

Interest in Disguise: Taxing the “Time Value of Money”

Daniel I. Halperin†

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Questions of timing—such as the correct period for reporting income or claiming deductions—present some of the most critical and vexing issues in the design of an income tax. Economists¹ and accountants² have gener-

† Professor of Law, Georgetown University Law Center. As some readers will realize, this Article has had a long gestation period, making it difficult to specifically thank all those who have contributed to my understanding of this subject. I want to mention my colleagues at the Treasury Department, particularly Professors David Shakow, Theodore Sims and Michael Melton, who first helped me appreciate some of the relationships described herein. I have also greatly benefitted from discussions with Professors Alvin Warren, Steven Cohen and Michael Graetz. Finally, I am indebted to Harvard Law School and the Fund for Public Policy Research for sponsoring a conference on March 30, 1985, which provided the occasion for a detailed discussion of this paper. Just as this Article was going to press, the House passed The Tax Reform Act of 1985, H.R. 3838, 99th Cong., 1st Sess. (1985), which adopts some, but not all, of President Reagan's proposals described in this Article. Because congressional action is not final and does not, in any event, affect the analysis of these issues, citations to the House bill are not included.

1. See Sunley, *Summary of the Conference Discussion*, in *COMPREHENSIVE INCOME TAXATION* 261, 262 (J. Pechman ed. 1977).

2. See P. WALDENBACH, N. DITTRICH & E. HANSON, *PRINCIPLES OF ACCOUNTING* 17 (2d ed. 1980).

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ally chosen accrual—the time when income is earned or an obligation is fixed³—as the proper standard in principle. In practice, however, most individuals and many businesses are allowed to use the cash method of accounting, with income reported and deductions taken when payments are made or received.⁴ These traditional methods of tax accounting led to transactions designed to avoid taxation by disguising interest or the “time value of money.”⁵ In the Tax Reform Act of 1984,⁶ Congress addressed a number of these abuses.⁷ But the new legislation, without explanation, took a variety of approaches. Congress placed some transactions on a mandatory accrual basis,⁸ others on a mandatory cash basis,⁹ and for a third group extended matching provisions that require parties to treat the transactions consistently.¹⁰

3. “Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right [of the taxpayer] to receive such income and the amount thereof can be determined with reasonable accuracy.” Treas. Reg. § 1.451-1(a) (1978).

4. The Internal Revenue Code permits the cash method if its use clearly reflects income. I.R.C. § 446(b), (c)(1) (1982). The Internal Revenue Service requires the accrual method whenever “production, purchase, or sale of merchandise . . . is an income-producing factor.” Treas. Reg. §§ 1.446-1(a)(4)(i), 1.446-1(c)(2)(i) (1973), but companies may in certain circumstances use the installment method to defer tax until cash is received. I.R.C. § 453A (1982). The Treasury has never required a service business, no matter how large, to adopt the accrual method. PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY Ch. 8.03 at 212 (May 1985) [hereinafter cited as PRESIDENT’S PROPOSALS]. President Reagan, however, would limit the cash method to small businesses which do not use accrual accounting for any purpose. *Id.* at 213.

5. See *Hearings on Abusive Tax Shelters Before the Subcomm. on Oversight of the Internal Revenue Service of the Senate Comm. on Fin.*, 98th Cong., 1st Sess. 67, 70, 100-09 (1983) (statement of Robert G. Woodward, Acting Tax Legislative Counsel, Dept. of the Treasury) (describing certain transactions as time value of money abuses).

6. The Tax Reform Act of 1984 was enacted as §§ 5-1082 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) [hereinafter cited as the 1984 Act].

7. The provisions of the 1984 Act that I put in this category are not quite the same as the congressional listing. Compare 1 S. REP. NO. 169, 98th Cong., 2d Sess. at vii, 249 (1984) [hereinafter cited as S. REP. NO. 169] with Halperin, *The Time Value of Money—1984*, 23 TAX NOTES 751, 752 (1984) (listing provisions that affect time value of money).

8. Sellers of property for deferred payments must report ordinary income resulting from depreciation recapture at the time of the sale, I.R.C. § 453(i) (West Supp. 1985), and must generally pay tax on accrued interest on an annual basis. I.R.C. § 1274(c)(1) (West Supp. 1985). Purchasers deduct accrued interest on the same schedule. I.R.C. § 163(e)(1) (West Supp. 1985). In 1985, Congress permitted a below-market interest rate to be used in certain “small” transactions, and also allowed the parties in such transactions to agree to cash method treatment on both sides. Act of Oct. 11, 1985, Pub. L. No. 99-121, § 101(a)(1), 1985 U.S. CODE CONG. & AD. NEWS (99 Stat.) 505 (to be codified at I.R.C. § 1274A). The 1984 Act also accrues interest at market rates on loans between related parties. I.R.C. § 7872 (West Supp. 1985). In addition, in some circumstances lessors and lessees must take account of accrued rents which have not been paid. I.R.C. § 467 (West Supp. 1985).

9. For example, despite accrual of an expense, Congress deferred deductions, pending “economic performance,” I.R.C. § 461(h) (West Supp. 1985), which under certain circumstances would require cash accounting. I.R.C. § 461(h)(2)(C) (West Supp. 1985) (workers’ compensation and tort liabilities).

10. For example, restrictions on deductibility of amounts owed by an accrual basis taxpayer to a related cash basis taxpayer, modified to allow deduction only when paid, were extended to new situations, including transactions between a partnership and its partners and between affiliated corporations. I.R.C. § 267(b)(3), (e) (West Supp. 1985). See also I.R.C. §§ 83(h), 404(a) (5) (West Supp. 1985).

This Article provides a comprehensive theory for understanding these transactions. The key to proper taxation is to account explicitly for the investment income from what may often be described as disguised loans. There are at present three possible approaches to accomplish this. First, the investment income could be taxed *directly* by taxing the imputed interest on such loans. Second, the beneficiary could be taxed *indirectly* by denying an otherwise allowable deduction. When taxation of the beneficiary is infeasible, a third alternative could be *substitute* taxation of another party to the transaction, accomplished by denying the substitute party a deduction for interest. The Article analyzes the relative advantages and drawbacks of these three approaches—direct taxation of the beneficiary, indirect taxation of the beneficiary, and substitute taxation of another—as they would be applied to a number of transactions. It explains when and why the latter two methods may be successful, so that the choice among the three approaches may be a more informed one.

Part I of this Article analyzes original issue discount obligations and interest-free loans, where the recent statutory remedy is current taxation of the beneficiary. Part II applies the analysis to a number of other transactions, including accelerated payments, deferred payments, and premature accruals. In analyzing each of these transactions, I suggest the theoretically appropriate rule, as well as a way of implementing that treatment. Part III contains a more in-depth analysis of the treatment of certain deferred compensation arrangements and suggests a new—and I hope more accurate—approach to substitute taxation. Given the pervasiveness of the transactions discussed here, this Article should be regarded as a first attempt to arrive at a unified understanding of “time value of money” abuses, rather than as a final solution.

I. CURRENT TAXATION OF INVESTMENT INCOME TO THE RECIPIENT

“Income” generally means the sum of consumption and savings during an accounting period. As Henry Simons put it in his 1938 classic, *Personal Income Taxation*:¹¹

Personal income may be defined 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.

This approach, generally referred to as the Haig-Simons definition of income, suggests that all changes in asset value should be taken into ac-

11. H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

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count as they occur. The 1982 and 1984 legislation implements the Haig-Simons ideal with respect to both original issue discount obligations¹² and interest-free and below-market loans.¹³ This Part establishes the need for this legislation by demonstrating how departures from the accrual approach in these two cases may lead to tax avoidance with respect to investment income.

A. *Original Issue Discount Obligations*

Suppose that a lender transfers \$100 to a borrower on December 31, 1984, with the loan to be repaid on December 31, 1986. Although the market rate of interest is 10%, the parties agree that no interest will be payable on the obligation, but that the borrower will transfer \$121 to the lender on the due date. Since the \$121 obligation is issued for only \$100 (at a discount of \$21 from the final amount due), it is said to be an "original issue discount" obligation.¹⁴ Apart from taxes, the parties are in the same position they would be in if market interest were charged each year and there were an additional loan of \$10 from the lender to the borrower offsetting a payment of interest in 1985. The "original issue discount" obligation can be thought of as disguising this additional loan. If the accrual method were accurately applied, the borrower would have interest deductions of \$10 in 1985 and \$11 in 1986, and the lender should have interest, or investment income, in the same amounts in those years.

Congress did not easily come to the conclusion that original issue discount obligations should be treated the same as obligations on which market interest was currently charged. It was not until 1954 that the Code specifically characterized the \$21 in our example as ordinary income.¹⁵ It was not until 1969 that the interest income had to be accrued over the course of the loan,¹⁶ and only since 1982 has such accrual reflected compounding of interest.¹⁷

This failure prior to 1982 to tax the original discount transaction in accordance with its substance lowered tax revenue and could have led to

12. See *infra* note 14.

13. I.R.C. § 7872 (West Supp. 1985).

14. I.R.C. § 1273(a) (West Supp. 1985). The difference between the issue price of a debt instrument (here \$100) and the maturity value (here \$121) is referred to as original issue discount and is taxed as interest as it accrues. I.R.C. § 1272(a) (West Supp. 1985).

15. I.R.C. § 1232 (1954). Currently these provisions are in I.R.C. §§ 1271-75 (West Supp. 1985).

16. I.R.C. § 1232 (1969).

17. I.R.C. § 1232A (1982). See Canellos & Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983) (describing effect of 1982 Act).

The 1984 Act recognized for the first time that "market discount bonds" produce interest income due to discounting which occurs after issuance. Yet, that interest income is recognized only on disposition of the bond. I.R.C. § 1276 (West Supp. 1985). In effect, the 1984 legislation applied the pre-1969 original issue discount rules to market discount.

activities that would be uneconomic in the absence of the tax savings. This can be illustrated by the following examples. Suppose first that the transaction was taxed in accordance with its economic substance by requiring accrual accounting. If both parties had a marginal tax rate of 40%, the results to the lender would be as follows:¹⁸

Example 1 — Accrual Taxation

	<u>1985</u>	<u>1986</u>
a. Principal	\$100	\$106.00
b. Interest (.1xa)	10	10.60
c. Income Tax (.4xb)	(4)	(4.24)
d. Net income (b-c)	6	6.36
e. Net assets (a+d)	106	112.36

The detriment of the transaction to the borrower would, of course, be precisely the same as the benefit to the lender, as long as both parties were 40% taxpayers. Thus, the borrower would incur an obligation of \$100 in 1984, which, after taking into account the benefits of interest deductibility, would have a burden of \$112.36 in 1986. Since the benefit and the detriment are equal in these circumstances, the government's net tax collection would be zero.

If, however, the lender was able (as was true prior to 1969) to use cash accounting to report interest income in the year received, she would be undertaxed even if the \$21 was correctly characterized as interest. After taxes of \$8.40 on the interest, the lender would retain \$112.60 rather than \$112.36. The lender's benefit of \$.24 stems from deferring the tax on 1985 investment income until 1986. As will be developed below,¹⁹ such deferral is equivalent to a tax exemption for the interest earned on deferred income. If interest were taxed on the accrual basis as in Example 1, \$6 would be earned after-tax in 1985 and the interest on this amount in 1986 would have been 60 cents. The benefit to the lender and the cost to the government is the effective elimination of the tax due on this 60 cents, or 24 cents (.4 x \$.60).²⁰

In these circumstances, however, the cost to the government can be

18. The lender's investment at the end of 1985, \$106, consists of the outstanding loan, \$110, less \$4, which would have to be borrowed to pay the tax due. Similarly, taxable income in 1986 is \$10.60 (\$11 interest on the original loan, less 40 cents interest on the amount borrowed to pay the tax). Subtracting \$4.40 due on the 1985 loan, plus tax of \$4.24 in 1986 from the \$121 payment, leaves \$112.36.

19. See *infra* text accompanying notes 46-47.

20. The difference of 24 cents can also be explained as the benefit of an interest-free loan. The deferral of tax for one year on \$10 of interest income can be considered an interest-free loan of \$4. The cost at 10% interest of borrowing \$4 for one year would be 40 cents before tax or 24 cents after tax.

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eliminated by mandatory cash accounting delaying the borrower's deduction until 1986. Cash accounting overtaxes the borrower by delaying the deduction of 1985's interest expense until 1986; this, in effect, reduces the amount of interest which is deducted. Mandatory cash accounting is, thus, an example of substitute taxation because the borrower is overtaxed for the exact amount of investment income that the lender/beneficiary has avoided.

Since the borrower can obtain the benefit of accrual accounting (Example 1) by arranging to pay interest annually, there is no reason for her to accept this additional detriment. The parties would reduce the 1986 payment to \$120.60 in order to achieve exactly the same loan burden (\$112.36) as in Example 1.

Example 2 — Cash Accounting (Adjusted Payment)

	<u>1986</u>
a. Principal	\$100.00
b. Interest	20.60
c. Income Tax (.4xb)	8.24
d. Net Income (b-c)	12.36
e. Net Assets (a+d)	112.36

Under these circumstances, although the lender's nominal tax payment has been reduced, there is no harm or benefit to either party or the government.²¹ The undertaxation of the lender will be exactly offset by the overtaxation of the borrower,²² and the parties can adjust their payments so that they will not be advantaged or disadvantaged by the shift in tax liability. Hence, cash basis taxation might be a viable approach if parties were thought generally to face similar tax rates, and if the alternative of full accrual taxation seemed too complicated to implement directly.

Unfortunately, these transactions are often designed to exploit differences in tax rates. If the undertaxed party is in a higher bracket than the overtaxed party, matching will collect less than the correct amount. For example, under mandatory cash accounting if the "overtaxed" borrower is tax exempt, the transaction will no longer be revenue neutral.²³

21. Even so, since publicity about tax abuse tends to focus on nominal tax liability rather than after-tax earnings, if the impact is substantial, there can be an appearance of inequity, which can affect the image of the tax system even though the lender's after-tax income is not increased.

22. For this transaction the correct amount of total government revenue is zero, but matching can also maintain a correct positive amount of tax, as when the borrower would be required to capitalize her interest deduction and recover it by way of amortization over a number of years. *See infra* text accompanying note 118.

23. Because taxes are deferred until the lender's receipt of cash, the lender in our example would be willing to accept a payment of \$120.60 in 1986—thus reducing the loan's cost to the tax-exempt borrower. If the lender's position is unchanged and the borrower has secured an advantage, the reve-

Conversely, if the lender is overtaxed, tax-exempt institutions will become lenders. For example, between 1969 and 1982, lenders were overtaxed because interest had to be ratably deducted and included over the life of the loan.²⁴ As one would expect, before the change in the Code in 1982, deep discount bonds were primarily held by tax-exempt lenders, such as pension funds.²⁵

Transactions such as these show the limitations of matching. When both parties are subject to the same rates, a matching requirement may prevent certain types of abuses—such as the coupling of a current deduction by an accrual basis payor with the deferred inclusion by a cash basis recipient²⁶—but matching cannot stop shifting investment income to exploit a difference in tax rates.

