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The Taxation of Barter Transactions

Robert I. Keller*

INTRODUCTION

This Article discusses the tax consequences of two varieties of barter[1] transactions. One is the familiar direct barter in which one taxpayer exchanges goods or services for the goods or services of a second taxpayer. The second, and of a more recent vintage, is the organized form of indirect bartering accomplished through so-called trade exchanges or barter clubs. In barter clubs, a member who performs services for, or sells goods to, another member receives trade credits that can be exchanged for goods or services of other members.[2]

Part I of this Article focuses on the tax treatment of direct barter exchanges. It considers not only exchanges between previously unrelated individuals, as where a doctor swaps services with a plumber, but also those between employers and employees. While the term barter in common parlance connotes only the former type of transaction, many transactions between employers and employees also involve the exchange of noncash considerations. For example, when an employer compensates an employee in property, the employer is, in effect, engaging in

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* Professor of Law, University of Maryland School of Law. The author is grateful for the research assistance of Jon J. Robinson.

1. According to the RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 122 (unabr. ed. 1967), to barter means "to trade by exchange of commodities rather than by the use of money." The word barter is derived from the French *barater,* to cheat or exchange, and *barate,* confusion, trouble or deceit. *Id.* In a recent IRS survey, 62% of U.S. taxpayers said their consciences would not bother them if they failed to declare the value of income derived from barter. Maital, *The Tax-Evasion Virus,* PSYCHOLOGY TODAY 74 (1982).

Estimates of unreported income from barter transactions were omitted from a recent IRS report on noncompliance "because no reliable data could be developed." *See* INTERNAL REVENUE SERVICE, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS, PUB. NO. 1104, at 19 (1979). The report referred to a study conductd for H & R Block by The Roper Organization which presented "estimates of barter income ranging from $1.6 billion to $4.1 billion" but noted that "shortcomings in the underlying methodology [made those] figures suspect." *Id.*

2. Barter clubs and their members have recently come under the intense scrutiny of the Internal Revenue Service. *See infra* notes 209-20 and accompanying text.

a barter exchange of its property for the employee's services.[3] Similarly, if an employer allows an employee the rent free use of the employer's property, a barter exchange of the rental value of the employer's property for the employee's services takes place.[4] Finally, even the much discussed interest-free loan between employer and employee is, in fact, another example of a direct barter exchange,[5] in which the employee's services are exchanged for the use of the employer's money.[6] Part I sets forth five basic tax principles to govern the taxation of direct barter transactions which, if consistently adhered to by the Internal Revenue Service[7] and the courts, will always produce proper and rational tax consequences.

Part II explains how trade exchanges or barter clubs operate and describes the tax consequences of transactions taking place within such exchanges or clubs. Specifically, it addresses three questions regarding the taxation of such transactions: (1) Does a taxpayer receive income on the receipt of a trade unit, or only when it uses the units to acquire goods or services? (2) If a taxpayer must report income on the receipt of a trade unit, how are the units to be valued? (3) Finally, what are the tax consequences when a taxpayer exchanges its trade units for goods or services?

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3. *See infra* text accompanying notes 113-29.

4. *See infra* text accompanying notes 130-36.

5. *See generally* Bond, *The Use of Interest Free or Low-Interest Loans by Publicly Held Corporations to Reward Executives,* 58 TAXES 542 (1980) (noting advantages of interest-free loans for corporations and executives; advocating their consideration in designing executive compensation packages); Joyce & Del Cotto, *Interest Free Loans: The Odyssey of a Misnomer,* 35 TAX L. REV. 459 (1980) (distinguishing tax consequences of interest-free term loans from interest-free demand loans); Keller, *The Tax Treatment of Interest Free Loans: A Two Transaction Approach,* 1 VA. TAX REV. 241 (1981) (two components of interest-free loans are 1) arm's-length loan from lender to borrower at a fair interest rate followed by 2) a payment by the leader to the borrower which allows the borrower to pay the interest on the loan) [hereinafter cited as Keller, *Tax Treatment*]; Keller, *The Tax Consequences of Interest-Free Loans From Corporations to Shareholders and From Employers to Employees,* 19 B.C.L. REV. 231 (1978) (arguing for two payment transaction approach in taxing of interest-free loans) [hereinafter cited as Keller, *Tax Consequences*]. Actually, when properly analyzed, interest-free term loans between employer and employee are not really barter exchanges at all. *See generally* Keller, *Tax Treatment, supra,* at 250 ("In effect . . . when [an employer] makes a noninterest-bearing term loan to a borrower, two functionally unrelated transactions occur simultaneously. The [employer-lender] (i) makes the [employee-borrower] an arm's length loan of the present value of the amount due at maturity and (ii) simultaneously transfers the additional cash amount, i.e., the excess of the purported "loan" proceeds over the note's present value, as . . . compensation. . . ."). *See id.* at 253-54, 275-81, 296-97.

6. *See infra* text accompanying notes 137-66.

7. Hereinafter referred to as "the Service."

I. DIRECT BARTER TRANSACTIONS

A. The Two-Payment Approach

All taxpayers who engage in barter transactions are in the same economic position they would have been had they received cash for their goods or services in an amount equal to the value of the goods or services actually received and used that cash to purchase goods or services from the other party to the exchange. Two examples illustrate this basic economic fact. First, consider a transaction in which an employer compensates an employee for $2,000 worth[8] of current business services with appreciated stock originally costing the employer $1,000 but having a current fair market value of $2,000. This, in effect, is a barter exchange of property for services. The equivalent two-payment cash transaction would be as follows:

Payment 1—Employer pays employee $2,000 for services performed.
Payment 2—Employee pays employer $2,000 cash for the stock.

The tax consequences of the two-payment transaction are obvious. The employer recognizes a $1,000 capital gain on the sale of the stock (Payment 2)[9] and is entitled to a $2,000 business deduction for compensation paid (Payment 1).[10] The employee has $2,000 of income (Payment 1)[11] and takes a $2,000 basis in the stock (Payment 2).[12]

A second type of barter exchange might involve a swap of

8. The employee's services will generally be presumed to be equal in value to that of the stock given up by the employer to acquire those services. *See infra* notes 50-59 and accompanying text.

9. Gain from the sale or other disposition of property is defined by § 1001(a) to be the excess of the amount realized over the property's adjusted basis. In the two-payment example in the text, the amount realized is simply the $2,000 cash received. I.R.C. (26 U.S.C.) § 1001(b) (1976). The employer's basis in the stock is the $1,000 original cost of the stock to the employer. I.R.C. § 1012 (1976). Because stock is generally a capital asset under § 1221, the gain of $1,000 realized on its sale will be treated as long-term or short-term capital gain depending on the holding period of the stock. *See* I.R.C. § 1222 (1976).

10. The Code provides that a taxpayer's deductible business expenses shall include a "reasonable allowance" for salaries and other compensation. I.R.C. § 162(a)(1) (1976). Generally, if compensation payments are unreasonable and bear a close relationship to the employee's stockholdings, such payments will be treated as nondeductible dividend distributions. *See* Treas. Reg. § 1.162-8 (1958). Much more rarely, the Service has been successful in using the requirement of "reasonableness" in § 162(a)(1) to deny a corporate deduction for an unreasonably large salary payment to a nonshareholder. *See, e.g.,* Patton v. Commissioner, 168 F.2d 28 (6th Cir. 1948) (deduction of $46,049 for compensation to firm's bookkeeper unreasonable).

11. I.R.C. § 61(a)(1) (1976).

12. I.R.C. § 1012 (1976). Section 1012 provides in relevant part that "[t]he basis of property shall be the cost of such property. . . ."

services between an accountant and a doctor. The doctor performs a physical examination on the accountant, and in exchange the accountant prepares the doctor's individual income tax return. Each would have charged $500 in a cash transaction for his or her services. The equivalent two-payment cash transaction in these circumstances would be as follows:

Payment 1—Doctor pays accountant $500 cash to prepare an individual income tax return.

Payment 2—Accountant pays doctor $500 cash for a physical examination.

In this two-payment cash transaction, the doctor has $500 gross income (Payment 2)[13] and a $500 itemized deduction for tax return preparation (Payment 1).[14] The accountant also has $500 gross income (Payment 1)[15] and may list $500 as a medical expense (Payment 2). The medical expense is deductible in full if the accountant itemizes deductions[16] and has other medical expenses equal to or greater than three percent of adjusted gross income.[17]

If, on the other hand, the doctor had performed the $500 of medical services for a painter who, in exchange, painted the doctor's personal residence, the doctor would still have $500 gross income (Payment 2), but the doctor could not claim any offsetting deduction for the painter's personal services (Payment 1).[18] Similarly, if the doctor swapped services for those of an architect, who drew up plans for the doctor's new home, the doctor would again have $500 gross income (Payment 2), but the $500 payment to the architect would simply be included in the basis of the doctor's new house (Payment 1).[19]

A rational tax system would treat every barter exchange in the same manner as its economically equivalent two-payment

13. I.R.C. § 61(a)(1) (1976).

14. I.R.C. § 212(3) (1976). This assumes that the doctor itemizes his deductions. *See* I.R.C. § 63(g) (1976 & Supp. 1980). A taxpayer will itemize his deductions only if they exceed the zero bracket amount. *Id.* That amount is $3,400 in the case of a married taxpayer or a surviving spouse, $2,300 in the case of a single individual, and $1,700 in the case of a married taxpayer filing separately. I.R.C. § 63(d) (1976 & Supp. 1980).

15. I.R.C. § 61(a)(1) (1976).

16. *See supra* note 14.

17. I.R.C. § 213(a)(1) (1976). As a result of the Tax Equity and Fiscal Responsibility Act of 1982, a taxpayer may deduct medical expenses only to the extent they exceed five percent of adjusted gross income, effective for taxable years beginning after December 31, 1982. Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, § 311, — Stat. —, — (1982) [hereinafter cited as TEFRA].

18. I.R.C. § 262 (1976) denies deductions for "personal, living, or family expenses."

19. *See* Treas. Reg. § 1.263(a)-2(d) (1958).

cash transaction. To reach this result in all barter exchanges, the courts and the Service must consistently adhere to five basic tax principles. These principles are as follows:

Principle I ("The Taxability of All Noncash Benefits")—All economic benefits, regardless of form, are includable in income; the amount of the income is the fair market value of the benefit received.[20]

Principle II ("The Presumed-Equivalence-In-Value Principle")—If the value of the benefit received cannot be determined with reasonable accuracy but the value of the benefit given up can be, the value of the former is presumed to equal the value of the latter.[21]

Principle III ("The Value Received Theory of Cost")—The "cost" basis of property received in a taxable barter exchange is the property's fair market value at the time of receipt.

Principle IV ("The Value Received Theory of Deductions")—The term "paid or accrued" or "paid or incurred" includes the fair market value of an in-kind benefit received in a taxable transaction by the taxpayer.

Principle V ("The No-Wash Principle")—Even if the reporting of an item of gross income under Principle I would permit the taxpayer to claim an equal tax deduction under Principle IV, both the income and the deduction items must be reported on the taxpayer's income tax return.[22]

One can see generally how these five principles operate to provide the tax consequences prescribed by the two-payment analysis by applying the principles to the two previously described examples. In the first example, involving the employer's transfer of $2,000 worth of appreciated stock to the employee, the principles applicable to the taxation of the employee are Principles I and III, and those applicable to the taxation of the employer are Principles I, II, IV, and V. The employee reports the $2,000 value of the stock received as gross

20. *See infra* notes 28-44 and accompanying text. Certain barter exchanges of property can qualify for nonrecognition treatment if they meet the requirements of I.R.C. § 1031 (1976). Section 1031(a) provides that no gain or loss is recognized on exchanges of business or investment property (other than stock in trade, other property held primarily for sale, and stock and securities) solely for other property "of a like kind" to be held for business use or investment. *See generally* 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.2 (1981) (discussing the nonrecognition provision of § 1031(a)). It is assumed throughout this Article that § 1031 will be inapplicable to any described exchange of property.

21. *See infra* notes 45-65 and accompanying text.

22. *See infra* notes 89-105 and accompanying text.

income under Principle I (the taxability of all noncash benefits) and, under Principle III, takes a cost basis in the stock received equal to the stock's fair market value of $2,000 (the value received theory of cost). Under Principle I, the employer is required to treat the value of the employee's services as an amount realized on the sale of the stock,[23] which had a basis of $1,000. The employee's services, however, will generally not be independently valued, but rather will be presumed to be equal to the $2,000 value of the stock given up by the employer to acquire them (Principle II). Thus, the amount realized on the sale is $2,000, and the realized gain is $1,000. Under Principle IV (the value received theory of deductions) the employer will be entitled to a deduction for compensation paid equal to the $2,000 value of the services realized on the disposition of the stock. And finally, under Principle V (the no-wash principle), the employer may not net the $1,000 of realized gain against the $2,000 in deductions and simply deduct $1,000 for compensation paid.[24]

In the accountant-doctor example, in which $500 worth of services were exchanged, the principles governing the tax treatment of both taxpayers are Principles I (the taxability of all noncash benefits), IV (the value received theory of deductions), and V (the no-wash principle). The doctor reports the value of the accountant's services as income under Principle I and also claims their value as a deduction for tax return preparation under Principle IV. Similarly, the accountant, under Principles I and IV, has received $500 of gross income and has paid $500 for medical expenses. Even though the tax return preparation deduction and the medical expense deduction entirely offset the gross income reported on the transaction by the doctor and accountant, respectively, both must report the income and the deduction items on their tax returns, for no wash is permitted (Principle V).[25]

In the doctor-accountant example, both parties should generally be looking to the value of the services they received to determine their gross income, and not to the value of the serv-

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23. *See infra* note 35 and accompanying text.

24. Such a net approach would be unwise, in this example, since the $1,000 of gain would be capital gain, while the $1,000 deduction would be an ordinary deduction.

25. Even where the itemized deduction is equal in amount to the addition to gross income, the very inclusion of an item in gross income may have important tax consequences. *See infra* notes 96-105 and accompanying text.

ices they gave up. Principle II is not applicable.[26] For example, if the doctor's services were actually shown to be worth $600 and the accountant's only $400, the accountant should, under Principle I, report $600 of gross income and then, under Principle IV, list $600 for medical expenses paid. The doctor should report $400 of income (Principle I) and claim a $400 deduction for income tax return preparation (Principle IV).[27]

The next section sets forth the rationale for these principles. A detailed discussion of the current state of the law with regard to Principles IV and V follows in section C.

B. The Five Tax Principles

1. *The Taxability of All Noncash Benefits*

It is elementary that Congress in writing its broad definition of gross income in section 61,[28] and its predecessor in the 1939 Code, intended to tax all economic benefits without regard to the form in which such benefits are received.[29] The cases[30] and the Regulations[31] make it clear that income can be realized in any form, including services, property, or the rent-free use of

26. The value of the services given up may be considered, at best, some evidence of the value of the services received. *See infra* notes 50-61 and accompanying text.

27. *See infra* notes 79-88 and accompanying text.

28. "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ." I.R.C. § 61 (1976).

29. *See, e.g.,* General Am. Investors Co. v. Commissioner, 348 U.S. 434 (1955) (taxing insider profits as gross income in "accordance with the legislative design to reach all gain constitutionally taxable unless specifically excluded"); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (punitive damages award taxable as gross income as "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature"); Commissioner v. Smith, 324 U.S. 177 (1945) (predecessor of § 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form").

30. *See, e.g.,* Commissioner v. Smith, 324 U.S. 177, 181 (1945) (employee receiving stock options as compensation taxed on the difference between the option price and the market value of the stock when acquired); Helvering v. Bruun, 309 U.S. 461, 467-68 (1939) (lessor taxed on increase in value of leased property attributable to additions erected by lessee); Frueauff v. Commissioner, 30 B.T.A. 449, 450 (1934) (shareholder taxed on fair rental value of corporate-owned apartment which he occupied rent free). *See also* Staff of Joint Comm. on Internal Revenue Taxation, 93rd Cong., 2d Sess., Examination of President Nixon's Tax Returns For 1969 through 1972 at 158-61 (Comm. Print 1974) (free use of government transportation on personal business constitutes "income").

31. Treas. Reg. § 1.61-1(a) (1960) states that "gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash."

property. The Service recently reaffirmed this principle in Revenue Ruling 79-24,[32] involving a barter exchange of services for services and an exchange of the rent-free use of property for property. In the first situation, a housepainter painted a lawyer's personal residence in return for legal services. The Service ruled that "[t]he fair market value of the services received by the lawyer and the housepainter are includible in their gross incomes under section 61 of the Code."[33] In the second situation, an apartment building owner received a work of art from a professional artist in return for the artist's rent-free use of an apartment for six months. The Service ruled that the artist had to include the fair market value of the apartment in gross income and that the owner had to include the fair market value of the work of art in gross income.[34]

Not only is the form of the benefit received irrelevant where someone receives noncash consideration for services or rent, but it is also irrelevant where the in-kind benefit is received in whole or part payment of the purchase price of property. In the sale situation, section 1001(a) defines gain as the excess of the amount realized over the taxpayer's adjusted basis and defines loss as the excess of such basis over the amount realized. Section 1001(b) then defines amount realized as the "sum of any money received plus the fair market value of the property (other than money) received." While this language in section 1001(b) could be read literally to exclude such noncash considerations as services or the rent-free use of property in determining the amount realized, the law has long been settled that the word "property" in section 1001(b) includes all valuable noncash considerations.[35]

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32. 1979-1 C.B. 60.

33. *Id.* at 61. Since the services performed by the lawyer and painter were said to be of a personal nature, and therefore nondeductible, even if actually paid in cash by the two parties, it was not necessary for the Service to make any comment about the validity of the value received theory of deductions. *See infra* notes 79-88 and accompanying text.

34. 1979-1 C.B. at 61. Although the Service was silent on the point, it seems clear that the landlord would take a basis in the painting equal to its fair market value at the time of receipt. *See infra* text accompanying notes 66-78. The ruling does not state whether the artist used the apartment in whole or in part as his professional studio, and the I.R.S. does not discuss the possibility that the artist would, in such circumstances, be entitled to claim all or part of the rental value taken into income as a business deduction. *See infra* notes 79-88 and accompanying text.

35. *See, e.g.,* International Freighting Corp. v. Commissioner, 135 F.2d 310, 313 (2d Cir. 1943) (services rendered by employees who received shares of stock as bonuses from the taxpayer held to be "property received" in predecessor to § 1001(b)). *See infra* notes 113-29 and accompanying text.

