup>110</sup> This difference necessitates a different conceptual (though not necessarily practical) approach from that for advance receipts. In the advance receipt context, typically no income item exists on payment; it is earned later. In the claim of right context, the income may exist on payment, even though it is unclear whose income it is. The tax stakes for the government are much greater in the latter case than in the former, because the failure to identify a tax owner results in current income that goes untaxed until a future period.

### *E. Conclusion on the Taxation of Advance Receipts*

The preceding discussion suggests that not merely disagreement but confusion reigns in the tax analysis of advance receipts. In many cases, courts and commentators have focused on questions of control,<sup>111</sup> likelihood of retention,<sup>112</sup> or source of the satisfaction of an obligation as a basis for taxing advance receipts.<sup>113</sup> In others, they have focused on the fact of an offsetting obligation or unripened deductions as a basis for nontaxation, without regard to the source or even the contingency of the obligation or the deduction.<sup>114</sup> The problem is that the lines that these rules draw are mutually inconsistent. If the fact of an offsetting obligation is sufficient to defer tax, then prepaid services income should not be included in income; currently it is except in narrow circumstances. If the fact of an offsetting obligation is insufficient to defer tax, then not only the receipt of loan proceeds but also the transfer of rental property should trigger tax to the recipi-

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should be taxed on it. See, e.g., *United States v. Lewis*, 340 U.S. 590 (1951) (excess bonus repaid).

<sup>110</sup> In this regard, the simplification that the claim of right doctrine effects—assigning all the income to one of two (or more) logically possible parties—is similar to the simplification that treats the borrower under a nonrecourse debt obligation as the tax owner of the financed property. Conceptually, nonrecourse debt operates like a put option. A put option splits the risks of ownership between the option holder and the option writer. The division of ownership attributes fluctuate continuously over time as the probability that the option will be exercised fluctuates. See Daniel Shavero, *Risk-Based Rules and the Taxation of Capital Income*, 50 *Tax L. Rev.* 643, 659-60 (1995).

<sup>111</sup> See, e.g., *New Capital Hotel, Inc. v. Commissioner*, 28 T.C. 706 (1957) (taxpayer's control over prepayment resulted in inclusion for tax purposes).

<sup>112</sup> See, e.g., *Commissioner v. Indianapolis Power & Light Co.*, 372 U.S. 203, 210 (1990) ("The key is whether the taxpayer has some guarantee that he will be allowed to keep the money.").

<sup>113</sup> Johnson, note 2, at 403.

<sup>114</sup> See, e.g., *Beacon Publishing v. United States*, 218 F.2d 697 (10th Cir. 1955).

ent; currently neither is included in income. If the contingency of a future obligation is the sine qua non of inclusion of a current receipt, then fixed future liabilities should be available to offset a current receipt, whether or not the receipt is a loan or payment for future services, and contingent payment loans should be taxable until the amount of the liability is fixed. Neither is the operative rule.<sup>115</sup> If control over the advance receipt suffices as a basis to tax, then, again, all advance receipts should be taxable currently. Moreover, if control is both necessary and sufficient, one could argue that the size of the inclusion depends on the extent of control over the funds received. For example, many commercial loans are subject to substantial restrictions on the use of the proceeds. Where the restrictions are put in place as a result of negotiations with the lender, the borrower's control is reduced and, it would seem, the control analysis would require a discount to the size of the loan inclusion.

A further problem is that consistent application of any one of the theories advanced seems to generate unacceptable results in some cases. At the most general level, it does not seem appropriate that advance receipts all should be either includible or not includible. Nor does it seem that the existence or not of a contingency on future repayment tells us whether or not the recipient has income to the extent of the receipt, given the equally powerful intuition that a person in receipt of an amount subject to even a contingent repayment obligation seems less wealthy than a person who receives a like amount free and clear. Similarly, it is not clear why taxation should depend on whether a repayment obligation happens to fall within or outside of an arbitrarily defined period.

These inconsistencies suggest that an exclusive focus on the concept of income as a basis for the existing rules is unsatisfactory as both an explanatory and a normative matter. The following Part focuses more narrowly on the concept of income in order to provide a basis for understanding what rules would emerge if the tax system really tried to tax income from advance receipts as it arises. Part IV then explains why it is sometimes appropriate to depart from the income concept for taxing advance receipts even in a system that seeks to tax income.

### III. WHEN INCOME ARISES

The approaches previously discussed all seek to formulate a rule for the taxation of advance receipts that reflects an effort to tax real income, or to approximate the taxation of real income, under the in-

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<sup>115</sup> The rules for contingent payment debt instruments are set forth in Reg. § 1.1275-4. They do not generally require inclusion of loan proceeds on such instruments.

come tax. This Part explains why these efforts are misguided. As I argue, from a theoretical perspective, advance receipts generally would become taxable only as and when they are secured to the taxpayer without an offsetting obligation. Prior to that time, advance receipts reflect in economic terms either a shift of funds that is compensated for by interest or, if it is not so compensated, a separate arrangement such as a current gift or current compensation. Further, whether deductions associated with income that the advance receipt may or may not become have ripened is irrelevant to the analysis. The matching principle is a red herring. Similarly, the transfer of control or the use of an advance receipt to fund consumption rather than a business expenditure is immaterial.

Section A analyzes advance receipts from this theoretical perspective. Section B focuses on the effects that implicit interest in certain advance receipt cases has on the analysis.

#### *A. Timing of Income Under the Haig-Simons Definition*

Henry Simons famously defined personal income as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question,”<sup>116</sup> or:  $I = \Delta W + C$ , where  $I$  represents income,  $\Delta W$  change in wealth, and  $C$  amounts spent on consumption, all during the relevant tax period. Thus, an individual who earns \$40,000 in wages, receives \$9,000 in interest income, and spends \$15,000 on consumed items has \$49,000 of income during the tax period. It consists of a \$34,000 net change in wealth (\$40,000 + \$9,000 - \$15,000) and \$15,000 spent on consumption. Under this definition, all accessions to wealth, regardless of whether they result from earnings, gifts, capital gains, windfalls, or other sources, constitute income.

What of an individual who receives a payment subject to an offsetting obligation of some sort? In the case of loans, it generally is believed that no income arises for the borrower on receipt of loan proceeds, and no deduction is available on repayment of principal, assuming that the obligation carries a market rate of interest.<sup>117</sup> Similarly, the lender has no deduction or inclusion, respectively, on the transfer or the later return of principal. As previously discussed, the reason that typically is advanced (and that appears to have been accepted by Simons) is that the obligation to repay offsets the increase

<sup>116</sup> Simons, note 99, at 50.

<sup>117</sup> See Kohl, note 82, at 634 (“Borrowing money at a market rate of interest does not constitute receipt of gross income.”).

in wealth that the receipt reflects, assuming a market rate of interest is charged on the receipt.<sup>118</sup>

Less clear are the cases of other kinds of offsetting obligations, discussed in the preceding Part. As indicated, commentators have variously viewed the facts that the offsetting obligation can be satisfied by an exchange (rather than a "return"), that the obligation is contingent, that the obligation is incurred at a discount, or that the obligation may be satisfied with "pretax" amounts, as reasons for distinguishing between loan treatment and current taxation. Moreover, Dodge suggests that the Haig-Simons theory itself supports current inclusion of loan proceeds in the case of a realization-based income tax, without regard to the nature of the offsetting obligation, because the obligation arises in a future period.<sup>119</sup>

As a general matter, the notions that other kinds of advance receipts merit treatment that differs from loan treatment, or that loans themselves should be included in income under a realization-based income tax, are mistaken. They reflect three sorts of confusion. First, they may rely on the exigencies of tax administration rather than on any coherent concept of income to determine whether current payments should or should not be included in gross income. Second, they may rest on the mistaken notion that because the propriety of matching for accounting purposes does not imply its propriety for tax purposes, the deferral that would apply under the matching rule for financial accounting purposes also should not apply for tax accounting purposes. Third, commentators' analyses may be informed by concepts such as control over or dissipation of the receipt, or personal versus business use, rather than that of accession to wealth. Control, dissipation, and the use to which proceeds are put are relevant to a cash flow tax analysis of prepayments, typically associated with a consumption or a wealth tax, not to an income tax analysis. Focusing on the crux of the Haig-Simons concept, the question is whether the receipt of the advance payment represents an accession to wealth—that is, a genuine increase in wealth, either because the total store of rights has increased, or because another has suffered a genuine loss in rights (as when a loan becomes uncollectible). As argued below, where the advance payment is subject to an offsetting obligation of equal value

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<sup>118</sup> Simons does not appear ever to have formally set forth his views on the proper tax treatment of loan proceeds. Commentators, however, generally have assumed that Simons agreed with the standard approach, possibly taking his silence as assent to it. See, e.g., Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 *Tex. L. Rev.* 243, 296 n.232 (1992) (quoting and agreeing with the statement of Michael J. Graetz, *Federal Income Taxation: Principles and Policies* 216 (2d ed. 1988), that "In Henry Simons' terms, [in a loan] there is no change in the net worth of either party . . .").

<sup>119</sup> Dodge, note 1, at 263-65.

(taking into account time value of money principles), the answer to this question must be “no.”

The discussion below begins with the analysis of a basic loan transaction, demonstrating why it is incorrect to view the receipt of loan proceeds as an accession to wealth. Having established this proposition, the argument then demonstrates that other kinds of advance receipts are not meaningfully different from loans in conceptual terms. It is important to bear in mind that throughout the discussion, the focus remains on the conceptual underpinnings of advance receipts, and therefore on the tax rules that ought to apply under a pure income tax in which practical considerations play no role. The appropriate rules in the second-best world of the actual tax system differ.

### 1. *Basic Analysis—Simple Loans*

In a basic arm’s length loan transaction, the borrower receives loan proceeds in exchange for (1) a promise to repay the proceeds at some future date or dates and (2) a promise to make interest payments on the outstanding principal amounts.<sup>120</sup> Although the nontaxation of the receipt of loan proceeds is widely accepted as “correct,” its implications have not always been well understood.<sup>121</sup> It is critical to articulate the conceptual support for the result, because the treatment of advance receipts generally hinges on the same basic analysis.

There are at least three ways to illustrate the point that extension of a loan made between parties dealing at arm’s length does not result in income to the borrower under the Haig-Simons concept.<sup>122</sup> First, on an intuitive level one can say that two individuals, *A* and *B*, each in receipt of \$*X* on Day 1 but only one of whom, *A*, must return \$*X* two years in the future and pay adequate interest in the interim, do not have equal incomes. Each has disposition over cash, but the person who receives the \$*X* free and clear enjoys an accession to wealth that the obligated person does not. Put bluntly, it matters whether you are *A* or *B*.<sup>123</sup>

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<sup>120</sup> *Deputy v. DuPont*, 308 U.S. 488 (1940).

<sup>121</sup> See Klein, note 3, at 1691 (noting that the loan proceeds rule has been taken as “self-evidently correct” but appears inconsistent with the equally well settled rule that advance rent is taxable on receipt).

<sup>122</sup> The notion that parties dealing at arm’s length exchange value for value has been described as a “rule” of the income tax. See, e.g., Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 *Tax L. Rev.* 199, 220 (1996), but it is more properly viewed as axiomatic. Any other rule would be inconsistent with the assumption that parties operate within a market.

<sup>123</sup> See Charlotte Crane, *Loan Proceeds as Income: A Response to Professor Dodge*, 27 *Va. Tax. Rev.* 563, 566 (2008) (noting the same distinction).

One might object that while *A* is worse off than *B*, she is surely better off than *C*, who never receives  $\$X$  in the first place and therefore has no loan repayment obligation. This objection, however, illustrates the second and more important point. The fact that in an arm's length arrangement the obligor must pay adequate interest while  $\$X$  is in her possession demonstrates that she has exchanged value for value. Put otherwise, if parties are dealing at arm's length, *C* does not exist unless *C* also pays a market rate of interest on the  $\$X$ . The value that a genuine borrower receives is liquidity, and her purchase of it with interest is no different from a person's purchase of any other commodity. If *A* need not pay interest, then she has received value, not because of the receipt itself, but because of the right to use the money for free. That value is not, of course,  $\$X$ , but the cost of its use during the loan term, or the interest on  $\$X$  over two years.<sup>124</sup> The appropriate way to tax *A* is to tax her on that cost. Disregarding the obligation to pay interest, how much wealth the borrower would be thought to receive would depend on how long she was entitled to hold the proceeds. That is, setting aside any offsetting interest obligation, one might concede that the receipt of loan proceeds does not enrich one to the same extent as the receipt of the proceeds free and clear, but one also might argue that one who receives a loan subject solely to an obligation to repay is better off than one who receives nothing at all. The extent of the wealth received then would depend on the amount of time the recipient was entitled to hold the proceeds before repayment. If the proceeds must be returned shortly, the wealth accession is minimal. If for longer, it is greater. At the limit of zero, the receipt is worthless; at the other end of the spectrum, the receipt is worth its face amount. But the interest owed on the receipt is proportional to the time the receipt is held. Inasmuch as the exchange occurs at arm's length, the value the borrower receives in obtaining the loan proceeds is exactly equal to the interest she must pay for the right to hold the funds.