Several aspects of this analysis of original issue discount obligations can be applied to the various transactions described in this Article: (1) the transaction, as structured, shifts investment income from one party to another; (2) full, often very complex, implementation of the Haig-Simons concept is necessary to tax each party correctly; (3) matching will solve the problem only if the parties are subject to the same tax rate; but (4) the whole point of the transaction may be to achieve tax savings by shifting income from a higher-rate taxpayer to a lower-rate taxpayer, so it is extremely unrealistic to assume that the parties face the same tax rate.

B. *Interest-Free and Below-Market Loans*

Interest-free loans are an even more obvious example of an effort to shift investment income to another party by disguising interest payments. As Congress recognized in the 1984 Act, interest-free (and below-market-

nue must be reduced. The present discounted value of the government's tax collection falls to \$8.24 in 1986 (Example 2) in lieu of \$4 in 1985 and \$4.24 in 1986 (Example 1).

24. In our example, the deduction and inclusion in the first year of the loan would be \$10.50, thus overtaxing the lender, since only \$10 has accrued. The borrower, analogously, benefits from the extra deduction by achieving a one year deferral of taxes on \$.50.

25. See STAFF OF JOINT COMM. ON TAX., 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 161 (Comm. Print 1982). The Joint Committee provided the following example to illustrate the potential abuse: The taxpayer issues a bond for \$1 redeemable for \$66.21 in 30 years. This reflects an interest rate of 15% and a real interest cost of 15 cents in the first year. On a straight-line basis the interest deduction would be \$2.17 each year. In the first year this is more than twice the amount borrowed and more than 14 times the real interest. *Id.* at 159-60. The tax savings from the interest deduction, if invested, will provide more than enough funds to pay off the note, thus creating a windfall for the borrower.

26. Johnson, *A New Way to Look at the Tax Shelter Problem*, 23 TAX NOTES 765, 766 (1984). If both parties are in the same bracket, matching will also prevent the parties from taking advantage of the imperfections in the estimated tax rules. For example, a deduction for A of \$100 on December 31, 1985, coupled with inclusion by B of \$100 on January 1, 1986, should have only a minor impact. By this deduction, however, A may be sheltering income actually received on January 1, 1985, on which she has failed to pay estimated tax.

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interest) loans can be disaggregated and viewed as two separate transactions: a loan with interest payable at the appropriate market interest rate, coupled with an offsetting payment from the lender to the borrower equal in amount to the foregone interest.²⁷ For example, suppose that a lender transfers \$100 to a borrower on December 31, 1984, with the \$100 loan principal amount to be repaid without interest on December 31, 1986. Although the loan may appear to be interest-free, interest, in fact, accrues each year on the amount loaned. It is not actually paid because it is coupled with a simultaneous transfer of an identical amount from the lender to the borrower. Thus, no cash need actually change hands.

Like original issue discount obligations, if the form of the transaction were respected (*i.e.*, neither the payment nor the receipt of interest were imputed), an interest-free loan would enable the lender to avoid tax and would overtax the borrower if interest she would have paid would have been deductible. But in this situation the shift in taxation to the borrower may be offset by the failure to account for the offsetting payment.²⁸ If such payment would have been taxable to the borrower, the absence of imputation offsets the detriment from the failure to impute the interest deduction. Similarly, if the offsetting payment would have been deductible, the loss of the deduction by, say, an employer-lender, would eliminate the benefit to the lender of avoiding tax on interest and would cause the lender to be *indirectly* taxed on the investment income.

This range of possibilities can be illustrated by the following examples. First, in the case of an interest-free loan of \$100 from employer to employee, if the interest rate were 10%, the \$10 of accrued annual interest owed by the employee might be viewed as offset by \$10 of salary from the employer. In this particular transaction, ignoring the offsetting transfers does not forego taxation of investment income in the right amount to the proper party. The effect of not accruing interest is to shift investment income of \$10 each year from the employer to the employee.²⁹ But the effect of ignoring the salary in the same amount is to shift back an identical amount of income from employee to employer.³⁰ In effect, the failure to accrue the interest is exactly compensated for by the failure to accrue the

27. S. REP. NO. 169, *supra* note 7, at 477.

28. Original issue discount transactions also involve an offsetting imputed payment—the additional loan. Because this transaction has no tax consequences—loans are neither taxable to the borrower nor deductible by the lender—the substitute tax is not affected. This is not necessarily true in the case of interest-free loans.

29. The employer does not report \$10 of interest income and the employee loses a \$10 interest deduction.

30. The employee does not have to report \$10 of salary income, but the employer loses a deduction for \$10 of salary.

offsetting payment of salary. The lender is indirectly taxed on investment income.³¹

In other transactions, however, the failure to accrue interest may not be compensated for by the failure to accrue the offsetting payment. Depending on the relationship between borrower and lender, investment income will, in some transactions, be taxed at too low a rate to a substitute party; in others, it will escape tax altogether.

For example, with an interest-free loan from parent to child, the interest that accrues and is owed by the child can be viewed as offset by a gift from the parent. Again, the effect of not accruing interest is to shift investment income from the lender-parent to the borrower-child. But not recognizing the offsetting gift payment has no income tax effect, since gifts are neither deductible to the donor, nor includible by the donee.³² Since the failure to accrue the interest is *not* compensated for by the failure to account for the gift, the net effect is to shift investment income to the child. This substitution of the child as the taxable person for the parent will not matter as long as both face the same tax rate. But if the child is in a lower bracket—as is usually true in the case of interest-free loans between related parties—then the investment income will be undertaxed.

In other interest-free loan transactions, investment income may not be taxed at all. Suppose there is an interest-free loan from a corporation to its sole shareholder. The interest that accrues and is owed by the shareholder can be viewed as offset by a dividend from the corporation. Once more the effect of not accruing interest is to shift investment income from the lender-corporation to the borrower-shareholder. Ignoring the dividend has no effect on the corporation (since dividend payments are not deductible), but causes non-taxation of investment income to the shareholder. Although the shareholder ends up being taxed on the proper amount (not allowing an interest deduction is compensated for by not taxing the dividend), the corporation escapes tax on investment income (not accruing interest income is not offset by ignoring the dividend payment).

In general, if the form of the transaction is respected, a lender is indirectly taxed (despite the failure to disaggregate an interest-free loan) only when the offsetting payment would, if paid directly, produce an immedi-

31. The offsetting transactions, however, would not necessarily occur at the same time. Suppose in return for services worth \$21 performed in 1985 the employer makes an interest-free loan in 1985 of \$121 to be repaid in two years. At a 10% rate of interest, a lender would lend only \$100, if the borrower's sole obligation is a payment of \$121, 2 years later. The additional \$21 transferred in 1985 is compensation for services. If form is respected, the employee avoids tax in 1985 on \$21 of compensation and loses interest deductions in 1986 (\$10) and 1987 (\$11). On the other hand, the employer is disadvantaged. See I.R.C. § 7872(b) (West Supp. 1985) (implementing correct result in the case of term loans). Failure to recognize compensation may also permit the parties to avoid liability for employment tax.

32. DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 37 (1977).

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ate deduction. An interest-free borrower is subject to a substitute tax only if the offsetting payment would not be taxable, as in the case of a gift. On the other hand, the borrower secures a net tax advantage if the compensating payment would be taxable and the interest not deductible.³³

Given the variety of possible results, compounded by the use of interest-free loans to shift income to lower bracket parties, it is understandable why Congress decided in 1984 to require accrual of the interest implicit in interest-free loans.

C. Summary

The Internal Revenue Code's treatment of original issue discount obligations and interest-free loans implement the Haig-Simons ideal of current taxation of investment income³⁴ to the party who receives the income in one form or another. The implementation, however, is certainly not simple.

But it is difficult to imagine any other result which would not give taxpayers opportunities to avoid tax on investment income. The substitute party approach will not work here because the transactions generally involve taxpayers facing different tax rates and because, in the case of interest-free loans, the failure to account for the offsetting payments can sometimes eliminate the additional substitute tax on the borrower. Indirect taxation will only occur when such failure deprives the lender of a deduction.

II. INDIRECT AND SUBSTITUTE TAXATION OF INVESTMENT INCOME

A. Accelerated Payments

In every transaction involving the delivery of goods or services, there is a time of "actual economic performance," when the buyer obtains the benefit of the goods or services that are being purchased.³⁵ If payment is delayed beyond this point, the seller has made a loan to the buyer and, in

33. Taxpayers who do not itemize their deductions may lose the benefit of interest deductions. In addition, I.R.C. § 265(2) (West Supp. 1985) disallows any deduction for interest related to the acquisition or retention of tax-exempt bonds. See also I.R.C. §§ 189, 263(g), 1277, 1282 (West Supp. 1985) (deferring interest deductions on various obligations). Under President Reagan's tax proposal, many more taxpayers would be unable to fully deduct interest expense, as the current limit on deduction of investment interest, I.R.C. § 163(d), would be strengthened and extended to personal loans. PRESIDENT'S PROPOSALS, *supra* note 4, at Ch. 13.01.

34. This is only true of a direct loan of cash. If the loan arises from a deferred payment for property or services, ideal treatment requires accrual of the principal element as well. See *infra* Part II(B), (E).

35. Of course, it is not always obvious when "actual economic performance" occurs. Furthermore, in some cases the seller may claim not to have charged implicit interest because two or more otherwise similarly situated customers may pay equal amounts even though the date of payment in relation to "actual economic performance" differs among transactions.

addition to the payment for goods or services, the buyer will, functionally, transfer to the seller a sum for interest, even if none is explicitly stated. On the other hand, if payment is made before the time of actual economic performance, the buyer has made an implicit loan to the seller, and the seller will reduce the price charged to reflect the interest implicitly due the buyer. As in the case of interest-free loans, the transaction can be disaggregated into two separate components—a payment for goods or services and a disguised loan.

Suppose that a buyer pays a seller \$100 on December 31, 1984, in exchange for the delivery of goods or services worth \$110 on December 31, 1985. This prepayment implicitly involves a \$100 loan at 10% for one year from the buyer to the seller. The principal and interest (\$110) need not be actually repaid in cash, because it is coupled with the offsetting obligation of the buyer to pay \$110 for goods or services.

If the accrual method were strictly applied to this transaction, \$10 of interest income would accrue to the buyer and \$10 of interest deduction would be allowed to the seller in 1985.³⁶ As in the case of original issue discount obligations and below-market loans, if we ignore the loan and fail to accrue interest income and deductions, \$10 of investment income would be initially shifted from buyer to seller in 1985. Whether this ultimately leads to improper taxation of investment income depends on (1) whether the payment is deductible by the buyer; (2) when we take account of the buyer's business deductions and the seller's business income; and (3) whether both parties face the same tax rates. These factors determine whether the buyer will be *indirectly* taxed, whether the seller will be adequately overtaxed as a *substitute*, or whether neither or both will occur.

For example, when the payment is deductible by the buyer, *indirect* taxation can reach the proper result. Under strict accrual, the buyer should have a \$100 deduction in 1985, netting the \$10 of implicit interest and the \$110 deductible business expenditure. Similarly, the seller should have \$100 of income, netting the \$10 of implicit interest deduction and the \$110 of sales income. This result, however, can also be reached by accounting for the sale at the time of economic performance in 1985, but using the amount paid in 1984 so that the buyer gets a \$100 deduction and the seller has \$100 of income in 1985.

36. Full imputation does not necessarily require valuation of goods or services because it can be achieved, as with interest-free loan transactions, by imputing a market rate of interest and then attributing the residual payments to the value of goods or services. It would require, however, a determination of the date of "economic performance" which could result in additional difficulty. For example, in the situation described in the text, we can assume that the value of the services was \$110 since the buyer would earn \$10 of interest on his \$100 prepayment. This calculation, however, depends on being able to determine that December 31, 1985 was the date of "performance."

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Each party is indirectly taxed the correct amount. Understating the amount actually paid for the goods or services exactly offsets the effects of ignoring implicit interest. The buyer-lender fails to report \$10 of interest income, but she also loses a \$10 deduction. The seller-borrower loses a \$10 deduction, but her sales income is lowered by the same amount.³⁷

Equivalent tax results can sometimes also be achieved through substitute taxation of the seller, if we account for the sale when the cash is paid in 1984³⁸ rather than when economic performance occurs in 1985. In this case the amount paid for goods and services (\$110 in 1985) will be measured correctly and there will be no compensating error to overcome the effect of ignoring interest. The seller will be taxed on interest as a substitute.

The existence of substitute taxation can be more easily demonstrated if we account for the adjustment in the amount paid which would likely accompany such substitute taxation. If, for example, the tax rate were 40%, the seller would require, and the buyer would be willing to make, a prepayment in 1984 not of \$100 (\$110 discounted at the 10% pre-tax rate of return), but of \$103.77 (\$110 discounted at the 6% after-tax rate). The seller would retain \$66 after taxes in 1985, which is what she would have had if the payment were not accelerated and she received \$110 in that year.³⁹ Taxation to the seller of \$103.77 upon receipt is exactly equivalent to including \$110 in income a year later at the time of economic performance.⁴⁰ Similarly, if the buyer were allowed an immediate deduction of \$103.77, her tax savings (\$41.51), if invested for one year to earn 6% after tax, would total \$44, exactly the savings from a deduction of \$110 one year later.

In sum, when the payment would be deductible, deferring deduction until the time of economic performance indirectly taxes the buyer-lender

37. If the payment is not deductible by the buyer-lender, however, understating the amount paid has no tax effect. Although the seller is properly taxed, the buyer avoids \$10 of interest income.

38. The Internal Revenue Service has successfully insisted that even accrual basis taxpayers must include cash in income when received, whether or not income has accrued. *Automobile Club of Mich. v. Commissioner*, 353 U.S. 180 (1957); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Schlude v. Commissioner*, 372 U.S. 128 (1963); *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969). The Service has permitted, however, certain short-term delays. *Rev. Proc. 71-21*, 1971-2 C.B. 549; *Treas. Reg. § 1.451-5* (1976).

39. $\$66 = .6 \times \$110 = .6 \times \$103.77 \times 1.06$. \$103.77 is also the amount the buyer would need in 1984, if there were no acceleration, to fund the \$110 payment in 1985. (\$103.77 would yield \$110 if invested at an after-tax return of six percent: $\$103.77 \times 1.06 = \110 .)

40. In this case accounting for the transaction on a cash basis subjects the seller to substitute taxation. As we will see when we consider deferred payments, *infra* text accompanying notes 52-54, such "matching" is not essential to accomplish this result. The seller could be taxed at the time of economic performance in 1985 rather than on receipt of cash in 1984, as long as the amount subject to tax is increased to reflect the future value of the \$103.77 payment, thus taxing the seller on \$110 without any offset for imputed interest. This is equivalent to required discounting (at the after-tax interest rate) if compensation were deducted in a year prior to payment.

on investment income. Alternatively, taxation upon receipt of cash will substitute taxation of the seller for the investment income on which the buyer avoids tax. The combination of deferral of the buyer's deduction and immediate taxation of the seller, which may sometimes occur,⁴¹ would tax investment income to both parties.