The only type of economic benefit that most courts have yet to include as an item of gross income is that derived from the receipt of an interest-free or low-interest loan.[36] The interest-free loan cases will be considered later. For now it is sufficient to note that those cases are unique among barter transactions and should not cast any doubt on the scope of section 61 insofar as in-kind transactions not involving interest-free loans are concerned.[37]

a. Bargain Purchase as Income

In the barter transactions in Revenue Ruling 79-24,[38] the Service assumed that the recipient of the property or services paid no cash for the economic benefit received. It is, of course, possible that a recipient could pay some cash for the property or services, but in an amount less than the fair market value of the property or services received. For example, assume that the housepainter in Revenue Ruling 79-24 not only painted the lawyer's residence but also paid the lawyer $2,000 cash in exchange for the lawyer's personal services. If we assume the lawyer's services had a value of $5,000, the housepainter should recognize $3,000 compensation income, representing "the difference between the amount paid for the [lawyer's services] and the amount of [their] fair market value at the time of the transfer."[39] The lawyer, of course, has received $5,000 of income, computed by adding the $3,000 value of the housepainter's services to the $2,000 cash received.

b. Fair Market Value

In barter exchanges, the Regulations require the recipient of a noncash benefit to include the benefit in income at its "fair market value,"[40] defined as "the price at which the property

36. *See, e.g.,* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Dean v. Commissioner, 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4; authorities cited *supra* note 5.

37. *See infra* notes 137-66 and accompanying text.

38. 1979-1 C.B. 60.

39. Treas. Reg. § 1.61-2(d)(2), T.D. 7554, 1978-2 C.B. 71, 73.

40. *See* Treas. Reg. § 1.61-2(d)(1), T.D. 7554, 1978-2 C.B. 71, 73. That section provides that if payment is made for services in a form other than money, the fair market value of the property or services taken in payment must be included in income. It further states that "[i]f the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary." *See infra* notes 62-65 and accompanying text. Similarly, I.R.C. § 1001(b) (1976) provides that "[t]he amount realized from the sale or other disposition of property shall be . . . the fair market value of the property (other than money) received."

would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[41] The fair market value of an item is generally an objective determination, with "individual preferences, real or feigned . . . treated as irrelevant."[42] Nevertheless, this does not mean that, in barter transactions, fair market value must always be the same regardless of the identity of the recipient of the noncash benefit. For example, a retailer who would be in a position to purchase goods at wholesale from a dealer in a cash transaction should certainly not have to recognize the retail value of those goods if the retailer receives them in a barter exchange with a dealer of such goods.[43]

When the property being valued is the type sold in the retail market, there can be a variety of prices at which the property would change hands between a willing buyer and seller. A manufacturer might sell its product to a wholesaler for $5, who would then sell it to a retailer for $10; finally, the retailer might

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Moreover, it is provided in § 83 that if, in connection with the performance of services, an employee or independent contractor receives property not subject to a substantial risk of forfeiture, he must report in his gross income the excess of the property's "fair market value" over the amount, if any, he paid for the property. The fair market value is "determined without regard to any restriction other than a restriction which by its terms will never lapse." I.R.C. § 83(a)(1) (1976). *See also* Rev. Rul. 79-24, 1979-1 C.B. 60.

41. Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 367, 368. *See* Staley v. Commissioner, 41 B.T.A. 752, 769 (1940); Newberry v. Commissioner, 39 B.T.A. 1123, 1129 (1939).

42. M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 1.02, at 18 (3d ed. 1982). *But see* Reginald Turner, 23 T.C.M. (P-H) 464, 465 (1954) (steamship tickets won as prize valued at less than retail value, since they constituted "a luxury otherwise beyond their means").

43. The Regulations recognize the wholesaler-retailer distinction in the analogous situation involving the valuation of charitable contributions. *See* Treas. Reg. § 1.170A-1(c)(2) (1972). The general rule of § 170 is that a taxpayer donating property to charity is entitled (subject to the reductions set forth in I.R.C. § 170(e)(1) and Treas. Reg. § 1.170A-4) to a deduction equal to the fair market value of that property, Treas. Reg. § 1.170A-1(c) (1972), and that the fair market value is the price an ultimate user would pay the donor for the contributed property. Goldman v. Commissioner, 388 F.2d 476, 478 (6th Cir. 1967). Nevertheless, the Regulations specifically provide that,

> [i]f the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

Treas. Reg. § 1.170A-1(c)(2) (1972).

sell it to the ultimate consumer for $15. Each of these sales is an arm's-length transaction between willing buyers and sellers, but each is at a different price. Moreover, even sales from a wholesaler to a retailer, or a retailer to a consumer, may be made at different prices to different buyers. Certain preferred customers may be granted special low prices, different retail establishments may sell to the public at different discounts, and purchasers of large quantities of goods and services may receive special discounts. Given this variety of potential selling prices of the same goods, the proper rule of valuation in barter exchanges would be that goods and services received in a barter exchange from a seller should be valued at the cash price the recipient would have been required to pay had he or she purchased the same quantity of goods and services from this seller for cash.[44] Only that amount represents the economic benefit received by the taxpayer.

2. *The Presumed-Equivalence-In-Value Principle*

a. The Relevance of the Value of the Economic Benefit Given Up

In any exchange in which a taxpayer receives a noncash benefit, he or she is taxable on the value of the benefit received (Principle I), and not on the value of what he or she gave up. Nevertheless, at times, evidence of the value of what was given up may be relevant, or even conclusive, in determining the value of what was received. This is because proof of what one arm's length buyer would pay to acquire property is evidence of the value of the property.[45] For example, when Individual A exchanges land worth $100,000 for B's closely held stock, $100,000 represents the amount that A, an arm's length pur-

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44. *See supra* note 43.

45. *See supra* note 41. The courts have often used the so-called "comparable sales" method to value property. *See, e.g.,* Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 19 (1979); Estate of Fawcett v. Commissioner, 64 T.C. 889, 899 (1975); Estate of Nail v. Commissioner, 59 T.C. 187, 193 (1973).

> The "comparable sales" method functions by: (1) Locating [properties] as physically similar (comparable) as possible to the subject [property] which (2) have been sold on the open market in noncollusive, nonforced sales for cash or cash equivalent, within (3) a reasonable time of the date for which a value of the subject property is desired. . . . Like most valuation techniques, the comparable sales method is far from an exact science. However, it is based upon the commonsense approach of taking the actual sales prices of properties similar to the subject property and then relating these prices to the subject property.

Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. at 19.

chaser, was willing to pay to acquire the stock. The value of the land given up, therefore, is evidence of the value of the stock received.

The evidentiary weight attributable to the value of the benefit given up should vary with the circumstances of each case. Sometimes it will have virtually no probative value;[46] other times it will constitute important evidence to be weighed along with all other relevant evidence bearing on the value of the benefit received;[47] and still other times, when it is virtually the only significant evidentiary factor bearing on the value of the benefit received, it will be conclusive of that value.[48] Only in the last circumstance is the oft-quoted statement that "the value of the two properties exchanged in an arm's length transaction are either equal in fact, or are presumed to be equal,"[49] appropriate.

b. The Irrebuttable Presumption of Equality of the Two Sides of an Arm's Length Exchange: When Should It Be Used?

The leading case supporting the presumed-equivalence-in-value principle is the 1963 Supreme Court decision in *United States v. Davis*,[50] which involved the transfer of 1,000 shares of appreciated marketable stock by a husband to a wife as part of a divorce settlement. The Supreme Court viewed the transaction as a taxable exchange in which the husband transferred his stock in exchange for his wife's relinquishment of her marital rights. Thus, technically, the amount realized by the husband was the wife's marital rights. The Court, however, did not independently value the wife's marital rights, but simply assumed them to be equal in value to the marketable stock the husband gave in exchange. In holding that the "amount realized" by the husband on the exchange of his stock was equal to the value of such stock, the Court said:

> It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the

46. *See infra* notes 60-61 and accompanying text.
47. *See infra* notes 57-59 and accompanying text.
48. *See infra* notes 50-56 and accompanying text.
49. United States v. Davis, 370 U.S. 65, 72 (1962); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954). Experience tells us that a presumption of equality is simply not appropriate in many barter transactions. Often one side outbargains the other and in no sense can it be said that the two sides of the exchange are equal.
50. 370 U.S. 5 (1962).

contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold . . . that the values "of the two properties exchanged in an arms-length are either equal in fact, or are presumed to be equal."[51]

Similarly, if an employer pays a bonus to an employee or makes a contribution to a qualified trust for its employees in the form of appreciated property, the amount realized on the disposition of the employer's property is technically the intangible value of the employee's or employees' services, past or future, which the employer receives in exchange for the property. Again, however, because of the difficulty in valuing the services received, they are presumed to be equal to the value of the property given in exchange.[52] The employer's gain on the transfer, therefore, is the excess of the transferred property's value over its adjusted basis.[53] In the case of *Tasty Baking Co. v. United States,*[54] for example, the Court of Claims applied the *Davis* presumed-equivalence-in-value rule where the employer transferred a building, in which its executive offices and manufacturing facilities were housed, to a pension trust for the employees. The court held that the employer realized gain on the transfer of the property equal to the excess of the building's value over its adjusted basis, stating that,

[i]t is clear . . . that the [*Davis*] technique of presuming an intangible and unappraisable contribution as an equal exchange for property transferred is to be applied to a variety of situations broad enough at least to include a taxpayer who desires the separation of a wife; and one who wishes the continued adhesion of an employee.[55]

The presumption of equal value in cases like *Davis* and *Tasty Baking* is really an irrebuttable one, since in such cases either no other evidence of the value of the benefit received is available, or, if such other evidence is available, it is insignificant when weighed against the "best" evidence of what a buyer in an arm's length transaction—i.e., the buyer in the very transaction under examination—paid for the benefit.[56] As more in-

51. *Id.* at 72 (quoting Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954)).

52. *E.g.,* International Freighting Corp. v. Commissioner, 135 F.2d 310, 313 (2d Cir. 1943). *Cf.,* United States v. General Shoe Corp., 282 F.2d 9, 12-13 (6th Cir. 1960), *cert. denied,* 365 U.S. 843 (1961) (transfer of appreciated property to an employees' trust); Tasty Baking Co. v. United States, 393 F.2d 992, 995 (Ct. Cl. 1968) (same).

53. *See* cases cited *supra* note 52.

54. 393 F.2d 992 (Ct. Cl. 1968).

55. *Id.* at 995.

56. In Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969), for example, the Court of Claims stated that where one side of a barter transaction has no readily ascertainable market value but the other side does,

dependent evidence of the market value of the benefit received becomes available, however, and the clarity of the value of what was given up lessens, the irrebuttable presumption of *Davis* and *Tasty Baking* is less appropriate, and the value of what was given up is, at best, only one piece of evidence of the value of the benefit received.

c. The Value of the Benefit Given Up as Probative But Not Conclusive Evidence of the Value of the Benefit Received

Reliance on the value of the property given up as the sole and conclusive evidence of the value of the property received should clearly be limited to cases where the value of the property received cannot be reasonably ascertained in other ways. This does not mean, however, that in all other cases the value of the benefit given up is irrelevant in the valuation process. Sometimes it will be probative, though not conclusive, evidence of the value of the benefit received.[57]

Consider, for example, a barter exchange of land for a painting, where the land has a reasonably determinable value but the painting is by an artist who has sold few other works in the marketplace. The landowner's gain is, of course, the excess of the value of the painting received over the adjusted basis of the land given up. But in determining the painting's value, proof of the value of the land given up is surely a relevant factor. While independent appraisals of the painting received in this barter transaction would be appropriate, as would evidence

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the value of the side with the readily ascertainable value "constitutes the best evidence of the fair market value of the [other side]." *Id.* at 1252.

57. For example, in Bar L Ranch, Inc. v. Phinney, 426 F.2d 995 (5th Cir. 1970), the Fifth Circuit concluded that the value of property given up should be considered evidence of the value of property received, but that on the facts of the case, "[i]t would . . . be inappropriate to give the presumed-equivalence-in-value rule the full presumptive effect given in *Davis,* et al." *Id.* at 1001. In *Bar L Ranch* a taxpayer, who was insolvent, transferred some land in exchange for notes and accounts receivable with a face value of $118,000. The taxpayer, in determining the amount realized on the disposition of the land, valued the notes received at $50,000, the value of the land transferred. The district court concluded that evidence of the value of the land was irrelevant. 300 F. Supp. 839, 841 (S.D. Tex. 1969). It stated that "[o]nly two amounts—the land's adjusted basis . . . and the value of the note and accounts—are material." *Id.* The trial court noted further that "an expert witness offering a reliable appraisal of the note and accounts would have been more helpful." *Id.* at 842. The Fifth Circuit, in reversing and remanding the lower court's decision, agreed as to the relevance of a reliable appraisal but thought that "evidence of the value of the land is relevant in determining the fair market value of the note and accounts received. . . ." 426 F.2d at 1000.

of the price at which previous works of the same artist sold, the evidence of the amount paid by the landowner—the value of the land given up—is also probative of the painting's value.[58] The value of the land represents what one arm's length buyer was willing to pay for this artist's work. Since there have been few other market transactions in the artist's work in the past, the evidence of the amount actually paid in this market transaction for this unique work of art seems quite significant. Of course, proof that the landowner was not at all knowledgeable about the value of art would significantly detract from the weight of this evidence in determining the painting's value, as would evidence that the landowner was not knowledgeable about the value of the land given up.[59]

d. Circumstances in which the Value of the Benefit Given Up Is Virtually Irrelevant

If, in the above example, the painting had been acquired not for land, which was easier to value than the painting, but for another painting by an equally obscure artist, the value of the property given up would have little, if any, probative value in determining the value of the painting received. Where evidence of the value of the property given up is no more reliable than that of the value of the property received, using the former to value the latter would be a circular bootstrap operation, inevitably involving the use of the value of each painting to determine the value of the other.[60]

Similarly, where the value of the in-kind benefit received is readily determinable by numerous other market transactions,

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58. *See* Bar L Ranch, Inc. v. Phinney, 426 F.2d 995 (5th Cir. 1970), discussed *supra* note 57.

59. In Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1256 (Ct. Cl. 1969), for example, the Court of Claims, in applying its presumed-equivalence-in-value rule, found it important that the taxpayer had been fully informed and was knowledgeable about the value of the property being received.

60. The Court of Appeals for the Second Circuit made it clear in Seas Shipping Co. v. Commissioner, 371 F.2d 528 (2d Cir.), *cert. denied,* 387 U.S. 943 (1967), that the equating of two sides of a barter as a method of valuation should be used only under certain limited circumstances. *Id.* at 532. It noted the obvious dangers in evaluating the consideration involved on one side of a barter by determining the worth of the consideration on the other side:

> In the first place, the two sides of the barter may, for various reasons, not be equal in value. Secondly, the barter equation method is in the nature of a bootstrap operation since there is usually no logical reason to start with one side rather than the other. . . . Thirdly, the evidence on the value of one side of a barter may be no more reliable than that on the value of the other side.

Id. at 529-30.

evidence of the value of the benefit given up, even if relatively easy to ascertain, has little, if any, probative value.[61] Assume, for example, that a doctor performs a standard physical examination for which the doctor customarily charges $500 to cash patients. One time, however, the doctor agrees to perform the same physical examination for an accountant in exchange for which the accountant is to prepare the doctor's tax return. The accountant should, of course, report the $500 value of the doctor's services as income. That the accountant could show conclusively that his or her usual charge for preparing a similar return would have been only $400 is virtually immaterial to determining the value of the doctor's services received. Since there presumably exist numerous other market transactions in which patients paid $500 for the same medical services performed by this doctor, additional evidence of what this one purchaser was willing to pay seems entirely insignificant.

e. The Effect of the Parties' Stipulating a Cash Price for the Property or Service Exchanged

At times, a taxpayer may initially contract to sell his or her property or perform services at a stipulated cash price but may subsequently agree to accept an in-kind consideration in lieu of the stipulated cash price. In such cases the Regulations state that the stipulated cash price "will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary."[62] For example, assume Individual *A*, a cash basis taxpayer in an arm's length transaction, agrees to perform services for Individual *B* for $20,000. When payment is due, however, *A* accepts 10 shares of closely held stock owned by *B* in lieu of the $20,000 stipulated. In general, under the Regulations, no independent inquiry need be made into the value of *B*'s closely held stock. Rather, the Regulations presume it to be worth $20,000 (the stipulated cash price). *A* should therefore report $20,000 of income and take a $20,000 cost basis in the acquired property.

The presumption that the property received is equal to the stipulated cash price is appropriate in the above example, since the described transaction, when properly viewed, is not a bar-

61. There is no precedent authorizing the use of a barter-equation method where there is an active market for the property to be valued. *Id.* at 532.

62. Treas. Reg. § 1.61-2(d)(1), T.D. 7544, 43 Fed. Reg. 31,913 (1978). Some examples of evidence to the contrary might be where the stipulated price is obviously a sham or where the stipulated price had been the subject of renegotiation.

ter exchange at all. Rather, it is two cash transactions. If a taxpayer accepts property in satisfaction of a cash debt, it is well settled that such transaction "is to be treated no differently than as if the debtor issued his check to the creditor in payment of the debt and then received the creditor's check in payment for the property."[63] Thus, *A* should be viewed as having received $20,000 in cash compensation and then as having used the $20,000 cash to purchase *B*'s stock. Whether *A* got a good deal or a bad deal by purchasing *B*'s stock for $20,000, or whether *B*'s stock is worth more or less than $20,000, is of no immediate tax concern, since taxpayers do not realize gain or loss when in an arm's length transaction they pay cash for goods or services.[64] They are simply assumed to have received what they paid for.

The stipulated price concept explains what would apparently be the tax consequences in a barter exchange if the property received could be independently valued, but the property given up was of such highly marketable quality that one could say that the parties were dealing with one another with a stipulated cash price in mind and then discharging that cash price with property. For example, assume that Individual *A* acquires a painting from Individual *B* and in exchange gives Individual *B* stock which had a basis to *A* of $50,000 and was selling on the New York Stock Exchange for $100,000. Individual *A* should report a $50,000 gain on the transfer of the stock (the excess of the value of the marketable stock given up over its basis), without regard to any independent proof as to the value of the painting received. As in the prior example, this transaction should properly be viewed as one in which *A* agreed to purchase *B*'s painting for a $100,000 stipulated cash price and then satisfied the obligation thus created by transferring the marketable stock. In such a transaction, the amount realized is the $100,000 obligation cancelled.[65] Whether *A* received a painting worth more or less than $100,000 will be taken into account at the time *A* disposes of the painting. It is only in true barter transactions, in which the value of the benefit received is the measure of the amount realized on the disposition of the property given up, that good or bad deals are reflected at the time of the initial barter exchange.