Therefore, to the extent the obligor in an arm's length arrangement prefers (1) to receive the proceeds in exchange for the obligations to return them in the future and to pay interest in the interim, over (2) no advance receipt and no interest obligation, she enjoys nothing

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<sup>124</sup> As an alternative, *A* could be viewed as having received two items: a current, taxable transfer (assuming it is not otherwise exempt from tax) of the difference between  $\$X$  and its present value in two years, and a loan of that present value. Compare IRC § 7872(a) (providing for treatment described in the text for certain below-market loans), and § 7872(b) (providing for discounted present value treatment).

more than consumer surplus—that is, an ordinary gain from trade.<sup>125</sup> The liquidity she purchases with her interest payments is worth more to her than the amount it costs. Of course, the same is true of a factory owner who purchases a machine for use in her business or an individual who purchases a ticket to a movie she is particularly keen on seeing, but in neither case has the excess of the value to the purchaser over its cost ever been subject to tax under the income tax.<sup>126</sup> In short, the excess of the reservation price of the liquidity to the borrower over its cost is no different from the excess value that a patron in a restaurant gets from an exceptionally good meal or a factory owner gets from the purchase of factory machinery. It is not taxable. Further, there is no reason to assume that the amount of consumer surplus equals the advance receipt amount.<sup>127</sup>

Third, it is impossible to make sense of the claim that the borrower has income on receipt by reason of a value shift, given, as must be the case under the income tax, that the lender does not have an economic loss. The lender, of course, acquires an asset—the borrower's obligations to repay and to pay interest—in exchange for the proceeds. The notion that the lender has not suffered an economic loss in an arm's length exchange of value for value is basic to the income tax, and indeed to any tax system that purports to apply to a system of voluntary exchange among typically self-interested parties.<sup>128</sup> In a free exchange, no economic loss arises, because individuals do not voluntarily incur losses. To dispense with the notion that the transaction creates no loss for the lender is to assume that individuals voluntarily part with economic value. Consequently, taxation of the borrower on an advance receipt would entail the presupposition that wealth has

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<sup>125</sup> One might argue that a borrower's relative creditworthiness results in an inclusion or a deduction to the extent her cost of funds differs from some benchmark rate. I disregard this issue here.

<sup>126</sup> The factory owner will be subject to tax, if at all, on sale of the goods produced with the machine. By contrast, the surplus enjoyed by the moviegoer remains untaxed.

<sup>127</sup> Indeed, standard economic theory holds that any individual's consumer surplus will vary from person to person, because different individuals may value the same goods differently. See Joseph Mayer, *Consumer's Surplus*, 16 *Am. Econ. Rev.* 77, 78-79 (1926), for an early statement of this point.

<sup>128</sup> All commentators seem to acknowledge this. See Dodge, note 1, at 255; Geier, note 4, at 42-43; Johnson, note 2, at 384; Klein, note 3, at 1710. Note that at the cited text, Johnson distinguishes receipt of loan proceeds from prepayment of future services on the basis that the prepayment "can be *expected* to increase [the payee's] present value net worth by [the amount of the expected profit]." Johnson, note 2, at 384 (emphasis added). The word "expected" demonstrates that what is being subject to tax in the prepayment case is likely or expected income that does not yet exist, not actual income. The payee has not yet provided the services that will produce the profit. See Part III. Contrast a consumption tax, under which the payor would have a deduction. See, e.g., Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 *SMU L. Rev.* 53 (2003).

been created to the extent of the transfer merely by the fact of the transfer, because the borrower is deemed to be enriched but the lender suffers no loss. To state the proposition is to refute it.<sup>129</sup>

To be sure, where the transaction is not at arm's length or involves a separate relationship, such as a gift or a low-interest loan between an employer and an employee to provide compensation, an advance payment may result in a net transfer of value in the form of understated (or overstated) interest. This problem is distinct from the treatment of the advance receipt itself. To the extent the arrangement involves a genuine exchange of value for value, the offsetting obligation analysis is as apt in these cases as it is in an arm's length loan. To the extent the arrangement involves underpayment (or overpayment) in the form of inadequate (or excessive) interest, separate treatment of the deficit or excess is required. As a general matter, current law provides for such treatment.<sup>130</sup> More to the point, a true income tax would always identify both this separate element, be it compensation, a gift, or something else, and any disguised interest component and tax each accordingly.

## 2. *Dodge's Realization Rule Counterargument*

Dodge offers a novel criticism of this basic analysis. Conceding that a true Haig-Simons income tax would prevent inclusion of loan proceeds in income on receipt, Dodge argues that under the current realization-based system, it is inappropriate to take obligations into account prior to the period in which they are payable.<sup>131</sup> The reason is that the realization rule generally provides that gains and losses are not taken into account for tax purposes until there is some sort of disposition, or severance, of property or services from the taxpayer.<sup>132</sup>

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<sup>129</sup> Note that the argument here is distinct from the claim that the exchange of cash for the borrower's note generates income to the borrower because she lacks basis in the note. This claim is discussed in Subsection III.A.2.v.

<sup>130</sup> See, e.g., IRC § 483 (certain property sales), § 1274 (certain publicly traded debt instruments), § 7872 (below-market loans).

<sup>131</sup> Dodge, note 1, at 260-65.

<sup>132</sup> The Code does not incorporate an explicit realization requirement, but it does presuppose that gains and losses generally will be accounted for on realization, and not before. See IRC § 1001(a) (taxable gain on disposition of property equals the difference between the amount realized and the taxpayer's adjusted basis in the property). In particular, the numerous nonrecognition provisions can only be understood against the backdrop of a general realization requirement. See, e.g., IRC § 351 (contribution of property to a controlled corporation), § 361 (exchange of stock for stock in certain reorganizations), § 721 (contribution of property to a partnership), § 1031 (exchange of properties of like kind). The same is true for the comparatively fewer provisions that expressly provide for gain or loss recognition in the absence of realization. IRC § 471 (accrual accounting for inventory), § 475 (securities held by dealers), § 1256 (certain forward, futures, and option contracts).

Prior to that time, accrued gains and losses are disregarded. Thus, in contrast to a pure accretion income tax, the actual tax system does not require that market appreciation or depreciation of property be taken into account on an ongoing basis; rather such gains and losses are accounted for only on disposition of the property, at which time a “true-up” occurs.

In support of his position, Dodge observes that under the actual tax system “accretion taxation occupies a small island in a realization ocean.”<sup>133</sup> Since the few items that are accounted for on a true accretion basis are done so for narrow policy reasons,<sup>134</sup> it does not appear obvious why loans should be counted among them. Therefore, as applied to liabilities, the actual income tax would seem to require their exclusion from the tax base prior to the period in which they are payable, in just the manner that built-in gain and loss on the asset side of the ledger are disregarded prior to disposition. Under this theory, a currently realized advance receipt should not be offset by a future liability if the liability will not be payable until a future period. Hence, the recipient of a loan would be treated as acceding to the full loan value at the time of receipt, except to the extent that repayment of principal was required in the current period. In future periods, the borrower would be entitled to a deduction as and when the principal was repaid.<sup>135</sup>

There are several difficulties with Dodge’s argument. In the first place, the notion that no offsetting liability currently exists in the case of a standard loan is incorrect. Consider an on-market loan arrangement. Failure to make interest payments (or, for that matter, principal payments) generally results in acceleration of the loan.<sup>136</sup> More to the point, the analysis remains essentially the same even if failure to make (some) interest payments simply triggers a larger interest payment obligation rather than repayment of the loan. Ultimately the borrower pays for the loan proceeds on an ongoing basis. That is precisely what interest is—the cost of the use of funds.<sup>137</sup> Hence, the realization event is payment of interest. In economic terms, the loan is a series of payments made for the use of money.

Dodge hopes to avoid this conclusion by distinguishing between the receipt of the money and its use. Interest pays for the latter, but not

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<sup>133</sup> Dodge, note 1, at 265.

<sup>134</sup> See note 132.

<sup>135</sup> Dodge, note 1, at 265-66.

<sup>136</sup> See, e.g., R. Wilson Freyermuth, *Enforcement of Acceleration Provisions and the Rhetoric of Good Faith*, 1998 B.Y.U. L. Rev. 1035, 1035 (“Today, virtually all mortgages contain acceleration clauses permitting the mortgagee to accelerate the mortgage indebtedness upon default by the mortgagor as defined in the mortgage loan documentation.”).

<sup>137</sup> *Deputy v. DuPont*, 308 U.S. 488, 498 (1940).

the former.<sup>138</sup> But this claim merely obfuscates the matter, because there is no real difference between the two. One does not imagine that the lender would be willing to forgo interest if the borrower promised not to “use” the money. Further, “obtaining” and “using” money are functionally indistinguishable. If the borrower does not pay the interest, the loan must be returned. One could make the same point conversely: The loan itself is worthless if it must be repaid immediately because the “borrower” does not agree to pay interest. Interest is what entitles the holder to retain—that is, to use—the loan proceeds. Consider that as an economic matter, and apart from market fluctuations, a lease, rental, or advance payment of any kind in which the recipient makes ongoing payments for the use of the transferred item is equivalent to a series of such arrangements, each separately negotiated, for the term during which payment for the use is due. Thus, if we disregard the fact that market conditions change over time, there is no economic difference between a one-year loan of \$*X* that provides for monthly interest payments of \$*Y* and a return of the \$*X* principal at term, and twelve successive one-month loans of \$*X* each, each having \$*Y* of total interest due. On Dodge’s view, tax would apply in the first case, but not the second. To be sure, there is generally no reason to assume that market conditions will remain constant, but it is in fact this assumption, and not the deferred obligation to return the \$*X*, that reflects the operation of the realization rule in the case of advance receipts.<sup>139</sup> Thus, a twelve-month lease will lock in the rental rate for the entire term, whereas successive one-month leases lock in the terms for only one month. As market rates fluctuate during the year, the value of the year-long lease will tip in one or the other party’s favor, but the tax system does not pick up this value shift in the absence of a disposition, precisely because of the realization rule.<sup>140</sup>

Second, Dodge’s argument is based on a mistaken application of the realization concept to advance payments.<sup>141</sup> Even under a realization-based income tax, incurring a liability should no more have a tax consequence than does the purchase of an asset. If *A* purchases a long-lived asset, we do not provide a deduction to *A* on the ground either

<sup>138</sup> Dodge, note 1, at 266-67.

<sup>139</sup> Thus, debt obligations generally are not marked to market. See IRC § 1271.

<sup>140</sup> One also might argue that value is created *ex ante* in the parties’ agreement to lock in the rate for the term of the arrangement. Except to the extent both parties are risk averse, one party will pay the other for assuming the risk she does not wish to bear. As an example, nonrecourse debt generally bears a higher rate of interest than recourse debt. See, e.g., Lloyd Cohen, *The Puzzling Phenomenon of Interest-Rate Discounts on Auto Loans*, 27 J. Legal Stud. 483, 495 (1998) (noting the phenomenon in the case of auto loans). This value, however, is consumer surplus.

<sup>141</sup> I thank Reed Shuldiner for clarification on this point.

that she no longer has the cash used to purchase the asset or that she will not realize the benefits of the purchase until future years. She is deemed to have an asset the value of which equals its cost. That is, we include in the value the future benefits that are expected to be received from the asset. If we did not, the income tax would become a cash flow tax. As explained above, the realization rule applies only in that our expectation of the future value is not adjusted by market-based events that occur after the purchase and before any disposition of the asset. We presume, that is, that the value-for-value exchange that occurs on the acquisition date remains the case (apart from depreciation or amortization<sup>142</sup>) until subsequent disposition, at which time the true-up occurs. If one wishes to treat obligations symmetrically, as Dodge advocates, then the proper conclusion is that incurring a liability is exactly analogous: Neither the receipt of the cash nor the fact that the obligations will not become payable until a future period should trigger an inclusion.<sup>143</sup> Fluctuations in the value of the debt are not taken into account unless and until there is a disposition or other realization of the obligation prior to maturity.<sup>144</sup>

Third, the preceding observation demonstrates as well that Dodge's realization argument rests on an incorrect analysis of the role that the annual accounting period plays under the income tax. The realization rule neither implies nor is implied by adoption of the annual accounting principle. In principle, it would be possible to have continuous accounting under the income tax and yet to preserve the realization rule, just as it is possible to have periodic accounting with mark-to-market rules.<sup>145</sup> In either case, the law would not disregard known future liabilities. Again, if it did, the income tax would become a cash

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<sup>142</sup> See IRC §§ 167, 168. As explained at note 178, the deductions for business-related expenditures under these provisions or under § 162 reflect a decision to account for value shifts rather than an attempt to account for a loss the taxpayer suffers.