Once again, these are not complete solutions. Substitute taxation of the seller is not a very attractive approach, because prepayments can be expected to occur most frequently when payees are tax-exempt or in lower brackets than payors. For example, some universities are now offering to accept prepayment of four years' tuition at the current rate.⁴²

Indirect taxation can be accomplished only when the buyer's payment is deductible and even then is not fully achieved in the case of a multi-year prepayment. In the above example, if delivery did not occur in 1985, the understatement of the amount paid for goods and services would not occur in the same year that the full amount of implicit interest is earned. A portion of that implicit interest is earned in 1985, but it is not *indirectly* taxed until the year of performance, 1986 or later. This delay effectively exempts the interest on the untaxed interest from tax.⁴³

Therefore, in the absence of full imputation, accelerated payments offer opportunities for shifting income similar to those offered by original issue discount obligations and interest-free loans. Yet the Code has not taken a full imputation approach in the case of prepayments.⁴⁴ The 1984 legislation did defer deductions for prepayments in "tax shelters,"⁴⁵ thus imple-

41. See *supra* note 38 for circumstances under which seller is taxed on receipt and *infra* note 45 for rules deferring buyer's deduction.

42. Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 23 (1984). If tuition increases at more than the after-tax rate of interest, but at less than the before-tax rate, both parties benefit.

43. The effect is the same as taxation of original discount obligations on a cash basis. See *supra* text accompanying note 20. For example, assume the seller is to provide \$121 of services in 1986 in exchange for a payment of \$100 in 1984. The buyer should have \$10 of interest income in 1985. In 1986, she should have \$11 of investment income and a business expense of \$121, for a net deduction of \$110. If, instead, the deduction for the \$100 payment is allowed in 1986, the buyer has, in effect, deferred tax on \$10 of interest from 1985 until 1986.

The delay has the opposite effect on the seller. She indirectly gets the benefit of a deduction for interest by understating sales income. This understatement could not occur until the sales income would otherwise be reported. Therefore, the interest accrued in 1985 is not deducted until economic performance occurs. Whether such *substitute* taxation prevents tax avoidance again depends upon the relative tax rates of the seller and buyer.

44. I.R.C. § 7872 (West Supp. 1985), however, may apply full imputation to certain transactions which the parties view as equivalent to prepayments. The Conference Report states: "[A]ny transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans." H. R. REP. NO. 861, 98th Cong., 2d Sess. 1018 (1984). In 1985, Congress exempted from these provisions certain transfers to "continuing care facilities for the right to use the facilities for life." Act of Oct. 11, 1985, Pub. L. No. 99-121, § 201(a), 1985 U.S. CODE CONG. & AD. NEWS (99 Stat.) 511 (to be codified at I.R.C. § 7872(g)). There is no reason why § 7872 should not generally apply to prepayments regardless of whether a refund is potentially available.

45. I.R.C. § 461(i) (West Supp. 1985). Except where I.R.C. § 461(i) applies, the proper timing

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menting indirect taxation in those cases, but it took no action for other types of prepayments.

B. *Deferred Payments*

1. *Shifting of Income*

If payments are deferred, the issues are the same except here the implicit loan runs from the seller to the buyer, rather than in the opposite direction. Assume that an employee performs services on December 31, 1984, for which the employer would pay her \$100 at once. If the interest rate were 10% and taxes were not a consideration, the parties would be indifferent among payments of \$100 in 1984, \$110 in 1985 or \$121 in 1986. Taxes, of course, will make a difference. If the tax rate were 40%, an employee who received \$100 on December 31, 1984 would accumulate \$67.42 by December 31, 1986 ($100 \times .6 \times (1.06)^2$). Suppose, however, they agreed on deferral until 1986. If the transaction were taxed in accordance with its form, the employee who receives \$121 on December 31, 1986 would retain \$72.60 after tax, exactly the amount that would be accumulated if payment were made on December 31, 1984 and the net amount after tax (\$60) were invested at the pre-tax rate of return of 10% ($60 \times (1.10)^2 = 72.60$).⁴⁶ Thus, deferral of \$121 would be equivalent to exemption of investment income.⁴⁷

This exemption could, of course, be eliminated by accrual taxation—current imputation of both the compensation earned and the interest

of a deduction by a cash basis taxpayer for prepaid expenses, other than interest, is unclear. Deductions are not allowed to the extent they result in material distortion of income, and expenditures may not be deductible if they relate to an asset with a useful life extending substantially beyond the close of the taxable year. See S. REP. NO. 169, *supra* note 7, at 270-71.

46.

	Interest Taxable	Interest Non-taxable
a. Compensation	\$100.00	\$100.00
b. Income Tax (.4xa)	40.00	40.00
c. Net Income (a-b)	60.00	60.00
d. Interest - 1985 (.1xc)	6.00	6.00
e. Income Tax (.4xd)	2.40	—
f. Net Interest (d-e)	3.60	6.00
g. Accumulation - 12-31-85 (c+f)	63.60	66.00
h. Interest - 1986 (.1xg)	6.36	6.60
i. Income Tax (.4xh)	2.54	—
j. Net Interest (h-i)	3.82	6.60
k. Accumulation - 12-31-85 (g+j)	67.42	72.60

47. See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1126 (1974); Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 551 (1985). Prof. Andrews' article, by describing deferral in terms of exemption for investment income, probably first pointed toward the analysis that led to this Article.

thereon to the employee. This approach may not only be complex but also would require tax payment before cash is received. As before, it is therefore useful to inquire whether there is some indirect means of subjecting the employee-lender to tax on her interest income or whether tax avoidance can be prevented by substitute taxation of the employer-borrower as a surrogate for the employee.

In the case of deferred payment of compensation, the response to tax avoidance has been substitute taxation of the employer through imposition of a matching requirement, which denies an employer's deduction until the deferred amount is included in the employee's income.⁴⁸ But contrary to the emphasis of previous discussions, the conclusion reached here is that a matching requirement is neither necessary nor sufficient to prevent tax avoidance.

2. Matching

Matching on a cash basis is sometimes said to achieve correct taxation whenever a deduction foregone by a payor upon deferral of payment produces additional revenue that just offsets the revenue lost by deferring inclusion.⁴⁹ This equivalence is irrelevant, however. Because the employee's tax advantage stems from the treatment of investment income, if tax rates on investment income are the same, tax avoidance can be prevented by substitute taxation of the employer without matching the timing of the deduction and inclusion. If compensation is earned in year 0 and paid in year n, current law provides three different rules for determining when the employee has income and when the employer is entitled to the deduction: (1) both occur in year 0;⁵⁰ (2) both occur in year n;⁵¹ or (3) the employer's deduction is taken in year 0, while the employee reports income in year n.⁵²

The hypothesis advanced here is that if the tax rate for investment income is the same for both employee and employer, all three approaches can produce the same result.⁵³

48. I.R.C. § 404(a)(5) (West Supp. 1985).

49. See Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C. INDUS. & COM. L. REV. 739, 741 (1976) (erroneously describing benefits of matching). But see *id.* at 799 (correctly focusing on investment income).

50. I.R.C. §§ 402(b), 404(a)(5) (1982) (required for funded deferred compensation plans).

51. I.R.C. § 404(a)(5) (1982); Rev. Rul. 60-31, 1960-1 C.B. 174 (unfunded deferred compensation plans).

52. I.R.C. §§ 402(a), 404(a)(1)-(3) (West Supp. 1985) (required for funded qualified plans). The employer is not allowed a further deduction at the time of receipt by the employee, even though the amount paid exceeds the original deduction by the amount of investment income.

53. If the compensation is a capital item and not deductible immediately, rule 2 would be more favorable than either rule 1 or 3. See *infra* text accompanying note 118. If the employee's marginal tax rate is lower after retirement, she will benefit under both rules 2 and 3. For a discussion of such life time averaging, see *infra* text accompanying notes 159-61.

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a. *Equivalent Results*

These relationships can be illustrated with a simple numerical example. Consider an employee and employer who both face a marginal tax rate of 40%. The employee performs services for which she is due \$10,000 in year 0.⁵⁴ If she is paid currently in year 0 (rule 1) and the interest rate is 10%, she will be able to accumulate \$6,360 by the end of year 1 and \$6,741.60 by the end of year 2 ($.6 \times \$10,000 \times (1.06)^2$). Similarly, a taxable employer whose deduction is deferred (rule 2) will have \$6,000 to invest in year 0, the amount it would have been willing to spend after taxes on salary in year 0, and will therefore also accumulate \$6,741.60 by the end of year 2. After "grossing-up" by the tax savings on distribution, the employer will be able to pay the employee \$11,236 in year 2, which will again yield her \$6,741.60 after taxes.⁵⁵

Finally, assume that the employer receives the deduction in year 0 (rule 3), so it has \$10,000 to invest, which will compound to \$11,236 by the end of year 2 ($10,000 \times (1.06)^2$). This amount will be distributed as salary, so the employee will once again receive \$6,741.60 after taxes in year 2. Under all three rules, then, the taxable employer would have to provide \$6,000 of its own funds in year 0 and the employee would have accumulated \$6,741.60 in year 2.⁵⁶

54. The example may be illustrated as follows:

	Employer Invests		Tax if Distributed-40%		Employee Invests
Wages Year 0	\$10,000	less	\$4,000.00	equals	\$6,000.00
Income Year 1	+1,000				+600.00
Tax	<u>-400</u>				<u>-240.00</u>
Year 1 Accumulation	10,600	less	4,240.00	equals	6,360.00
Income Year 2	+1,060				+636.00
Tax	<u>-424</u>				<u>-254.40</u>
Year 2 Accumulation	11,236	less	4,494.40	equals	6,741.60

55. "Grossing-up" inflates an after-tax burden to a before-tax equivalent amount. For example, under rule 2 a deduction for the amount distributed, \$11,236, provides a tax savings of \$4,494.40 ($.4 \times \$11,236$). An employer can therefore increase the accumulated investment of \$6,741.60 by this amount upon distribution. The potential distribution equals the amount on hand divided by one minus the rate of tax.

56. These equivalences also can be demonstrated with simple algebra, where s is the amount of salary to be paid in year 0, t the applicable tax rate, r the pretax rate of return, and n the number of periods the payment is deferred. Under rule 1, the employer's after-tax cost in year 0 would be $(1-t)s$, which would yield the employee $(1-t)s[1+r(1-t)]^n$ in year n . Under rule 2, the employer would also set aside $(1-t)s$ in year 0, which would compound to $(1-t)s[1+r(1-t)]^n$ in year n . Because the amount paid in that year would be deductible, the employer would pay salary of $1/(1-t)$ times that amount, or $s[1+r(1-t)]^n$, which would yield the employee $(1-t)s[1+r(1-t)]^n$ after taxes. Under rule 3, the employer would receive the benefit of the deduction in year 0, so it could invest s , which would compound to $s[1+r(1-t)]^n$ in year n , which would be the amount paid as salary, as there would be no further deduction. As the salary payment is the same under both rules 2 and 3, the employee would again receive $(1-t)s[1+r(1-t)]^n$ after taxes. Under all three rules, the employer would incur an after-tax cost of $(1-t)s$ in year 0, and the employee would have accumulated $(1-t)s[1+r(1-t)]^n$ in year n .

b. *Explanation*

What explanation can be offered for the somewhat counter-intuitive result that deferral of the employee's receipt, coupled with a current deduction for the employer (rule 3), is no more advantageous than matched inclusions and deductions (rules 1 and 2)? The rules are equivalent because under all three the employee is fully taxed on the compensation and either the employee or employer is taxed on the investment income. Although the employee is taxed on investment income only under rule 1, the employer is taxed on investment income under both rules 2 and 3. Thus, rules 2 and 3 are equivalent forms of substitute taxation.

If the compensation is taxed when earned, \$6,000 remains after tax. The employee seems to have an advantage under rule 3 because \$10,000 is invested for her account rather than \$6,000 as under rules 1 and 2. But upon distribution, 40 percent of the fund will be paid to the government, so even under rule 3 only \$6,000 is effectively invested for the employee's account. Further, by viewing the deferred distribution as reflecting the original compensation and not earnings thereon, we can see that deferral does not reduce the tax on compensation. If the compensation (\$10,000) is taxed at the employee's marginal rate (40%) when it is earned (rule 1), the tax will be \$4,000 in year 0. If taxation of deferred compensation is delayed (rules 2 and 3), the 40% tax will not be collected until distribution, but it will be levied against the value of the accumulation at that time. Since the increase in tax exactly compensates for the delay, the deferred tax has the same present discounted value as the immediate tax.⁵⁷ Any tax advantage to the employee therefore, must arise from the failure to tax her investment income under rules 2 and 3. There is no tax advantage in this example, however, because investment income is taxed under all three rules at the same rate—under rule 1 to the employee and under rules 2 and 3 to the employer.⁵⁸

The additional tax on the employer under both rules 2 and 3 results from the denial of a deduction for interest paid for the privilege of defer-

57. At the after-tax rate of interest (6%), the tax on \$10,600 (\$4240) is exactly equal to what the employee would be able to accumulate by deferring for one year the tax on \$10,000 (\$4000). The analysis here corresponds to the conclusion elsewhere that the ability to defer tax on dividends by accumulating funds at the corporate level does not reduce the tax burden on distributions unless the funds can ultimately be withdrawn at lower rates or invested at higher rates in the interim. American Law Institute, Federal Income Tax Project, sub. C, at 350 (1982) (Reporter's study on the taxation of corporation distributions); C. MCLURE, MUST CORPORATE INCOME BE TAXED TWICE? 34 (1979) (citing D. Bradford, The Incidence and Allocation Effects of a Tax on Corporate Distributions, Center for Operations Research and Econometrics, Discussion Paper 7738 (Aug. 1977)).

58. This corresponds to the Treasury's demonstration that the advantage of qualified plans can be eliminated by an additional tax at the trust level on investment income. U.S. DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 56-58 (1977); see Sunley, *Employee Benefits and Transfer Payments*, in COMPREHENSIVE INCOME TAXATION, *supra* note 1, at 75, 84.

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ral. This treatment is obvious under rule 3 which limits the employer to a deduction in year 0 for the original amount of compensation. No deduction is allowed for the additional payment. This denial of a deduction also occurs under rule 2. Just as the entire amount included by the employee can be seen as the original \$10,000 compensation, so can the entire deduction to the employer. No deduction is allowed for interest.