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63. Schultz v. Commissioner, 59 T.C. 559, 565 (1973). *See generally* 2 B. BITTKER, *supra* note 20, ¶ 40.4.1 (property transferred in satisfaction of a debt).

64. 1 B. BITTKER, *supra* note 20, ¶ 5.8.4 (gain); Treas. Reg. § 1.165-1(b), T.D. 6735, 29 Fed. Reg. 6,493 (1964) (loss).

65. *See supra* note 63 and accompanying text.

3. *The Value Received Theory of Cost*

Whenever a taxpayer receives property in a taxable exchange, he or she is in the same economic position as the taxpayer who receives additional cash income which the taxpayer then uses to purchase equivalent property. In a rational tax system, the two taxpayers must be treated alike. That is, the property recipient must not only be required to report income equal to the value of the property received (Principle I), but he or she must also be given a cost basis in the property equal to its value. If a taxpayer were not given a fair market value basis in property includable in the taxpayer's gross income, the taxpayer would be subject to a double tax on the property—once on the value of the property when received and a second time on the amount realized upon its disposition.

For this reason the courts have long held that, for purposes of section 1012, the "cost" of property that is taxable upon receipt is the fair market value of such property.[66] The literal value, if any, of the quid pro quo given in exchange for the property does not justify the rule, for it applies regardless of the actual value of the property transferred in the exchange. Rather, the justification for the rule is the need to reach rational tax results.[67] This nonliteral-value-received interpretation of "cost" applies equally to found property or property won as a prize, where there is literally no cost to the taxpayer,[68] as to property received in a taxable exchange for other property, where it can be said that the taxpayer has a literal cost equal to the fair market value of the property given in exchange.[69]

Professor Ernest Brown, in his seminal article, *The Growing 'Common Law' of Taxation*,[70] hypothesized the case of a taxpayer who received an automobile valued at $5,000 as a bonus from his employer or as a prize in a lottery.[71] The taxpayer

66. *See, e.g.,* Smith v. Russell, 76 F.2d 91, 93 (8th Cir. 1935), *cert. denied,* 296 U.S. 614 (1936); Knight v. Commissioner, 28 B.T.A. 188, 190 (1933); Heninger v. Commissioner, 9 B.T.A. 1318, 1320 (1928); B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 464 (4th ed. 1972); 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 838 (1972); Brown, *The Growing 'Common Law' of Taxation,* 1961 SO. CAL. TAX INST. 1, 7-8; Greenbaum, *The Basis of Property Shall Be the Cost of Such Property; How is Cost Defined?,* 3 TAX L. REV. 351, 360-61 (1948); Wurzel, *The Tax Basis for Assorted Bargain Purchase or: The Inordinate Cost of "Ersatz" Legislation,* 20 TAX L. REV. 165, 175 (1964-65).

67. *See* Brown, *supra* note 66, at 7-8.

68. *Id.*

69. *See infra* note 73. *See also infra* notes 74-76 and accompanying text.

70. 1961 SO. CAL. TAX INST. 1.

71. *Id.* at 7-8.

reported the automobile's value as income, but soon decided to sell it for cash.

> Its value, let us say $5,000, is clearly income to him when received. He reports it as such and pays the appropriate tax. But he decides that such a car is beyond his needs and style and sells it for cash. What is the tax result? What is his basis? Search the statute as we will, all we can find is "cost". And what is cost? Literally, in the case of the bonus it is zero. Literally, in the case of the lottery prize, it is the price of the ticket. But we should all be startled if our taxpayer were required to pay a tax on the value of the car when he received it and another tax on all, or almost all, of the proceeds of sale. So we should, I am sure, stretch the word "cost" almost out of recognizable shape to make it mean the amount at which the car was taken into income, and we should feel justified in doing so in order to give the statute the quality of rationality.[72]

When Professor Brown speaks of giving "the statute the quality of rationality," he obviously means that it would be an irrational tax statute that taxed a person who received a $5,000 car in a lottery or as compensation differently from a similarly situated taxpayer who received $5,000 cash and used it to purchase the car.[73]

The leading judicial exposition of the value received theory of cost is the Court of Claim's 1954 decision in *Philadelphia Park Amusement Co. v. United States*.[74] In that case, a taxpayer conveyed a bridge to the City of Philadelphia in exchange for a ten year extension of its franchise to operate a passenger railway in the park. The issue was the cost basis of the depreciable franchise extension to the amusement company under the predecessor of section 1012. The court held that, in a taxable exchange of properties, it is the value of the property received in the exchange, and not the value of the property given up, that determines the property's basis in the

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72. *Id.* Professor Brown goes on to note that "[p]rior to 1954, we would have been faced with the same problem [of reading the word "cost" in a nonliteral fashion] had our taxpayer sold property received as a dividend in kind, but Section 301(d)(1) has now filled that gap. . . ." *Id.*

73. The same sort of double taxation recognized by Professor Brown in his hypothetical involving the receipt of a car as a bonus can occur in a barter exchange of properties. Suppose that taxpayer *A* exchanges property with a fair market value of $1,000 and a basis of $900 for property of taxpayer *B* which has a fair market value of $2,000 and a basis of $1,000 ($2,000 amount realized—$900 basis). If *A*'s basis in the property received were the $1,000 value of the property given up, instead of the $2,000 value of the property received, and *A* decided to sell the property received from *B* for $2,000, *A* would be required to recognize another $1,000 in income. Thus, *A* would recognize a total of $2,100 on the two transactions, in which *A*'s economic gain was only $1,100. *See infra* text accompanying note 76.

74. 126 F. Supp. 184 (Ct. Cl. 1954).

hands of the recipient.[75] Therefore, the basis of the franchise to the taxpayer was its fair market value on the date of the exchange. The court explained its reasoning as follows:

> When property is exchanged for property in a taxable exchange the taxpayer is taxed on the difference between the adjusted basis of the property given in exchange and the fair market value of the property received in exchange. For purposes of determining gain or loss the fair market value of the property received is treated as cash and taxed accordingly. To maintain harmony with the fundamental purpose of these sections, it is necessary to consider the fair market value of the property received as the cost basis to the taxpayer. The failure to do so would result in allowing the taxpayer a stepped-up basis, without paying a tax therefor, if the fair market value of the property received is less than the fair market value of the property given, and the taxpayer would be subjected to a double tax if the fair market value of the property received is more than the fair market value of the property given. By holding that the fair market value of the property received in a taxable exchange is the cost basis, the above discrepancy is avoided and the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, or that should have been recognized, or minus any loss recognized, or that should have been recognized.[76]

The Court of Claims noted, however, that in most taxable exchanges the same basis figure would result whether the taxpayer used the value received or the value given up theory of cost, since generally the value of "the two properties exchanged in an arms length transaction are either equal in fact, or are presumed to be equal."[77] And, in fact, the Court of Claims said that if the value of the franchise received could not be determined with reasonable certainty, then the fair market value of the bridge given up should be established and presumed to be the value of the extended franchise (Principle II), and hence the basis of that franchise.[78] In such a case, the court would end up using the literal value of the property given up (the bridge) to determine the basis of the property received (the franchise). But, in the final analysis, it remains the value of the benefit received—albeit arrived at by reference to the value of the benefit given up—that determines the basis of the property received.

4. *The Value Received Theory of Deductions*

The term "paid or accrued"[79] or "paid or incurred"[80] as

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75. *Id.* at 188.
76. *Id.* at 188-89.
77. *Id.* at 189.
78. *Id.*
79. See, for example, I.R.C. §§ 163, 164 (1976) which allow a taxpayer a deduction for interest or taxes "paid or accrued."

used throughout the Code plays the analogous role for expenditures resulting in immediate deduction that the term "cost" plays for capital expenditures. In fact, the Regulations specifically define the cost basis of property as "the amount paid for such property."[81] Thus, when taxpayers "pay" a capital expense they get a cost basis; when they "pay" a current expense they receive an immediate tax deduction. As the discussion of the value received theory of cost made clear, courts have long felt justified in stretching "the word 'cost' almost out of recognizable shape" to make it mean the value at which property is taken into income "in order to give the statute the quality of rationality."[82] To achieve the same rational tax results in the case of deductible items received as income, the amount "paid or accrued" or "paid or incurred" must include the fair market value of the in-kind benefit to the taxpayer.

To illustrate this theory, we can once again consider the tax position of the doctor who receives $500 worth of personal tax return preparation services from an accountant, in exchange for providing the accountant with medical services. The doctor, of course, reports the $500 worth of services received in gross income. But the tax consequences cannot stop there. The doctor must also be treated as having paid $500 for the tax preparation service and should be entitled under section 212(3) to an itemized deduction in that amount.[83] Only an irrational tax system would tax a person who received $500 worth of accounting services as in-kind compensation differently than a taxpayer in the economically equivalent position of having received $500 of cash compensation which the taxpayer used to pay for the accounting services. Faced with this issue, Professor Brown certainly would feel justified in stretching the words "paid or incurred," as used in section 212, "out of recognizable shape to make [them] mean the amount at which the [accounting services were] taken into income, . . . in order to give the statute the quality of rationality."[84]

80. See, for example, I.R.C. § 162 (1976) (ordinary and necessary business expenses) and § 212 (1976) (ordinary and necessary expenses for the production of income), which allow a taxpayer a deduction for expenses "paid or incurred."

81. Treas. Reg. § 1.1012-1 (1960).

82. Brown, *supra* note 66, at 8. *See supra* notes 66-78 and accompanying text.

83. I.R.C. § 212(3) (1976) permits an individual a deduction for the "ordinary and necessary expenses paid or incurred during the taxable year—. . . in connection with the determination, collection, or refund of any tax."

84. *See* Brown, *supra* note 66.

While the doctor literally paid for the accountant's services by furnishing medical services to the accountant, it is not the literal worth of the services given up that determines the amount of the deduction, but rather the value of the services received and reported in income.[85] This is clear from *Philadelphia Park*.[86] Therefore, even if it were conclusively shown that the doctor had given up $600 worth of medical services to acquire only $500 of tax preparation services, the section 212(3) deduction would remain $500—the value of the accountant's services reported in income. To allow a deduction for the literal value of the services the doctor gave up would mean granting a deduction for an amount "paid" with untaxed dollars.

In essence, the value received theory of cost and the value received theory of deductions are but one theory: Whenever a taxable noncash economic benefit is received, the taxpayer must be treated as if he or she paid an amount equivalent to the value of the in-kind benefit. Thus, when a taxpayer receives title to property in a taxable transaction, the property's fair market value is the amount includable in income and is treated as the amount paid to acquire the property; the value of the property received becomes the cost basis of the property in the taxpayer's hands. Similarly, when a taxpayer receives the deductible tax preparation services of an accountant in lieu of cash income and includes the value of those services in gross income, the value included is considered the amount paid to the accountant for the latter's services.

If a taxpayer exchanges both cash and noncash consideration for a deductible economic benefit, the proper analysis should be identical to that used for bargain purchases of property. Our doctor, for example, might have performed services and paid $100 cash to acquire the accountant's tax preparing services worth $500. In that case, the doctor would report $400 of income and deduct $500 as an itemized deduction. The $500 deduction includes $400 for the value of the accountant's in-kind services to the doctor includable in the latter's gross income (Principle IV)[87] plus the $100 the doctor actually paid for

85. By analogy, see the discussion of the value received theory of cost, *supra* text accompanying notes 66-78.

86. 126 F. Supp. at 188. While *Philadelphia Park* dealt with the value received theory of cost, its reasoning is equally applicable in determining the amount of the available deduction in a barter exchange.

87. In a barter transaction in which cash is included as part of the exchange, the value of the in-kind benefit received by the barterer who also gave some cash in return is the difference between the benefit's fair market value

the services.[88]

5. *The No-Wash Principle*

The basic structure of our tax system involves setting out items of gross income and then listing deductions therefrom. Therefore, whether the inclusion of an in-kind benefit in a barterer's income would entitle a taxpayer (under Principle IV) to claim an equal current deduction should be entirely irrelevant to the determination that the taxpayer received an item of gross income in the first place.

If, for example, Individual *A* exchanges inventory for *B*'s deductible services, Principle I dictates that *A* has gross income to report from the sale of inventory equal to the fair market value of the services received from *B*. Furthermore, Principle IV permits *A* to claim an equal business deduction in the amount of the value of *B*'s services. This final principle makes it clear that *A* must separately report the income and deduction items. Principles I and IV operate independently and may not be combined to create a wash transaction in which neither the income nor the deduction items need be listed. It is theoretically no more appropriate for Individual *A* to exclude the value of *B*'s deductible services from income in the described barter exchange, than it would be for *A* to exclude cash income derived from the same inventory simply because *A* used the cash to purchase the deductible services of *B*.

As the following discussion illustrates, however, it is not simply a matter of theoretically correct reporting that justifies the requirement that taxpayers always list both income and deduction items. It is often a matter of considerable substantive importance.

a. The Audit Issue

From an administrative viewpoint, the most obvious reason for requiring taxpayers to list on their tax returns what they consider to be the equal income and deduction items resulting from a barter exchange is to enable the Service to audit the returns properly and to determine if the taxpayer was, in fact, correct. For example, what a taxpayer may think is a currently

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and the amount of cash paid for it. *See supra* notes 38-39 and accompanying text.

88. In addition to the value of the in-kind benefit received, the amount "paid or accrued" or "paid or incurred" also includes amounts actually paid or incurred in the literal sense of these words.

deductible business expense may, in fact, prove on examination to be a nondeductible personal or capital expenditure. But if the return on its face shows neither the income nor the deduction items, such an examination is unlikely to occur. If taxpayers were allowed to omit reporting items of gross income whenever they had a "reasonable basis"[89] to believe that the inclusion of that income item would entitle them to an offsetting current deduction, the Service's audit capability would be severely diminished. Furthermore, a taxpayer's conclusion that a barter transaction results in a total wash for tax purposes could be erroneous for a variety of reasons.

b. An Equal Deduction is Not Available

While in every barter transaction, taxpayers should be treated as having paid for the in-kind benefit they receive (Principles III and IV), that, of course, does not mean they will always be entitled to a current deduction for the amount that they are deemed to have paid. Obviously, if a taxpayer exchanges services for the personal services of a plumber, the taxpayer should properly report the value of the plumber's services as income without the benefit of any offsetting deduction.[90] Similarly, if the services received are those of a doctor, the recipient can claim an offsetting deduction only if he or she otherwise itemizes deductions[91] and his or her other medical expenses exceed three percent of adjusted gross income.[92]

Moreover, a barter exchange might result in a situation where the taxpayer would be entitled to a deduction equal to the income reportable, but the deduction would be properly available only over a period of time. An example would be a situation in which a taxpayer exchanges inventory for the services of an architect who designs the taxpayer's new factory building. The taxpayer would have current income from the sale of the inventory but would be required to capitalize the cost of the architect's services[93] and take depreciation deduc-

89. *See* ABA Comm. on Professional Ethics, Op. 314, 51 A.B.A.J. 671 (1961); Rowen, *When May a Lawyer Advise a Client That He May Take a Position on His Tax Return?*, 29 TAX LAW. 237 (1976).

90. I.R.C. § 262 (1976) states that: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

91. *See supra* note 14.

92. Medical expenses must exceed five percent of adjusted gross income to be deductible, effective with taxable years beginning after December 31, 1982. *See supra* note 17.

93. *See* Treas. Reg. § 1.263(a)-2(d) (1960).

tions over the life of the new factory building.[94] A system permitting taxpayers to exclude both the income and deduction items would in effect allow taxpayers to expense items required to be capitalized.

There are also situations where the deemed payment under Principle IV would not give rise to a deduction, notwithstanding its relation to the taxpayer's business. For example, if Individual *A* swaps services for the business related services of Individual *B*, Individual *A* would normally have both income and a current deduction. But if Individual *B* were a government official and the payment constituted an illegal bribe, Individual *A* would not be entitled to an offsetting deduction by reason of section 162(c)(1).[95]

c. The Income to Be Reported is Capital Gain

Taxpayers would be disadvantaged if they were required to exclude both the income and deduction items in a barter exchange that resulted in the realization of capital gain and an ordinary business deduction. Assume, for example, that Individual *A*, a fifty percent bracket taxpayer, owns stock with a basis of $1,000 and a value of $4,000, which *A* trades for the currently deductible services of Individual *B*. Individual *A* should be taxed as if *A* sold the stock for $4,000 and then used the $4,000 to purchase the services. *A*, therefore, should report $3,000 of capital gain and $4,000 in business deductions. Assuming the $3,000 is long term capital gain, a fifty percent tax bracket taxpayer would have a tax liability of $600. The $4,000, however, would decrease the same taxpayer's taxes by $2,000, for a net reduction in taxes of $1,400 on the transaction. If, on the other hand, the taxpayer netted the $3,000 capital gain against the $4,000 deduction and claimed a deduction of only $1,000 on his or her tax return, the taxpayer's tax savings would be only $500.

94. Under the new Accelerated Cost Recovery System (ACRS), the factory building could be depreciated over 15 years using either straight line depreciation or the 175-declining balance method, switching to straight line at the time that will maximize the deductions. *See* I.R.C. § 168(b)(1)(B)(2) (Supp. 1982).

95. I.R.C. § 162(c)(1) (1976) states, in part, that "no deduction shall be allowed under [§ 162] for any payment made, directly or indirectly, to an official or employee of any government . . . if the payment constitutes an illegal bribe or kickback. . . ."

d. The Exchange Affects the Amount of a Taxpayer's Itemized Deductions

In our complex tax system, some deductions are allowable in computing an individual's adjusted gross income, while others are allowable only as itemized deductions from adjusted gross income.[96] Where a barter exchange produces income and an equal itemized deduction, the omission of both items would often have significant tax repercussions. For example, a married taxpayer having $3,000 of itemized deductions for the year who exchanges property or services for $500 worth of services for which an additional itemized deduction is permitted is entitled to deduct only $100 of the $500 worth of services acquired. Analyzed as a two-payment transaction, this exchange increases the taxpayer's taxable income by $400. A no income, no deduction rule, on the other hand, would not cause an increase in the taxpayer's taxable income at all.