<sup>143</sup> Dodge argues that asymmetry on this point is justified because the payor can sell the right acquired from the payee at any time to a third party, whereas the obligor cannot discharge the obligation except by providing services or payment in the future. Dodge, note 1, at 257-58. The main problem with this observation is that it should lead to mark-to-market taxation of the repayment right. Further, in many instances the obligor on the payment also will be able to discharge the obligation through payment to a third party, in which case, on Dodge's view, she should not be taxed. In point of fact, the capacity of the payor to dispose of the obligation is irrelevant to the nondeductibility of the loan. The reason the payor is treated as having an equal offsetting asset has nothing to do with the fact that it can be sold. It follows from the fact that an income tax reaches changes in wealth, and there has been none.

<sup>144</sup> See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) (holding that the taxpayer realized cancellation of indebtedness income on repurchase of its own obligations at a discount); see also IRC § 166 (deduction for worthless debts).

<sup>145</sup> See Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 *Yale L.J.* 1817, 1822 (1990) (noting that a Haig-Simons accretion tax can have any period in principle).

flow tax.<sup>146</sup> The point of periodic accounting is not to disregard obligations that fall outside of the present period, but to provide a convenient method for reckoning known tax liabilities. That is why, even under a realization-based income tax, it is incorrect to say that whether a genuine accession to wealth occurs depends on the arbitrary period in which it is accounted for, when known future obligations (or income items, for that matter) happen to fall outside of the period. In this regard, the realization rule merely requires holding off on certain inclusions or deductions that arise apart from a transaction or disposition of some sort. Indeed the very idea that a present right to a future value represents an item of wealth, widely accepted as a core principle of income taxation, is inseparable from the idea that the concept of wealth must include anticipated events expected to occur outside of the period in which income is calculated.<sup>147</sup> There is no apparent reason why the same rule should not apply to future liabilities.<sup>148</sup>

The following example illustrates the fundamentally arbitrary nature of the accounting period and its relationship to real economic income. Assume that the income tax were calculated on the basis of a calendar decade rather than a calendar year. Under Dodge's proposal, the tax consequences to a borrower of a nine-year term loan would vary dramatically depending on the date of borrowing—if after the first year of the calendar decade, a large tax liability would arise from the borrowing; if prior to the first year, none at all. The periodic nature of the income tax, which results largely from the administrative need to collect tax on an ongoing basis, coupled with the fact that it is not possible to know lifetime income prior to the end of the life,<sup>149</sup> should not be thought determinative in assessing the timing or amount

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<sup>146</sup> *Id.* at 1819.

<sup>147</sup> The concept underlies the doctrine of economic benefit, according to which taxpayers will be deemed in receipt of income when their rights to an item of income in the future are fixed and do not depend on the provision of services or other consideration for them. See *Pulsifer v. Commissioner*, 64 T.C. 245 (1975). The notion that a fixed right to a future payment constitutes present income is so fundamental to the income tax that the few provisions deferring tax in such situations are expressly understood to constitute tax-favored rules that adopt consumption tax or consumption tax-like principles. See, e.g., IRC § 72(a) (tax-free inside build-up of annuities), § 401(k) (retirement plans), § 403(b) (certain retirement annuities), § 408 (IRAs), § 408A (Roth IRAs); see also Bittker & Lokken, note 22, ¶ 3.7 (discussing the consumption tax features of such provisions).

<sup>148</sup> Consider that consistent application of Dodge's rule would seem to require disregard, for tax purposes, of the obligation to do the work as a condition of payment therefor. Thus, in the common case of a term employment contract of an accrual method taxpayer, the taxpayer under the Dodge approach would seem to be required to report the expected income when the contract was signed, since the obligation to provide the future services should be disregarded in the same way as it is when the payment is made immediately.

<sup>149</sup> See generally Lee Anne Fennell & Kirk J. Stark, *Taxation over Time*, 59 *Tax L. Rev.* 1 (2005) (discussing reasons for, and effects of, periodic income taxation).

of the taxpayer's economic income. There is nothing substantive about the period itself. How much wealth a person has right now does not depend on whether the period in which "right now" occurs extends far enough out to embrace an obligation that we also know about, "right now."

Ultimately, the problem with Dodge's analysis is that he proceeds from the assumption that the receipt of loan proceeds represents an accession to wealth, so that the question becomes whether there is any reason to treat the future obligation to repay as a basis for denying the inclusion. The preceding analysis shows that the receipt of loan proceeds is a fully paid-for purchase of liquidity, not an accession to wealth. The borrower purchases the use of the money in a voluntary transaction. Therefore the question of whether the future obligation provides a currently creditable "offset" to a current accession never arises. There is no current accession.

### 3. *Other Receipts and Rationales*

I return now to the question of advance receipts more generally. As indicated in Part II, commentators have suggested that factors such as the payee's complete dominion over the receipt or her ability to use the receipt to finance personal consumption indicate that, at least as far as a realization-based income tax is concerned, advance receipts should be treated as income prior to being earned.<sup>150</sup> The object here is to show that other sorts of advance receipts generally cannot be distinguished from loans. Therefore, if the case for the nontaxation of loan proceeds is sound, then, purely as a matter of measuring income and without regard to practical questions of tax administration, other kinds of advance receipts also should not be taxed before they have been earned.

#### i. *Dominion*

Consider first the idea that the recipient's control over the proceeds of an advance payment would be relevant to the income tax treatment of them. If the normative justification for income taxation is that it reflects ability to pay, then inclusion on the basis that control provides such an ability is misguided because control can be purchased, as the

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<sup>150</sup> Dodge, note 1, at 256-58 (dominion); Johnson, note 2, at 387-88 (criticizing on grounds of availability for personal use the argument that prepaid services income is akin to a trust fund the payee holds on behalf of the payor); see also *Am. Auto. Ass'n v. Commissioner*, 367 U.S. 687 (1961); *Schlude v. Commissioner*, 372 U.S. 128 (1963) (both noting as relevant that the taxpayer faced no restrictions on the use of the funds received).

loan case illustrates.<sup>151</sup> More to the point, the tax law must and does assume that control, or liquidity, is purchased separately from ownership in the case of an advance receipt, a point that commentators on both sides of the advance receipts debate recognize.<sup>152</sup> A pure income tax will always impute interest to advance payment obligations, because it is taken as axiomatic that parties dealing with each other at arm's length exchange value for value.<sup>153</sup> In the case of a loan, the borrower has full control over the loan proceeds, but no income because the control is paid for with interest.

The same holds for other kinds of advance receipts, and for the same reason. The recipient of the advance payment will pay for control over the receipt in one way or another. Either there will be an explicit interest component (as, for instance, in the case of a "deposit" that requires the payee to pay or set aside interest for the benefit of the payor), or the prepayment will be made at a discount that reflects implicit interest that otherwise would be earned, or the arrangement will combine elements of both explicit interest and a discount.<sup>154</sup> In all events, the noninterest portion must be excluded from income on the same basis that loan proceeds are: It is paid for with interest, which is another way of saying that dominion is purchased. Total after-tax wealth before the purchase equals total wealth after, assuming that the purchase of control is financed with after-tax dollars.<sup>155</sup>

Consider the case of a prepayment of salary income at the end of Year 1 for work to be done at the end of Year 2. Suppose that if the amount were to be paid at the end of Year 2, the service provider would be expected to charge \$X. One would expect any of the following to occur: First, the amount of the prepayment (\$Y) could be less than \$X by an amount such that, if invested at the rate of return the service recipient could otherwise earn, the prepayment would equal \$X at the end of Year 2.<sup>156</sup> The service provider therefore should be

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<sup>151</sup> Note that Simons himself seems to have recognized this point, as he did not view the receipt of loan proceeds as income. See Dodge, note 1, at 253 n.33 ("Even Henry Simons ignored the tax treatment of borrowing . . .").

<sup>152</sup> Johnson, note 2, at 387 ("[T]here is no such thing as an interest-free loan"); Klein, note 3, at 1695 ("From an economic perspective there are no interest free loans, only hidden, or imputed, interest. The hidden interest . . . is always there."); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 Yale L.J. 506, 516 (1986).

<sup>153</sup> See, e.g., Klein, note 3, at 1695; see also IRC § 7872.

<sup>154</sup> Klein, note 3, at 1695.

<sup>155</sup> Where the purchase is financed in whole or part with pretax dollars, tax would arise on the purchase. If, for example, the debtor made interest payments with appreciated property, the gain on the property would be taxed to the debtor on its transfer to the creditor. See IRC § 1001. Of course, the tax would not be on the receipt of the proceeds but on the dollars used to pay the interest obligation.

<sup>156</sup> The example unrealistically assumes that \$X remains the market price of the services during the entire period. If the actual price of the services kept pace with the rate of return

charged interest, which it is then deemed to pay over to the service recipient. Second, the full  $\$X$  could be prepaid to the service provider, with the service provider paying explicit interest on the prepayment until the work were performed. Finally, the prepayment could be some amount between  $\$Y$  and  $\$X$ , with explicit interest covering the difference. Note that in substance these are the only possibilities.<sup>157</sup> Thus, if the arrangement involved solely a prepayment, with no explicit interest component, a pure income tax would impute interest on the payment.<sup>158</sup> In each of these situations, the interest component should be taxable, but because interest is the price of control, there is by definition no income from the receipt itself.

Lastly, the control argument proves too much. Lessees of property obtain control over the leased property, at least to some extent, but as far as I am aware no one has suggested inclusion of leaseholds in income in a manner consistent with the control theory.<sup>159</sup> Although there are limits on the extent of that control, under the control theory it is these limits, and not the fact that the lessee pays rent (tantamount to interest) for the use of the property, that would determine the extent of the lessee's income. For example, consider a lease of undeveloped real property for a fifteen-year term. The lease customarily requires monthly rent at a fair market rate. Under the control theory, on the date the lease is signed, the lessee has income to the tune of the portion of the fair market value of the land over which it has acquired control, which is to say the value of the land that will be available to the lessee during the term of the lease.<sup>160</sup> Separately, the lessee has deductions for rent and, presumably, a deduction either on termination of the lease equal to the original inclusion (if the realization rule is thought to preclude the deduction prior to that time) or over time as the value of the term declines due to the passage of time (if the realization rule is not thought to preclude such a deduction).<sup>161</sup> At the

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that the service recipient could earn on the proceeds, then one would expect the prepayment to be  $\$X$ , but interest would be imputed as described in the example nonetheless.

<sup>157</sup> The same principle operates in the original issue discount context and in the deferred sale context. See IRC §§ 1271-1275 (original issue discount), § 483 (imputing interest to certain deferred sales of property).

<sup>158</sup> See IRC § 7872.

<sup>159</sup> Charlotte Crane makes the same observation in connection with her criticism of Dodge's article. See Crane, note 123, at 580.

<sup>160</sup> Assuming economic rather than statutory depreciation, the sinking fund method would apply to determine what percentage of the factory's value the lease term consumed. See Marvin A. Chirelstein, *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* 169-72 (10th ed. 2005) (describing the sinking fund theory as applied to depreciable capital assets).

<sup>161</sup> Strictly speaking, the lessee should be permitted to amortize the leasehold under the sinking fund method. See *id.* Generally, however, the tax law will not permit amortization as long as the lessor remains the "tax owner" of the property. See Shaviro, note 110, at

same time, however, the lessor either will (inconsistently) disregard both the “loss” on disposition and the “gain” on reacquisition for the simple reason that each involves an exchange at arm’s length,<sup>162</sup> or would treat the transaction entirely differently from how it is treated under current law, as generating a deduction equal to the present value of the leasehold and generating inclusions over time as the lease’s term nears. The former reflects current law but is inconsistent with the lessee’s inclusion, while the latter has no support in the income tax because the lessor is in the same position as a lender.

## ii. *Source of Payment or Repayment*

As previously discussed, a number of commentators have suggested that the source or presumptive source of repayment is relevant to the question whether the advance receipt should trigger an immediate inclusion. This approach would seem to offer a basis for distinguishing advance payment of salary income from loans and other items, such as deposits, which may reflect an expectation that the recipient will return an “after-tax” amount. Calvin Johnson uses the example of a lawyer, *L*, who is prepaid \$1 million for five years of personal services, to illustrate the idea.<sup>163</sup> As contrasted with a recipient of loan proceeds, *L* will discharge the obligation with personal services, and “[w]hether the services are future services, past services or services performed simultaneously with payment, they cannot offset reported compensation,”<sup>164</sup> because the service provider has no basis in those services. Thus, the failure to include the receipt currently is not merely a timing error, “but a graver error of giving respect to items that cannot be treated as a cost at any time.”<sup>165</sup>

The source of repayment approach fares no better as a measure of the true income of the parties than does the dominion approach or any other that focuses on the flow of funds rather than on accessions to wealth. Like the others, it mistakes an identification of the likely future consequence of the advance payment (that it will be offset by an income item and thereby become income to the service provider)

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649-50. Assuming the lessor does remain the tax owner, on return the lessee instead would simply deduct the original payment, as described in the text.

<sup>162</sup> Dodge, note 1, at 258-59. In other words, on Dodge’s view, loans, leases, and other advance payment transactions create income out of nothing on inception, and then cancel that income on termination. This problem is explored in more detail below. See text accompanying notes 174-180. Crane notes the same difficulty with Dodge’s argument as that discussed here. Crane, note 123, at 568-69.