This additional tax burden to the employer can also be said to arise from the investment income which it earns on assets that in other circumstances would be distributed to and invested by the employee.⁵⁹ Viewed from this perspective, substitute taxation is an inadequate solution not only when the employer is generally tax-exempt or is in a lower tax bracket than the employee, but also when the normal rate of corporate tax does not apply to particular investment income.⁶⁰ On the other hand, the fact that the employer is in a lower bracket than the employee will not create an advantage if investments are in tax-exempt bonds⁶¹ or other items, such as life insurance,⁶² exempt from tax without regard to the recipient's normal tax bracket.

c. *Implications*

Several conclusions are suggested by this analysis. First, deferred compensation would be correctly taxed if there were a special tax on investment income paid by the employer but at a rate equal to that of the employee. Since the employee is effectively taxed on the compensation despite deferral, a special tax on investment income would make the tax burden equivalent to that under accrual. This marriage of the substitute tax approach with what might be said to be an indirect tax on the employee is discussed in detail in Part III of this Article.

Second, the equivalence in result between rules 2 and 3 demonstrates that it is not essential to allow a deduction or require inclusion at any

59. If the employer merely substitutes borrowing from the employee for borrowing from other sources and does not increase its total assets, the additional burden on the employer is the extra tax, if any, caused by the loss of the deduction for interest.

60. This is the case when the income is from dividends on corporate stock or from gains on investment in the employer's own stock. See *infra* text accompanying notes 129-30; cf. Moore, *Compensation Planning: A Mathematical Analysis and Reference Guide*, 36 U.S.C. TAX INST. 4-1, 4-34, 4-36 (1984) (describing when deferred compensation is advantageous). Moore indicates the employee would also benefit from deferral if the employer could earn a higher pre-tax return than the employee. The pass-through of such benefits to employees is not a tax policy concern.

61. I.R.C. § 103 (1982).

62. Life insurance proceeds payable on death are exempt from tax. I.R.C. § 101(a) (1982). If a policy is surrendered, the amount by which the cash surrender value exceeds the premiums paid is subject to tax. However, this amount will be small, if not zero, because premiums include amounts paid for term insurance. McClure, *The Income Tax Treatment of Interest Earned on Savings in Life Insurance*, in JOINT ECON. COMM., 92D CONG., 2D SESS., THE ECONOMICS OF FED. SUBSIDY PROGRAMS, PART 3: TAX SUBSIDIES 375 (Comm. Print 1972).

particular time. The timing can be flexible as long as the amount of the item is adjusted to achieve an equivalence in the present discounted value of the income or deduction. Allowing a deduction for deferred compensation in year 0, however, may require estimates of the amount and timing of future distributions and the proper discount rate, creating dangers of overdeduction.⁶³

Third, permitting a deduction in year 0 while deferring inclusion until year *n* leaves more funds in private hands in the interim, as compared with matching the deduction and inclusion in year *n*. These last two matters are discussed in the next Section, which deals more generally with estimated deductions.

3. *Summary*

Deferred payments present exactly the same analytical issues as accelerated payments with respect to the shifting of investment income. Because matching has long been thought to be an adequate response in certain cases of deferral, we have considered in detail whether such rules deal adequately with tax avoidance. While a matching requirement can be useful, for example, to preclude an increase of funds in private hands, it is neither a sufficient nor a necessary response to the shifting of investment income. Indeed, the limited usefulness of matching has not been generally appreciated in the design of tax policy.

The 1984 Act makes several changes with respect to deferred payments. Nevertheless, there are still many opportunities for taxpayers to shift income by deferring payments. The next three Sections examine three provisions of the 1984 Act in light of the investment income approach. Two of these provisions—welfare benefit trusts and installment sales—explicitly involve efforts to require more matching of income and deductions. The third, premature accruals, is particularly interesting because in providing alternative treatment of certain costs, Congress at least implicitly recognized the above-described equivalency of deduction of cash when paid and current deduction for the present value of the ultimate payout (discounted at the after-tax rate of interest).

63. No such estimates were required in the example. Since the employee was entitled to the accumulated fund, the amount set aside equalled the present value of the distribution. This equality would not be true, for example, if the employee were promised a specified annuity, particularly if the beginning and end of such payments were uncertain.

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C. *Premature Accruals*

1. *In General*

In 1984, Congress became concerned that taxpayers could claim a current deduction for the full amount of future liabilities even though payment would not occur for a number of years.⁶⁴ The problem was generally described as involving "premature accruals" in that accrual basis taxpayers could arguably accrue deductions for future payments without discounting those payments to present value.⁶⁵ Examples include the future costs of restoring land disturbed by mining⁶⁶ and payments to be made for a term of years in settlement of workers' compensation⁶⁷ or tort claims.⁶⁸ Congress did not directly require discounting,⁶⁹ but rather sought to postpone deductions until closer to the date of payment by imposing a new requirement of "economic performance" as a condition for deduction under accrual accounting.⁷⁰ This condition to which I will refer as "statutory economic performance," in most situations only requires performance of the task to which the deduction relates. In the case of tort

64. S. REP. NO. 169, *supra* note 7, at 266.

65. For an analysis, including a discussion of the authority of the IRS to require discounting to present value, see New York City Bar Ass'n, *Transactions Involving Deferred Payment of Accrued Liabilities*, 20 TAX NOTES 699 (1983).

66. Federal and state laws and certain municipal ordinances require reclamation of surface mines and waste disposal sites. The Internal Revenue Service took the position that expenses could not be accrued until reclamation occurs. Notwithstanding the Service's position, the Tax Court in *Ohio River Collieries v. Commissioner*, 77 T.C. 1369 (1981), held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the surface soil was removed.

67. The Ninth Circuit held that liability for uncontested workers' compensation claims could be deducted in the year in which the injury occurs even though medical services may be rendered and disability may occur at a future time. *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772 (9th Cir. 1975).

68. Under old law a tortfeasor who agreed to pay her victim \$5 million a number of years after settlement, may have been allowed to deduct \$5 million at the time of the agreement without discounting to the present value. See New York City Bar Ass'n, *supra* note 65, at 701; see also McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 TAXES 251 (1982).

69. Taxpayers in some circumstances cannot claim an undiscounted present deduction for a long-term future liability. If the liability arises out of the purchase of property, the interest element must be separately stated in almost all circumstances. I.R.C. §§ 483, 1274(c) (West Supp. 1985). *But see* I.R.C. § 483(c)(1)(A), (d) (West Supp. 1985) (for exceptions). If the deferred liability is for services, deduction must normally await payment. I.R.C. § 404(a)(5). If the liability arises out of the use of *tangible* property and there is a delay in payment beyond the end of the first calendar year following the calendar year of use, rent is determined by discounting to present value. I.R.C. § 467 (West Supp. 1985). *But see* I.R.C. § 467(d)(2) (exception for transactions not exceeding \$250,000). Would there be any significant cases not covered by these provisions? Suppose the prize on a TV game show is \$10,000 per year for 20 years. Can \$200,000 be deducted immediately or does I.R.C. § 404(a)(5) apply? Suppose \$10,000 per year is the prize in an advertiser's "sweepstakes." Have any services been performed? Of course, there may be a "common law" prohibition against undiscounted deductions, at least in extreme circumstances. *Mooney Aircraft v. United States*, 420 F.2d 400 (5th Cir. 1969); see also New York City Bar Ass'n, *supra* note 65, at 710-12.

70. I.R.C. § 461(h) (West Supp. 1985).

liability or workers' compensation,⁷¹ however, it requires actual payment before a deduction can be taken. In the latter circumstances, accrual taxpayers are effectively required to use cash basis accounting.

a. *Premature Accruals as Examples of Income-Shifting*

Although the problem of premature accruals has not generally been thought to involve the avoidance of tax on investment income, the 1984 legislation can be approached from this perspective. In these terms, the new rules generally tax investment income to the payor up to the point at which statutory economic performance occurs. This result is illustrated by the deferred payments that follow the "structured settlement" of a law suit.

A patient sues a doctor for malpractice. A \$1000 settlement is agreed upon, but the doctor suggests delaying payment for 3 years. The patient agrees, provided the amount is increased to \$1331, because the interest rate is 10%.

Prior to the 1984 Act the doctor may have asserted a right to deduct \$1331 at the time of settlement. It should be clear, however, that the value of the claim at that time is only \$1000; the remainder of the payment represents interest. If the doctor can deduct \$1331 at the time of settlement, she in effect takes a current deduction for interest which has not yet accrued, thus overstating her actual interest expense.⁷² Full implementation of the Haig-Simons ideal would allow the doctor to deduct only \$1000 at the time of settlement, with subsequent deductions for implicit interest of \$100 in year 1, \$110 in year 2, and \$121 in year 3.

The 1984 legislation, however, defers the entire deduction until payment. As we have seen, this approach is equivalent to allowing a deduction for the present value of the liability in year 0, the year of settlement, and thus effectively denies the doctor a deduction for interest. The justification may be substitute taxation. If the patient were to receive \$1,000 immediately, she would be taxable on the return from investment of this amount. Congress, however, has recently enacted legislation that specifically exempts the recipient of a deferred tort settlement from taxation of any component due to interest.⁷³ Limitations on the deductions allowed to

71. I.R.C. § 461(h)(2)(c)(i), (ii) (West Supp. 1985).

72. In some circumstances, the tax benefit from the deduction could actually exceed the present value of the liability, making it worthwhile to create liabilities. See Gunn, *supra* note 42, at 1, 26.

73. I.R.C. § 104(a)(2) (West Supp. 1985). The easy passage of this legislation probably reflects the assumption that it was merely declaratory of existing law as well as a failure to consider its implications. Cf. PRESIDENT'S PROPOSALS, *supra* note 4, at 267-68 (stating that such interest income should be taxed).

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the doctor can be seen as a way of subjecting her to tax on income accruing for the benefit of the patient, who would otherwise avoid tax on this investment income.⁷⁴

b. *Insured Arrangements*

Such substitute taxation may not be achieved, however, if an intermediary is involved. For example, rather than setting aside \$1000 at the time of settlement, the doctor may transfer \$1000 to a third party who assumes the liability to the patient. The cash transfer of \$1000 is the true economic obligation of the doctor. If the doctor can immediately deduct the payment to the third party, she is no longer over-taxed on investment income. Unless the third party is subject to the same treatment as an uninsured doctor, it also could avoid tax on such income.⁷⁵

Similarly, if the doctor is insured against malpractice and deducts premiums currently, she will not pay tax on the income earned between the time the premium is turned over to the insurer and the time of payment to the injured party. Since the insurance company can set up a reserve to cover the undiscounted amount of liability from anticipated claims,⁷⁶ it will not be taxed on the investment income either. In fact, since the company immediately deducts the equivalent of \$1331 in our example, its deduction for interest exceeds the value of investment income, resulting in a negative tax on such income. Under present law, therefore, there is a definite bias in favor of insured arrangements. President Reagan's tax reform proposal would eliminate this bias by subjecting the insurance company to a tax on investment income.⁷⁷

74. Presumably the doctor will only credit interest at her after-tax rate. If the doctor's marginal rate is 40%, the payment in year 3 would be \$1191, not \$1331.

75. PRESIDENT'S PROPOSALS, *supra* note 4, at 266-67. See I.R.C. § 130 (West Supp. 1985) (under which the third party would apparently avoid tax on investment income).

76. PRESIDENT'S PROPOSALS, *supra* note 4, at 266.

77. *Id.* at 268-69. Interestingly, it would allow insurance companies to continue to deduct undiscounted reserves, *see id.* at 270 (discussing reasons for this approach), but would recapture this benefit by subjecting the unused reserve, after crediting interest thereon, to tax once all claims are satisfied, *id.* at 268. As described below, *infra* text accompanying note 96, under certain circumstances this approach can fully compensate for even an erroneous deduction.

Under the President's proposal, on the other hand, a third-party assignee could not effectively deduct more than the discounted value of its obligation, although it also could choose the time of deduction under rules designed to tax it on investment income. *Id.* at 269.

The approach taken in this Article is also useful in analyzing other Reagan proposals relating to insurance. Life insurance reserves would be limited to the cash surrender value of the policy and interest thereon would be taxed to the policyholder. *Id.* at 262. If the cash surrender value proves to be an inadequate reserve, additional expenditures would be deductible when made. We know from the consideration of deferred compensation that this approach taxes the investment income at the company level. Would this be a proxy for the policyholder's income or an indication that to this extent the return on the reserve inures to the company?

For an interesting application of the idea that discounting can be avoided by taking account of items of income or deduction in the year of payment, consider the treatment of a business taxpayer who

2. Nuclear Decommissioning Expenses

Under the requirement of statutory economic performance as a condition for deduction, the operator of a nuclear plant, who is required to decommission⁷⁸ the plant upon closing, could not deduct decommissioning expenses until the work was actually performed. Affected taxpayers have argued, however, that these costs must be met out of current operations and should be deducted over the period the power plant is operated.⁷⁹ In response, Congress enacted a special provision in 1984, allowing an election to deduct amounts set aside for future costs.⁸⁰ Although the amount ultimately spent would exceed the amount originally set aside, reflecting investment income earned in the interim, no further deduction is allowed. In effect, eligible taxpayers were given a choice between the two methods of imposing a substitute tax on the payor of deferred compensation, described above as rules 2 and 3.⁸¹

The legislation thus arguably over-taxes the nuclear power company, perhaps again as a substitute for not taxing the beneficiary of the funds which are set aside. The rationale for taxing the nuclear power company as a substitute is presumably that the ultimate beneficiaries of income earned by the fund are either not identifiable or cannot be practicably taxed. However, there is also an argument that the payor's increasing liability in this case is not matched by investment income that should be taxed to anyone. Consider this example:

A nuclear plant will be decommissioned in year 3, when \$1331 will be required to clean up the nuclear waste created by operation in year 0. The interest rate is 10%, so the present value of that obligation in year 0 is \$1000 if the fund's income is untaxed.⁸² When should the plant recover the cost of decommissioning?

Some analysts have argued that although the plant incurs imputed interest (\$100 in year 1, \$110 in year 2, and \$121 in year 3) on its out-

incurs \$1,000 of property damage on December 31, 1985, but will not be reimbursed by her insurance company until December 31, 1986. Such a taxpayer has a loss equal to the difference between \$1,000 and the present value (at the after-tax rate of interest) of the \$1,000 payment to be received in one year. The Administration suggests that discounting be avoided by allowing the full \$1,000 loss in 1985 and including the \$1,000 payment in income when received. *Id.* at 271.

78. Decommissioning requires either dismantling or sealing the plant to minimize the hazard from radioactive materials.

79. Letter from William McCollam, Jr., President, Edison Electric Inst., to John E. Chapoton, Treas. Ass't Sec. for Tax Policy (Aug. 16, 1983), reprinted in 20 TAX NOTES 818 (1983) (discussing tax treatment of nuclear plant decommissioning cost).

80. I.R.C. § 468A (West Supp. 1985).

81. See *supra* text accompanying notes 50-52.

82. If the fund is taxed, and therefore discounted at the after-tax rate of 6%, the present discounted value is \$1117.53.