Even if a married taxpayer's itemized deductions otherwise exceed $3,400, so that an additional itemized deduction would be fully deductible, the very inclusion of an additional item of gross income could affect the taxpayer's itemized deductions for medical expenses and charitable contributions. Medical deductions are limited to the amount which exceeds three percent of a taxpayer's adjusted gross income.[97] If the adjusted gross income, therefore, is not increased by the in-kind benefit received, the medical deduction may be overstated. If, for example, a taxpayer with medical expenses well in excess of three percent of adjusted gross income receives $500 of in-kind tax preparation services in a barter exchange, the taxpayer should: (i) increase adjusted gross income by the $500 value of the services received; (ii) claim a $500 itemized deduction for tax return preparation; and (iii) reduce otherwise allowable medical deductions by $15 (three percent of the $500 of additional adjusted gross income). The no income, no deduction approach would result in giving the taxpayer $15 more in medical deductions than he or she is entitled to. On the other hand, a no income, no deduction approach could understate the amount of a taxpayer's charitable deductions, since the Code limits the maximum amount permitted as a charitable deduction to a percentage of the taxpayer's adjusted gross income.[98]

96. *See* I.R.C. § 62 (1976).

97. I.R.C. § 213(a)(1) (1976). *See supra* note 17.

98. *See* I.R.C. § 170(b) (1976).

e. The Exchange Affects Whether Certain Code Sections Apply

Even where the receipt of an in-kind benefit would entitle the taxpayer (under Principle IV) to an equal deduction in computing his or her adjusted gross income, including the item in gross income could have important tax repercussions. For example, section 6501(e) extends the running of the normal three-year statute of limitations to six years where a taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return."[99]

Moreover, an increase in gross income may cause problems of qualification for a subchapter S corporation[100] or could generate personal holding company problems for a corporate barterer. Section 1372(e)(5)(A) states that a subchapter S election terminates in any year in which a corporation has gross receipts, more than twenty percent of which is passive investment income. Such income includes "gross receipts derived from . . . rents . . . interest, . . . and sales or exchanges of stock or securities."[101] Thus, if a subchapter S corporation exchanges stock or securities, or the use of its monetary or nonmonetary property, for immediately deductible business items, the exchange could jeopardize the subchapter S election. That the exchange generates an equal deduction is immaterial to the application of this provision.

Similarly, the classification of a corporation as a personal holding company depends, in part, on the amount of its gross income derived from rents, interest, and personal service contracts.[102] If a corporate barterer were entitled to omit such gross income items because it would be entitled under Principle IV to an equal deduction, the personal holding company rules could be avoided.

Finally, a number of Code sections provide tax breaks to certain taxpayers, usually based on their adjusted gross in-

99. I.R.C. § 6501(e) (1976).

100. I.R.C. § 1372(e)(5)(A) (1976).

101. I.R.C. § 1372(e)(5)(C) (1976). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.03, at 6-14 (4th ed. 1979) (termination of election under subchapter S).

102. Section 542(a)(2) defines a "personal holding company" as any corporation where "[a]t least 60 percent of its adjusted ordinary gross income . . . is personal holding company income." I.R.C. § 542(a)(1) (1967). Under I.R.C. § 543(a) (1976), personal holding company income includes, inter alia, interest and rents. *See generally* B. BITTKER & J. EUSTICE, *supra* note 101, ¶ 8.22.

comes. For example, whether taxpayers must include unemployment compensation benefits in gross income depends on the amount of their adjusted gross income. In general, under section 85, if a married taxpayer's unemployment compensation and adjusted gross income exceeds $18,000, part of the unemployment compensation received becomes taxable income.[103] Similarly, under section 105(d) of the Code[104] the determination whether certain disability payments are includible in a taxpayer's gross income depends on the amount of the taxpayer's adjusted gross income.[105] If taxpayers did not have to report in-kind benefits in income because they would be entitled to an itemized deduction equal to the value of the in-kind benefit received (under Principle IV), they could avoid the intended income restrictions of sections 85 and 105.

C. THE VALUE RECEIVED THEORY OF DEDUCTIONS AND THE NO-WASH PRINCIPLE

The two-payment analysis demonstrates that every barter exchange should be treated the same as its economically equivalent cash transaction.[106] To achieve tax parity between barter and cash transactions, the courts and the Service should consistently adhere to the five tax principles described in the previous section. This section of the Article discusses current law regarding barter exchanges, with particular focus on the

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103. The part of the unemployment compensation included is the lesser of one-half of the amount of the excess over $18,000 or the amount of the unemployment compensation. I.R.C. § 85(a) (1976 & Supp. 1980), *amended by* TEFRA, *supra* note 17, § 611.

104. I.R.C. §§ 105(d)(1) & (3) (Supp. 1982) read as follows:

(d) Certain disability payments.

(1) In general.—In the case of a taxpayer who—

(A) has not attained age 65 before the close of the taxable year, and

(B) retired on disability and, when he retired, was permanently and totally disabled,

Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of permanent and total disability.

. . .

(3) Phaseout over $15,000.—If the adjusted gross income of the taxpayer for the taxable year (determined without regard to this subsection and section 221) exceeds $15,000, the amount which but for this paragraph would be excluded under this subsection for the taxable year shall be reduced by an amount equal to the excess of the adjusted gross income (as so determined) over $15,000.

105. I.R.C. § 105(d)(3) (Supp. 1982). *See supra* note 104.

106. *See supra* notes 8-19 and accompanying text.

last two of these principles: Principle IV, the value received theory of deductions, and Principle V, the no-wash principle.

Taxpayers, the Service, and the courts have suggested a number of different solutions to deal with various barter exchanges. The various approaches can be classified as: (1) "The Deduction Without Income Approach;" (2) "The Income Without Deduction Approach;" (3) "The No Income, No Deduction Approach;" and (4) "The Both Income and Deduction Approach" (the two-payment solution).

To illustrate the various approaches, assume a barter exchange in which Individuals *A* and *B* swap currently deductible business services. The deduction without income approach would permit *A* and *B* each to claim a deduction for the value of the other's services without requiring them first to report the value of those services in income. The equally asymmetric income without deduction approach would require each to report the value of the other's services in income but would not allow either to claim any offsetting deduction. The remaining two approaches would require *A* and *B* either to report the value of the other's services in income and claim a business deduction in the same amount (both income and deduction approach) or to omit both the income and deduction items from their returns (no income, no deduction approach).

The two asymmetrical approaches, the income without deduction approach and the deduction without income approach, seem patently absurd. There is surely no rational reason why barter recipients should be better off (in the case of the deduction without income approach) or worse off (in the case of the income without deduction approach) than they would have been had they received cash and used it to pay for the economic benefit received.

These approaches, in fact, seem so unjustified that it is hard to imagine that either taxpayers or the Service would have seriously urged them. But taxpayers have actually advanced the deduction without income approach in two types of barter exchanges: the exchange of services for property[107] and the exchange of services for the rent-free use of property.[108] Moreover, the Service consistently has advanced the income without deduction approach in another type of barter transaction: the exchange of the use of money for services, a transaction more commonly referred to as the interest-free loan

107. *See infra* notes 113-29 and accompanying text.
108. *See infra* notes 130-36 and accompanying text.

between employer and employee.[109]

While no court has ever accepted the deduction without income approach,[110] a trial judge in the Court of Claims recently affirmed the Service's income without deduction approach in an interest-free loan case.[111] But even those courts that have rejected both asymmetric approaches have not determined conclusively whether our tax law includes a value received theory of deductions, and consequently have left open the issue whether barter exchanges for deductible items should be reported by using the two-payment approach or the "no income, no deduction approach."[112]

Three of the four possible approaches are illustrated in the 1941 case of *International Freighting Corp. v. Commissioner*,[113] in which a corporation transferred 150 shares of marketable DuPont stock to its employees under a bonus plan. The stock had a basis to the taxpayer corporation of $16,153 and a value of $24,858 at the time of delivery. The taxpayer claimed a $24,858 deduction but did not report any gain on the disposition of the stock (the deduction without income approach). The Service at first did not argue that the corporation had realized a taxable gain on the disposition of its DuPont stock;[114] rather, the Service argued that the proper amount of the deduction was only the $16,153 cost of the stock transferred. This was essentially a no income, no deduction approach. Before the Board of Tax Appeals,[115] however, the Service made an alternative argument that if the court held that the taxpayer was, in fact, entitled to a $24,858 fair market value deduction, then it should also hold that the taxpayer realized a taxable gain of $8,705 (the $24,858 value of the stock less its $16,153 basis) on the disposition of the DuPont stock (both income and deduction approach).[116]

The Board of Tax Appeals concluded that the Commis-

109. *See infra* notes 137-66 and accompanying text.

110. *See infra* notes 113-36 and accompanying text.

111. Hardee v. United States, 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. 1982). *See infra* notes 146-49 and accompanying text.

112. *Compare* International Freighting Corp. v. Commissioner, 135 F.2d 310, 313-14 (2d Cir. 1943) (two payment approach) *and* United States v. General Shoe Corp., 282 F.2d 9, 14 (6th Cir. 1960) (same) *with* Bellows v. Commissioner, 26 T.C.M. (CCH) 978, 980 (1967) (no income, no deduction approach) *and* Greenspun v. Commissioner, 72 T.C. 931, 946 (1979) (same) *and* Martin v. Commissioner, 649 F.2d 1133, 1134 (5th Cir. 1981) (same).

113. 135 F.2d 310 (2d Cir. 1943).

114. *Id.* at 312.

115. International Freighting Corp. v. Commissioner, 45 B.T.A. 716 (1941), *aff'd*, 135 F.2d 310 (2d Cir. 1943).

116. *Id.* at 720.

sioner's alternative argument was correct,[117] and the Second Circuit affirmed.[118] With respect to the gain issue, the Second Circuit reasoned that the receipt of the employees' services constituted an "amount realized" under the predecessor of section 1001(b).[119] It rejected the taxpayer's argument that, since the term "amount realized" was defined as the sum of "any money received plus the fair market value of the property (other than money) received," services could not be included.[120] The court noted that while literally the corporation received no property or money, the receipt of its employees' services nevertheless should be considered a receipt of money's worth as required by the statute.[121] Moreover, in accord with Principle II, the Second Circuit concluded that the value of the employees' services received should be assumed to be equal to the $24,858 value of the stock transferred.[122]

Subsequent cases involving voluntary transfers of appreciated property by corporations to employees' retirement trusts[123] have consistently followed the *International Freighting Corp.* decision and have rejected taxpayers' attempts to claim a fair market value compensation deduction without also reporting the gain on the transferred property. For example, in *United States v. General Shoe Corp.*,[124] a corporation contributed appreciated real estate to such a trust and claimed the fair market value of the real estate as a business deduction, without also reporting the previously unrealized appreciation as income. The Sixth Circuit, analogizing to the transaction's economically equivalent two-payment exchange, held that the deduction was appropriate but that the income had to be reported:

> The taxpayer realized exactly the same gain here by transferring the real estate as it would have had it sold the real estate for the fair market (or appraised) value and contributed the funds to the trust. Would the taxpayer say that if it had sold the real estate that there would have been no taxable capital gain in this situation? Can a taxpayer circumvent the capital gains tax by such a simple device? . . . To argue, as the taxpayer does here, that there can be no gain because nothing is realized, is unrealistic. Literally the taxpayer is correct in its conten-

117. *Id.* at 720-21.
118. 135 F.2d 310 (2d Cir. 1943).
119. *Id.* at 313-14.
120. *Id.*
121. *Id.* at 313.
122. *Id.*
123. *E.g.,* United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), *cert. denied,* 365 U.S. 843 (1961); Tasty Baking Co. v. United States, 393 F.2d 992 (Ct. Cl. 1968).
124. 282 F.2d 9 (6th Cir. 1960).

tion that it did not receive a tangible benefit . . . however, we do not conceive that in this day and age we are restricted to tangibles in tax matters where there is actual recognizable benefit, albeit intangible, the taxation of which is implicit in the statutory scheme, and where such benefit is clearly capable of being evaluated on an objective basis [by looking to the value of what was given up].[125]

Thus, the appreciated property-for-services cases represent not only a clear rejection of the asymmetrical deduction without income approach in barter cases but also a clear acceptance of the two-payment approach over the no income, no deduction approach. Moreover, these cases, when read in conjunction with the *Philadelphia Park* decision,[126] are also firm authority for the value received theory of deductions. Although the courts in *International Freighting Corp.* and its progeny generally speak of the amount of the deduction as being the fair market value of the property given up,[127] rather than that of the services received, that is only because, on the facts of those cases, the courts were forced to use the value given up to determine the value of the benefit received in accordance with the presumed equivalence in value theory.[128] Surely, if property that was difficult to value was transferred in exchange for deductible services with a readily ascertainable value, a court, by analogy to *Philadelphia Park,* would conclude that the property transferor should claim a deduction in the amount of the value of the services received, without regard to any proof of the literal value of the property given up to acquire that benefit.[129]

Another group of cases in which the courts have rejected taxpayers' attempts to use the deduction without income approach involves the exchange of the rent-free use of property for services.[130] These cases, however, do not clearly support either the both income and deduction approach or the no income, no deduction approach.

For example, in *Bellows v. Commissioner,*[131] Mrs. Bellows,

125. *Id.* at 12.

126. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954). *See supra* notes 74-78 and accompanying text.

127. *See, e.g.,* International Freighting Corp. v. Commissioner, 135 F.2d at 313.

128. *See, e.g.,* United States v. General Shoe Corp., 282 F.2d at 13; International Freighting Corp. v. Commissioner, 135 F.2d at 313; Tasty Baking Co. v. United States, 393 F.2d at 995.

129. *See supra* text accompanying notes 74-78.

130. *See, e.g.,* Reynard Corp. v. Commissioner, 37 B.T.A. 552, 559 (1938); Reynard Corp. v. Commissioner, 30 B.T.A. 451, 454 (1934); Solon v. Commissioner, 39 TAX CT. MEM. DEC. (CCH) 1245, 1250 (1980); Bellows v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 978, 980 (1967).

131. 26 TAX CT. MEM. DEC. (CCH) 978 (1967).

who owned two apartment buildings, deducted the fair rental value of an apartment occupied rent free by a couple who performed managerial and janitorial services for the two buildings. Mrs. Bellows had not reported any rental income on the transactions (the deduction without income approach). The Service simply denied her the deduction (the no income, no deduction approach), apparently not arguing, as it did in the property-for-services cases, that Mrs. Bellows should include the fair rental value of the apartment in income and take an equivalent deduction for compensation paid (the both income and deduction approach).

The Tax Court affirmed the Commissioner's no income, no deduction approach, but apparently only because the tax consequences would have been no different under the two payment approach.[132] The Tax Court approvingly cited *United States v. General Shoe Corp.* and *International Freighting Corp. v. Commissioner* for the proposition that "where property is used to pay for an item of deductible expense, the transaction gives rise not only to a deduction but also to the realization of income on such use of the property."[133]

The Tax Court stated further that the taxpayer should be in the same position when she pays for deductible services with the rent-free use of her property as she would be if she had paid "cash to the [employees] as compensation for their services and [then] charged them an equal amount as rent."[134] Having said this, however, the Tax Court noted that in the particular case, denying the deduction to the taxpayer achieved the same result as permitting the deduction and charging the taxpayer with an equivalent amount of income: "Whether the situation is viewed as one requiring that the deduction for the fair rental value be offset by an equal amount of realized taxable income or simply a denial of the deduction, respondent's determination as to the rental issue must be sustained."[135] In

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132. *See id.* at 980.

133. *Id. See supra* notes 113-25 and accompanying text.

134. 26 TAX CT. MEM. DEC. (CCH) at 980.

135. *Id.* The Board of Tax Appeals had reached the same results, based on equivalent two-payment reasoning, in Reynard Corp. v. Commissioner, 37 B.T.A. 552 (1938). In that case the president of the Reynard Corporation, Fontaine Fox, occupied a dwelling owned by the corporation. *Id.* at 556. The occupancy was regarded as a part of his compensation for services and the corporation claimed the $3,000 fair rental value of the property as a business deduction for compensation paid. *Id.* at 557. No rental income was reported by the corporation from this transaction. *Id.* at 559. The Board concluded that the corporation could not take a $3,000 deduction for compensation paid unless it first reported the $3,000 as rental income:

considering this statement in *Bellows,* it is significant to recall that, in the property-for-services cases, where the two approaches would not have led to the same net tax consequences, since the gain on the property would have been capital, while the equal deduction would have been ordinary, the courts have specifically sanctioned the both income and deduction approach.[136]

In the interest-free loan cases, the Service has consistently argued for the asymmetrical income without deduction approach. And until recently, every court that has considered the question has rejected the Service's position in favor of a no income, no deduction approach. The Service has argued in these cases that an employee who receives a compensatory interest-free loan has income equal to the fair market value of the use of the employer's money but cannot claim an interest deduction for the interest not literally paid.[137] In other words, the Service adheres to Principal I, that all economic benefits regardless of form are includable in gross income, but rejects Principle IV, the value received theory of deductions.[138] In fact, in disallowing the employee an interest deduction, the Service implicitly rejects the theory that an individual can "pay" an expense in services, as well as in cash, and claim a deduction for

> If Reynard had rented the dwelling to Fox and had received $3,000 cash therefor during the taxable year there would be no question but that the amount would be includable in income as rent. If during the taxable year Reynard had paid the $3,000 to Fox as a part of reasonable compensation for his services there would be no question but that such payment would constitute a deductible expenditure. The net effect of the two items would be to offset each other, and Reynard's net income apart from them in no wise would be affected. Instead of making cash payments to each other, Reynard gave Fox the use of the house for services and Fox rendered to Reynard the required services for the use of the house. . . . The only theory upon which it can be held that Reynard paid the $3,000 to Fox is that it offset that amount against a like amount owed to it by Fox for house rent. Under this theory the rental value of the house was income to petitioner and, if the deduction claimed is to be allowed, such income must be accounted for in determining its correct tax liability. To allow Reynard a deduction of the $3,000 on any other theory would be allowing a deduction for an amount which it neither paid nor was obligated to pay. Therefore, since Reynard is not charged for tax purposes with income from house rent it is not entitled to deduct the amount thereof as compensation paid to Fox.

Id. at 558-59.

136. *See supra* notes 113-29 and accompanying text.

137. *See, e.g.,* Greenspun v. Commissioner, 72 T.C. 931, 950-51 (1979), *aff'd,* 670 F.2d 123 (9th Cir. 1982). *See also* Keller, *Tax Treatment, supra* note 5, at 259-61 (criticizing Service's argument that a taxpayer's receipt of an interest free loan results in realization of taxable income but does not entitle taxpayer to a deduction).