<sup>163</sup> Johnson, note 2, at 385-86. In his example, Johnson designates the lawyer as *F* and the lawyer’s client, which I refer to below as *C*, as *Z Inc.*

<sup>164</sup> *Id.* at 385.

<sup>165</sup> *Id.*

for the nature of the advance payment itself. But the question is not the anticipated source of repayment, but whether the advance payment itself constitutes income. It is clear that it does not. As an initial matter, note that essentially the same analysis Johnson adopts for advance services receipts should apply to loan proceeds, yet Johnson is not troubled by the general rule for loans.<sup>166</sup> Suppose that instead of securing advance payment from *C*, *L* obtains a bank loan on the strength of his anticipated future earnings. This, of course, is perfectly typical: In the case of individual borrowers, even secured debt is expected to be repaid out of future wage income, yet no one, other than Dodge, suggests that loan proceeds should be taxable. The question then becomes whether, from the perspective of pure income measurement, the fact that the lender is also the service recipient should matter. Thus, one can imagine a series of intermediate steps between a genuine third-party loan that is repaid by the borrower directly, and a loan that the service recipient extends to the service provider and treats as repaid by means of book entries as and when the service provider actually provides her services. The differences among the arrangements that lie along this continuum are purely formal.<sup>167</sup> Unless one is prepared to say that *L* has income under this ordinary bank loan, there is no reason in pure economic terms to treat a loan extended by the service recipient any differently, and indeed this arrangement is not materially different from most consumer loans, which are expected to be repaid with as-yet untaxed borrower income.

More to the point, Johnson's analysis, like Dodge's in the case of loan proceeds, conflates two distinct issues that must be kept separate in order to arrive at a proper understanding of the income tax consequences of an advance receipt. The fact that an obligation will or is highly likely to be discharged with services income, or indeed with anything having a basis in the advance payee's hands different from the value of what is received, does not answer the question of whether the recipient has income now. The basis of the property or services that the recipient will use to discharge the liability tells us only how much income (or loss) she will have if and as the obligation is discharged. Prior to that time (and setting aside the very real issue of the

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<sup>166</sup> Id. at 384.

<sup>167</sup> Intermediate arrangements might include: (1) a genuine loan from a third-party bank where the borrower permits the bank to garnishee her wages, (2) an agreement among the bank, the borrower/service provider, and the service recipient that the service recipient would deposit wages directly with the bank as they were earned, and (3) the service provider's borrowing from the service recipient directly, but in an arrangement where the loan and the service contract were kept formally separate, so that the service recipient formally paid wages and the service provider formally paid interest and repaid loan principal.

time value of the \$1 million payment),<sup>168</sup> the economic position of *L* is no different from that of the obligor on a \$1 million loan, as evidenced by the fact that it is possible to replicate the arrangement through an explicit loan. *L* is on the hook for \$1 million, either of services, or of cash (or property) if he fails to provide the services. Before *L* provides those services, he is obligated to pay “rent” for the prepayment that he holds, just because the exchange of services for cash—which is what gives rise to the creation of income—has not happened yet. Rent is, after all, the cost of the use of an item that one does not own. If the income had been created, then no rent for the right to hold the prepayment would arise. The fact that *L* has a zero basis in the services is immaterial, because the exchange of the services for the payment has not occurred, as indeed not even the production of the services themselves has occurred. To be sure, the enrichment of *L*, or some of it, is likely to occur, and we might well (indeed we often do) impose a tax on likely income, for administrative reasons.<sup>169</sup> Setting aside practical concerns about tax collection or administration and focusing only on the conceptual question of when income arises, there is no basis for attributing \$1 million to *L* on receipt of the proceeds. Likely income, while often a good administrative substitute for actual income, is not the same as actual income.

It is worth noting that the source argument has an affinity with the rejection of the matching principle as a basis for the timing of advance receipts for tax purposes. The matching principle, it will be recalled, seeks to associate income items with the costs associated with earning them. From an accounting perspective, the deferral of the income until the costs are incurred makes sense, because the purpose of the accounting rules is to provide an accurate reflection of the financial health of the business.<sup>170</sup> If items are accounted accessions to wealth without regard to how much it costs to earn them, then the accounting rules will fail to provide a measure of the true financial soundness of the business. For example, the taxpayer may receive \$100 today for services it provides next year that turn out to cost her \$105. Booking the \$100 as income would fail to provide an accurate picture of the business. By deferring the inclusion for accounting purposes until the costs are incurred, the distortion is eliminated.

Tax accounting, however, is not transactional in this regard; rather its purpose is to provide an accurate measure of wealth accessions during the accounting period. The question is not whether the tax-

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<sup>168</sup> See Section III.B.

<sup>169</sup> See Gunn, note 17, at 20-21 (1984) (noting and questioning arguments for immediate taxation of prepayments on the grounds of administrative convenience and protecting the fisc).

<sup>170</sup> *Id.* at 12-13.

payer makes money on an ongoing basis, but how much income she had during the current period. Accordingly, the availability or not of a deduction in a future period does not bear directly on whether the taxpayer has income on a current advance receipt, and commentators in the tax area have rightly rejected the notion that tax should “follow book.”<sup>171</sup> Johnson’s source argument for current inclusion takes this observation one step further, noting that the costs *L* may incur to provide services to *C* will be in the form of zero-basis labor, so no future deduction will be available anyway.<sup>172</sup> Hence, the tax justification for deferring inclusion that the matching principle might be thought to justify disappears: Even if one thought tax accounting ought to defer inclusion where known future liabilities loomed, the argument for deferral dissolves if the future liabilities have zero tax cost.

The problem with this argument, and with the rejection of the matching theory on which it is based, is not that it is wrong but that it misses the point. Although, in my view, tax commentators are correct to reject the matching principle as a basis to determine the timing of income for tax purposes, the question of deferral of an advance receipt for tax purposes has nothing to do with the matching principle, because deferral of an income item has nothing to do with the deduction side of the equation in the first place. It has to do with the income side, which means that the matching principle plays no role. Wholly apart from whether lawyer *L* has incurred or will incur expenses—deductible or not—to provide the services, he has not earned the income at the time of receipt because he has not done the work. Rather, he is still beholden to the client until the time during which he is obligated to provide them has elapsed. Prior to that time he holds the money subject to return, and therefore subject to an obligation to pay interest, whether explicit or imputed by the tax law.

A simple elaboration of Johnson’s example illustrates the issue. Consider the case in which the services *L* is to provide are personal to the client *C*. *C* has no deduction on payment because she has received a long-lived asset worth what she paid,<sup>173</sup> and she would have no amortization over the five-year term because the expenditure is personal in nature.<sup>174</sup> If *L* has income on receipt, prior to his providing any services at all, we must explain how income has been created out of nothing. After all, *C* still has an asset worth \$1 million, and there is no reason to view *C*’s payment as creating a loss to *C* at any time: If *L* in the following year cancels the arrangement, never providing the

<sup>171</sup> Geier, note 4, passim; Gunn, note 17, at 2 and passim.

<sup>172</sup> See Johnson, note 2, at 375 (expressly assuming that *L* has a zero basis in all costs associated with satisfying the service obligation).

<sup>173</sup> *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

<sup>174</sup> IRC § 262.

services, he would have to return the full \$1 million to *C*, who would be out nothing in income terms.<sup>175</sup> Hence, in addition to positing the creation of wealth *ex nihilo*, we also must posit its subsequent return to the void should the arrangement be cancelled. The only way to avoid this ultimately nonsensical result is to recognize that treating the prepayment as income represents a decision to tax “likely income,” not income itself.

Nor is the situation any different where the cost is deductible or amortizable to the payor; the analysis is just more nuanced. In the above example, if *C*’s expenditure is business rather than personal in nature, she still may not deduct the expense, though she may be able to amortize it over the five-year term, assuming the services are not otherwise allocable to a particular asset.<sup>176</sup> Thus we are still left with the difficulty of creating income out of thin air on initial transfer, but at least over time there is some recognition that *C* bears a cost that is associated with *L*’s income. Moreover, in some instances a prepayment for benefits might be deductible to a cash method taxpayer even though the benefits were not to be realized until sometime in the future.<sup>177</sup> In that case, the advance payee’s putative income would be matched by a deduction on the payor side.

Even if all business related advance payments were immediately deductible, however, the analysis would not change. The deduction for business expenses, set forth in § 162(a), is predicated on the idea that the value the payor receives in exchange for the expense in fact appears in the goods or services the payor sells, not that the payor has suffered a loss as a result of the payment.<sup>178</sup> The deduction does not

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<sup>175</sup> Again, for purposes of the discussion, I disregard the implicit interest element inherent in such an arrangement. The interest element is discussed in detail in Section III.B.

<sup>176</sup> Section 263 continues to apply to deny the immediate deduction, and § 263A may apply where the services are used for the production of an asset by *C*, but the general rules permitting amortization of long-lived business assets apply. § 167. If *C* is an accrual method taxpayer, she also must negotiate the economic performance rules of § 461(h), which generally would require her to deduct the payments over the five-year term. See Reg. § 1.461-4(d)(2). These rules would not change the argument here.

<sup>177</sup> See IRC § 174 (research and experimental expenditures), § 175 (soil and water conservation expenditures), § 179 (certain tangible business assets or computer software).

<sup>178</sup> Note that this is the theory underlying § 263A’s requirement that certain costs be capitalized to inventory. See § 263A(a)(1); S. Rep. No. 313, 99th Cong. 140 (1986). Losses are separately accounted for under § 165. See generally Bittker & Lokken, note 22, ¶ 25.8.5; Rev. Rul. 79-80, 1979-1 C.B. 86 (distinguishing between expenses for acquiring securities deductible under § 162(a) and losses on purchase or sale of wrong securities deductible under § 165(a)); *Holt v. Commissioner*, 69 T.C. 75 (1977) (“The distinction between losses and expenses has generally been regarded as self-evident.”).

There is some disagreement in the literature on this point. A number of commentators view deductions for depreciation and § 162 expenses as reflective of a loss that the taxpayer sustains, either over time or immediately, as the case may be. Geier, for example, describes the role of the depreciation deduction as “allow[ing] the deduction of final, pas-

represent an ex ante loss, for if it did the payor would not enter into the transaction that produces it. Rather it represents a recognition that a deduction is an appropriate way to account for the transfer of value from the item paid for to the goods or services that their producer sells. The deduction will be appropriate because either the connection between the expenditure and the associated income is too attenuated to be identified with a particular item (and there is no mismatch of income and expense in permitting an immediate deduction) or there is no functional difference between providing an immediate deduction and requiring capitalization into the goods or services the taxpayer sells, followed by reduced income on sale of the goods or services.<sup>179</sup> In short, the deduction under § 162 is a kind of realization rule, not an acknowledgment of a loss to the payor.<sup>180</sup> It remains the case even in the business setting that wealth is deemed created out of nothing under the inclusion/no deduction approach to advance receipts.

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sage-of-time losses of income-producing property.” Geier, note 4, at 58. This characterization seems implausible, however, inasmuch as, first, it is not the passage of time but the use of property that causes depreciation—at least of tangible assets—and, second, it becomes wholly unclear why depreciation is not available for personal expenditures, since the putative loss would be sustained in either case. A better view understands § 165 as applying when the taxpayer sustains a loss, while depreciation (and amortization) and expensing reflect accounting principles. No loss is sustained under depreciation or expensing; rather, value is transferred from the used asset to, ultimately, goods or services sold, and the deduction loosely reflects the portion of after-tax dollars “transferred” from the depreciated or expensed asset to the good or service. In other words, these provisions reflect a method to account for the transfer of value. A deduction offers a method for reasonable approximation of net income. The associated income is recognized on disposition of the goods or services the expenditure enables the taxpayer to create. Thus, one could achieve the same result by denying the deduction and, instead, increasing the costs of goods sold by the same amount. In the personal context the value is transferred to the owner as an item of consumption and so no deduction for depreciation, amortization, or expense is allowed. See Charlotte Crane, *Liabilities and the Need to Keep the Income Tax Base Closed*, 25 Va. Tax Rev. 31, 42-45 (2005); Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 Mich. L. Rev. 1 (1979). This account also explains why a deduction for a casualty loss remains available in the case of personal property. See IRC § 165(c)(3).

<sup>179</sup> See *Encyclopaedia Britannica v. Commissioner*, 685 F.2d 212 (7th Cir. 1982) (discussing theory of capitalization and expensing). Thus, it is not surprising that Congress, the courts, and the Service all generally have endeavored to force capitalization whenever the prospect that an expenditure creates a long-lived asset is real. See, e.g., IRC § 263 (requiring capitalization for long-lived assets), § 263A (extending same principles to self-created assets); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) (capitalization required even if expenditure does not create a separate, distinct asset but merely enhances life of existing asset); Rev. Rul. 2000-4, 2000-1 C.B. 331 (explaining capitalization and expensing principles); see generally Bittker & Lokken, note 22, ¶ 105A.1.