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standing liability, there is no corresponding asset and hence, no offsetting interest or investment income that should be taxed to someone else.⁸³ This view considers the nuclear waste to be cleaned up in year 3 as a net loss to society, which has a present burden in year 0 of \$1,000, with the burden increasing each year by the imputed interest. This view suggests that the nuclear power company should deduct \$1000 in year 0 and the imputed interest in years 1-3.⁸⁴

An alternative perspective on this transaction would be that there is income each year, but not income that should be taxed. If the \$1000 obligation imposed on the power plant in year 0 is due to the burden borne by society for the increasing proliferation of nuclear waste that will require decontamination in year 3, society also holds an asset worth \$1000 in year 0, which is the power company's obligation to clean up the plant in year 3. As the power company's obligation increases in years 1-3, so does the value of society's corresponding asset. On the other hand, the return on that asset may not be a return that should be taxed, because it simply substitutes for a return that would not generally be taxed, such as the enjoyment of an environment free of nuclear waste.

A final perspective takes us full circle. If there is current damage or foreseeable future damage, but society has agreed to require only a clean up of \$1331 in three years, should not the tax system consider the actual cost to the power company to be \$1331 in year 3? From this perspective, the 1984 legislation appropriately restricts the power company to a deduction in year 3 or its equivalent in present value. Because society does not get any benefit until year 3, the benefit of the earnings from any amount set aside inures to the power company and the company is properly taxed for that benefit.

The difficulty with the last perspective may be that it sanctions discrimination between two means of avoiding damage that would have been equal in a no-tax world. Thus, if it would cost \$1000 in year 0 to prevent nuclear waste, a power company would be indifferent (as a matter of cost) between that approach and spending \$1331 in year 3. However, if expenses are not deductible until year 3, the latter course is less desirable.⁸⁵ This may be just a further example of how an income tax might discrimi-

83. See Kiefer, *The Tax Treatment of a 'Reverse Investment': An Analysis of the Time Value of Money and the Appropriate Tax Treatment of Future Costs*, 26 TAX NOTES 925, 928 (1985).

84. See Aidinoff & Lopata, *Section 461 and Accrual Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future*, 33 TAX LAW. 789 (1980). Sunley refers to this as economic depreciation. See Sunley, *Observations on the Appropriate Tax Treatment of Future Costs*, 22 TAX NOTES 719, 720 (1984).

85. Sunley, *supra* note 84, at 719-23; *Hearings on Timing and Measurement of Taxpayer Deductions for Obligations to be Paid in the Future Before the Subcomm. on Oversight of House Comm. on Ways and Means*, 98th Cong., 2d Sess. 105 (1984) (statement of Gerard M. Brannon).

nate against future as compared to current expenditures,⁸⁶ but some believe that this discrimination should be limited to consumption and not extended to business outlays. Under this view, an income tax appropriately treats a current obligation to pay \$1331 in three years as more costly than a \$1331 obligation arising at the time of payment. Similarly, it would more heavily tax a corresponding right to receive \$1331 in year 3 than as compared to a right which arose just before payment.⁸⁷

To summarize, there are at least four different ways to characterize transactions typified by nuclear decommissioning expenses: (1) the power company's increasing obligation is matched by someone else's investment income that escapes taxation, so it is appropriate to tax the power company as a surrogate, as under the 1984 Act; (2) there is no income that corresponds to the power company's imputed interest, so such taxpayers are over-taxed by the 1984 legislation; (3) there is corresponding income, but it is not the type of income we normally tax, so the power company should not be taxed as a surrogate; and (4) whenever the physical damage occurs, the liability rules fix damage in the year of payment, so the 1984 legislation is correct. It may be that each of these four paradigms applies to different transactions.⁸⁸

3. *Mining Reclamation Expenses*

Mining reclamation costs are subject to the same analysis as nuclear power plant decommissioning costs. The statutory mechanism enacted in 1984 for mining reclamation, however, differs from that governing nuclear plant decommissioning.⁸⁹ Taxpayers are permitted current deductions for

86. See Andrews, *supra* note 47, at 1114-18 (discussing how income tax distorts saving and consumption choices).

87. I am indebted to the participants of the March 30, 1985, seminar at Harvard Law School, particularly Professor David Bradford, for this insight. I am not sure of my reaction but I believe it may depend upon the values that cause one to favor an income tax over a consumption tax or vice versa. This is a complex issue well beyond the scope of this paper. For the most comprehensive analysis of this issue, see Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1083 (1980). Initially at least, I am not necessarily troubled by the potential asymmetry.

88. These four characterizations could also apply to a modified version of the earlier malpractice example:

A doctor performs 1000 operations per year. She knows that one patient is likely to sue successfully for malpractice. Deciding to self-insure, she sets aside \$1000 of her current income, which, in the absence of tax, will grow to \$1331 by year 3 when the suit will end. Who should be taxed on the income earned on that fund? The doctor, the injured patient (who is as yet unknown), all patients, no one?

Previously, when the set-aside coincided with settlement, we considered only the first paradigm. But the future liability may also be viewed as a net loss to society, or the patient's return could be viewed as replacing the return on human capital which would not be taxed. On the other hand, the 1984 legislation may correctly tax a doctor who pays upon settlement if we view her liability as arising in that year.

89. I.R.C. § 468 (West Supp. 1985).

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future reclamation in the amounts that would be incurred if the reclamation costs were performed currently. These amounts are deemed deposited in a sinking fund that earns interest at specified, apparently pre-tax rates.⁹⁰ The fund is then used to measure whether the taxpayer has claimed too great a deduction.⁹¹ The rationale for this elective mechanism is difficult to understand, for it actually treats a taxpayer less favorably than the general rule for deferred deductions, unless the taxpayer's after-tax rate of return exceeds the pre-tax rate of return assumed by the statute.⁹²

4. *Alternative Means of Substitute Taxation*

The 1984 legislation and President Reagan's tax proposals are consistent in the area of premature accruals in their effort to tax the obligor on investment income by effectively denying an interest deduction. But there is a confusing variety of approaches to achieving the desired result. Sometimes a deduction is allowed only when the claim is paid or statutory "economic performance" otherwise occurs; sometimes a taxpayer may elect a smaller, earlier deduction, equal to the present value of the liability; and sometimes an immediate deduction is allowed for the full value of the future liability. The analysis of deferred compensation demonstrated that, despite a temporary difference in the amount of money in private hands, the first two approaches can be equivalent.⁹³ The third method can also achieve an equivalent result by correction of the earlier error.

One reason for the Treasury to prefer the deferred deduction approach generally adopted by the 1984 legislation is that this approach does not require advance knowledge of the payment date, the payment amount, or the discount rate.⁹⁴ On the other hand, the possibility of an erroneous estimate need not damage either the taxpayer or the Treasury, if there is a procedure to correct errors. Given such a procedure, we can view any

90. After a short phase-in period, these funds will be considered to earn the "Federal short-term rate" determined under I.R.C. § 1274 (West Supp. 1985). I.R.C. § 468(a)(2)(B)(i)(I) (West Supp. 1985).

91. The "balance" of the fund, including imputed interest at the end of each tax year, is limited to the current cost of reclaiming land that has been disturbed but not previously reclaimed. Amounts in excess of this limit are deemed withdrawn and are included in taxable income for the year. If the amount paid for reclamation or closing activities exceeds the year-end "balance," the excess is deductible when paid. I.R.C. § 468(a) (West Supp. 1985).

92. The Administration-proposed repeal suggests there is an unwarranted subsidy to mining resulting "in a reduced effective tax rate for those companies that find the special tax treatment to be advantageous for them." PRESIDENT'S PROPOSALS, *supra* note 4, at 221. This is obviously a tautology.

93. See *supra* text accompanying notes 52-6.

94. See, e.g., *Hearings on S. 237 and S. 1006 Before the Subcomm. on Energy and Agricultural Taxation of the Senate Comm. on Finance, 98th Cong., 1st Sess.* (statement of William S. McKee, Acting Deputy Assistant Treasury Secretary for Tax Policy), reprinted in DAILY TAX REP. (BNA) No. 100, at J-5 (May 23, 1983).

initial under or overpayment of tax—caused by an erroneous estimate or by a failure to recognize a liability or income on accrual—as a loan, from the government to the private parties or vice versa, to be repaid with interest at the rate earned by the private parties.

To illustrate, the employer in the compensation example who was denied an immediate deduction for the accrued compensation of \$10,000 in effect made a \$4,000 loan to the government. The tax savings from a deduction of \$10,600 in year 1 (\$4,240) reflected a return on the \$4,000 loan at the 6% after-tax rate of interest.⁹⁵

Alternatively, assume a taxpayer claims a deduction for \$100, which turns out to be entirely erroneous. If the taxpayer is in the 40 percent bracket, she has inappropriately obtained \$40 from the Treasury. However, any advantage from an erroneous estimate can be eliminated if the estimated amount (\$100) is kept separate and any unused sum, together with interest thereon, is included in income when it is no longer needed. Suppose the fund resulting from a \$100 set-aside increases over time to \$300, when it is determined that the expenditure will not be made. If the fund is then taxable and the taxpayer remains in the 40 percent bracket, the tax liability becomes \$120. The taxpayer would retain \$180 and the Treasury would receive \$120, each tripling their original investment. The loan would be repaid at an interest rate reflecting the taxpayer's rate of return on investment.⁹⁶

The conclusion that underpayment or overpayment of tax in these circumstances is rectified with interest does not, however, necessarily mean we always should be indifferent between current and deferred payments. In the above examples the private party either pays or receives interest at the rate it earns in the transaction. Under these circumstances, whether the government is better off as a borrower or lender depends on whether this rate of interest is more or less than the rate of interest normally payable on government borrowing.⁹⁷ If the government pays a lower interest rate than that earned in the private sector, the Treasury gains by borrowing at the normal government rate to lend at the higher rate. Conversely, the government loses when it borrows at a private sector rate which is higher than its normal rate. On average, assuming that the private sector rate is set at arms length, the rate of return in the private sector should exceed the Treasury's cost of funds.⁹⁸ This suggests in the long run the

95. If the fund were taxable at a special rate as proposed in Part III, the increase in the fund would not reflect the employer's after-tax rate of return, if she were subject to a different rate.

96. See PRESIDENT'S PROPOSALS, *supra* note 4, at 266-73 (suggesting such a procedure for treatment of property and casualty insurers).

97. INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* (1978) (Report of a Committee chaired by J. Meade).

98. At first glance it may appear that the government's "return on the investment" is at the after-

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government does not gain revenue if it “borrows” by denying a doctor, employer or nuclear power plant a deduction for accrued expenses; nor does it necessarily lose when it “lends” by deferring inclusion of an employee’s income or even when it allows an erroneous deduction subject to future correction. But it may be difficult to insure that such correction will occur. Moreover, rules to prohibit self-dealing would be needed to assure that the private sector rate earned by the government will reflect an arms-length transaction.⁹⁹ Finally, the government is not necessarily ready and able to loan to all comers with a flexible date for repayment even if market rates are charged.

On the other hand, taxpayers are not always made whole by the deferred deduction. A taxpayer with insufficient income in the year the deduction is allowed, including the loss carryback period, loses all or part of the benefit of the deduction and the prior overpayment of taxes is not fully offset. Even where there is reasonable assurance that taxes paid may eventually be recovered with interest, taxpayers may be placed at a disadvantage by not being allowed to deduct accrued liabilities. Thus taxpayers, like the nuclear power companies who must satisfy statutory or regulatory reserve requirements to guarantee their ability to meet future liabilities, may be unable to meet their obligations by setting aside after-tax amounts subject to gross-up by the tax savings from a future deduction. In other words, they may not be able to treat the “loan” to the Treasury as an asset, forcing them to set aside additional cash from other sources.

To recapitulate, any of these approaches can accomplish the goal of taxing investment income to the payor and produce identical results, provided there is a procedure to correct for errors in estimates. An immediate deduction, if correctly determined, would allow the accrued expenses to be deducted in the year in which the related income is earned. Deferral until payment, on the other hand, avoids the risk of over-deduction by taxpayers and protects the Treasury in those cases, such as deferred compensation, in which the tax on the other party to the transaction is deferred. The third approach—immediate deduction without discounting—seems to be based on the assumption that we can estimate the amount of future expenditures, but either the timing of such expenditures or the interest rate is too uncertain to make discounting to present value feasible. There can be no justification for this approach. The time of an expenditure gen-

tax rate of interest (6% in the deferred compensation example) while the cost of borrowing would be at a pre-tax rate (presumably lower than 10% but probably higher than 6%). However, the actual return on the deferred tax is at the pre-tax rate—the additional amount is collected by taxation of the additional investment income. Conversely, since interest is taxable, the net cost of borrowing may be said to be the after-tax rate.

99. See, e.g., I.R.C. § 468A(e)(5) (West Supp. 1985) (prohibiting self-dealing in case of nuclear decommissioning fund).

erally seems no harder to estimate than the amount and a choice of a proper interest rate may well be easier. Certainly we can come closer to the proper amount than we can by not discounting at all. Thus, the third approach is unwarranted. The choice between the first two approaches depends on the accuracy with which the future payment (or its present value) can be predicted, administrative concerns, and the allocation of risk between taxpayers and the Treasury.

5. *Summary*

Three major points emerge from the foregoing discussion. First, the "premature accrual" issues addressed by the 1984 legislation are additional examples of the general problem of proper taxation of investment income. Second, the 1984 Act does not require full imputation of the relevant flows, but often taxes the payor on investment income that benefits the payee. Third, assuming that the payor is to be taxed as a substitute, the choice between the two methods of accomplishing that result depends on administrative considerations.

D. *Welfare Benefit Plans*

The general postponement of deductions for deferred compensation until the payment is received by, and taxable to, the performer of services has not generally been applied to welfare benefits, such as medical benefits, life insurance, and supplemental unemployment benefits.¹⁰⁰ In addition, such benefits can be provided through tax-exempt trusts.¹⁰¹

In 1984, Congress was concerned about undue acceleration of the deduction and overfunding of these trusts to take advantage of the tax-exemption.¹⁰² As a result, the 1984 Act subjects unfunded welfare benefits to the rules applicable to deferred compensation¹⁰³ and limits deductions for contributions to trusts to amounts needed for current benefits plus specified reserves.¹⁰⁴ If excessive funding occurs, not only is the deduction

100. Treas. Reg. §§ 1.162-10 (1960); 1.404(a)-(1)(a)(2) (1963). See *Greensboro Pathology Assocs. v. United States*, 698 F.2d 1196 (Fed. Cir. 1982) (employer's educational trusts not deferred compensation). But see *Presto Prods., Inc. v. United States*, 571 F. Supp. 1171 (N.D. Ga. 1983) (sick leave plan is deferred compensation).

101. I.R.C. § 501(c)(9) (West Supp. 1985).

102. See STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 804 (Comm. Print 1984); Halperin, *supra* note 7, at 754.