138. *See* Keller, *Tax Treatment, supra* note 5, at 259-61.

the value of the services given up. In other words, to say that an employee receiving an interest-free loan has not literally "paid" interest is to say that one can never pay expenses in kind. This conclusion is clearly incorrect. The Regulations specifically state that expenditures "need not be in the form of cash."[139]

The Service's posture in the interest-free loan cases is particularly puzzling since it has never advanced the same asymmetrical income without deduction approach in any other barter transaction. For example, in the services for property cases, such as *International Freighting Corp. v. Commissioner,*[140] the employer-taxpayer initially took the position that it was entitled to a deduction equal to the fair market value of the appreciated property transferred as compensation, even though it did not have to report gain on the disposition of the property. The Service countered that either the employer had to report the gain as well as the deduction (the both income and deduction approach) or claim only a basis deduction (the no income, no deduction approach). It never argued, as it does in the interest-free loan cases, that the taxpayer had to report gain but could only claim a basis deduction (the income without a deduction approach).

Similarly, in the rent-free use of property for services cases, like *Bellows,*[141] the Service simply denied an employer-landlord a deduction for compensation paid, where the employer did not report the value of the services received as rental income. If the Service acted consistently with its position in the interest-free loan cases, it not only would have denied Mrs. Bellows the deduction for the compensation paid, but it also would have charged her with the rental income. This, it did not do.[142]

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139. Treas. Reg. § 1.446-1(a)(3) (1957). This section states that "[i]tems of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money." *Id.*

140. 45 B.T.A. 716 (1941), *aff'd,* 135 F.2d 310 (2d Cir. 1943). *See supra* notes 113-22 and accompanying text.

141. 26 TAX CT. MEM. DEC. (CCH) 978 (1967). *See supra* notes 131-36 and accompanying text.

142. In Rev. Rul. 79-24, 1979-1 C.B. 60, *see supra* notes 32-34 and accompanying text, the Service managed to avoid the deduction issue entirely. In Situation 1 of the ruling it clearly stated that a painter and lawyer were exchanging "personal" nondeductible services, and thus no discussion of deductions was necessary. *Id.* at 60. In Situation 2, a landlord received a painting from an artist in exchange for which the artist obtained the rent-free use of an apartment for six months. The Service stated only that both parties to the exchange real-

The Service's treatment of the employee in the interest-free loan cases has even been inconsistent with its own treatment of the employer in the same transaction. The Service has apparently been content to allow the employer making an interest-free loan to report neither interest income nor a deduction for compensation paid.[143] Yet, if it acted consistently with its position regarding the employee, the Service should have required the employer in these situations to report the value of the employee's services received as interest income but denied the employer a business deduction for the services for which it did not literally pay.

Oddly, it appears that the initial reporting position of the taxpayer in these barter cases has determined the Service's response. In the property for services and the rent free use of property for services cases, where the taxpayer advanced a deduction without income result, the Service countered with the no income, no deduction result, or the both income and deduction result.[144] On the other hand, in the interest-free loan cases, where the taxpayer initially advanced a no income, no deduction result, the Service countered with an income but no deduction result. Ironically, the employees in the interest-free loan cases might have avoided their difficulties with the Service had they initially placed themselves in the untenable position of claiming an interest deduction without reporting the value of the interest-free loan as income (the deduction without income approach).

From 1961 until 1982, every court that considered the problem of the interest-free loan rejected the Service's asymmetric income without a deduction approach.[145] Given the consistent

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ized income. The landlord would, of course, under the value received theory of cost take a basis in the painting equal to the value of the painting taken into income (although this was not mentioned in the ruling). No deduction would be available to the landlord. A deduction issue could arise, however, for the artist, but only if the artist used the premises as a studio or for some other deductible purpose. The ruling makes no such assumption.

143. *See* Keller, *Tax Treatment, supra* note 5, at 287-97.

144. *See supra* notes 113-16, 131-32 and accompanying text.

145. *See* Baker v. Commissioner, 75 T.C. 166 (1980), *aff'd*, 677 F.2d 11 (2d Cir. 1982); Creel v. Commissioner, 72 T.C. 1173 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Zager v. Commissioner, 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Greenspun v. Commissioner, 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Dean v. Commissioner, 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4; Ruwe v. Commissioner, 41 TAX CT. MEM. DEC. (CCH) 1458 (1981); Beaton v. Commissioner, 40 TAX CT. MEM. DEC. (CCH) 1324 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981); Parks v. Commissioner, 40 TAX CT. MEM. DEC. (CCH) 1228 (1980); Estate of Liechtung v. Commissioner, 40 TAX CT. MEM. DEC. (CCH) 1118 (1980); Martin

rejection of the Service's position for more than twenty years, the inherent irrationality of the approach, and the Service's inconsistent application in analogous situations, the recent decision by a trial judge in the Court of Claims accepting the Service's position is somewhat shocking. In *Hardee v. United States,*[146] the trial judge concluded, contrary to prior case law, that interest-free loans from a closely held corporation to its shareholders resulted in gross income to those shareholders. In a holding of equal significance, the judge also held that the shareholder-borrowers could not claim an offsetting deduction for interest they did not literally pay. The judge specifically rejected the value received theory of deductions as a fiction, while at the same time noting that if the loan had actually been structured as two separate transactions—a cash dividend payment combined with a cash interest payment on the loan—an interest deduction presumably would have been allowed.[147]

Since the *Hardee* case involved interest-free loans to shareholders, it is unclear whether the Court of Claims—assuming it adopts the decision of its trial judge—would extend its no deduction result to a case in which the loan recipient was an employee. In the latter situation, the court conceivably might grant the employee an offsetting deduction for the interest literally paid in kind with services.[148] To make such a distinction between an employee and a shareholder, however, misses the very essence and rationale of the value received theory of deductions—that it is the value of the benefit received and reported as income that supports the deduction, and not the quid pro quo, if any, given in exchange for the benefit received.[149]

Prior to the *Hardee* decision, the Tax Court[150] and four circuit courts[151] had rejected the Service's income without a deduction approach in cases involving low-interest and interest-free loans to both employees and shareholders. But those cases created their own problems by accepting a no income, no

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v. Commissioner, 39 TAX CT. MEM. DEC. (CCH) 531 (1979), *aff'd,* 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 37 TAX CT. MEM. DEC. (CCH) 1638 (1978), *aff'd,* 625 F.2d 1127 (4th Cir. 1980); *cf.* Marsh v. Commissioner, 73 T.C. 317 (1979) (interest-free loan part of a purchase agreement), *nonacq.* 1980-2 C.B. 2. *See generally* Joyce & Del Cotto, *supra* note 5 (distinguishing term from demand loans); Keller, *Tax Treatment, supra* note 5 (two transaction approach to taxation of interest-free loans).

146. 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. 1982).

147. *See id.*

148. *See supra* text accompanying notes 138-39.

149. *See supra* notes 79-88 and accompanying text.

150. *See* cases cited *supra* note 145.

151. *See id.*

deduction solution, rather than a both income and deduction approach. That is, the courts in all those cases prior to *Hardee* concluded that the loan recipient had neither income nor a deduction. They reasoned that a no income result was appropriate, since if a taxpayer were actually to pay interest on the loan, the taxpayer would be entitled to a deduction that would offset any income reported.[152]

The courts were apparently concerned that, if they were to include the economic benefit derived from the interest-free loan in a taxpayer's income, they could not then have granted the taxpayer a deduction for interest not literally owed or paid.[153] To avoid the harsh income without a deduction approach of the Service, the courts simply adopted the wash approach and did not charge the taxpayer with income.[154] Thus, these courts' refusal to adopt the two-payment approach in interest-free loan cases seems clearly to stem from their erroneous belief, shared by the Court of Claims, that our tax system contains no value received theory of deductions.[155]

Interestingly, however, the clearest judicial expositions of the justification for the value received theory of deductions are found in opinions in two recent interest-free loan cases. One is the majority opinion of Judge Fay in the 1979 Tax Court case of *Greenspun v. Commissioner*.[156] The other is Judge Goldberg's dissenting opinion in *Martin v. Commissioner,*[157] decided by the Fifth Circuit in 1981. In *Greenspun,* Judge Fay, the trial judge, was apparently in favor of abandoning the no income, no deduction principle first established in interest-free loan cases in *Dean v. Commissioner,*[158] but he could not convince a majority of the Tax Court to go along with him.[159] He therefore wrote a "majority" opinion, which clearly justified the adoption of a two-payment approach, but which ended up affirming *Dean*.[160] Nevertheless, Fay, to show where he actually stood on the issue, listed his name along with three other concurring judges, who actually would have overturned *Dean*.[161] With respect to the Service's argument that no deduction would be al-

152. *See id.*
153. *See* Keller, *Tax Treatment, supra* note 5, at 261-63.
154. *See id.*
155. *See id.* at 261-63, 271-72.
156. 72 T.C. 931 (1979).
157. 649 F.2d 1133, 1134 (5th Cir. 1981) (Goldberg, J., dissenting).
158. 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4.
159. *See* Keller, *Tax Treatment, supra* note 5, at 270 n.107.
160. *See id.*
161. 72 T.C. at 954. *See* Keller, *Tax Treatment, supra* note 5, at 270 n.107.

lowed to a taxpayer even if the taxpayer actually reported the economic benefit of the interest-free loan in income, Judge Fay said:

> With respect to respondent's contention that petitioner would not be entitled to an offsetting interest deduction under section 163(a), we recognize that as a general rule a cash basis taxpayer may not deduct interest unless such interest has actually been paid pursuant to a legal obligation [citations omitted]. However, none of the cases which have applied the general rule have dealt with the precise question of whether a taxpayer who must report as income the economic benefit associated with a low or no-interest loan is entitled to claim an offsetting interest deduction. In such a case, we think an exception to the general rule of deductibility is both appropriate and necessary to give recognition to the economic realities of the transaction.[162]

More recently, Judge Goldberg, in a forceful dissent to the Fifth Circuit's affirmance of *Dean* in *Martin v. Commissioner,*[163] also set forth the justification for the two-transaction approach and the value received theory of deductions. The majority of the court suggested that adopting the value received theory of deductions and the two-payment approach in lieu of the *Dean* no income approach simply substituted one fiction for another.[164] Judge Goldberg responded:

> This illogical and unjust [no income] result is neither required by nor even permitted under a fair and proper application of the Internal Revenue Code. Rather, once it is recognized that the receipt of an interest-free loan is equivalent to the receipt of additional income by which to "purchase" the loan, it must also be recognized that having received an interest-free loan is equivalent to having paid the interest on that loan.[165]

Judge Goldberg rationalized the value received theory of deduction by reference to the same arguments advanced in this Article—that the value received theory of deductions is perfectly analogous to the value received theory of cost and that both are necessary in order to give the statute "the quality of rationality."[166]

D. Conclusions Concerning Direct Barter Transactions

This part of the Article argued that every direct barter exchange should be taxed the same as its economically equivalent two-payment cash transaction, in which each party purchases the other's goods or services for cash. It demon-

162. 72 T.C. at 951.
163. 649 F.2d 1133, 1134 (5th Cir. 1981) (Goldberg, J., dissenting).
164. 649 F.2d at 1133.
165. *Id.* at 1137.
166. *Id.* at 1143 n.17 (quoting Keller, *Tax Consequences, supra* note 5, at 242).

strated that to reach these logical tax results in all cases, five basic tax principles must be consistently followed. Of these five principles, both the courts and the Service have readily accepted three. The viability of the other two—the value received theory of deductions and the no-wash principle—are in need of clarification, however.

If the full Court of Claims adopts the decision of the trial judge in *Hardee,* and the taxpayer applies for, and the Supreme Court grants certiorari in that case, the high court will become the final arbiter in the interest-free loan area. In that event, it is hoped the Supreme Court will approve the propriety of applying Principles I (The Taxability of All Noncash Benefits), IV (The Value Received Theory of Deductions), and V (The No-Wash Principle), not only to all interest-free loan cases but, by analogy, to every direct barter transaction.

II. THE TAX CONSEQUENCES OF BARTERING THROUGH TRADE EXCHANGES

Although barter is as old as man, old direct trading methods have recently given way to new computerized systems and new sophistication. Trade exchanges, also referred to as barter clubs or barter exchanges, are the newest wrinkle in the barter business.[167] No longer does a dentist who wants to swap services with a plumber have to go searching for a plumber with a toothache. Rather, as a member of a trade exchange, the dentist can perform services for any exchange member, whether merchant, lawyer, or plumber, and thereby earn "trade units" which the dentist can immediately use to obtain services from any member plumber. This part explains how such trade ex-

167. Barter clubs have in recent years, attracted considerable attention in the media. *See, e.g.,* Gallagher, *Stamford Firm Trades on the Barter Instinct,* Fairpress (Stamford, Conn.), Aug. 19, 1981, at A1, col. 5; Knight, *Swap and Shop: Bartering Away the Middleman,* Washington Post, July 23, 1981, at D1, col. 1; Rankin, *Taxes & Accounting,* N.Y. Times, Feb. 20, 1979, at D2, col. 1; Leff, *Trading Flourishes on Many Exchanges You Never Heard Of,* Wall St. J., Sept. 8, 1978, at 1, col. 4; Wells, *Barter Clubs Become Big Business as Americans Cash In On Their Skills,* N.Y. Times, June 19, 1978, at D10, col. 1; Goodman, *Barter: A New Look For an Old Custom,* N.Y. Times, April 19, 1978, at C16, col. 2; Lindsey, *It's the Newest Trade-Off: Bartering Your Services,* N.Y. Times, Nov. 18, 1976, at 48, col. 1; Thompson, *When Money Gets Tight, Bargain by Barter,* PURCHASING, Nov. 7, 1979, at 91; *Bartering Gets to Be a Business in the Billions,* U.S. NEWS & WORLD REP., March 21, 1977, at 47; *Using Barter as a Way of Doing Business,* BUS. WK., Aug. 4, 1980, at 57. Recent books in the area include P. STRASSELS & R. WOOL, ALL YOU NEED TO KNOW ABOUT THE IRS 109-11 (1980); WILSON, LET'S TRY BARTER (1976).

changes operate and analyzes the tax consequences[168] to the Exchanges[169] and to the exchange members.

A. TRADE EXCHANGES AND HOW THEY OPERATE

A Trade Exchange provides a forum for, and arranges the barter of, goods and services between the members of the exchange. Business and professional people become members of the exchange by signing an agreement with the Exchange under which they generally agree:

(i) to sell goods and services to other members, for trade units, with each trade unit representing one dollar of "prevailing price" or "prevailing retail price;"[170]

(ii) to pay the Exchange an initial fee, which is normally about $25 to $50, and an annual charge of about $300;[171] and

(iii) to pay a commission, usually 10%, to the Exchange on each acquisition of goods and services.[172] The commission is generally payable solely in trade units, although some Exchanges, finding themselves with cash flow difficulties, have recently turned to cash commissions or commissions payable partly in cash and partly in trade units.[173]

The trade unit is the medium of exchange of a trade exchange. Initially, the Trade Exchange issues all the trade units itself.[174] New members normally obtain their initial trade units in one of two ways. Either they transfer goods or services to the Exchange, which credits their account with trade units

168. A recent article has considered in some detail the antitrust implications of barter exchanges. *See* Allison, *The Antitrust Implications of Barter,* 58 CHI.-KENT L. REV. 89 (1981).

169. Hereinafter, when the owner of the exchange is referred to, the capitalized word "Exchange" or words "Trade Exchange" will be used. The business may be owned by an individual, a partnership, or a corporation. The membership is not itself a legally recognized entity.

170. For example, the contract of Barter Systems International (BSI) uses the term "prevailing prices," while that of Exchange Enterprises uses the phrase "prevailing retail prices." Butcher Trade Exchange, Inc. (Fort Washington, Pa.), on the other hand, has no such language in its contract.

171. Annual membership fees, however, may range anywhere from $150 to $1,000 a year. Quinn, *IRS Is Tightening Up on Tax Avoidance Through Bartering,* Washington Post, November 16, 1981, (magazine) at 47.

172. The commission may vary between 5% and 10%. *Id.*

173. *Id.* For example, Butcher Trade Exchange, Inc. (Fort Washington, Pa.) collects its commissions, 8% in cash and 2% in trade credits.

174. LTR 8216010, National Office Technical Advice Memorandum, December 31, 1981, *reprinted in* IRS Letter Rulings No. 269, April 28, 1982 (CCH); LTR 7945009, National Office Technical Advice Memorandum, August 1, 1979, *reprinted in* IRS Letter Rulings No. 141, November 14, 1979 (CCH).

equal to at least the retail value of those goods and services,[175] or the Exchange extends a line of credit in trade units to new members that can be used for purchases, but which must be repaid from credits earned by future sales.[176] After joining the exchange, members generally acquire additional trade units by supplying goods and services to other members or to the Exchange itself at "prevailing prices."[177] Less often, existing members will acquire additional units by borrowing or by purchasing them for cash from the Exchange.[178]

Members may use trade units to acquire goods and services as soon as they are credited to their account.[179] Members may also transfer trade units to their employees as salary, or to shareholders as dividends.[180] Exchanges have suggested other creative uses. For example, one major Exchange advises its members "to set up a dental program for your employees and their families and pay for it with trade units" or to "give employees legal service coverage through prepaid legal service premiums acquired with trade units."[181] No Trade Exchange, however, guarantees that a member will be able to use all its units, nor does any agree to purchase unused units for cash.[182]

The manner in which a trade exchange operates is most easily understood by following a series of imaginary steps:

1. *D*, a dentist operating as a sole proprietor, has 330 trade units, which *D* has accumulated by performing services for other exchange members at *D*'s prevailing rate.

2. Corporation *C*, also an exchange member, is the owner of a retail men's clothing store.

3. If *D* wants to acquire a new suit with the trade units, *D* will call the Trade Exchange and receive authorization to purchase clothing at Corporation *C*'s store, or at the store of another member who sells men's clothing.

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175. LTR 8216010, *supra* note 174; LTR 7945009, *supra* note 174. In the early stages of operation, when an Exchange is anxious to get trade units into circulation, it may issue bonus units to new members. *See* LTR 7945009, *supra*.

176. *See* INTERNAL REVENUE MANUAL (Audit) (Supp. 45G-324, March 17, 1982) [hereinafter IRM 45G-324]. The previous instructions in this area were issued in 1979.

177. *See* LTR 8216010, *supra* note 174.

178. *Id.*

179. *See* Rev. Rul. 80-52, 1980-1 C.B. 100; LTR 8216010, *supra* note 174; LTR 7945009, *supra* note 174; IRM 45G-324, *supra* note 176.

180. *See* IRM 45G-324, *supra* note 176.

181. The "Reference Manual" of Barter Systems International (BSI) devotes an entire page to the topic of "How to Use Trade Units for Your Employees."

182. *See* Rev. Rul. 80-52, 1980-1 C.B. 100, 100; LTR 8216010, *supra* note 174.