<sup>180</sup> See Crane, note 178, at 55 (noting that costs of production are generally accounted for either by immediate deduction or by additions to basis in costs of goods sold).

*iii. Personal Use*

Essentially the same criticism may be made of the idea that the personal benefit associated with consumption or potential consumption of advance receipts justifies treating them as income on receipt. The tying of the taxation of receipts to their use is not inherently a part of the income concept, but rather reflects a cash flow model of taxation designed to approximate a consumption tax.<sup>181</sup> Under an income tax, the object is not to trace the type of use made of wealth, but to identify the accession to wealth in the first place.<sup>182</sup> In this regard it focuses on the "front end" of the taxpayer's activities. A consumption tax, because it applies only to the preclusive use of wealth for personal purposes, cannot apply until the use to which an item is put is identified. Further, because the use of funds can be purchased separately (as in a loan), and therefore dissociated from an accession to wealth, tying the income tax consequences to their use will be incorrect whenever borrowed funds finance consumption. In short, the income concept is different from the consumption concept. One can be perfectly capable of consumption or use of property that does not represent an accession to wealth. That, indeed, is why people borrow.

*B. Time Value of Money Principles*

The discussion to this point has largely disregarded the way in which the tax law should address a disguised interest element that is present in an advance payment arrangement. In this Section, I address some of the mechanisms available under current law that reach hidden interest.

Consider an agreement to prepay service income. To the extent the agreement fails to provide for adequate interest, a pure income tax would assume either that a discount is present on the amount paid to account for the fact that the recipient receives the money earlier, or, if a discount is absent, that some additional compensatory or other com-

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<sup>181</sup> William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1116, passim (1974). Note that strictly speaking, a cash flow tax is not the same as a consumption tax, because a cash flow tax presumptively treats outlays used for personal items as fully taxable on receipt. Such personal items, however, often are not fully consumed in the period in which the outlay occurs, as for instance a car or any other long-lived consumer durable. The failure to allow a partial deduction of the cost of such outlays is the consumption tax version of the realization rule under the income tax. See Engler & Knoll, note 128, at 73-78. The distortion from this error is ameliorated by the fact that the imputed interest on consumption value under a cash flow tax is disregarded as well. See Andrews, *supra*, at 1155-56.

<sup>182</sup> Andrews, note 181, at 1113 ("Serious thought about personal income tax policy has come to be dominated by an ideal in which taxable income is set equal to total personal gain or accretion, without distinctions as to source or use.").

ponent is present that should be taken into account for income tax purposes.<sup>183</sup> The presence of interest in actual cases makes the analysis of prepayments more complex, because a true income tax will pick up interest as it accrues (and generally provide a deduction therefor to the payor).<sup>184</sup> Contrary to the conclusions of some commentators, however, the presence of interest does not change the fundamental analysis of whether the prepayment constitutes income.<sup>185</sup> In fact, the presence of interest explains why prepayments are not taxable: Interest is the fee the payee pays for the right to use the funds while they remain the property of the payor.

Consider again Johnson's example of the lawyer, *L*, who receives \$1 million at the close of Year 0 in exchange for the obligation to provide personal services to a client during Years 1-5. If *L* and the client, *C*, deal with each other at arm's length, then the present value of *C*'s payment should equal the expected cost of the services if they were paid for on an as-rendered basis. Suppose interest rates are 10% compounded annually, and payments for *L*'s services ordinarily would be due in full at the close of the calendar year in which they are provided. Suppose further that *L*'s fees are expected to keep pace with interest rates, and that the discount to which *L* and *C* agree simply reflects this expectation. In that case, *L*'s current fee for a year's worth of services is \$200,000. Assuming annual compounding, the obligation to pay \$1 million at the close of Year 0 is equivalent in present value terms to annual payments totaling \$1.343 million over the five-year term.<sup>186</sup> In effect, *C* is paying for future services in part by earning interest on a loan to *L*, who in turn applies the interest earned to offset a portion of *C*'s obligation to pay for the services, the balance coming from remaining "principal" on the prepayment. If we suppose the arrangement lasts for the full five years, then at the end of each of Years 1-5, *C* would have interest income and, depending upon the nature of the legal services purchased (business or personal), potentially an offsetting deduction. *L* would have a deduction for deemed interest paid and an inclusion equal to the interest and a portion of the principal

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<sup>183</sup> See generally Halperin, note 152, at 517.

<sup>184</sup> The concern to identify and tax interest that economically accrues under a multitude of arrangements pervades the Code. See IRC § 61(a)(3) (general interest inclusion), § 163 (interest deduction), § 453 (imputing interest to certain installment obligations), § 483 (inclusion of disguised interest in deferred payment property transactions), § 1272 (inclusion for accrued but not currently payable interest on original issue discount obligations), § 7872 (identifying and taxing as such interest implicit in certain below-market-loan arrangements).

<sup>185</sup> See Section III.B; Johnson, note 2, at 386-90.

<sup>186</sup> That is, at the close of Year 1, *C* would pay \$220,000, at the close of Year 2, \$242,000, and so on.

together totaling the amount of his service income. Table 1 illustrates these outcomes.

TABLE 1  
INTEREST AND PRINCIPAL PAID ON \$1 MILLION  
DRAWN OVER FIVE YEARS

<i>Year</i>	<i>Interest Earned</i>	<i>Payment to L</i>	<i>Post-Payment Principal</i>
1	\$100,000	\$220,000	\$880,000
2	88,000	242,000	726,000
3	72,600	266,200	532,400
4	53,240	292,820	292,820
5	29,282	322,102	0
Total	\$343,122	\$1,343,122	—

The interest that is earned represents a true accession to wealth, ultimately for *C*, and the tax system should pick it up as well as provide a deduction for *L*. As discussed previously, under current law this would not be the result. Instead, *L* would have to include the \$1 million on receipt.<sup>187</sup> Full inclusion is incorrect because it overtaxes *L* and undertaxes *C*, while deferral that does not include a deemed interest portion also would be incorrect because it undertaxes *L*. Further, if, as may be customary in such arrangements, the agreement provides that *C* is entitled to return of a portion of the fee in the event of cancellation, an additional amount needs to be accounted for if the arrangement in fact is cancelled. For example, if the agreement is cancelled after Year 1 with *L* returning \$800,000 to *C*, *C* still should include the interest earned on the full \$1 million during the year, or \$100,000. *C* also should be treated as having paid \$220,000 in attorney's fees, since that is *L*'s going rate. Finally, *C* has made an additional \$80,000 payment to *L* at that time, representing an additional fee for services, includible in Year 1.<sup>188</sup>

<sup>187</sup> See Reg. § 1.451-1(a) (cash method taxpayers). Even if *L* were an accrual method taxpayer, it does not appear he could defer inclusion under the theory that the arrangement parallels that in *Artnell*. The exception for future services is particularly narrow and generally applies only where the particular services can be closely identified with the payment.

<sup>188</sup> The analysis is similar to that applicable to Indianapolis Power & Light and its customers, discussed at text accompanying notes 36-51. The \$80,000 payment is a separate income item paid to the service provider that should be included in income. The difference from the *Indianapolis Power* facts is that because payment of the item is contingent on *L*'s not providing the services, it cannot be included before the contingency is resolved unless the likelihood that the services will be provided is so low as to be negligible. See Reg. § 1.1275-4 (applying the wait-and-see approach to certain contingent payment debt instruments). In any event, the item is best viewed as a cancellation penalty. See Edward J.

Although current law does not provide for the preceding treatment, it now provides a mechanism to tax the hidden interest element present in such arrangements, assuming the transaction was treated as a loan. Under § 7872, the unstated interest element present in certain “below-market loans” is taxed under one of two regimes. In the case of term loans, the initial payment is bifurcated into an OID-like debt instrument and a separate payment that is characterized according to its economic substance (as, for example, rent, compensation, a gift, and the like).<sup>189</sup> In the case of demand or gift loans, the lender is deemed to make an annual payment to the borrower equal to the interest forgone by the lender on the loan amount.<sup>190</sup> This supplement likewise is characterized according to its economic substance. Under both term-loan and demand-loan treatment, the interest on what is characterized as principal is treated as accruing during the life of the arrangement, generating an inclusion for the lender and, subject to the limits on interest deductions generally, a deduction for the borrower.<sup>191</sup>

Under regulations proposed under § 7872, the \$1 million payment to *L* would be subject to § 7872, assuming it were treated as a loan. Under the broad interpretation of the term “loan” that applies under those regulations,<sup>192</sup> the \$1 million fee would be treated as a demand loan, assuming that the arrangement could be cancelled at any time with a ratable portion of the \$1 million returnable to *C*.<sup>193</sup> In that case, at the end of each year during which a portion of the deposit was outstanding, *C* would be deemed to make a payment to *L* equal in amount to the interest forgone on the loan arrangement, and *L* in turn would be deemed to pay *C* the interest.<sup>194</sup> Thus, at the end of Year 1, *C* would be deemed to pay *L* \$100,000, which would be characterized according to its substance as compensation. *L* would be deemed to

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Schnee, Contract Cancellation Payments Raise Income and Deduction Issues, *Practical Tax Strategies for Lawyers/Accountants* (2003).

<sup>189</sup> IRC § 7872(b).

<sup>190</sup> IRC § 7872(a).

<sup>191</sup> IRC § 7872(b)(2). Section 163 generally permits a deduction for business interest. Personal interest generally is not deductible, see IRC § 163(h), while investment interest is subject to a separate basketing regime that may result in the deferral of the interest deduction until the taxpayer has offsetting investment income. IRC § 163(d). In addition, the passive activity rules and the at-risk rules may defer interest deductions for business interest in certain cases. IRC §§ 465, 469.

<sup>192</sup> See Prop. Reg. § 1.7872-2(a)(1), (3); see also Staff of Joint Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 529 (Comm. Print 1984) (“[A]ny transfer of money that provides the transferor with a right to repayment is a loan.”).

<sup>193</sup> See Prop. Reg. § 1.7872-10(a)(5) (treating all compensation-related loans in which the benefit of the below-market discount is not transferable as demand loans).

<sup>194</sup> See Prop. Reg. § 1.7872-6.

pay *C* \$100,000 in interest. Finally, *C* would be deemed to transfer \$200,000 of principal to *L*, also as compensation for services. Similarly, at the end of Year 2, *C* would be deemed to pay *L* \$80,000, equal to the interest forgone on \$800,000. *C* also would have an \$80,000 interest inclusion and a deemed payment of \$200,000 principal to *L*.

Although the preceding treatment does not precisely track the real economics of the arrangement, it is tolerably close. If we assume that \$200,000 of the deposit is "paid" to *L* annually, then the total imputed interest turns out to be \$300,000.<sup>195</sup> The result differs from the preceding analysis because it unrealistically assumes that the services account for \$200,000 annually. Nonetheless, the \$43,000 discrepancy is relatively minor given the total values involved. At all events, neither the fact of imputed interest nor the fact that the proposed regulations fail to reach the precisely correct result bolsters the case for immediate inclusion of the \$1 million. Johnson argues to the contrary, stating that the extra services that *C* impliedly receives for interest "supports the argument that *L* has a \$1 million improvement in value immediately when the unearned payments are received."<sup>196</sup> As a basis for this conclusion he notes that the presence of implicit interest indicates that the future services have a present value of \$1 million, and that the provision of interest and principal in the form of zero-basis services means *L* must be taxed immediately. As contrasted with a genuine loan (which Johnson would treat as a nontaxable event with respect to the transfer of the loan proceeds, just as under current law), the interest on the loan is retained by *L*.<sup>197</sup>

Johnson's analysis appears simply to restate the conclusion. The fact that *L* receives a payment of \$1 million does not establish that the payment is income, even if it earns (or is deemed to earn) interest at a market rate. To the contrary, the fact that it earns interest establishes the opposite conclusion. It is what makes the arrangement in substance a loan. If *L* has a \$1 million "improvement in value," while *C* has suffered no loss in value (*C* has an asset worth \$1 million), then as previously noted, value has been created out of nothing, only to be destroyed if or to the extent that *L* never provides the services and refunds the balance.<sup>198</sup> If retention of the money is contingent on *L*'s provision of future services, and they are of equal value to the \$1 million, then he has received nothing: He has an obligation to turn over to *C* an amount equal to what he has received from her. His basis in

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<sup>195</sup> This amount equals the sum of deemed interest payments resulting from a deemed annual allocation of \$200,000 to *L* (\$100,000 + \$80,000 + \$60,000 + \$40,000 + \$20,000).

<sup>196</sup> Johnson, note 2, at 386.

<sup>197</sup> *Id.* at 386-87.

<sup>198</sup> Under Johnson's and Dodge's approaches, income could be multiplied without limit by the simple expedient of having taxpayers make obligations to each other.

the services is not relevant to what he has received. Similarly, the fact that in a genuine loan arrangement explicit interest would be paid over (or accounted for as OID) to the lender, whereas *L* pays no express interest to *C*, is of no significance. *L* economically turns over the interest by providing services worth \$1 million plus the interest that \$1 million generates in an arm's length transaction, as Johnson himself stipulates. In fact, it is the payment of interest for the use of the money that justifies treating the advance payment itself as not income. *L* purchases the use of the money in an on-market transaction.