Congress was also concerned about the deduction for contributions to be used for the acquisition of capital items such as child care facilities. See I.R.C. § 419(c)(3)(C) (West Supp. 1985) (limiting such deductions). The tax advantage in providing capital items through a tax-exempt trust is a tax-exemption for the imputed income from allowing use of the facilities, similar to what would occur if the assets were invested and earned tax-free income used to pay for child care.

103. I.R.C. § 404(b)(2) (West Supp. 1985).

104. I.R.C. § 419 (West Supp. 1985).

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deferred, but the trust is made subject to tax on all or part of its investment income.¹⁰⁵ Moreover, when the deferred deduction is allowed, it will be measured by the amount contributed, rather than the amount of the accumulation.¹⁰⁶

Employers have criticized this legislation as precluding adequate funding, claiming that prefunding was essential to guard against events that might cause an unusually large liability in one year.¹⁰⁷ As should now be obvious, the advantage of these plans derives from the exemption of trust income, rather than the earlier deduction. Thus, denial of the deduction at the time of contribution should not in itself systematically affect the amount of funding.¹⁰⁸ Limiting the deduction to the initial contribution despite deferral would seem improper and a detriment to funding, however, unless it serves as a proxy for taxing the employer on the trust's investment income.¹⁰⁹

The 1984 legislation apparently creates a penalty for overfunding by taxing that income twice: once directly to the trust and once indirectly to the employer. Although the income is effectively taxed twice, the applicable rate in each case may be inadequate. The trust rate may be lower than the employer's rate and the indirect burden on the employer is deferred until the deduction is allowed (perhaps at the time of distribution).¹¹⁰ If Congress is concerned about overfunding, a preferable approach would be to tax excessive trust investment income at the employer's rate, while measuring the delayed deduction by the amount of the payout, rather than the original contribution.

E. *Installment Sales*

Deferred payments for the sale of property, often termed installment sales, are another example of disguised loans. The transaction, like deferred compensation, can be disaggregated into a sale for cash and a loan from seller to buyer. It differs, however, from the deferred payments previously considered in two respects: (1) the buyer's expense is often capitalized and not immediately deducted; and (2) the seller's receipts are not

105. I.R.C. § 512(a)(3)(e) (West Supp. 1985).

106. I.R.C. § 419(d) (West Supp. 1985).

107. See Employer Benefit Research Institute, *Employer-Paid Retiree Health Insurance: History and Prospects for Growth*, Issue Brief No. 47 (Oct. 1985), at 6.

108. See *supra* text accompanying note 54.

109. See *supra* text accompanying note 37. As in the case of prepayments, deferral of a deduction while limiting it to the initial outlay would result in *indirect* taxation of investment income to the payor.

110. See *supra* text accompanying note 43. As is true of multiyear prepayments, the indirect tax is not complete because investment income is not taxed currently. Instead, it is deferred until a later year when a deduction is reduced.

fully taxed because a portion may represent recovery of her investment or partially taxed capital gain.

Longstanding provisions of the Internal Revenue Code permit sellers of property to defer gain until payment is received,¹¹¹ with a portion of the deferred payment characterized as interest.¹¹² The 1984 Act affected this practice in two ways: First, income from depreciation recapture must be reported on sale.¹¹³ Second, interest must be accrued under the rules for original issue discount, which were extended to sales of property.¹¹⁴

While the 1984 legislation improved the situation, the installment reporting provisions remain inconsistent with the full accrual approach. Even if the deferred payment is correctly divided into principal and interest components using the original issue discount rules, the seller will benefit from continued deferral of taxation, and hence effective exemption for investment income, on the taxable portion of the principal amount of the implicit loan which could be far larger than the appropriately taxed interest element. This case differs from others discussed in this Article because there is no shifting of income from one taxpayer to another. The analysis in this Article is, however, germane because it suggests that substitute taxation of the buyer or indirect taxation of the seller might be alternatives to full imputation of the relevant flows.¹¹⁵

As was true with deferred compensation, the buyer could be taxed as a surrogate for the seller by denying the buyer a deduction for interest with respect to the acquired property.¹¹⁶ In the case of deferred compensation, the denial of an interest deduction could be accomplished in two distinct ways. First, the employer could be granted an immediate deduction for the compensation as accrued but no further deduction to reflect the larger payment actually made. Second, the employer could be allowed a deduction upon payment for cash paid. As previously described, the cash payment, although larger, is equivalent in present value terms to the original compensation so that a deduction for the cash payment equals a deduction for the original compensation.

Our earlier discussion assumed, however, that compensation would be

111. I.R.C. § 453 (1982).

112. I.R.C. § 483 (adopted 1964).

113. I.R.C. § 453(i) (West Supp. 1985). The "recapture rules," e.g., I.R.C. § 1245 (West Supp. 1985), generally require that gain be treated as ordinary income, rather than capital gain, to the extent that the gain occurs because the basis for determining gain has been reduced by depreciation deductions. The buyer could be said to be depreciating the same cost over again and the 1984 Act does not allow that to occur without first "recapturing" the seller's deduction.

114. I.R.C. § 1274(c) (West Supp. 1985). For the 1985 exceptions to these rules, see *supra* note 8.

115. See I.R.C. §§ 667(a)(3), 668 (West Supp. 1985) (effecting full taxation on foreign trusts income through explicit interest charges for deferral of taxes).

116. See *supra* text accompanying notes 58-59.

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currently deductible and did not consider a capital item which should be included in basis. For capital items, under the first approach the value of the services or the purchase price of the property would be added to basis rather than deducted immediately.

Treatment of a capital item under the second approach is more difficult.¹¹⁷ If an immediate cash payment would have been capitalized (and therefore not immediately deductible), a deduction upon deferred payment for a larger amount would be more valuable. For example, suppose a payment of \$10,000 in year 0 would have permitted a deduction of \$5,000 each in years 0 and 1. It should be clear that a \$10,600 deduction in year 1, which is equivalent to an immediate deduction of \$10,000, is more valuable than \$5,000 per year for two years. To reach the correct result in this case, the date of payment should be treated as the date of acquisition. Thus, the larger deferred payment should be included in basis at the time of payment and depreciated at the same rate (e.g., straight-line) as an immediate payment. In the preceding example, deducting \$5,300 in years 1 and 2 is equivalent to deducting \$5,000 in years 0 and 1.

The second approach could be quite complex.¹¹⁸ The first approach to denial of the interest deduction is more promising even though it may require an estimate of the purchase price of the property. Such an estimate will often not be difficult and is in fact already made for purposes of separating interest and principal.¹¹⁹

But there is a complication with installment sales not present with deferred compensation. Recall that denial of an interest deduction is intended to impose a substitute tax on the buyer to compensate for the tax avoided by the seller. The seller, however, because of an offset for basis

117. Because I.R.C. § 404 (1982) refers to deductions otherwise allowed under I.R.C. § 162 or 212, apparently it is believed that § 404(a)(5) does not apply to postpone deductions claimed under other sections through recovery of basis. See STAFF OF THE JOINT COMMITTEE, *supra* note 102, at 291. Thus, under I.R.C. § 467(g) (West Supp. 1985), the IRS would currently have the regulatory authority to impute interest income, but not principal, to the employee. Even if the principal is not accrued, the employee can be fully taxed by including the value of the compensation in income upon distribution. When the tax is paid at the employer level, as under rules 2 or 3, this can be measured by the amount distributed. However, when the employee pays the tax on income, the fund held by the employer will grow at a pre-tax rate and using the fund to measure compensation will overstate the value. On the other hand, since investment income is explicitly taxed to the employee, taxpayers are likely to believe that only the original amount of compensation should be subject to tax on distribution. Taxing this amount despite the delay will retain most of the advantage of deferral. How does one explain that the "correct" taxable income is the amount that would have been in the fund if the tax on investment income were paid from that source?

118. For example, if the purchase is a nondepreciable item, such as vacant land, Treas. Reg. § 1.167(a)-2 (1956), equivalent treatment requires recovery of the larger basis at an interim following resale that equals the delay between initial acquisition and payment.

119. I.R.C. § 1274 (West Supp. 1985). But query whether the pre-tax rate of interest is appropriate. Since the buyer will be taxed on this interest, it will presumably pay only an after-tax rate. If nevertheless the discount is at a pre-tax rate, the principal will be understated. It also is not obvious how the proposed approach would apply to contingent payments.

and the capital gain exclusion, may only benefit from deferral as to a portion of the selling price. To compensate for the seller's advantage, therefore, it is only necessary to deny part of the buyer's interest deduction, *i.e.*, the amount allocable to that portion of the proceeds equal to the deferred gain. The relevant portion is not easy to identify.¹²⁰

Another approach would indirectly tax the seller on investment income by denying a deduction for a portion of its interest expense. This is most readily accomplished when the installment obligation is pledged as security for a loan. The Administration seeks to end deferral for such secured loans,¹²¹ but the scope of its proposal appears narrower than that originally recommended by Treasury.¹²² Perhaps, it would be easier to achieve the desired result by denying an interest deduction when an installment obligation is pledged as security for a loan. While it can be shown that only a portion of the interest should be non-deductible,¹²³ perhaps this complexity can be avoided by offering an election to treat the pledge as equivalent to payment.

F. Summary

Accelerated payments, deferred payments, premature accruals, and welfare benefit plans all involve the same issue as original issue discount obligations and interest-free loans—whether investment income will be taxed currently to the beneficiary of that income. For the transactions discussed

120. For example, assume that property with a \$200 basis sells on installment for \$1200 plus interest. The taxable gain would be \$400 (or one-third of the sales price) determined as follows:

a. Amount Realized	\$1200
b. Basis	200
c. Gain (a-b)	1000
d. Capital Gain Deduction (.6xc)	600
e. Taxable Income (c-d)	400

If the interest rate were 10%, the annual interest payment would be \$120, of which one-third (the interest on the deferred gain) would not be deductible. But if the buyer's interest is not deductible, it would probably be unwilling to pay 10%. If the buyer is in a 40% bracket, it would pay only 6% on the nondeductible portion or \$24. Total interest would then be \$104 ((6% x 400) + (10% x 800)) of which \$24 should be nondeductible.

121. The President's proposal would require gain to be recognized on the pledge of certain installment obligations. PRESIDENT'S PROPOSALS, *supra* note 4, at 208-11.

122. 2 TREASURY DEPT., REPORT TO PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 212-14 (1984).

123. Recall that deferral is equivalent to payment of the tax and reinvestment of the after-tax proceeds at a tax-free rate of return. This suggests that it is the interest on the after-tax proceeds which should be denied a deduction. Consider the example *supra* note 120. If payment were not deferred, the seller would have paid tax of \$160 (.4x\$400) and would have \$1040 to invest. This consists of \$800 of non-taxable proceeds plus \$240, the after-tax equivalent of \$400 of taxable income (the taxable income equals 40% of the \$1000 capital gain). Suppose payment is deferred and the taxpayer pledges the \$1200 note as security for a \$1040 loan (In a sense, the note is worth only \$1040 because of the potential tax of \$160 whenever collected.). The net result ought to be equivalent to immediate tax if the interest on \$240 of the loan (\$24) were nondeductible. Being able to invest \$1200 in lieu of \$1040 provides the taxpayer with an extra \$16 of income, or \$9.60 after tax. Denying a deduction for \$24 costs \$9.60.

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in this Part, Congress applied in the 1984 Act a variety of substitute and indirect taxes, some of which are more successful than others. The Administration seeks further changes in 1985. Virtually all of the areas discussed here should be reviewed for consistency and improvement in light of the similarity of the issues.

III. NONQUALIFIED DEFERRED COMPENSATION

The analysis developed above can be applied to an area that was not generally considered in the 1984 legislation—the tax treatment of deferred compensation that does not qualify for preferential treatment under the Internal Revenue Code, usually referred to as “nonqualified” deferred compensation plans. This Part makes the case for a special tax on investment income earned on nonqualified deferred compensation, and describes how such a tax might operate.

A. *The Case for a Special Tax on Investment Income*

Under the current taxing scheme, investment income earned on deferred compensation in a nonqualified plan often goes untaxed. This unwarranted subsidy undermines the incentives created by Congress to establish qualified retirement plans. Furthermore, because nonqualified plans usually benefit highly paid individuals, the subsidy violates the rationale for giving a tax preference to retirement savings, namely to benefit low and middle income wage earners. To eliminate this subsidy, a special tax must be imposed on the investment income generated by nonqualified plans.

1. *Treatment of Qualified and Nonqualified Plans*

Specific types of employer-established retirement programs, generally referred to as “qualified plans,”¹²⁴ are not taxed on investment income.¹²⁵ To promote adequate retirement income for low and moderate wage earners,¹²⁶ Congress required that qualified plans be available to a broad group of employees.¹²⁷ Thus, retirement plans which are only offered to highly paid employees are not eligible for the statutory tax exemption on investment income afforded to qualified plans.¹²⁸

124. I.R.C. § 401 (West Supp. 1985). See generally Halperin, *supra* note 49 (discussing qualified plans).

125. I.R.C. § 501(a) (West Supp. 1985). As described above, see *supra* notes 52 & 56, the ability to claim an immediate deduction without current taxation of the employee, which applies only to qualified plans, is not in itself an advantage.

126. PRESIDENT'S PROPOSAL, *supra* note 4, at 375; PRESIDENT'S COMM'N ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 11 (1981).

127. See I.R.C. §§ 401(a)(4)–(5), 410(b) (West Supp. 1985) (nondiscrimination rules); see also I.R.C. § 415 (West Supp. 1985) (maximum benefit limit).

128. Deferral of taxation is available provided the employer does not establish a trust or its

The benefit of exemption, however, is often achieved in practice by such nonqualified plan sponsors. Tax-exempt employers can realize the exemption by investing retirement assets on behalf of the employees. Because the employer is tax-exempt, the investment income earned on the retirement assets is similarly not taxed. Congress has responded to this tax avoidance technique by imposing a \$7,500 annual limit on the amount of deferred compensation that can be allocated to an employee of a governmental unit under a nonqualified plan.¹²⁹ Congress, however, ignored the larger problem of tax-exempt employers other than government.¹³⁰

Taxable employers may effectively exempt investment income from tax to the extent that they have excess loss carryovers.¹³¹ Alternatively, these employers can invest deferred compensation in securities that pay dividends, which are 85% exempt from tax.¹³² In addition, if the employer invests in its own securities, appreciation in the value of those securities will not be subject to tax if, instead of issuing stock directly to the employee, the employer holds the stock itself for the benefit of the employee or provides for a deferred compensation arrangement tied to the value of the stock.¹³³

Since comparable benefits can be achieved under nonqualified plans that do not meet the statutory coverage requirements, employers may

equivalent. Rev. Rul. 60-31, 1960-1 C.B. 174, 178. As discussed *supra* note 56, such deferral will not provide a tax benefit unless investment income is more favorably taxed.