4. *D* will then go to *C*'s store and acquire, for 300 trade units, a suit retailing for $300. The Exchange will credit *C*'s account for 300 trade units and debit *D*'s account for 330 units, the additional units representing a 10% commission on *D*'s purchase of the clothing. These 30 units are credited to the Exchange's own account.

5. Corporation *C* may then use all or some of its newly acquired trade units to acquire business goods and services within the exchange, or to pay a salary to its employees, or a dividend to its shareholders. The employee or shareholder can then use the credits to acquire personal goods and services within the exchange and the cycle continues.

1. *The Multiple Roles of a Trade Exchange*

a. Broker and Trader of Goods

A Trade Exchange performs the role of broker, trader of goods, central bank, and government. In its role as broker, the Exchange "makes available to members information concerning goods and services that other members are offering for exchange" and "operates as a vehicle for the exchange of [such] goods and services."[183] The Exchange also accounts for members' transactions. Each time an exchange of goods takes place between members, or between a member and the Exchange, the Exchange debits or credits the appropriate accounts and periodically provides the members with reports of their bartering activities.[184]

It is in its capacity as broker that the Exchange receives commission from members. Any commissions the Exchange receives in trade units it can use in the same manner as any member to acquire goods and services within the system.[185] The Exchange may use the goods and services it acquires from its members for its own business purposes or may transfer them to the individual shareholders, proprietors, or partners of the Exchange to be used by them for personal purposes. Frequently, however, Exchanges use their trade units to acquire merchandise which is maintained in the showrooms and warehouses of the Exchange for retrade to members.[186] This results in the Exchange's second role as a trader of goods.

183. LTR 8216010, *supra* note 174.
184. IRM 45G-324, *supra* note 176.
185. *See* LTR 8216010, *supra* note 174; LTR 7945009, *supra* note 174.
186. *See* LTR 8216010, *supra* note 174. Goods and services acquired by the Exchange from members might also be sold by it for cash.

To the extent the Exchange sells the acquired merchandise for the same number of trade units it paid for them, it simply acts as a clearing house for members' goods. Nevertheless, the Exchange clearly benefits from this activity. Most importantly, by acquiring members' goods for trade units, the Exchange keeps units circulating and thereby maintains an active barter economy. Also, to the extent the Exchange succeeds in retrading the acquired goods to members, the Exchange earns additional commissions.

b. Central Bank and Government

In its more controversial role, a Trade Exchange acts as the creator of the economy's currency, a role normally reserved to governments and their central banks.[187] It is this quasi-governmental role that, at times, has been abused or simply misused by certain Exchanges, resulting in the collapse of their barter system.[188] As in all economies, "[l]imitation in the supply of money is the necessary condition if it is to have value."[189]

An unscrupulous Exchange, not having earned sufficient trade units to meet its own business needs or the personal consumption desires of its owners, might give in to temptation and simply use its printing press to create additional trade units for itself. There are, today, no effective controls on an Exchange's ability to do this,[190] although recently an Exchange owner entered a plea of no contest to a charge of grand theft stemming from this practice.[191] Moreover, the International Association of Trade Exchanges (IATE), the trade association for the industry, has proposed an internal regulation to deal with this problem of deficit spending.[192] The regulation identifies "unsecured, uncollateralized deficit spending" as a practice that is to be eliminated, and "establishes standards and guidelines for the collateralization of exchange deficits."[193] Deficit spending

187. *See generally,* P. SAMUELSON, ECONOMICS 252-315 (7th ed. 1967) (general discussion of the monetary system).

188. *See, e.g.,* Flanagan, *Barterers Beware,* FORBES, August 17, 1981, at 102, 103.

189. P. SAMUELSON, *supra* note 187, at 264.

190. *See* Flanagan, *supra* note 188. Some state authorities question the unregulated use of barter club scrip, saying that such scrip may constitute the issuance of a security. They have, consequently, insisted that clubs modify their operation to comply with securities law. Leff, *supra* note 167, at 1, col. 4.

191. State v. Kincaid, No. 80CR-10-3270 (C.P. Franklin Cty., Ohio 1981).

192. A copy of this regulation can be obtained from the International Association of Trade Exchanges, 5001 Seminary Road, Suite 310, Alexandria, Virginia 22311.

193. *See supra* note 192.

is defined as "the spending of trade credits in excess of earnings by an exchange, exchange owner, stockholder, or other principal, where the amount spent is not secured by acceptable collateral."[194]

Exchanges may also damage the system by over issuing trade units, even where their stated and actual purpose is to benefit the system as a whole. For example, Exchanges may issue new units to entice businesses to join the exchange;[195] they may issue new units as loans to new or existing members;[196] or they may issue new units to acquire merchandise for retrade through their own showrooms.[197] Unless these actions, which increase the money (trade units) supply, are followed by a proportionate increase in production, or activity within the exchange, there presumably will be a devaluation of the currency.[198]

2. *The Proliferation of Trade Exchanges*

Nationally, trade exchanges have flourished since the 1960's. Today there are nearly 300 such exchanges, representing some 60,000 members and exchanging $300 million annually in all sorts of products and services.[199] The list of goods and services available from the country's leading trade exchange includes accounting, advertising, airline tickets, architects, art work, attorneys, audiovisual equipment, automobile rental and repair, books, children's apparel, commercial real estate services, dentistry, financial consulting, health clubs, holistic medicine, hotel rooms, marketing consultants, office furniture,

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194. *See supra* note 192. In 1981 an Ohio man pleaded no contest in Franklin County (Ohio) Common Pleas Court to a charge of grand theft, stemming from his creation of trade credits for his own benefit "beyond the express or implied consent of the Exchange Membership." Plaintiff's Hearing Brief at 2, State v. Kincaid, No. 80CR-10-3270 (C.P. Franklin Cty., Ohio 1981). Despite his plea of no contest, Kincaid insisted he had not committed a crime by his actions since " 'deficit spending' is all that he was doing and that somehow 'deficit spending' must be lawful because his instruction booklet [said] that 'pump priming' is to be expected at first." *Id.*

195. LTR 7945009, *supra* note 174.

196. *See* IRM 45G-324, *supra* note 176.

197. *See* LTR 8216010, *supra* note 174.

198. *See generally* P. SAMUELSON, *supra* note 187, at 270-73 (discussion of the quantity theory of money).

199. 128 CONG. REC. S3060 (daily ed. March 30, 1982) (remarks of Sen. Baucus) (hereinafter cited as Remarks of Sen. Baucus). It has been reported "that the commercial barter industry has been growing at the rate of about 20 percent a year for the past 6 or 7 years, and will probably sustain a 15 percent growth in the immediate future." *Id.* If this data is correct, commercial barter "will double in size every 4 to 5 years," a development of potential significance to the economy of the United States. *Id.*

picture framing, planning and design, plants and trees, plumbing, printing, public relations, restaurants, sales promotion, tax consulting, vitamins, water filtration systems and yacht rentals.[200]

The major trade exchanges are national franchise operations. For example, Barter Systems International (BSI), the largest of the exchanges, now claims to have 27,000 members in 66 cities throughout the United States[201] and is planning to expand to Australia, England, Canada, the Phillipines, and various Latin American countries.[202] BSI boasts a computer network that allows their franchises all over the country to trade among themselves.[203] This means that, for trade units, members can acquire goods not otherwise available in their city and dispose of their goods for barter in a national market.

Assuming all tax liability stemming from the bartering will be reported properly,[204] the major advantage to a taxpayer in joining a barter exchange is simply that of obtaining new business. The electrician joins hoping that club members will call him or her rather than the hundreds of other electricians in the yellow pages. Restaurants join for the same reason. So do retailers or manufacturers with excess inventory or spare capacity. On the other hand, doctors or lawyers with all the cash business they can handle would gain little from joining.

3. *The Prevailing Price Requirement*

Trade Exchanges generally require members to provide their goods and services to other members at "prevailing

200. *See* TRANSACTIONS, Oct. 1, 1981, at 3-4 (a monthly periodical of BSI franchises in New York and southern California).

201. *Id.* at 1. All franchise offices of Barter Systems, Inc. changed their name to Barter Systems International as of April 1, 1982.

202. *See* BARTER SYSTEMS INT'L, THE BARTER SYSTEM, April, 1982, at 1 (a newsletter from Kensington, Maryland).

203. *See* TRANSACTIONS, *supra* note 200, at 1.

204. Newly enacted legislation requiring information reporting by Barter Exchanges will help insure such compliance. *See infra* notes 217-20 and accompanying text. Many club presidents claim that they now inform their members of their obligation to report trades as income, but they cannot help it if the members do not in fact comply. Leff, *supra* note 167, at 19. Other clubs, however, are reported routinely to destroy all records pertaining to individual transactions every year. *Id.* On the other hand, at least one exchange, the Butcher Trade Exchange, includes the following provision in its contract with members:

> The [member] represents and warrants to the Exchange that it will fully report and pay all taxes, including, but not limited to, sales taxes, income taxes, or other taxes arising from any transaction in which the Exchange is involved, to the appropriate federal, state or county taxing authority.

prices" or "prevailing retail prices."[205] On its face this seems to compel members to conduct all trades at the same price they would charge cash customers. In practice, however, the Trade Exchanges and their members understand this prevailing price requirement somewhat differently. It seems to mean that a member cannot charge more than the undiscounted retail price or its membership will be cancelled.[206] On the other hand, members are not required nor even expected to discount goods sold in barter, even though such discounts are generally available to all or some cash customers.[207] This means that the true value of the goods and services acquired by an exchange member (true value being the amount of cash it would have taken the member to acquire the same item from the same merchant) will often be less than the trade unit price charged that exchange member.[208]

B. The Government's Response to Trade Exchanges

Concern about the size of the "underground economy" in general[209] and the growth of trade exchanges in particular led the Service in 1979 to examine the extent of income tax evasion through organized bartering.[210] The Service authorized its agents to obtain membership lists from Trade Exchanges by using the special "John Doe summons" procedure of section 7609(f) if necessary.[211] Section 7609(f) authorizes the Service

205. For example, the agreement between Exchange Enterprises, Inc. and its members states, "Members agree to sell goods and or services for trade units, at their PREVAILING RETAIL PRICES, to other members. The Exchange has the right at any time to check on over-pricing. Violation may subject member to immediate cancellation of membership." The contract of BSI is similar but uses the term "prevailing prices" rather than "prevailing retail prices." Butcher Trade Exchange, Inc. (Fort Washington, Pa.), on the other hand, has no such language in its contract.

206. *See, e.g., supra* note 205.

207. For example, BSI specifically states, under its general trading policies and procedures, "Discounting should not be anticipated nor requested." It adds, "Normal markups should be realized in each trade transaction." BARTER SYSTEMS, INC., REFERENCE MANUAL, at 2.

208. *See infra* text accompanying notes 246-62. For example, member *A* may go to the retail store of Member *B* to buy a tape recorder which lists for $600 but which *B* is currently selling for $480. *A* will probably have to use 600 trade units to acquire this tape recorder, even though *A* could buy it for $480 in cash.

209. *See, e.g., Underground Economy "Growing Very Nicely,"* Baltimore Morning Sun, Apr. 17, 1981, at A11; Lohr, *How Tax Evasion Has Grown,* N.Y. Times, March 15, 1981, § 3, at 1, col. 2; INTERNAL REVENUE SERVICE, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS, PUB. NO. 1104 (September, 1979).

210. *See* IRM 45G-324, *supra* note 176, § 1.02.

211. *Id.,* § 8.02(1). Since the names of the members whose tax liabilities are

to issue a summons upon a third party without identifying the taxpayer with respect to which the summons relates if the summons concerns the investigation of a particular person or identifiable group of persons, the Secretary has a reasonable belief that such person or group of persons may have violated the tax laws, and the information sought is not readily available elsewhere.[212]

The Service has generally been successful in enforcing its John Doe summonses against the Trade Exchanges.[213] The principal issue in the litigated cases has been whether the Service had a reasonable basis to believe that exchange members had not complied with the tax laws. The courts concluded that such a reasonable basis existed. They accepted the Service's argument that barter transactions are inherently error prone, based on prior audits of members of other exchanges, and did not require the Service to demonstrate an actual violation by any member of the summoned exchange.[214]

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being examined are unknown, the normal third party summons procedure, detailed *infra* note 216, is not applicable. Instead, the Service must generally use the special "John Doe" summons procedure specified in section 7609(f).

212. I.R.C. § 7609(f) (Supp. 1982).

213. *See, e.g., In re* The Tax Liabilities of John Does, Members of the Columbus Trade Exchange in the Years 1977 and 1978, 671 F.2d 977, 980 (6th Cir. 1982); United States v. Pittsburgh Trade Exchange, Inc., 644 F.2d 302, 306 (3d Cir. 1981). *See infra* note 214.

214. The leading case in this area is United States v. Pittsburgh Trade Exchange, Inc., 664 F.2d 302 (3d Cir. 1981). The Third Circuit was satisfied that the Service had met the "reasonable basis" requirement through testimony of an IRS agent to the effect that barter transactions are inherently susceptible of tax error, because no cash is involved and because the only records of a member's transactions are kept by the Exchange and are not available to the members. *Id.* at 306.

The Service was again successful in *In re* The Tax Liabilities of John Does, Members of the Columbus Trade Exchange in the Years 1977 and 1978, 671 F.2d 977 (6th Cir. 1982), where the Sixth Circuit reversed the district court's finding of lack of a reasonable basis to suspect noncompliance with the tax laws. The Service had argued that its experience with errors in the tax returns of members of other barter exchanges was enough to satisfy the reasonable basis requirement, but the district court disagreed, ruling that an inference that members of this exchange (the Columbus Trade Exchange) had committed errors because members of other exchanges had, was too tenuous to satisfy the requirement. *In re* The Tax Liabilities of John Does, Members of the Columbus Trade Exchange in the years 1977 and 1978, No. C-2-80-410 (S.D. Ohio, June 17, 1980). The Sixth Circuit reversed, holding that it was not necessary for the Service to produce evidence of an actual violation. It was enough that the facts surrounding a transaction suggested the probable occurrence of reporting errors. 671 F.2d at 980.

The Service has, however, lost a case involving a John Doe summons issued to a Barter Exchange for failure to employ the proper procedural steps involving a preissuance hearing as required by § 7609(f). In United States v. Barter Systems, Inc., 49 A.F.T.R.2d (P-H) ¶ 82-399 (D. Neb. 1981), the Service

In examining the returns of uncooperative members, the Service frequently has had to summon the records of the Exchanges themselves under section 7602(2) to obtain information regarding the volume of a particular member's barter activity. Before enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[215] the Code did not classify Trade Exchanges as third party recordkeepers for purposes of section 7609. As a result, exchange members had no right to notice of a summons to an Exchange concerning their records under section 7609(a) and no right to stay compliance with such summonses under section 7609(b).[216]

In enacting TEFRA, Congress gave Barter Exchanges[217]

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issued a § 7602 summons to a Barter Exchange requesting, among other things, a list of the members. The special requirements of § 7609 were not followed, because the Service maintained that it was only interested in the tax liability of the Barter Exchange, which, because it was identified, did not call for the special procedures associated with a John Doe summons. The court disagreed, finding that since one of the announced purposes of the Service was to check on compliance with the tax laws by members of barter exchanges, it followed that the summons before it was at least partially aimed at unknown persons, which required following the § 7609(f) procedures. The court found in favor of the Service, however, in United States v. Constantinides, 80-2 U.S. Tax. Cas. ¶9830; 47 A.F.T.R.2d (P-H) ¶ 81-308 (D. Md. 1980), where the court enforced a § 7602 summons issued to a barter exchange requesting a list of members, despite the Service's failure to follow the § 7609(f) procedures. The *Constantinides* court expressly found that the summons before it was issued solely to determine the tax liability of the Exchange itself and was not in any way being used to check on the members. *Id.* at 85,735, 47 A.F.T.R.2d (P-H) at ¶ 81-324.

The Service has lost John Doe summons cases in contexts other than barter exchanges for failure to demonstrate a reasonable basis. *See, e.g., In re* Oil and Gas Producers Having Processing Agreements with Kerr-McGee Corp., 500 F. Supp. 440, 443 (W.D. Okla. 1980); United States v. Brigham Young University, 485 F. Supp. 534, 538 (D. Utah 1980), *rev'd,* 679 F.2d 1345 (10th Cir. 1982). It has not lost any cases for that reason, however, in the barter exchange area. The court in United States v. Barter Systems, Inc., 49 A.F.T.R.2d (P-H) ¶ 82-399, at 82-625 did not even suggest the possibility that the Service would not have been successful if it had employed the special § 7609(f) procedures. There seems no reason to believe, therefore, that the Service could not eventually obtain the names of every member of an organized barter exchange in the country.

215. *See supra* note 17.

216. I.R.C. § 7609 (1976) (originally enacted as the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1205(a), 90 Stat. 1520, *amended by* TEFRA, *supra* note 17, §§ 331, 332), establishes special procedures for certain third-party summonses. Generally, under the law as amended, if a taxpayer's records are summoned from a third party recordkeeper, the taxpayer is entitled to receive notice of the summons. If the taxpayer desires to prevent compliance with the summons by the recordkeeper, the taxpayer must begin a civil action in court to quash the summons not later than the 20th day after notice of the summons was given. A prerequisite to the taxpayer's right to intervene and stay compliance with the summons is that the summonsee be one of the specifically listed third party recordkeepers in § 7609(a)(3). Before the enactment of TEFRA, the list did not include barter exchanges.

217. A "barter exchange" is defined under the new Act as "any organization

status as third party recordkeepers under section 7609, so that members are now entitled to notice of any summons directed to an exchange for their records and to intervene in order to prevent an exchange from complying with any such summons.[218] The Trade Exchanges' new status was not without its price, however. Congress also included Exchanges in the definition of broker under section 6045,[219] thus requiring Exchanges, like other brokers, to file annual informational returns with the Service.[220] These returns will have to detail the barter activities of the members of the exchange. The increased attention given Trade Exchanges by both Congress and the Service demonstrates that the activities of exchange members will not go unscrutinized for tax compliance. Thus, it is essential that the Service and exchange members understand the tax consequences of bartering through Trade Exchanges.

C. THE TAX CONSEQUENCES OF BARTERING THROUGH TRADE EXCHANGES

Bartering through trade exchanges raises a number of interesting tax issues:

(i) Does a member of a trade exchange, or the Exchange itself, recognize income when trade units are credited to its account, or only when it expends the units to obtain goods and services?

(ii) If income is recognized to a member or the Exchange upon the crediting of trade units to its account, how is the value of those trade units to be determined for tax purposes?