### *C. Conclusion on Timing*

Pure income tax treatment of advance payments would defer taxation unless and until the payment is earned in some way. This result follows on any sufficiently precise definition of "income," which ultimately is neither an accounting concept nor a measure of the extent to which an individual may appropriate a particular item for use of whatever kind. Income is a measure of net accession to wealth.<sup>199</sup> If it were not, it would become impossible to explain the most elementary propositions of any true income tax, all of which, as far as I am aware, are accepted by all authorities: that the mere entry into an executory contract does not create wealth,<sup>200</sup> that the purchase of an item in an arm's length exchange substitutes one form of wealth for another of equal value, and that current income includes the increase in the fair value of known future rights. A focus on dominion, realization, or the deferral of a known repayment or performance obligation, if used as a criterion for determining when and whether someone has income, yields conclusions inconsistent with these basic verities. Concomitantly, the use of control as a criterion of income disregards the essential role that interest—be it explicit, paid in the form of future services or property, or present as an implicit discount on the amount the payor pays—plays in the advance receipt context. The economic value of what the recipient gets, which is the use of funds, is precisely its cost, and that cost is paid for with interest.

It would not suffice to respond that the question is one of definition, and that it makes more sense to include in the definition of income the concept of control or receipt of cash than to omit either of these. If

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<sup>199</sup> Simons, note 99, at 50.

<sup>200</sup> It might be argued that entry into an executory contract creates wealth in the form of utility. See Daniel Shavero, *The Man Who Lost Too Much: Zarin v. Commissioner and the Cost of Taxable Consumption*, 45 Tax L. Rev. 215, 225-29 (1990). While I question the appropriateness of treating income as a proxy for utility, it must be borne in mind that even if income is so viewed, the taxation of the utility created through the conclusion of a contract would be a unique instance of taxing consumer surplus. See text accompanying notes 124-27.

income is equated with the arrival of value at the doorstep, regardless of the terms on which it comes, the notion that income has anything to do with accession to wealth must be abandoned. Such a definition does not merely require effacing the distinction between the one who gets the value with no strings attached and the one who must repay. It also presents an untenable choice on the payor side. Either the payor who has a right to be made whole must be treated the same in income terms as the one who has no such right, or only the payor who has a right to be repaid must be treated as having received an asset from the payee. The former proposition cannot possibly be right, and commentators, presumably in an effort to avoid that contradiction, have gravitated to the latter instead.<sup>201</sup> That is surely correct as an income matter, but this option only pushes the problem back to the payee side. How can the mere arrangement between the parties have provided income to the payee without reducing the payor's wealth, even though no net wealth has been created? Only by abandoning the idea that income involves an accession to wealth is it possible to maintain that an advance payment is genuine income to the payee. This abandonment is entirely reasonable under a cash flow consumption tax, because such a tax does not purport to differentiate between consumption that is financed by an obligation and consumption free and clear; it simply measures, by the proxy of cash received, the preclusive use of resources.

#### IV. PRACTICAL CONSIDERATIONS

I have argued that from an economic perspective, no income apart from traditionally nontaxed consumer (or producer) surplus can be said to arise on an advance receipt. What, then, of the various rules providing for current taxation of advance receipts in some settings, and deferral of tax in others? Should not all advance receipts be treated as taxable as and when they are no longer subject to an offsetting obligation, and not before?

The tax administrator does not have the luxury of imposing tax only as and when true income arises. The accrual method is an effort to approximate that ideal, but even the accrual method gives way to practical considerations that may result in deferral or acceleration of income or expense for tax purposes as compared to the time at which real economic income or expense arises.<sup>202</sup> The cash method, of

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<sup>201</sup> See, e.g., Dodge, note 1, at 258-59.

<sup>202</sup> As argued above, the general rule of immediate inclusion on prepayments for accrual method taxpayers represents an acceleration of inclusion. Conversely, the economic performance rules of § 461(h) represent a noneconomic deferral of expense deductions that operate as a substitute for discounting of future payments on existing obligations.

course, is a still coarser approximation of true income, designed in part to make allowance for the fact that liquidity may not always attend income. These departures from a regime that taxes true income generally reflect the need to accommodate tax collection to these realities. Moreover, when uniformity in the economic circumstances and marginal tax rates of all parties involved is assumed, the revenue consequence (though not the tax incidence) of current inclusion of the advance receipt will be the same as an economically accurate accrual of income and expense. From this perspective, the rule of current inclusion where it is not possible to tax the interest element of an advance payment arrangement offers a decent approximation of true income taxation. The difficulties are that in the typical case such uniformity does not exist and the immediate inclusion rule taxes the wrong party.

*Beacon Publishing Co. v. Commissioner*<sup>203</sup> illustrates the issues. Beacon, an accrual method taxpayer, received prepayments for periods of up to five years for subscription services it provided. Consistent with generally accepted accounting principles, Beacon deferred inclusion of the subscription amounts until the years in which the subscriptions were provided.<sup>204</sup> The Service sought to tax the subscriptions on receipt and prevailed in the Tax Court. The Tenth Circuit reversed on the basis that requiring current inclusion was inconsistent with the accrual method, which, it held, requires deferral of both income and expense items until the right or obligation, respectively, is fixed.<sup>205</sup> According to the court, requiring inclusion of subscription payments on receipt while continuing to treat Beacon's deductions under the accrual method would result in a failure of Beacon's accounting method accurately to reflect its income.<sup>206</sup>

Although the court's ruling stood in tension with prior authority on the question<sup>207</sup> (and certainly is in tension with subsequent Supreme Court authority<sup>208</sup>), the result is in substance correct, apart from the interest question. Because Beacon's entitlement to the subscription payments was dependent upon its provision of the services, the amounts were not earned prior thereto. The problem, of course, is that Beacon obtained the use of the subscription income at no tax cost, thereby creating a tax benefit. No interest was paid on the pre-

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<sup>203</sup> 218 F.2d 697 (10th Cir. 1955).

<sup>204</sup> *Id.* at 698.

<sup>205</sup> *Id.* at 700-01; see Reg. § 1.451-1(a) (inclusion), § 1.461-1(a)(2) (deduction for accrual method taxpayers).

<sup>206</sup> *Beacon*, 218 F.2d at 701.

<sup>207</sup> See *id.* at 702 (Bratton, J., dissenting and citing authority).

<sup>208</sup> *Auto. Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *Am. Auto Ass'n v. Commissioner*, 367 U.S. 687 (1961).

payments, meaning that in substance the prepayments amounted to interest-free loans. As the previous Part demonstrated, economically accurate treatment would impute income to Beacon on receipt of the loan proceeds to the extent an interest obligation was avoided, and subsequently it would impute interest income to the subscriber (and provide a deduction to Beacon) as it economically accrued. For example, if a five-year subscription prepayment is analogized to a series of five term loans (one for one year, one for two years, and so on), then on receipt, Beacon in effect receives five separate payments, each discounted to reflect the time between payment and the date of future service. The discount would be income to Beacon.<sup>209</sup> At the end of each year, the corresponding “loan” is repaid together with interest on all the then outstanding loans. The interest would be deductible to Beacon and would be income to the subscriber. The subscriber then uses the loan repayment to purchase the subscription services in that year (“term-loan treatment”). As an alternative (and the treatment that would apply under § 7872 if the prepaid amounts were held to constitute loans), Beacon could be treated as in receipt of an additional payment from its subscribers each year equal to the interest that would accrue at a market rate on the loan, which it then would be deemed to pay at the end of the year to the subscribers (“demand-loan treatment”).<sup>210</sup> The results to the parties would be substantially similar to term-loan treatment.

If we assume that subscribers and Beacon are taxed at the same marginal rate, that the cost of Beacon’s subscription services would rise at the same rate as its cost of funds (for example, the interest rate) and that liquidity concerns are absent, then the government’s attempt to force a current inclusion of the full \$1 million in Year 1 generally results in the same present value tax liability (taking Beacon and its subscribers together) as does tax accrual under demand-loan treatment.<sup>211</sup> Hence, the effort to include the full \$1 million on receipt becomes an administratively easy way of capturing the gross economic value of the arrangement, albeit in a way that fails to tax the individ-

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<sup>209</sup> As previously discussed, this is the treatment specified under § 7872(b).

<sup>210</sup> IRC § 7872(a).

<sup>211</sup> If, for example, Beacon’s cost of funds is 10% and the applicable marginal tax rate is 30%, then current inclusion will result in \$300,000 of tax due. Similarly, under demand-loan treatment, Beacon’s fee would be \$220,000 after Year 1, resulting in \$66,000 of tax, the present value of which (for example, in Year 0, on receipt) would be \$60,000. In Year 2, Beacon’s fee would be \$242,000, resulting in \$72,600 of tax, which likewise has a present value of \$60,000, and so on. Separately, the deemed interest inclusions and deductions would be a wash. For example, in Year 1, Beacon would be deemed to receive \$100,000 of subscription income as a separate payment, but it would deduct that \$100,000 as interest paid. IRC §§ 163, 7872. Note that the overall results could be affected by limitations on interest deductibility. See, e.g., IRC § 163(j).

ual parties accurately.<sup>212</sup> The problem, of course, is that these assumptions often do not hold. Taxpayers frequently will be in different brackets, will be subject to different borrowing rates, may be subject to loss limitations of various sorts, and may be liquidity constrained even though in receipt of an advance payment, requiring them to engage in costly borrowing to cover the tax liability. When any of these circumstances arises, current taxation of the full prepayment will only approximate, perhaps quite crudely, the real tax consequences of the transaction. The effect can be compounded where the arrangement is canceled in a later year, resulting (under the government's approach) in a large deduction that may not be fully usable.<sup>213</sup>

Section A discusses these issues in particular settings, and Section B contrasts the advance receipt case with issues arising under the claim of right doctrine.

### *A. Advance Receipts*

#### *1. Prepaid Services Income*

Perhaps the most significant departure from true income taxation for advance receipts is the taxation on receipt for most items of prepaid services income.<sup>214</sup> It is fair to say that the general rule of taxation reflects the expectation that prepaid services receipts generally will turn out to be received in exchange for actual services. If so, a good time to tax them is when they are received. The tax administrator has no interest in permitting the taxpayer to dissipate the fund and thereby become insolvent before the tax that is likely to be due can be collected. Therefore, the better presumption is taxation subject to a later deduction if it turns out the item will never be earned and the payment is returned.

This rule is inconsistent with the availability of deferral to certain accrual method taxpayers on advance receipts. As previously discussed, if the taxpayer can closely tie an advance receipt with associ-

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<sup>212</sup> Subscribers are never taxed on the interest income that economically accrues to them over the loan term. See Part III.

<sup>213</sup> If, for example, the arrangement is cancelled in Year 2, then under the current inclusion approach, Beacon would have an \$800,000 deduction. Depending on Beacon's tax position, some or all of the deduction may not be usable in Year 2 or, indeed, any other year.

<sup>214</sup> A relatively large literature on prepaid services income exists. Christopher Hanna, *From Gregory to Enron: The Too Perfect and Tax Law*, 24 Va. Tax. Rev. 737, 770 n.148 (2005). As previously discussed, much of that literature argues for or against inclusion on the basis that the matching principle in accounting should or should not apply to prepayments. See, e.g., Steven J. Willis, *It's Time for Schlude to Go*, 93 Tax Notes 127 (2001) (arguing for the matching principle); Geier, note 4, at 42 (arguing that the matching principle is not an income tax value).

ated future expenditures, the taxpayer may defer inclusion until the expenditures are made.<sup>215</sup> The exception seems to rest on application of the matching principle, or more precisely on the notion that satisfaction of the matching principle constitutes a method of accounting that does not fail to clearly reflect income.<sup>216</sup> Thus, the Supreme Court trilogy denied deferral on the basis that the taxpayer in each case had failed to match income with expenses with sufficient accuracy, while in *Artnell* and *Boise Cascade* the taxpayer was permitted to defer because the showing was adequate. Also as previously discussed, commentators have rightly criticized application of the matching rule as a basis for determining whether deferral is appropriate in the advance receipts context.<sup>217</sup> Because the matching rule is designed to serve the accounting principle of determining the profitability of a business, whereas the tax rule seeks to identify accessions to wealth within the tax period, use of the former to determine the latter improperly imports transactional accounting into the tax law. I have argued that while this observation is valid, it is beside the point. The question on advance receipts is whether the taxpayer remains under an obligation to the payor in order to retain the receipt, not whether the taxpayer has or will make a profit when the dust settles. To the extent she does remain under such an obligation, the amount is not earned, is implicitly subject to an interest charge, and therefore is not an accession to wealth; rather it is indistinguishable from a loan.