129. I.R.C. § 457 (West Supp. 1985).

130. The Reagan Administration has proposed extension of the rules applicable to government employees to all employees of tax-exempt organizations. See PRESIDENT'S PROPOSAL, *supra* note 4, at 379-82. For earlier legislative proposals on this issue, see *Hearings on S. 1587 Before the Subcomm. on Private Pension Plans and Employee Fringe Benefits of the Senate Comm. on Finance*, 95th Cong., 1st Sess. 20 (1978) (statement of Daniel Halperin, Tax Legislative Counsel); Letter from Michael Blumenthal, Sec'y of Treasury, to Sen. Russell Long (May 4, 1978), reprinted in DAILY TAX REP. (BNA), May 16, 1978, at G5, J9 [hereinafter cited as Blumenthal Letter].

131. The safe-harbor leasing controversy indicates that a large number of nominally taxable companies have losses for tax purposes. See Apar, *Is There Life After Tax Leasing?*, Wall St. J., Aug. 4, 1982, at 20, col. 4.

132. I.R.C. § 243 (West Supp. 1985) allows a deduction equal to 85% of dividends received. An offsetting factor is that the 28% capital gain rate for corporations, I.R.C. § 1201(a) (1982), exceeds the 20% maximum tax on capital gains for individuals, I.R.C. §§ 1, 1202 (1982).

133. Assume the stock of the employer is valued at \$10 per share. First the employer issues 10 shares to the employee in year 0 as compensation for services. The employee sells 4 shares to raise enough money to pay the tax and retains 6 shares valued at \$60. If by year *n* the shares triple in value to \$30 per share, 6 shares would be worth \$180. Second, assume the employer holds the stock or promises deferred compensation equal to the value of 10 shares. If the compensation is distributed in year *n* when the stock is worth \$30 per share, the employee will receive \$300 in cash or 10 shares worth \$300. In the latter case, she would again sell 4 shares to raise enough to pay the tax and would retain after tax \$180 or 6 shares worth \$180. However, in the second example, the basis of the six shares would be the value when distributed (\$180) and the shares can be sold without further tax. In the first example, upon sale the employee would owe tax on the \$120 capital gain, the difference between current value and the value upon receipt. The difference between the two examples is that when the employer holds the stock appreciation in value is not taxed. I.R.C. § 1032 (West Supp. 1985).

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choose to provide benefits only for their highly paid employees, thus circumventing the congressional mandate to protect low and moderate wage earners. Even if such nonqualified plans do not impact significantly on the establishment of qualified plans, they provide an unwarranted and unintended subsidy to high-income individuals.

2. *Inadequacy of Alternative Approaches*

To maintain the incentives for qualified plans and to avoid subsidizing highly compensated employees, nonqualified plans must be taxed on their investment income. This Section demonstrates the inadequacy of the principal alternatives to a special tax on investment income—full accrual taxation of compensation and expansion of the doctrine of constructive receipt.

a. *Accrual Taxation of All Compensation*

The tax benefits of nonqualified deferred compensation could be eliminated if compensation were taxed to the employee upon performance of services.¹³⁴ Since most employees rely on W-2 forms furnished by the employer, calculating the amount of accrued income would not unduly burden employees. Measurement of accrued income could, of course, require assumptions as to interest rates and mortality risks, but the IRS could provide tables for this purpose.¹³⁵ Resources to pay the tax could be provided by requiring employer withholding on accrued compensation. The employer could derive funds for withholding either out of the tax savings resulting from the allowance of an immediate salary deduction or from the funds which would otherwise be set aside for the employee.¹³⁶

In some circumstances, however, such as when benefits are forfeited if death occurs before normal retirement age, full accrual would tax employees on benefits they might never receive. For example, if \$10,000 deferred compensation were set aside for an employee who survives to age 65 and there were an 80% chance that the employee would reach that age, the employee would be charged with current income of \$8,000. Although this is analogous to receiving cash compensation of \$8,000 followed by the purchase of an annuity contract that might never pay benefits, employees might find it difficult to understand why they should be taxed on money that they may never receive.

134. Generally the test will be satisfied if the performance of services has been completed and there is no substantial risk of forfeiture for failure to perform future services. *Cf.* I.R.C. §§ 83, 402(b) (West Supp. 1985), and regulations thereunder (implementing such a test).

135. *See* Treas. Reg. § 1.403(b)-(1) Tables I and II (1972) (providing such tables for measuring employer contributions in another context).

136. Withholding only would be burdensome if an employer who did not establish a segregated fund was not currently taxable.

Another problem with full accrual taxation is the potential bunching of income which could cause higher than normal rates to apply. For example, a state university may adopt a special retirement program for a football coach who has been successful over many years. If the value of all of the past years' benefits were allocated to the year the plan is implemented, the amount would likely far exceed the \$7,500 limit applicable to government plans¹³⁷ and accrual would inflate the marginal rate of tax. In other circumstances, by properly allocating income to the year in which it is earned, full accrual taxation would eliminate the tax saving that results from the reduction in the employee's marginal tax bracket after retirement. To the extent that the averaging possibilities of current law are thought to be desirable,¹³⁸ such a result would be a disadvantage.

In sum, there are serious obstacles to immediate accrual taxation of all compensation. These include the real or imagined inability to pay the tax, problems of measurement, and significant bunching of income. A lack of employee understanding of the accrual method, however, may be the most serious obstacle to implementing such a system.

b. *Constructive Receipt*

The constructive receipt doctrine provides another possible avenue for eliminating the tax benefits of nonqualified deferred compensation. Current income tax regulations view income as constructively received if an individual has an opportunity to claim it.¹³⁹ If the employee could have received cash had she wished to do so, many of the problems generated by a scheme of accrual taxation would disappear. The amount of current income could readily be measured, and cash would, at least presumably, be available to pay the tax. It might also be easier to justify current taxation to employees.

Nevertheless, the IRS has not been aggressive in asserting the constructive receipt doctrine in the context of deferred compensation.¹⁴⁰ At present, as long as an employee agrees to deferral before services are performed,

137. See *supra* text accompanying note 129.

138. See *infra* text accompanying notes 159-61 (discussing whether averaging income to take advantage of low earning years after retirement is sound policy).

139. Treas. Reg. § 1.451-2(a) (1977) provides:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time. . . . However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

140. The IRS believes that "the [Internal Revenue Code] cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment." Rev. Rul. 60-31, 1960-1 C.B. 174, 178.

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constructive receipt is not applied.¹⁴¹ A later election to defer may also be permissible, particularly if the amount of compensation remains uncertain at the time of performance or if the day of payment is not immediate.¹⁴²

In 1978, the Treasury responded to perceived abuses in plans adopted by state and local governments and other tax-exempt employers by urging a broader application of the constructive receipt doctrine. The Treasury suggested that when it is clear that the compensation has been withheld at the direction of the employee or when there has been a specific set-aside, the employee should not be permitted to exclude that amount from current gross income.¹⁴³ Constructive receipt might also be established by focusing on whether the employee has significant control over investment or distribution.

Nevertheless, it seems unlikely that expansion of the constructive receipt doctrine would be very successful. This approach would undoubtedly foster administrative difficulty and uncertainty as tax advisors develop ways to disguise the election or the set-aside. Moreover, if the employee were not permitted to demonstrate that, despite the set-aside, the employer was unwilling or unable to pay currently, the result would be tantamount to accrual accounting.

Because compensation may be deferred for reasons other than tax avoidance, it is impractical to overcome these difficulties by a harsh brightline standard which makes deferred compensation impossible. Legitimate nontax reasons for deferring payment of compensation by an employer include a shortage of current funds and the stimulation of savings for retirement above the amounts permitted by qualified plans,¹⁴⁴ either to promote an employer's image as socially responsible or to encourage retirement while making room for younger employees.¹⁴⁵ Ideally, deferred compensation should be neither favored nor disfavored relative to the tax treatment of current compensation.

Thus, neither full accrual taxation of deferred compensation nor the

141. Rev. Proc. 71-19, 1971-1 C.B. 698.

142. See *Oates v. Commissioner*, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953); Sollee, *Executive Compensation Revisited*, 60 TAXES 863, 865 (1982).

143. See Proposed Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638 (1978). Under one Treasury proposal, an employee would have been taxed whenever (1) a choice as to the time of compensation was clearly available, even if that choice had to be exercised before services were performed, or (2) there was a specified set-aside, regardless of whether there was a choice to defer. See Blumenthal Letter, *supra* note 130. Under this proposal the first rule would have applied only to employees of tax-exempt institutions or governments.

144. Congress recognized the validity of benefits larger than those allowed under qualified plans by facilitating the establishment of so-called "excess benefit plans," providing such benefits, through exemption from the rules of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, §§ 3(36), 4(b)(5), 88 Stat. 831, 838-40 (codified as amended at 29 U.S.C. §§ 1002(36), 1003(b)(5) (1982)).

145. See W. GRAEBNER, A HISTORY OF RETIREMENT 264, 265 (1980).

expansion of the doctrine of constructive receipt seems likely to eliminate the potential for tax savings under current law with respect to nonqualified deferred compensation plans. Instead, a special tax on the investment income generated by such plans is needed.

B. *A Special Tax on Investment Income*

A special tax on investment income designed to capture the tax that would have been paid by the employee can accomplish the goal of accrual taxation while avoiding most of the difficulties described above. Despite deferral, an employee *will* pay the proper amount of tax with respect to the deferred *compensation*; she will not, however, pay tax on the *interest* earned on that compensation during the period of deferral. Denial of the employer's deduction for compensation until paid increases the employer's taxable income by the amount of such interest. This "matching" approach, however, does not prevent the parties from taking advantage of the employer's lower rate of tax. It seems preferable, therefore, to allow the employer a deduction for interest credited to the employee while at the same time imposing a tax on an equal amount of investment income. Such a tax would be paid by the employer, but at a special rate.

The feasibility of a special tax on investment income earned on deferred compensation in nonqualified plans depends upon being able to determine the appropriate tax rate and the amount of investment income subject to the tax. This Section describes how these two factors might be determined and offers a specific proposal.

1. *The Rate of Tax*

The rate of tax applied to investment income should ideally be the rate applicable to the beneficiaries of the deferred compensation arrangement. By using the beneficiaries' tax rate, the deferral of compensation is neither encouraged nor penalized. When the amount of investment income allocable to each employee can be determined, the proper tax could be assessed by applying the rate from the employee's filed tax return.¹⁴⁶ When contingencies such as mortality rates or future service make individual allocation difficult, the weighted average marginal rate of all participants could be used.

In practice, however, the rate of tax applied to the investment income would probably have to be the top marginal rate for individuals. While undoubtedly erring on the high side in some cases, this rate preserves the

146. Cf. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT 30-31 (Tent. Draft No. 12 1983) (amendments to Subchapter J) (proposing to tax trusts at grantor's rates).

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maximum incentive for deferral through qualified plans. Furthermore, employees may always avoid the special tax by opting out of the plan.

2. *Determining the Amount of Investment Income Subject to the Tax*

To implement a special tax on investment income, the value of the retirement asset pool must be known. Determining this value depends upon the manner in which the retirement program is structured.

Although the retirement benefits could be paid out of the general assets of the employer, the employer may choose to segregate assets for that purpose. Under some defined contribution plans,¹⁴⁷ the amount to be set aside will be fixed. Under all defined benefit plans¹⁴⁸ and some defined contribution plans, however, the amount set aside will depend upon estimates of mortality, turnover, or the plan's investment performance. Whether a set-aside occurs and whether the required amount is fixed or uncertain affects the feasibility and the accuracy of a special tax on investment income.

a. *Certain Set-Aside*

In a defined contribution plan without any contingencies on payment, the amount of deferred compensation, or the amount to be set aside, is a fixed and currently known sum. The employer ordinarily withholds the specified amount of current compensation in a segregated account. Upon departure from the firm, employees receive the deferred compensation plus the investment income that has accumulated during the intervening years. Investment income attributable to the employee's share is thus readily determined.¹⁴⁹

b. *Required Set-Aside Uncertain*

Investment income cannot be measured as easily when the deferred compensation obligation of the employer depends on future events. Defined benefit plans are the predominant example. In a defined benefit plan, some funding method must be employed to determine the portion of

147. Under defined contribution plans, fixed contributions are credited to individual employee accounts along with an allocable share of the plan's investment income, I.R.C. § 414(i) (1982); actual retirement benefits thus depend upon investment performance. Under a profit-sharing plan, the contribution may depend upon profits or be determined at the employer's discretion. Treas. Reg. § 1.401-1(b)(2)(i) (1976).

148. Defined benefit plans specify the benefit to be paid employees on retirement. I.R.C. § 414(j) (1982). Thus, the employer's cost depends upon investment performance and other factors.

149. Because of the tax deferral, the amount set aside for the employee may be increased to reflect what I have called an investment on behalf of the government. Applying the special rate of tax to this portion of the income does not affect the conclusion that the government will be compensated for the deferral of tax at the rate of return earned by the employee.

the cost allocable to the current year,¹⁵⁰ and a rate of return must be assumed in order to determine the required contribution. The employer's funding obligation can depend on future investment returns, employee mortality rates, or employee length of service with the company.¹⁵¹ For example, if the employee must live to receive a benefit, the amount set aside may prove to be incorrect in either defined contribution or defined benefit plans if the average employee's life is longer or shorter than the estimate. Thus, the amount of the set-aside required to fund the employer's liability must be based upon actuarial statistics. If this amount proves excessive or inadequate, retroactive correction of the tax on investment income is possible. But, at least initially, upon adoption of this proposal it is probably better to avoid this additional complexity.¹⁵² Thus, if the employer, either voluntarily or because it was required to do so, sets aside an amount based upon reasonable actuarial estimates, the earnings of that fund would be subject to tax at the rate appropriate for employees.¹⁵³

c. *Absence of a Set-Aside*

In some situations, the employer may not set aside the deferred compensation in an identifiable account, even if the amount to be set aside is determinable.¹⁵⁴ When there is no actual set-aside of funds, some method must be devised to identify the investment income subject to tax. In selecting an appropriate method, it is necessary to envision the existence of a separate fund that lends all of its principal and interest to the employer

150. See H. WINKLEVOS, PUBLIC PENSION PLANS: STANDARDS OF DESIGN FUNDING AND REPORTING 86, 202 (1979). The cost of a pension benefit will be spread in a variety of ways over a period beginning either when service began or at the point the plan or an amendment was adopted.

151. Employees are not taxed even on funded benefits until there is no substantial risk of forfeiture. I.R.C. §§ 83, 402(b) (1982). Arguably, any earnings up to that point, at least in an individual plan, inure to the employer. On the other hand, in a group arrangement, turnover would be estimated in determining the cost of the plan and thus the required set-aside. Earnings on this amount would seem to be for the employees' benefit.