(iii) Assuming a member or the Exchange includes the value of a trade unit in income on receipt, what are the tax consequences when it disposes of those units? More specifically, will any gain or loss be recognized when the trade unit is used

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of members providing property or services who jointly contract to trade or barter such property or services." TEFRA, *supra* note 17, § 311 (amending I.R.C. § 6045 (1980)).

218. TEFRA amends § 7609(a)(3) (defining third party recordkeeper) to include "any barter exchange (as defined in section 6045(c)(3))." TEFRA, *supra* note 17, § 311.

219. TEFRA, *supra* note 17, § 311 (amending I.R.C. § 6045 (1980)).

220. Every person doing business as a broker must "make a return, in accordance with such regulations as the Secretary may prescribe, showing the name and address of each customer, with such details regarding gross proceeds and such other information as the Secretary may by forms or regulations, require with respect to such business." I.R.C. § 6045(1980), *amended by* TEFRA, *supra* note 17, § 311.

to acquire goods and services? And, if deductible items are acquired with trade units, what amount will be deductible?

1. *Taxation of Exchange Members*

a. Revenue Ruling 80-52

In Revenue Ruling 80-52,[221] the IRS dealt with the tax consequences of two exchange members, *A* and *B*, and an employee of the Exchange, *C*. All three taxpayers used the cash receipts and disbursements method of accounting, and they were free to use trade units to acquire goods and services within the system as soon as the units were credited to their accounts.

In situation 1 of the ruling, "*A* bartered to *B* for 200 credit units services that *A* would normally perform for $200."[222] In that same year, "*B* bartered to *A* for 200 credit units services that *B* would normally perform for $200."[223] In situation 2, *C*, an employee of the Trade Exchange, received 10,000 trade units as compensation for services performed. The Service ruled that members *A* and *B* had to include $200 in gross income and that employee *C* had to include $10,000 in gross income for the taxable year in which the units were credited to their accounts.[224]

In reaching its conclusion that these three taxpayers realized income at the time the trade units were credited to their accounts, the Service appeared to reason that the taxpayers were in "actual" receipt of the trade units, which themselves constituted valuable property rights taxable under section 61, rather than that they were in constructive receipt of the goods and services they could immediately obtain by using the trade units:

> In this case *A*, *B*, and *C* received income in the form of a valuable right represented by credit units that can be used immediately to purchase goods or services offered by other members of the barter club. There are no restrictions on their use of credit units because *A*, *B*, and *C* are free to use the credit units to purchase goods or services when the credit units are credited to their accounts.[225]

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221. 1980-1 C.B. 100.
222. *Id.* at 100.
223. *Id.* The coincidence of *A* and *B* exchanging equal value services during the year was obviously introduced by the Service to make the ruling simple. In the more usual situation, *A* would do work for *B* and use the trade units earned to acquire goods or services from a third party.
224. *Id.* at 101.
225. *Id.* at 101. The Service stated that *C*'s income constituted wages subject to withholding. *Id.* In LTR 7945009, *supra* note 174, the Service similarly

With respect to the tax consequences when a member uses a trade unit to acquire goods and services, the ruling implicitly concluded that a taxpayer is entitled to a deduction of $1.00 per trade unit used to pay for currently deductible goods and services.[226] If a member expends the trade units on capital items, it must capitalize the expenditure of $1.00 per trade unit expended, and, if the member uses them to acquire personal goods and services, it receives no tax benefit.[227] The commissions paid in trade units by members similarly may be expensed or capitalized if the cost of the goods or services acquired with respect to which the commissions were paid may be expensed or capitalized.[228]

Since the Service assumed in Revenue Ruling 80-52 that a trade unit has a value of $1.00 when received[229] and will be used to acquire property or services worth $1.00,[230] it did not discuss the possibility of a taxpayer realizing gain or loss on the disposition of a trade unit or taking a deduction in an amount other than one dollar per unit.[231]

b. Is Income Realized on the Receipt of a Trade Unit?

The trade exchange industry rejects the Service's contention that income is realized the moment a taxpayer has a trade unit credited to its account. They argue that income is not realized until the taxpayer uses its units to acquire goods and serv-

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concluded that a sole proprietor, who was the owner of a Trade Exchange, had income when the commissions earned in trade units were credited to his account. In so ruling, the Service spoke in terms of constructive receipt, but seemed to be saying only that the owner of the Exchange was in constructive receipt of the trade units "in the year they are added to his account in the normal course of events," not that he was in constructive receipt of the underlying property which he could purchase with the units. *Id.*

226. 1980-1 C.B. at 101.

227. *Id.*

228. *Id.*

229. The ruling specifically states that "[e]xchanges are made on the basis that one credit unit equals one dollar of value." *Id.* at 100. Similarly, in IRM 45G-324, *supra* note 176, at 8279-3, it is stated that "[g]enerally, one credit received will equal one dollar received." On the other hand, in LTR 8216010, *supra* note 174, the Service notes, without comment, that in the exchange under discussion, trade units have been sold at "x" per trade unit, and that the Exchange included trade credits in its income (in one year) at that price. It seems clear that "x" in the ruling is less than $1.00. Similarly, in LTR 7945009, *supra* note 174, no conclusion as to valuation is stated. Rather, it is stated that "the fair market value" of the credits were includible in the taxpayer's income in the year credited to the taxpayer's account.

230. 1980-1 C.B. at 100.

231. For such a discussion, see *infra* notes 266-96 and accompanying text.

ices.[232] The Service's position should be sustained, however, for a number of reasons. First, barterers, whether cash or accrual basis taxpayers, are arguably in receipt of the goods or services ultimately acquired through the use of the trade units at the time they receive the trade units under the doctrine of constructive receipt,[233] since they can convert the trade units into goods or services at any time. That members must first contact the Exchange for authorization, and then may not immediately be able to obtain the exact goods or services ordered, does not seem to constitute such a "substantial limitation or restriction"[234] on a member's right to obtain the goods and services as to render these transactions outside the scope of the constructive receipt doctrine.[235]

Second, the Service's position is supportable on the alter-

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232. *See* International Association of Trade Exchanges, Press Release, Sept. 16, 1981 (hereinafter cited as IATE). This position is claimed by the taxpayer in LTR 8216010, *supra* note 174. *See infra* text accompanying note 318.

233. A cash basis taxpayer, not otherwise in actual receipt of property, may be required to report income under Treas. Reg. § 1.451-2 T.D. 7663, 1980-1 C.B. 101, dealing with the concept of constructive receipt. *See generally* 4 B. BITTKER, *supra* note 20, ¶ 105.2.3 (1981) (constructive receipt); Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income,* 29 TAX. L. REV. 525 (1974); Watts, *Some Problems of Constructive Receipt of Income,* 27 TAX LAW. 23 (1973). Treas. Reg. § 1.451-2 provides in part:

> 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, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

Treas. Reg. § 1.451-2, T.D. 7663, 1980-1 C.B. 101.

An accrual basis taxpayer reports income when "all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a) T.D. 6500, 25 Fed. Reg. 11709. This means that an accrual basis taxpayer will often be required to report income before a cash basis taxpayer. If, however, upon performing services or selling goods, the accrual basis taxpayer is immediately paid in cash, property, or services, the accrual basis taxpayer, like the cash basis taxpayer, will simply value the receipt (if non-cash) and report it immediately as income. *See* 4 B. BITTKER, *supra* note 20, ¶ 105.3.4. Moreover, like a cash basis taxpayer, an accrual basis taxpayer can be in constructive receipt of property. *Id.* at ¶ 105.2.3 n.13.

234. *See* Treas. Reg. § 1.451-2; *supra* note 233.

235. Any delay in converting the unit into property is wholly voluntary with the taxpayer, and the Exchange seems to be no more than a passive custodian of the units until the taxpayer chooses to use them. *See generally* 1 B. BITTKER, *supra* note 20, ¶ 10.2.3 (payments to employees).

native theory, apparently adopted by the Service, that the trade units are themselves valuable property rights of a nature traditionally considered to constitute income taxable under section 61(a).[236] This seems the more correct theory. Cash basis taxpayers are required to include in income not only cash income received during the taxable year but also the value of any noncash consideration received.[237] A cash basis taxpayer does not receive reportable income upon the receipt of noncash consideration only when the consideration takes the form of the nonassignable promise of the one for whom the taxpayer has performed services or to whom the taxpayer has sold goods.[238] Trade units, however, represent more than the mere promise of the individual member for whom the taxpayer performed services or to whom he or she sold goods. Rather, each trade unit represents the promise of the entire exchange membership, as a group, to allow the recipient of the unit to use it to acquire the goods and services offered by the membership.[239] Moreover, at least in the case of the established exchanges, these promises represented by trade units, are readily assignable or transferable to other members of the trade exchange.[240] As the medium of exchange of the trade exchange, trade units resemble foreign currency, which the tax law has long required U.S. citizens to include in their gross income upon receipt.[241]

236. "Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash." Treas. Reg. § 1.61-1(a) (1960). This seems to be the theory adopted by the Service in Rev. Rul. 80-52, 1980-1 C.B. 100. *See supra* notes 221-31 and accompanying text.

237. The cash receipts and disbursements method of accounting requires "all items which constitute gross income (whether in the form of cash, property or services) . . . to be included [in income] for the taxable year in which actually or constructively received. . . ." Treas. Reg. § 1.446-1(c)(1)(i) (1960).

238. *See* 4 B. BITTKER, *supra* note 20, ¶ 105.2.2; Watts, *supra* note 233, at 28-29.

239. *See supra* notes 170-82 and accompanying text.

240. While the mere promise of an income obligor does not generally represent income to a cash basis recipient, such a promise may be a cash equivalence, requiring inclusion by a cash basis taxpayer, where the form and substance of the contract make it readily assignable, or transferable in commerce. Cowden v. Commissioner, 32 T.C. 853 (1959), *rev'd,* 289 F.2d 20 (5th Cir. 1961), *on remand,* 20 TAX CT. MEM. DEC. (CCH) 1134 (1961). *See* 4 B. BITTKER, *supra* note 20, § 105.2.2; Watts, *supra* note 233, at 29.

241. Trade units seem most closely analogous to a special type of so-called "blocked" foreign currency, which, due to exchange restrictions, cannot be readily converted into U.S. dollars, but which can be used freely within the foreign country itself to acquire goods and services. The income tax consequences of foreign exchange transactions and exchange rate fluctuations are discussed in abundant detail in D. RAVENSCROFT, TAXATION AND FOREIGN CUR-

An additional argument the barter industry advances for not taxing trade units on receipt is that, although such units are property, they have no ascertainable fair market value. This "open transaction" approach[242] is appropriate, however, only where neither side of an exchange has an ascertainable fair market value.[243] Where the value of the property received cannot be determined with reasonable accuracy, but the value of the property given up can be, one can merely presume the value of the property received to be equal to the value of the property given up.[244] Thus, even if trade units have no independently ascertainable fair market value, they still have a value for tax purposes equal to the fair market value of the goods and services exchanged for the units.[245]

RENCY (Harvard Law School International Tax Program, 1973). On the subject of blocked currency, see generally *id.*, at 123-65, 479-539. Generally, unrestricted foreign currency received by U.S. citizens as payment for goods and services is treated as property, and is reportable as income on receipt at its value in U.S. dollars. Rev. Rul. 74-222, 1974-1 C.B. 21. *See generally* D. RAVENSCROFT, *supra*. In the 1930's and 40's, taxpayers argued that if the received currency was not readily convertible into U.S. dollars nor usable to pay U.S. taxes, it should not be currently taxable, even though usable within the foreign country. In a number of cases, however, courts have rejected this argument, finding the taxpayer could get full "economic satisfaction" by spending the blocked currency in the foreign country. *See, e.g.*, Edmond Weil, Inc. v. Commissioner, 150 F.2d 950 (2d Cir. 1945); Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943); Cooper v. Commissioner, 15 T.C. 757 (1950), *acq.*, 1951-1 C.B. 2; Freudmann v. Commissioner, 10 T.C. 775 (1948), *acq.*, 1948-2 C.B. 2; Marty, Jr. v. Commissioner, 31 TAX CT. MEM. DEC. (CCH) 26 (1972).

242. *See, e.g.*, Burnet v. Logan, 283 U.S. 404 (1931). Enactment of the Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980), will narrow the use of the "open transaction" approach of *Burnet v. Logan*. The open transaction approach will be "limited to those rare and extraordinary cases . . . where the fair market value of a purchaser's obligation cannot reasonably be ascertained." S. REP. No. 1000, 96th Cong., 2d Sess. 24, *reprinted in* 198 U.S. CODE CONG. & AD. NEWS 4696, 4719. *See* Rev. Rul. 58-402, 1958-2 C.B. 15 (contracts and claims to receive indefinite amounts must be valued for tax purposes).

243. *See* 2 B. BITTKER, *supra* note 20, ¶ 43.2. The approach of United States v. Davis, 370 U.S. 65 (1965), "suggests that the 'open transaction' theory of *Burnet v. Logan* applies only if *neither* the property given up *nor* the property received can be valued with reasonable accuracy." 2 B. BITTKER, *supra*, ¶ 43.2 (emphasis in original).

244. *See supra* notes 45-65 and accompanying text.

245. It is only the Trade Exchange itself which might argue for an open transaction approach, since it is receiving trade units for services which are so specialized as not to have any independently ascertainable fair market value. But, in the end, the Exchange also must lose this argument, since the trade units in fact do have an ascertainable value. *See infra* notes 246-62 and accompanying text. In LTR 8216010, *supra* note 174, a Trade Exchange failed to convince the Service that the value of the trade units it received could not be ascertained with reasonable accuracy.

c. Valuation of Trade Units

Having determined that trade units constitute reportable income upon receipt, the next major issue is their value—that is, how much income does a taxpayer realize upon receiving a trade unit? The Service, as previously noted, takes the position that a trade unit is generally worth one dollar, because, under the relevant contract, a trade unit can buy one dollar's worth of goods and services at "prevailing prices."[246] But, as earlier discussed, the term "prevailing price" often means a price above that at which goods and services are normally sold for cash.[247] Therefore, a trade unit's real value is clearly less than one dollar.

The Trade Exchanges advance the position that, if trade units are to be taxed upon receipt, they should be valued by reference to the value of what the member gave up to obtain them.[248] Thus, the Trade Exchanges support a presumed-equivalence-in-value approach.[249] In a fact sheet on barter tax issues,[250] the IATE states that:

> [Revenue Ruling 80-52] did not satisfactorily address the question of how trade units are to be valued. It implies that one trade unit is to be valued at one dollar, which is demonstrably incorrect as a general expression of the fair market value of a trade unit, though it may be accurate in particular transactions. . . . IATE believes that, if trade units are to be declared as income upon receipt, as IRS now requires, their fair market value is properly determined by the fair market value (wholesale, average, or incremental cost) of the goods or services given in exchange for the trade credits.[251]

Under a presumed-equivalence-in-value approach,[252] if member *A* trades goods with a value of $75 for 100 trade units, *A* will have $75 of income to report. If member *B,* on the other hand, trades goods with a value of $90 for 100 units, *B* will recognize $90 of income. Thus, each member might report a different amount of gross income on the receipt of the same number of trade units.

As a matter of substantive law, the use of a presumed-equivalence-in-value technique is clearly inapposite, at least for the large national exchanges. To use the presumed-equivalence-in-value approach requires a determination that the prop-

246. Rev. Rul. 80-52, 1980-1 C.B. 100, 100. *See supra* notes 229-31 and accompanying text.

247. *See supra* text accompanying notes 205-08.

248. *See* IATE, *supra* note 232.

249. *See generally supra* notes 45-65 and accompanying text.

250. IATE, *supra* note 232.

251. *Id.*

252. *See supra* notes 43-45 and accompanying text.

erty received has no readily ascertainable fair market value.[253] This simply is not the case with respect to trade units used by large numbers of taxpayers to make thousands of purchases of goods and services each year within a trade exchange. Each one of these purchases represents a disposition in the marketplace of a trade unit, and from these thousands of transactions, a value for a trade unit is surely ascertainable. In essence, each member, upon receipt of a trade unit, is getting an item of property entitling it to acquire the same goods and services as every other member. Therefore, the economic value of a trade unit to each member is the same regardless of what the member gave up to acquire it.

In less established exchanges, however, where the number of members is small and the purchasing power of a trade unit is very volatile, the use of the value of the goods and services given up may be an appropriate valuation technique. But even in such cases the IATE fact sheet is misleading or simply wrong. The IATE's statement does not make it clear that it is the "value," not the "cost," of the goods and services given up that determines the barterer's income. The value of the goods and services given up is that price at which the barterer would have sold such goods or services to the purchaser in a cash sale.[254] Since most exchange members are retailers, the retail value of the goods given up generally will be the appropriate valuation for reporting income. The IATE's suggestion[255] that wholesale or average value might be used is misleading. Its implication that incremental cost is somehow relevant is simply wrong. In equating the two sides of a barter exchange, the only relevant factor is the value, not the cost, incremental or otherwise, of the goods and services given up.

Thus, having rejected valuing trade units at $1.00 or on the basis of the value of what was given up, the only remaining solution is to value a unit at less than one dollar and to require all members to use the same value for income tax reporting purposes. The value so determined should reflect the "purchasing power ratio" between trade units and dollars. That is, a trade unit's value is the average value, in dollars, of goods and services acquired within the exchange during the year for a trade unit.[256]

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253. *See supra* notes 43-45 and accompanying text.
254. *See supra* notes 43-45 and accompanying text.
255. *See supra* text accompanying note 251.
256. *See infra* note 259.

The Trade Exchanges themselves should be responsible for determining this value.[257] Having done so, they would then, under the 1982 legislation, be required to submit information returns to their members and to the IRS showing the amount of barter income received by members during the year.[258] Because individual members would not have the facts available to challenge successfully the valuation determined by the Exchange, the Service's enforcement efforts could be limited to the Trade Exchange itself.

If a Trade Exchange informally makes cash sales of its trade units to members for less than their value as determined above, it is possible to argue that the cash price for which they can be purchased represents their value to all recipients. But while the price at which property would sell in a cash transaction generally is a proper measurement of the value of in-kind income, this rule is not appropriate with respect to trade units. The value of a trade unit should be determined by what it can buy within the exchange, and not the cash price for which it can be purchased or sold. By analogy, if a U.S. taxpayer receives foreign currency, usable within the foreign country to acquire goods and services, but not readily convertible into U.S. dollars, an informal market often develops, in which the taxpayer can sell the foreign currency to U.S. citizens wishing to invest or spend the currency in the foreign country.[259] In such circumstances, it would be clearly improper to value the cur-

257. A Trade Exchange could compute this value by sampling transactions occurring in the Exchange during the year.

258. *See supra* notes 217-20 and accompanying text.