The question here is whether the *Artnell/Boise Cascade* exception to the general rule makes practical sense, given that the rule of current inclusion does, even though it is “wrong” from a pure income tax perspective. One approach to the question would reframe the basic rule of inclusion in terms of the discharge-of-obligation theory rather than a certainty-of-collection theory. Under the discharge theory, one might view the general rule as resolving any ambiguity on the question of the extent of a future obligation in the government’s favor. Where the taxpayer incurs an obligation that extends beyond the current period, failure to identify the precise extent of that future obligation creates a presumption that no future obligation exists. In certain commonly recurring fact patterns, such as where the taxpayer is required to provide some amount of service at uncertain times, this may not be a bad rule, both because there is significant complexity to forecasting the extent of future services to be demanded and because the rule of current inclusion will not substantially distort the taxpayer’s

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<sup>215</sup> *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968); *Boise Cascade v. United States*, 530 F.2d 1367 (Ct. Cl. 1976); see Section II.A.

<sup>216</sup> See IRC § 446(b).

<sup>217</sup> Geier, note 4; Gunn, note 169.

true income where the obligation will be discharged in relatively short order. As a relatively typical example, consider the situation in *Schlude*.<sup>218</sup> The taxpayers received payments for a set number of dance lessons to be provided, typically over a long period of time although in some cases over the lifetime of the customer. The timing of the lessons was largely in the control of the taxpayers' customers. No refund for lessons not requested was available. One might suspect that many if not most of the lessons that customers demanded under the contract were provided in the year of payment or soon after. Given the difficulty of realistically accounting for the contingencies in the amount of service expected in future periods, together with the relatively minimal distortion resulting from current inclusion if most lessons were provided soon after the year of receipt, the Commissioner's determination that deferral did not "clearly reflect income" seems perfectly reasonable.

From this perspective, the *Artnell* exception to the general rule may be understood as permitting deferral where the taxpayer has shown with sufficient precision, not the extent to which the receipt ultimately represents profit-making activity, but the extent to which the receipt remains unearned—regardless of whether it is part of a profitable activity. That is, the matching rule may not be a bad proxy for the discharge rule. If in Year 1 a customer purchases tickets to eighty White Sox games, half of which occur in that taxable year and half of which in the next, it is reasonable to view the taxpayer as discharging one-half of its obligation in each year, regardless of the extent to which associated expenses are discharged in Year 1 or Year 2. For example, if all the Year 1 services were provided but the taxpayer went bankrupt in Year 2 before any games were played, the customer presumably would be entitled to a refund of one-half of the purchase price. As to Year 1, no refund would be available.<sup>219</sup> In this relatively simple setting, the basis for denying deferral on the ground that the taxpayer's method of accounting fails to clearly reflect income would seem quite weak.

A problem with this explanation of the current regime is that it does not adequately resolve either of the other two trilogy cases, or any case in which the extent of the future obligation can be clearly identified. Thus, in both *Auto. Club of Mich.* and *Am. Auto Ass'n (AAA)* the taxpayer received membership payments in exchange for a prom-

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<sup>218</sup> *Schlude v. Commissioner*, 372 U.S. 128 (1963).

<sup>219</sup> One also can look at the example from the perspective of the purchaser. If the White Sox had gone under after one-half the games had been played, a purchaser would be entitled to a loss under § 165 equal to her basis in the season tickets (subject to the separate limits on personal losses under § 165(h)).

ise to provide services for a year.<sup>220</sup> Assuming that, on average, a customer can expect to receive the same quantity of services at any point during the membership term, the taxpayers in each case should be viewed as “owning” the receipt only to the extent of the portion of the membership period elapsed with respect to each member. Put otherwise, the member contracted for service over the period and, as in *Artnell*, presumably would be entitled to a ratable refund if the taxpayer failed to supply contracted-for services on demand at some point during the membership term (and, perhaps, to damages associated with that failure). No refund (or damages) would be available for periods in which the services had been provided. Any amount not yet earned should be treated the same as the portion of the receipts allocable to Year 2 in the *Artnell* setting. It therefore appears that the *Artnell* exception ought to apply more broadly than it does, extending to any situation in which it is possible to make a reasonable allocation of the obligation between the current period and future periods.

There are, however, reasons to be wary of extending the deferral exception to all cases in which it is possible to allocate the services between current and future periods. The first is that many arrangements may appear to satisfy the allocation rule when they do not, and as a practical matter it may be impossible for the government to distinguish between them. Thus, where the services provided are interrelated, the extent to which a failure to provide some portion of future services would vitiate the performance in prior periods is uncertain.

Second, it often will be possible to report earnings in a way that differs from the proper allocation. Thus, consider a law firm that enters into an arrangement similar to that described previously between *L* and *C*. The firm stands ready to provide counseling services for five years to its client in connection with a large transaction that will occur in Year 1. The most expensive services (the ones the senior partner of the firm will provide) are expected to occur in Year 1, and the balance of the services are expected to be provided in diminishing quantities in Years 2-5 by lower-level firm associates, even though the senior partner stands ready to provide services through the entire term. A proper accounting of the receipt would seem to allocate most of it to Year 1, but it is not clear how or how to police that rule should a ratable allocation be reported.<sup>221</sup>

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<sup>220</sup> *Auto. Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *Am. Auto. Ass'n v. Commissioner*, 367 U.S. 687 (1961).

<sup>221</sup> Again, the allocation would have nothing to do with the deduction side. Even if the majority of the expenses would be expected to occur in Year 1, so that on a transactional basis the actual profit from the arrangement were more nearly equal from year to year, the question on inclusion of the receipt would take no account of the associated expenses.

These considerations suggest that the general rule and the *Artnell* exception to it are not terribly wrong. When the prepayment does not cover an extended future period the distortion under the general rule will be relatively small, and the reduction in administrative burden—both to the taxpayer and to the Service in policing taxpayer reporting—is likely to be substantial. If the taxpayer can make the kind of unambiguous allocation of discrete services present in *Artnell*, the worries over deferral of amounts that represent current income are essentially alleviated (though the failure to tax the interest inherent in the loan remains a problem). A material distortion arises where the arrangement is of the sort present in *AAA* or *Auto. Club of Mich.* and the deferral occurs over a number of years. It is notable that Congress has provided relief for many such taxpayers that would embody the discharge of obligation theory advanced here.<sup>222</sup> The analysis offered here suggests that these provisions should not be interpreted as exclusive but rather as authorizing the Service and the courts to apply similar accounting for similar situations not described in those provisions.

## 2. *Loans and Deposits*

The treatment of loan proceeds and deposits under the current income tax is also consistent with an effort to tax likely income on receipt and not to tax on receipt an item that is unlikely to become income, but it is less clear in this context than in the prepaid services context that this administrative regime is necessary. As a general matter, genuine loan proceeds are not a close substitute for income: They will be repaid. Therefore the appropriate presumption is that no tax will arise in connection with their receipt, and the corrective is inclusion when it turns out that the presumption is false.<sup>223</sup> Notably, however, in those instances in which loan proceeds are a close substitute for income, they are taxed on receipt. For example, a taxpayer who borrows against an annuity is treated as cashing out the annuity to the extent of the loan.<sup>224</sup> Similarly, sellers of property under the installment method are treated as selling the purchaser's installment note to the extent of any proceeds received on pledging the purchaser's note.<sup>225</sup> The reason for these exceptions is that the offsetting obligation of the borrower is effectively zero, because the income that will

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<sup>222</sup> See IRC § 455 (prepaid subscription income), § 456 (prepaid dues).

<sup>223</sup> Typical situations include cancellation of debt, which generally is included in gross income subject to limitation for insolvent debtors, see IRC §§ 61(a)(12), 108, and compensation, as long as the parties initially believed the amount was genuine debt or the property was subject to a substantial risk of forfeiture when it was transferred. See IRC § 83.

<sup>224</sup> IRC § 72(e)(4)(A).

<sup>225</sup> IRC § 453A(d). The section applies only to installment sales greater than \$150,000.

be used to satisfy the note already exists, which is to say the transaction is effectively a sale. It is not that the security for the loan is available should the borrower default (that is always the case), but rather that the security is what the borrower is expected to use to satisfy the loan.

Contrast the annuity and installment sale rules with the rules for borrowing against appreciated property. Even in the case of nonrecourse debt, the loan is not treated as a disposition of the property,<sup>226</sup> presumably because in the case of a genuine loan the lender does not act primarily as a purchaser of the security but as the seller of liquidity.<sup>227</sup> Unlike the pledging rules, in the case of genuine debt the grant of security is a backstop to the promise to fulfill the obligation, not the sale of property in satisfaction of it. When an installment obligation or annuity is used as security, however, the arrangement is indistinguishable from a prepaid forward sale of the note or the annuity.<sup>228</sup>

Deposits are a closer substitute than loans for income, since they typically function as a reserve against the realistic possibility of nonpayment of a future obligation of the payor, often nonpayment for services to be rendered.<sup>229</sup> A blanket rule of inclusion, however, would be inappropriate, at least where the recipient can be expected to account for the deposit by appropriately characterizing any hidden interest in the arrangement. Ordinarily § 7872 would ensure this outcome, but cases such as *Indianapolis Power & Light* present a diffi-

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<sup>226</sup> *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).

<sup>227</sup> *Crane v. Commissioner*, 331 U.S. 1 (1947). Economically, borrowing on a nonrecourse basis is equivalent to borrowing on a recourse basis and purchasing a put option on the loan. See Shaviro, note 161, at 659-60. The purchase of a put on property one owns represents a division of the incidents of ownership. The lender assumes the risk of loss while the borrower retains the benefits of potential appreciation. As a general matter, the tax law is uncomfortable with such intermediate arrangements and generally will treat arrangements that straddle two distinct boxes as entirely one or entirely the other (examples include debt versus equity, housing and meals that are provided for the convenience of the employer versus compensation, and mixed personal and business outlays). Thus, in nonrecourse debt, the actual arrangement is between a sale and a simple loan; where the parties intend a loan arrangement, the tax law does not regard the transfer of risk in a nonrecourse loan as so great that it turns the transaction into a sale. See *Commissioner v. Tufts*, 461 U.S. 300, 308 n.5 (1983) (noting that the tax law could view nonrecourse debt as a coinvestment of the borrower and the lender in the security). Further, the realization rule prevents previously negotiated loans from turning into sales when subsequent developments make the probability that the lender will obtain the property much larger, unless and until the borrower actually puts the property to the lender. See *Tufts*, 461 U.S. 300.

<sup>228</sup> The taxation of prepaid forward contracts ("PPF") is somewhat uncertain. Under § 1259, a simple PPF of an "appreciated financial position" typically will be taxable, but if the payment amount is contingent it may not. See Rev. Rul. 2003-7, 2003-1 C.B. 363 (deferring tax on proceeds received under a variable PPF). Congress evidently has judged, however, that where the effect of the contract is to circumvent the limits that apply to a tax-favored item such as an annuity or an installment note, current taxation is appropriate.

<sup>229</sup> *Bittker & Lokken*, note 22, ¶ 105.5.

culty. Because no clear method exists for computing interest on a deposit where the timing of any refund is contingent,<sup>230</sup> the problem of accounting for the interest both to the payee and to the depositor remains, though it is not insurmountable.<sup>231</sup> Despite the practical difficulties of calculating interest, however, the provision of an interest computation method in § 7872 presumably removes opportunities for abuse. Further, where the payee is the sort of taxpayer unlikely to dissipate the deposit, and/or the depositor can be expected to monitor the holder, worries about nontaxation of the deposit if and when it is earned would seem overstated.

### 3. *Prepaid Rent Versus Deposit*

Advance rent is taxable,<sup>232</sup> but a “security deposit” accepted to secure future rent or other obligations of the lessee may or may not be taxable.<sup>233</sup> As previously argued, whether the item is denominated advance rent or a security deposit is immaterial if the sole effort is to tax income when it arises. The administrative questions are whether there is any reason for concern if payments in substance advance rents are deferred as deposits until the time the rent is due and, if there is, whether the concern is addressed by the parties’ observance of the formalities of a deposit.

As contrasted with prepaid services income, rent is often deductible or amortizable because paid as a business expenditure.<sup>234</sup> At one level this fact suggests the government should be less concerned about whether advance rent is included in income or not, because a corresponding deduction should be available to the lessee if, but only if, the amount is treated as rent rather than a nonincludible, nondeductible deposit, and tax on rent, unlike tax on items of prepaid compensation, is unlikely to prove uncollectible. In short, it is difficult to see why inclusion of prepaid rent only as and when earned would lead to non-payment of tax. Most lessors are solvent, and most are not going anywhere.

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<sup>230</sup> The arrangement in *Indianapolis Power & Light* would have constituted a “demand loan” under § 7872(f)(5), except that customers did not have the unfettered right to demand return of the deposits (although they could demand their deposits back, IPL reserved the right to cut off service in that event). The final sentence of that Code section provides for Treasury to promulgate regulations treating any loan having an indefinite term as a demand loan, but no regulations have been issued to date.

<sup>231</sup> See George K. Yin, *Of Indianapolis Power & Light and the Definition of Debt: Another View*, 11 Va. Tax Rev. 467, 487-90 (1991).

<sup>232</sup> Reg. § 1.61-8(b).