152. This is not the ideal solution but the current treatment of qualified plans does not (improperly in my judgment) attempt to correct for excessive funding. Thus, upon termination of an over-funded pension plan, the employer may recover plan assets in excess of those necessary to fund benefits as of the date of termination. Treas. Reg. § 1.401-1(a)(3)(iv) (1976). Even though the employer is taxable on the reversion, it retains the advantage of the tax-free buildup over the period of the plan. The President has proposed an excise tax of 10% on plan funds reverting to the employer upon plan termination to recover a portion of this benefit. PRESIDENT'S PROPOSALS, *supra* note 4, at 361. A more complete recovery does seem warranted.

153. There may be a reasonable argument for applying the special tax to the estimated rather than the actual rate of return. If an amount set aside is excessive because the employer actually earned a higher rate of interest, it may be equivalent to a payment of current compensation followed by a loan from the employee to the employer at the estimated rate which turns out to be a lower rate than the employer was able to earn by use of the funds. Perhaps a similar argument may be made as to "actuarial" gains and losses, but this seems more tenuous.

154. For example, the employer may want to use the funds for general business purposes.

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for the period of deferral. The initial size of this fund will depend upon the assumed rate of return. The amount of income credited to the fund would be reflected in an interest deduction for the employer and investment income for the segregated fund.

Three methods can be used to calculate the amount of "interest" paid by the employer: (1) assume the retirement fund earns investment income at the rate of return provided in the benefit plan; (2) calculate the employer's total investment income and prorate the earnings by the ratio of retirement funds to total investment funds; or (3) impute a rate of return based on relevant market security yields, such as those for U.S. Treasury notes or bonds.¹⁵⁵ Of course, there are practical, and perhaps even theoretical, difficulties with implementing each of these three methods. The following discussion will analyze some of the limitations of the first two methods.

(i) *Using the Plan's Formula to Calculate Investment Income*

It may be appropriate, in some cases, to use the formula provided in the plan to measure the investment income subject to the special tax. Suppose that the value of \$10,000 deferred compensation under a formula of a defined contribution plan is to parallel the value of a hypothetical \$10,000 investment in the common stock of AT&T. The investment income subject to the special tax could be determined by calculating the rate of return of the measuring asset even if the employer does not invest in the measuring asset.¹⁵⁶ This approach, however, would allow tax avoidance if the stated return was not appropriate to an arms-length transaction. Suppose, to take the extreme case, \$10,000 is contributed under a defined contribution plan and the stated rate of return under the plan is zero so that the principal amount remains fixed. Since an employee would ordinarily insist on a market rate of return, such an arrangement suggests that the amount of compensation actually earned is less than \$10,000; in effect, the amount of current compensation is overstated while investment income is understated. The ability to understate the investment income allocated to employees will be a concern whenever the rate of tax applied to investment income is higher than the employer's tax rate. If below-market returns are permitted, efforts to tax the employee's investment income at the appropriate rate will be thwarted easily.

155. I.R.C. § 1274(d)(1) (West Supp. 1985) (imputing interest on deferred payment sales based on Treasury yields).

156. If the employer does not purchase the measuring asset (*i.e.*, AT&T stock), but instead invests the \$10,000 in its business, the employer has assumed an investment risk equivalent to that of a borrower with a rate of interest determined by an external standard.

(ii) Allocating a Portion of the Employer's Income

The special tax can also be applied to that portion of the employer's investment income that equals the ratio of the amount required to be set aside to the entire investment portfolio held by the employer. Allocating a portion of the employer's investment income to the employees is impossible, however, if the employer does not have investment assets equal in value to the amount that should be set aside. For example, the deferred compensation plan may be funded on a pay-as-you-go basis, similar to Social Security, or it may be directly invested in the employer's business operations. In the latter case, for a fully taxable employer without investment income, it may be unnecessary to trace the employee's share. If the employee were considered a joint venturer, she would not be subject to significantly greater tax than a taxable employer. All investment income would therefore be properly taxed regardless of which party was entitled to the profits. This result, however, would not hold true if the employer were tax-exempt or if employees were considered to be lenders not entitled to special tax benefits such as accelerated depreciation.

In the first instance, the question may be whether there is in fact any investment income. The current generation of employees may be reducing their pay to provide the presently retired generation with pension income with the expectation that future generations will do the same for them.¹⁵⁷ Each generation should demand a return on their money since, by definition, they are foregoing current compensation. After all, a lender is entitled to interest whether or not the borrower, here the employer, invests the borrowed funds. On balance, therefore, there would not appear to be any need to make special provisions for pay-as-you-go plans except for the fact that a rate of return must be imputed.

3. Comparison with Other Approaches

Imposing a tax at the employer level solely on investment income and not on the deferred wage avoids many of the difficulties identified above in connection with accrual taxation and constructive receipt. While measuring income and fixing a tax rate are certainly not simple, a special tax does not require allocation to individual employees. It also has the advantage of fully eliminating the potential for tax avoidance. Current taxation of compensation alone would not eliminate the advantage of deferral if the investment earnings on the deferred compensation were not also taxed at employee rates. It is noteworthy that under current law, even when an

157. See Browning, *Social Insurance and Intergenerational Transfers*, 16 J.L. & ECON. 215, 219 (1973).

employee is taxed on wages she has not received, the investment income is taxed to the employee only upon actual or constructive receipt.¹⁵⁸ Since attribution of investment income would have to be specifically implemented even if accrual of earnings were required, it seems preferable to concentrate solely on earnings and thereby avoid the additional complexities associated with accrual of compensation.

As noted above, only accrual or constructive receipt will allocate income to the year in which it is earned and eliminate the advantage derived from a reduction in the employee's marginal tax bracket after retirement. It seems, however, that averaging would enhance the acceptability of this proposal to taxpayers without raising serious equity questions. First, the marginal rate of very high earners will not be reduced significantly, if at all, upon retirement.¹⁵⁹ Second, the effort to tax deferred compensation currently may flounder precisely because it may often subject employees to abnormally high tax rates.¹⁶⁰ Finally, averaging of income to reduce marginal rates is a widely accepted practice.¹⁶¹ Thus, a special tax on investment income appears to be a better approach than full accrual taxation of compensation.

4. *A Specific Proposal*

To implement the special tax, nonqualified deferred compensation should be funded through a trust or other segregated fund to facilitate identification of the employee's share. The taxable income of the fund, determined as if the fund were an individual, would be taxed at the top marginal rate. The employee then should be taxed on the total distribution, without credit for the tax paid on investment income, so that the present value of the taxable amount would be equal to the original accrued compensation. Thus, assuming similar tax rates, this proposal is

158. I.R.C. § 402(b) (1982) (funded nonqualified plans); Rev. Rul. 74-299, 1974-1 C.B. 154. Under the regulations the same is true of amounts deferred in excess of the \$7500 ceiling for a governmental plan under I.R.C. § 457(a) (West Supp. 1985). Earnings credited on such amounts are includable in gross income only when paid or made available. Treas. Reg. § 1.457-3(a)(1)-(2) (1982). Under a government plan, there would be no tax in the interim. Section 402(b) would impose an additional tax on the trust which could compensate or overcompensate for the deferral, but the trust may in fact be in a far lower tax bracket than the employee, particularly if the employee is the only beneficiary of the trust.

159. For 1984, a married taxpayer filing jointly reached the 50% bracket with \$159,000 of taxable income above the zero bracket amount. Such a person would pay taxes at less than the 45% rate only if post-retirement income fell below \$82,200 and would reach 49% at \$106,000.

160. See *supra* note 137 and accompanying text (football coach example).

161. I.R.C. §§ 1301-1305 (West Supp. 1985) (income averaging provisions); see also I.R.C. §§ 402(e), 667(b) (West Supp. 1985). Although averaging has been limited, probably for administrative reasons, to situations where income rises, see Steuerle, McHugh & Sunley, *Who Benefits from Income Averaging?*, 31 NAT'L TAX J. 19, 27 (1978), income ideally would be averaged over a lifetime, see Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969). But see PRESIDENT'S PROPOSALS, *supra* note 4, at 110 (advocating repeal of averaging).

equivalent in value, although not in timing, to accrual taxation of both principal and interest to the employee.

Identification of assets does not necessarily require a trust and can perhaps be achieved by bookkeeping without formal segregation. Because the proposal assumes deferral of taxation, a trust could not be mandated without a change in current law which taxes employees when such funding takes place under a nonqualified plan.¹⁶² Nonetheless, if deferral were permitted, employees would welcome the greater security provided by a trust. Employers should not object unless tying up the funds would significantly endanger their access to credit or their ability to respond to emergencies.¹⁶³

There are, however, policy objections to a trust requirement. The security offered by funding may be a principal factor in maintaining the incentive in favor of qualified plans even where the tax treatment of such plans is not significantly advantageous.¹⁶⁴ Therefore, permitting deferral despite a trust arrangement may be unwise. At the very least, deferral of amounts contributed to a nonqualified trust should not be allowed unless investment income were taxed at the highest individual rate, thus eliminating the advantage of deferral (aside from the possibility of averaging) without the use of qualified plans.

The employer's deduction for compensation would be allowed upon, and in the amount of, a distribution from the fund, just as it would be if no separate funding were required.¹⁶⁵ This approach seems preferable to allowing a smaller deduction when compensation is accrued, because the deferred deduction minimizes the need both for estimates and for additional safeguards, including a prohibition against self-dealing, to insure that the tax deduction will be accurately measured.¹⁶⁶

162. I.R.C. § 402(b) (1982).

163. Funding would be inconsistent with a pay-as-you-go plan. *See supra* text accompanying note 154.

164. There have been recent efforts to increase the security of employees under nonqualified plans by providing a surety bond or by segregating the assets so as to be virtually untouchable by the employer without creating an irrevocable trust for the benefit of the employee which would result in current tax. For an indication that the success of these efforts would make nonqualified deferred compensation more desirable but that the IRS may have had second thoughts following initial approval, see G.C.M. 39230, 23 TAX NOTES 1410 (1984); *Monday the Rabbi Went to Tax Court*, FORBES, Aug. 12, 1985, at 73; *More Firms Allowing Employees to Defer Bonuses to Save Taxes*, Wall St. J., Sept. 16, 1985, at 27, col. 3.

165. *See supra* text accompanying note 51 (defer deduction until amount received).

166. If these concerns can be resolved, it may be useful to allow a deduction for accrued deferred compensation. As noted earlier, such an approach makes it easier to treat capital items, *see supra* note 118, and to measure the deduction correctly where the employer's tax rate is different from the employees', *see supra* note 95.

IV. CONCLUSIONS

This Article has argued that a variety of transactions, ranging from nuclear decommissioning expenses to nonqualified deferred compensation plans, can be understood to involve a recurring issue—whether hidden investment income will be taxed currently to the beneficiary of that income. In many cases, the presence of this income is further obscured by disguised loans. In an income tax system, the appropriate treatment of these transactions follows directly from the Haig-Simons definition of income: increases and decreases in net worth should be accounted for as they occur. The Code currently adopts that approach in limited cases, such as those involving original issue discount obligations and interest-free loans.

For many other transactions, the Internal Revenue Code, especially after the 1984 amendments, indirectly achieves the theoretically correct result. In some cases, the beneficiary of the investment income is taxed indirectly, as when a deduction otherwise available to the beneficiary is denied.¹⁶⁷ In other cases, the Code taxes another party to the transaction as a substitute for the beneficiary, such as when it mandates cash accounting.¹⁶⁸ Sometimes these rules work fairly well, sometimes they permit significant tax avoidance, and sometimes they are inexplicable, as in the case of the new provisions applicable to mining reclamation expenses. At least part of the explanation for this state of affairs must be a failure to understand how indirect and substitute taxation occurs. It is hoped that this Article will fill the void and permit choices among the three approaches to be made on a more rational basis.

Because of the potential for exploiting rate differences under the cash method of accounting, I prefer full implementation of the Haig-Simons definition even where substitute taxation is feasible.¹⁶⁹ Such an approach, however, may sometimes be too complex—at least for transactions with a strong business purpose.¹⁷⁰ Moreover, some fear that expansion of the ac-

167. *See supra* text accompanying note 37 (prepayment). This also can occur in the case of an employer who makes interest-free loans to employees. Although the Code requires accrual in these circumstances, *see supra* text accompanying note 29, it provides regulatory authority to exempt a class of transactions if the application of § 7872 would not have a significant effect on the tax liability of the lender or borrower. I.R.C. § 7872(h)(1)(C) (West Supp. 1985). *See* Proposed Treas. Reg. 1.7872-5 (implementing this provision).

168. *See supra* text accompanying note 54 (deduction for deferred compensation); text accompanying note 39 (immediate taxation of prepaid income).

169. This preference is especially strong if the unwarranted tax benefits are interfering with other goals of public policy, as in the case of “qualified” retirement plans or the transactions have no business purpose. Attribution of investment income to the true beneficiary will terminate transactions which have no purpose other than tax avoidance. Harsh or complicated rules are not a concern when taxing such transactions.

170. If transactions have a significant business purpose, the tax regime must be fair and administrable. It is necessary to consider whether the wayward investment income can be identified, attributed to the proper person, and subjected to tax at the appropriate rate. Further, it may be relevant whether

crual method would foster tax shelters built upon exaggerated measurement of accrued liabilities.¹⁷¹ They may believe that the potential for income-shifting under the cash method is exaggerated because in order to exploit rate differences cash must be left in the hands of the lower-bracket taxpayer, who is perhaps less financially worthy. Others believe that shifting investment income to make use of a net operating loss carryover is not inappropriate¹⁷² and may therefore argue that shifting intended to exploit a tax-exemption is the principal concern and should be dealt with directly.¹⁷³

What is clear is that current law does not embody a consistent and coherent approach to the potential shifting or avoidance of tax on investment income. While the variety of transactions described above suggests that a single solution could not be applied in all cases, the current array of responses should be made more coherent. More importantly, the legislative approaches developed in 1984 should be extended to other areas that pose the same problems. A special tax on investment income earned on nonqualified deferred compensation is one such extension. The technique suggested here has the virtue of preventing exploitation of rate differences without the complexity and the potential risk of abusive deductions that may be inherent in the accrual method.

the person taxed will have resources available to meet the tax burden when it is imposed. It may also be important that the taxpayer involved be able to understand and accept the basis of taxation. These questions make it important to analyze each situation separately.

171. Johnson, *Silk Purses from a Sow's Ear: Cost Free Liabilities Under the Income Tax*, 3 AM. J. TAX POL'Y 231 (1984).

172. See *Hearings on Carryover of Net Operating Losses and Other Tax Attributes of Corporations Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 98th Cong., 1st Sess. 90, 91 (1983) (statement of Donald Schapiro setting forth argument for free transferability).

173. Tax-exempt organizations are now subject to tax on so-called unrelated debt-financed income, i.e., income from assets acquired with borrowed funds. I.R.C. § 514 (1982). It is at least arguable that deferred payments are an obligation and the income on investment equal to the deferred payment is taxable to an exempt organization. It is not that simple, however, because recognizing the existence of a debt would normally imply an interest deduction which would offset the imputed income unless a special rule precluded it.