<sup>233</sup> See, e.g., *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); see also Klein, note 3, at 1691-94 (discussing authorities).

<sup>234</sup> See IRC § 162(a)(3).

Like prepaid services income, however, amounts denominated advance rent are treated on the payor's side under genuine accrual principles. In general, advance rent is deductible only ratably over the lease term,<sup>235</sup> subject to a narrow exception where nontax business exigencies mandate the prepayment and the early deduction does not distort the taxpayer's income.<sup>236</sup> Thus, the same asymmetry in tax treatment arises here as in the prepaid service income context: accrual principles on the deduction side and cash flow principles on the income side. These considerations suggest the government's reasons for insisting on current inclusion for advance rent may have more to do with revenue raising than with fears about tax evasion or a distortion of income.<sup>237</sup> Requiring deferral of the deduction and current inclusion creates double taxation. Thus, if the rules on deferral of the deduction persist for advance rents, the more favorable treatment on the payee side for deposits represents an opportunity for self-help that taxpayers should be permitted to take advantage of, when possible. The disparate treatment of advance rents and deposits on the income side, coupled with the persistence of accrual taxation on the deduction side and the fact that worries about noncollection of tax are generally unfounded, indicate that deposits should continue to be treated as nonincludible on receipt.

#### 4. *The Taxpayer Option*

The preceding discussion discloses a further problem that the rules for taxing advance receipts create for the government, which is that the existing rules give taxpayers options they would not have under a pure income tax. Whenever tax rules create electivity, significant reductions in tax will occur and, where electivity requires modification of behavior, deadweight loss as well.<sup>238</sup>

Moreover, the electivity problem is greater than might appear. It is not confined to the choice to make or receive payments on an advance basis rather than currently. It also extends to control that taxpayers have over the tax treatment of payments after they have been made. Consider again the case of a formally separate loan made in connection with the provision of future services. Assuming the separate loan contract is respected, the parties may decide to defer inclusion to the

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<sup>235</sup> Rev. Rul. 74-589, 1974-2 C.B. 286.

<sup>236</sup> *Howe v. Commissioner*, 80 T.C.M. (CCH) 380 (2000).

<sup>237</sup> See Geier, note 4, at 19.

<sup>238</sup> See Daniel N. Shavero, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1, 57 (1992) ("Taxpayer elections tend to encourage the substitution of tax planning costs for tax payments, or in other words, excess burden for the transfer of value to the government.").

service provider, possibly because the service recipient is more lightly taxed and the two parties are willing to share the available tax benefit. The deferral arrangement also gives the parties the opportunity to lower their tax liabilities based on developments that occur or information that becomes available after the contracts are negotiated. Suppose that effective tax rates change so that the service provider becomes the more lightly taxed party. The parties may simply cancel the loan (or part of it) by deeming it to be forgiven.<sup>239</sup> The loan cancellation would result in compensation income to the service provider,<sup>240</sup> and a deduction to the service recipient. The net effect is to lower the total tax due. Conversely, where a prepayment was not structured as a loan because the service provider was initially the more lightly taxed party, in the case of a rate change in the opposite direction, the as-yet unearned portion of a previous prepayment could be “returned,” and a new loan plus services contract negotiated.

This difficulty may provide a partial explanation for the government’s hostility to prepayment arrangements generally. By insisting on a single rule on the payee side for as wide an array of cases as possible, and for real economic accrual on the payor side, the opportunities for abuse through the exercise of tax rate options are minimized, though they are not eliminated.

### *B. Claim of Right*

A claim of right represents an unusual kind of payment because it may well consist, in whole or part, of already created but untaxed wealth. As contrasted with many advance payments, what is uncertain in such a case is who has the income, not whether there will be any. By contrast, I have argued that advance receipts generally are not income to anyone at the time of receipt because there is no income that has arisen as a result of the payment. Rather they (1) will become income to the payee over time because provided in exchange for wealth that will actually be created (for example, prepaid services income for services that later are actually rendered), (2) will never be income because they will be returned to the payor (for example, loan proceeds repaid to the lender or prepaid services income for services cancelled), or (3) will be accounted as an income item to the payee because they unexpectedly turn out to represent a transfer of wealth to her from the payor (for example, loan proceeds not repaid to the

<sup>239</sup> As an example, the service recipient may have had a zero effective tax rate because of net operating loss carryovers. See IRC § 172. If the service recipient is acquired in a tax-deferred transaction, the successor to the recipient may not be able to make use of the NOL carryovers. See IRC § 382.

<sup>240</sup> Rev. Rul. 2004-11, 2004-11 I.R.B. 583.

lender), in which case an offsetting loss to the payor is allowed. In this third setting, what is accounted an income event is more properly understood as a reassignment of income already earned.

*North American Consolidated Oil*,<sup>241</sup> discussed above, illustrates the difference between a common claim of right case and an advance receipt. In *North American*, it will be recalled, the question was who was entitled to the 1916 profits from oil-producing land. The taxpayer received and was adjudged taxable on them in 1917, though the taxpayer might have been called upon to return the profits in a later year. As contrasted with the typical advance receipt case, here there was no question that at the time received the item itself represented or would represent net income to someone. The income, in short, already existed in 1917. In the advance receipt context, the item is not income when paid and the practical (though not theoretical) case for taxation at that time depends on whether it makes sense to view the payment as giving rise to likely future income. Thus claim of right cases, to the extent they involve such untaxed income items, raise a practical question different from those in the advance receipt cases: Who should be treated as the owner of an item that is indisputably income, when ownership of the item is uncertain? The question is to be contrasted with the usual prepayment questions: Is the item likely to be income to the transferee and, if so, is receipt the appropriate time to tax it? In the *North American* type of claim of right case, the proposition that someone should be taxed on receipt is stronger because someone does have income—we just do not know who it is. Unless the tax law is willing to tolerate unowned income, someone must be taxed.

A pure income rule for a claim of right thus would levy a tax on payment, to the extent the amount represented already earned income, assuming, as seems reasonable, that all income is owned by someone. The rule, however, would not make the payee fully liable for the tax, because the fact that the item is subject to possible repayment means that the real value of the item to the payee is less than its face amount (even setting aside time value concerns). A true measure of the payee's income on receipt would discount the amount by the probability that the payee would have to pay it (or part of it) to someone else. The balance of the income would be taxable to that other person.<sup>242</sup>

Needless to say, such a rule would be unworkable in practice. In most cases it will not be possible to discount the likelihood of repayment. Even if it is, the process of making adjustments over time as

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<sup>241</sup> 286 U.S. 417 (1920).

<sup>242</sup> Klein offers a similar analysis of the "pure" claim of right case. Klein, note 3, at 1689-90.

probabilities shift would be cumbersome at best. Finally, there may be comity or other reasons that would make discounting inappropriate.<sup>243</sup> The cash method accounting rule that the courts have adopted is an appropriate solution in most cases for reasons similar to the likely income rationale that applies where the prepayment is not itself an income item but is expected to be later on. In the greater scheme of things the item received under a claim of right is not (mere) likely income but actual income, which means there is very good reason to tax it currently. But with respect to the taxpayer in any individual case, the item is likely income, or, perhaps better said, it is more likely income to the taxpayer than to anyone else, assuming the item is initially assigned to the party most likely to be entitled to it at the end of the day.<sup>244</sup>

## V. CONCLUSION

A basic if over-simple understanding of a system of production, ownership, and consumption helps to explain the problems that advance receipts pose to the tax system. At the most general level, one might view social organization as an arrangement under which initially unrealized resources, principally human ability, are first transformed into wealth as goods or services, possibly then transferred or held, and finally consumed. The traditional tax bases roughly correspond to the imposition of tax at these various stages. Thus, a pure income tax is a tax on putting resources (goods or services) into the public store (producing or creating wealth); a consumption tax is a tax on taking them out; and a wealth tax is a tax on the existence of resources—the intermediate stage between income and consumption.<sup>245</sup>

Difficulties in actually taxing the chosen tax base arise because it may not be possible or even desirable to collect the tax directly. For example, under the income tax we do not mark all goods to market, nor do we effectively separate labor income from capital income in the case of employee owners of enterprises. Rather we defer tax until realization, and we make simplifying assumptions about the composi-

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<sup>243</sup> The comity issue would arise where the right to the income item depended on a state court adjudication of the taxpayer's rights. For example, a federal tax authority might resist discounting the probability of income inclusion of a state court litigant on the ground that it was unlikely the state court's ruling would be upheld on appeal. See *Commissioner v. Bosch*, 387 U.S. 456 (1967).

<sup>244</sup> This will not always be the case, of course. An amount awarded to a taxpayer on the basis of a clearly erroneous lower court judgment is likely to be taken away on appeal, but the claim of right rule still will apply.

<sup>245</sup> See Thomas Hobbes, *Leviathan* 387 (C.B. Macpherson ed., 1968) (1651).

tion of the return to various forms of business activity.<sup>246</sup> Further, a tax system may seek to achieve other ends, such as controlling conduct or implementing distributive principles, that to some extent run counter to the effort to tax solely on the base chosen. As examples, the income tax may seek to over- or under-tax income in order to control externalities, such as the over-production of carbon emissions, or it may seek to ameliorate the concentration of wealth by taxing some income more heavily than other income by means of graduated rates.

In the present context, it is the former set of issues—the impossibility of taxing the creation of wealth directly—that creates the greatest difficulty for the income tax in dealing with advance receipts. In order to implement a tax on income, the tax law necessarily makes simplifying assumptions that, as a general matter, work reasonably well in ensuring that the proper party is taxed at the proper time on the proper base. Arrangements such as advance receipts or income assignment, however, violate these assumptions. Thus, the income tax generally assumes that an individual's receipt of resources signals both their creation and that the recipient is the person who created them and therefore is the proper taxpayer. Advance receipts present the case where the first assumption is false, and anticipatory assignments of income present the case where the second is. In the advance receipt context, the result is the imposition of tax without associated income; in the anticipatory assignment case, the result is that the wrong party is taxed.<sup>247</sup> Thus, a prepaid service arrangement is not the creation of wealth but only a contract to create it; the problem for the tax system is that wealth also moves in a prepaid service arrangement, and the tax system often treats the movement of wealth as signaling the creation of income. Nevertheless, only as the wealth is really created may we say that there is genuine income.<sup>248</sup> If that were not the case, in-

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<sup>246</sup> The case of partnership profits interests is the most salient example of this simplifying assumption. Under current law, these interests generally are taxed as capital even though it is clear that a large portion of the return from many partnership investments is due to the labor of the partner. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1 (2008).

<sup>247</sup> See, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930).

<sup>248</sup> See Klein, note 3, at 1697-98 (arguing that contracts do not create wealth). One might object that the definition of income offered in the text fails to account for such items as cancellation of debt income or the gift exclusion. But the rules for these items reflect distributional or other decisions, not decisions to tax income (or to exclude it from tax). Thus, taxation of canceled debt reflects a distribution decision to reassign income formerly assigned to the lender to the borrower. The distribution principle is reflected in the associated deduction to the lender. IRC § 166. A pure income tax, however, because it says nothing about who should bear the tax (only that income is taxed when it appears), would no less accurately disregard the loss and the windfall to the creditor and debtor, respectively. Similarly, the nontaxation of gifts is matched by the absence of a deduction on the

come could be multiplied indefinitely by the expedient of entering into executory contracts, without regard to whether they were completed. In other words, the act of receipt is only a proxy for income, not the real thing. In the advance receipt context, the receipt proxy fails.

Similarly, the person who controls an item ordinarily, though by no means necessarily, is the one whose income it represents (or who exchanged her income for it). Hence, in the typical circumstance the taxation of the amount under a person's control will not be a bad proxy for taxing that person's income (assuming the income has not already been taxed directly). Again, however, the advance receipt context thwarts the assumption, because control over the advance receipt itself signals nothing more than a shifting of resources, not their creation. The fact that a pure income tax axiomatically attributes interest where ownership does not follow control means that the item cannot be income.

The focus that the Service, courts, and commentators have placed on facts such as control or use are misplaced because they operate on wealth or consumption as proxies for income rather than on income itself. In a simpler world in which all wealth were held by its producer until consumed by that same person (or exchanged along the way in an arm's length transaction), any of the proxies associated with income would work fine as a way of taxing income (apart from time value of money concerns). In the complicated world in which we live, where income may be owned or consumed by someone other than its producer and consumption may happen prior to an associated income event, the use of other tax bases as a proxy for income will result in improper taxation some of the time. To be sure, administrative, distributive, or other reasons may well counsel in favor of the use of such proxies, as Part IV argued. What is critical to understand, however, is that in using the proxy one only approximately taxes real income, and the question in these circumstances is whether the departure from income taxation is justified.

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transferor side. The decision as to which (as long as not both) of the parties is taxed on a gift is immaterial from the perspective of an effort simply to tax income; rather the decision about the proper taxpayer is based on other grounds. See Douglas Kahn & Jeffery Kahn, "Gifts, Gifts, and Gifts"—The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income, 78 Notre Dame L. Rev. 441 (2003).