259. Courts, reasoning that taxable income can be based on the potential of foreign income to satisfy foreign needs, have included such blocked currency in the income of U.S. citizens. *See supra* note 241. Having done this, however, the courts were faced with a valuation issue. For example, in Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943), after concluding that the blocked currency was includable in the taxpayer's income, the Second Circuit had to determine the amount of that income. The court said that, while the Commissioner and Tax Court's use of a "free peso" exchange rate was clearly inappropriate, "[t]here is nothing in the record to show how economic satisfaction . . . can be measured in American dollars." *Id.* at 28. The Second Circuit therefore remanded the case to the Tax Court "for further consideration of the appropriate measure of valuation." *Id.* In so doing, it suggested the following valuation technique: "Perhaps [the value of the currency] can be measured on the basis of the respective price indices in the United States and Colombia, restricting the commodities included in the indices to those which could readily be purchased in Colombia in the taxable year." *Id.* In fact, on remand, the taxpayer introduced, and the Tax Court accepted as "competent evidence . . . the [ratio] between the prices at which the same or similar foods and other commodities commonly used by citizens of this country living in Colombia sold in the United States and Colombia throughout the year 1938." Eder v. Commissioner, 3 TAX CT. MEM. DEC. (CCH) 460, 461 (1944). This use of such "purchas-

rency at the dollar amount realizable in the United States, since "the dollar amount realizable in the United States might be but a fraction of the dollar value of property . . . which the foreign income would buy in the foreign country."[260] Since trade units are the equivalent of a foreign currency, they too should be valued by their "purchasing power" within the trade exchange, and not by what they would bring in a cash sale.

If a trade unit's value reflects its purchasing power, the question arises whether a member realizes income on the bargain purchase of a unit for less than that value. The answer should be that a member realizes no income on such a purchase. Exchanges presumably sell units at a bargain for their own benefit, and not for the benefit of their members. Therefore, they should properly be treated as arm's length exchanges between seller and buyer, resulting in no gain to the buyer.[261] The same should not hold true, however, if an Exchange or an exchange member sold units to its own employees or shareholders for less than their value. In such a case, the amount by which the value of the trade unit exceeds the sale price should be dividend or compensation income to the shareholder or employee.[262]

d. The Tax Consequences on Disposition of Trade Units

(1) The Direct Barter Approach

Regardless of the value of a trade unit, so long as that value is considered income at the time the trade unit is credited to a member's account, there arises the problem of how to treat barterers upon exchanging their trade units for goods and services. Conceivably, each use of a trade unit could be treated as a direct barter exchange of the trade unit for goods and services. The barterer would realize gain on the disposition of the units

ing power ratios" is essentially the same as the one suggested herein for valuing trade units.

260. D. RAVENSCROFT, *supra* note 241, at 528.

261. *See, e.g.,* Aspegren v. Commissioner, 51 T.C. 945, 954 (1969); Pellar v. Commissioner, 25 T.C. 299, 309 (1955); Hunley v. Commissioner, 25 TAX CT. MEM. DEC. (CCH) 355, 357 (1967). The rule in these cases was well stated in Husted v. Commissioner, 47 T.C. 664 (1967): "To decide whether the petitioner's acquisition of [property] constituted the receipt of compensation, we must ascertain whether he acquired such [property] at a bargain and, if so, whether the purpose of selling it to him at a bargain was to provide him with compensation." *Id.* at 673.

262. When a taxpayer is allowed to make a bargain purchase as compensation, the excess of the value of the property received over its purchase price represents gross income. Treas. Reg. § 1.61-2(d)(2) T.D. 6500, 25 Fed. Reg. 11402.

to the extent the value of the property or services received exceeded the basis of the trade units and would realize loss to the extent that the basis exceeded the value of such property or services.[263] If the taxpayer received deductible property or services, the deduction would equal the value of the goods and services received.[264]

To illustrate this approach, assume that member *A* receives 1,000 trade units, which *A* properly includes in income at their value of $800. *A* then uses the 1000 units to acquire currently deductible business services that would have cost *A* $900 in a cash transaction. Under the direct barter approach, *A* would recognize a $100 gain on the disposition of the trade unit (the $900 value of the services received less *A*'s $800 basis in the trade units) and would take a $900 business deduction for the value of the goods received.[265]

(2) The Medium of Exchange Approach—No Exchange Fluctuation

While the direct barter approach may be appropriate for members of certain small unestablished exchanges who properly value the units on receipt by reference to the value of the goods and services given up,[266] the method seems entirely inappropriate for the larger national exchanges. In the latter exchanges, the more appropriate approach, both as a matter of substantive law and from the viewpoint of administrative convenience, would be one that treats trade units, when used to acquire goods and services, as a medium of exchange.[267] Under this approach, the goods and services acquired would be conclusively assumed to be equal in value to that of the trade units used to acquire them.[268] Good deals and bad deals would sim-

263. *See* I.R.C. § 1001 (1976).

264. This is the result under the value received theory of deductions. *See supra* text accompanying notes 79-88.

265. *See supra* text accompanying notes 79-88.

266. *See supra* notes 248-55 and accompanying text.

267. *Cf.* Dale, *Tax Consequences of Currency Fluctuations: Occasional Transactions,* 32 INST. ON FED. TAX'N 1683, 1694-95 (1974) ("foreign currency is usually a medium of exchange, and its acquisition or disposition as an incident of a transaction should not independently give rise to recognition of exchange rate gain or loss").

268. Similarly, for deduction and income purposes, when foreign currency is used to acquire goods and services, the goods and services are assumed to be equal in value to the dollar value of the currency used to acquire them. *See* RESEARCH INSTITUTE OF AMERICA, FEDERAL TAX COORDINATOR 2D, ¶ G-7012 (1982). In Rev. Rul. 80-52, 1980-1 C.B. 100, the Service, assuming a constant $1 per unit value for a trade unit, concluded that a taxpayer was entitled to a $1 per trade unit deduction when the taxpayer used trade units to pay for cur-

ply be ignored. The taxpayer would, in effect, be treated as receiving the average value of the goods and services a trade unit could buy, which, absent exchange fluctuation, would be the same amount the taxpayer took into income on receipt of the unit.[269] Assuming that there is indeed no change in the value of the trade unit itself from the time of acquisition to the time of disposition, this approach would result in no gain or loss to the taxpayer on the disposition of trade units, and produce tax deductions, if deductible business goods and services were acquired, equal to the value of the units used.

Assume, for example, that during 1982, member *A,* a sole proprietor, received 1,000 units valued and included in *A*'s income at $800. Then, in 1983, when the units were still worth $800, *A* used them to acquire goods from another member. *A* would realize no gain or loss on the latter transaction whether the goods acquired were worth more or less than $800, because *A* would be deemed to have acquired goods equal to the $800 in trade units used to acquire them. If the goods *A* acquired were currently deductible, *A* should claim an $800 deduction. If, on the other hand, the goods were personal, *A* would be entitled to no deduction, and, if the goods were capital assets, *A* would take an $800 basis instead of a current deduction. This is essentially the position of the Service in Revenue Ruling 80-52,[270] although there the Service considered a unit for both income and deduction purposes to be, at all times, worth one dollar.[271]

(3) The Medium of Exchange Approach—Exchange Fluctuation

The assumption that the value of trade units will not fluctuate from year to year may not be true as applied to any particular Exchange. The possibility of trade unit fluctuation raises two tax issues common to exchange rate fluctuation in foreign currency: whether gain or loss on the disposition of appreciated or depreciated trade units is ordinary or capital and whether losses incurred by noncorporate members on the disposition of depreciated units is allowable at all.[272]

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rently deductible goods and services. *Id.* at 101. *See supra* text accompanying note 226.

269. *See supra* notes 256-58 and accompanying text.

270. 1980-1 C.B. 100. *See supra* notes 226-28 and accompanying text.

271. 1980-1 C.B. at 100. *See supra* notes 221-31 and accompanying text.

272. "Foreign currency is usually viewed as 'property' rather than money, and transactions in foreign currency usually generate gain or loss if the exchange rate fluctuates between the inception of a transaction and its completion." 3 B. BITTKER, *supra* note 20, ¶ 65.7.1, at 65-21. *See generally* D.

To illustrate the first issue, suppose that an exchange member receives 1,000 trade units in a year in which a trade unit is worth 80 cents. Suppose further that this member exchanges these units for business related goods and services in a subsequent year when a trade unit is worth 90 cents. The disposition of these 1,000 units has two tax consequences for the member. The member has expended units worth $900 for which it is entitled to deduct $900 as a trade or business expense, and the member has realized a $100 gain on the appreciation of the units.[273]

Whether the $100 gain in the example is ordinary or capital depends on whether the trade units were a capital asset in the member's hands and were disposed of by sale or exchange.[274] Since the exchange requirement is clearly met in a barter transaction, the only issue is whether trade units are capital assets. Although trade units are "property" and do not fall within any of the express exceptions of section 1221, the courts have acknowledged that the disposition of certain assets not expressly excluded from the section 1221 definition of a capital asset nevertheless results in ordinary gain or loss. In *Corn Products Refining Co. v. Commissioner,*[275] the Supreme Court recognized that an asset acquired for a purpose integral to the taxpayer's business, rather than for investment, should produce ordinary gain or loss upon its disposition. The Court reasoned that profits and losses arising from the "everyday operation of the business" should be classified as ordinary since Congress did not intend the more favorable capital gains rates to apply to transactions which are a "normal source of business income."[276] The disposition of trade units acquired in

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RAVENSCROFT, *supra* note 241; Adams & Henrey, *Tax Consequences of Foreign Currency Fluctuations,* 30 TAX EXECUTIVE 301 (1978) (effect of fluctuations on various transactions).

273. The same analysis should apply if a member transfers depreciated or appreciated trade units to an employee as compensation. The member would take a business deduction equal to the value of the trade units in the year the compensation was paid and would realize gain or loss equal to the difference between the unit's value and its basis. If a corporate member transfers appreciated or depreciated units to its shareholder, the corporation would recognize no gain or loss since a corporation generally recognizes no gain or loss on a distribution of property with respect to its stock. I.R.C. § 311(a) (1982).

274. Thus, trade units would be treated identically to foreign currency. *See* 3 B. BITTKER, *supra* note 20, ¶ 65.7.2.

275. 350 U.S. 46 (1955).

276. In *Corn Products,* the taxpayer, a large manufacturer of corn-related products, reported gains and losses from the sale of corn futures purchased to protect it against unexpected price increases for corn in the spot market as capital gains and losses. The Court held that the gains and losses on the tax-

the ordinary course of a member's business constitutes a normal source of business income to the member. Thus, the *Corn Products* rule would require any gain or loss realized on such disposition to be treated as ordinary, rather than capital, gain or loss.[277]

If the disposition of a trade unit results in a loss instead of a gain, the loss is deductible only to the extent permitted by section 165, which limits the deductibility of losses sustained by individuals to those incurred in a trade or business or transaction entered into for profit, or attributable to casualty or theft.[278] No one would question that a loss incurred on a disposition of trade units acquired in the ordinary course of the taxpayer's business and used to acquire business goods or services is a deductible loss under section 165(c)(1). The answer, however, is not so clear if the trade units are disposed of by a noncorporate member to acquire nonbusiness goods or services.

The limitation on the deductibility of losses in section 165 is similar in structure to that imposed on the deductibility of expenses by sections 162 and 212.[279] Thus, section 165 must be read in light of section 262 which disallows any deduction for "personal living or family expenses."[280] Consequently, section 165's function is to identify allowable nonpersonal losses as opposed to nonallowable personal losses.[281]

In an ideal income tax system, realized losses on the disposition of property should be disallowed only to the extent the reduction in value is attributable to the taxpayer's personal consumption of the asset.[282] On the other hand, losses repre-

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payer's transactions in corn futures were ordinary, finding that the taxpayer had a business rather than an investment purpose in purchasing the corn futures. *See also* 2 B. BITTKER, *supra* note 20, ¶ 51.10.3 (discussing the *Corn Products* doctrine).

277. *Cf.* America-Southeast Asia Co., 26 T.C. 198 (1956) (gain on disposition of foreign currency for business inventory held to be ordinary income).

278. I.R.C. § 165(c) (1976).

279. Section 162 allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (1976). Section 212 allows individuals deductions for all "ordinary and necessary expenses" paid or incurred "for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax." I.R.C. § 212 (1976).

280. *Cf.* United States v. Gilmore, 372 U.S. 39 (1963) (section 262 limits section 212 to expenses that relate to a business).

281. *See* 1 B. BITTKER, *supra* note 20, ¶ 25.3.

282. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 15.02, at 258 (3d ed. 1982).

senting market fluctuation, unrelated to consumption, should be allowed in full.[283] Where an asset is used by a taxpayer for personal consumption purposes, however, any allocation of the loss between market fluctuation and personal consumption is administratively infeasible, and the entire loss is simply disallowed.[284] But if a taxpayer disposes of an asset which he or she has never used for personal consumption purposes, any loss realized must be due to market conditions, and should be allowed in total, even if the loss does not fit snugly into the literal language of section 165(c).[285] For example, in *Marx v. Commissioner,*[286] the court permitted a taxpayer to deduct a loss incurred on the sale of a yacht she had inherited from her husband. The taxpayer never used the yacht herself for personal purposes, but immediately attempted to sell it for the best price available. On the eventual sale of the yacht, she sustained a loss.[287] While, literally, the taxpayer did not acquire the property in a transaction entered into for profit, nor did she hold it for post-acquisition appreciation, the court allowed her the loss deduction. It reasoned that the loss was allowable since she never used the yacht for personal purposes.[288] In other words, the loss could only have resulted from market fluctuation.

Under this analysis, a loss sustained on the disposition of a trade unit should never be disallowed, since such a loss will always be due to market fluctuation, and never to personal consumption. Trade units, like stock and other intangibles, can never lose value due to personal consumption use. Moreover,

283. *See id.* Of course, under current law losses from sales of personal property are routinely disallowed in their entirety under section 165(c) despite the fact that a portion of the loss was attributable to market fluctuation. Chirelstein discusses an example in which a taxpayer buys a car for $5,000 for personal use and sells it sometime later for $3,800. *Id.* ¶ 6.05, at 121-22. The entire $1,200 loss is disallowed by section 165(c), regardless of whether some of the loss is attributable to a market decline in the value of the car, because the law presumes in the case of personal property that the loss is wholly attributable to personal use. *See id.,* at 122.

284. *See supra* note 283.

285. *See* Weir v. Commissioner, 109 F.2d 996 (3d Cir. 1940). In *Weir,* the court allowed a deduction for loss incurred on stock which the taxpayer had purchased to give himself a voice in the corporation that owned the apartment building in which taxpayer was a tenant. The deduction was properly allowed despite the absence of a profit motive because no part of the decline in the value of a piece of intangible property could be related to personal use.

286. 5 T.C. 173 (1945).

287. The sale price was less than her basis in the yacht, which, under the predecessor of § 1014, was the estate tax value of the yacht.

288. 5 T.C. at 174. The court concluded that holding the yacht for sale and its eventual sale constituted a transaction entered into for profit. *Id.*

in the case of the disposition of trade units by exchange members, there is no difficulty applying the literal words of section 165 to reach this logical result. An exchange member acquires trade units in the ordinary course of his or her trade or business, and disposes of them in an orderly fashion, in exchange for valuable goods and services.[289] Any loss realized on such a disposition of trade units seems clearly to be incurred in the taxpayer's trade or business, and, therefore, deductible under section 165(c)(1). This is true whether the goods or services acquired for the units are of a business or personal character.[290] The important question is why the units were initially acquired, and for what purpose they were being held. Surely, the result in *Marx* would not have changed had the taxpayer exchanged the inherited yacht for jewelry or other personal property, rather than for cash.[291]

289. Similarly, an employee who receives trade units from an employer as compensation has acquired those units in connection with the employee's trade or business as an employee.

290. One might analogize trade units acquired in a trade or business for goods or services normally provided by that trade or business as equivalent to an accrual method taxpayer's accounts receivable. Any loss realized on the disposition of such accounts receivable is clearly deductible, whether the amount realized on the disposition takes the form of cash or property of a business or personal character.

291. The Service and a few cases have held, however, that loss resulting from exchange rate fluctuation is not deductible if realized on the exchange of devalued foreign currency for personal goods and services. *See* Puttkamer v. Commissioner, 66 T.C. 240 (1976); Boyer v. Commissioner, 9 T.C. 1168 (1947); Rev. Rul. 74-276, 1974-1 C.B. 54; Rev. Rul. 74-7, 1974-1 C.B. 198. *Cf.* Rev. Rul. 71-134, 1971-1 C.B. 75 (loss incurred in exchanging devalued foreign currency representing sale of privately owned automobile for dollars not deductible). These cases and rulings are all distinguishable from the situation of an employee or exchange member who uses devalued trade units acquired in his or her trade or business to acquire personal goods or services. Moreover, it is arguable that these foreign currency cases are simply wrong.

For example, although both *Puttkamer* and Revenue Ruling 74-276 contain language to the effect that the exchange of foreign currency for personal goods can never result in a loss, both can be explained on other grounds. Properly read, they stand for the narrower proposition that no loss results to a taxpayer abroad who is required by the U.S. government to exchange U.S. dollars into foreign exchange at an official rate less favorable than the free market rate of exchange. In *Puttkamer* and Revenue Ruling 74-126, a taxpayer worked abroad for a U.S. agency, which paid its employees in U.S. dollars. The taxpayer-employee had to convert those dollars into the local currency at the official exchange rate in order to meet his personal needs for food, clothing, etc. The taxpayer claimed a loss equal to the difference between the free exchange rate and the official rate for his dollars. Both the Tax Court and the Service held that no deductible loss occurred, either at the time the taxpayer converted the U.S. dollars into foreign currency or when he exchanged the foreign currency to acquire personal goods.

In Revenue Ruling 71-134, 1971-1 C.B. 75, the Service denied a deduction for a loss incurred on the exchange of devalued foreign currency acquired outside

Although members usually acquire their trade units as part of their business operations and may therefore deduct any losses incurred on their disposition under section 165(c)(1), trade unit losses may also be deemed incurred in a transaction entered into for profit, and thus be deductible under section 165(c)(2) as well. This will be the case where a member affirmatively decides to hold units for future appreciation, rather than simply holding them until they can be disposed of in some orderly fashion. Such a subjective investment purpose will not, of course, affect the deductibility of any loss, but it could affect the nature of that loss. That is, a loss incurred on trade units held for investment purposes, even though initially acquired in the ordinary course of a trade or business, would not be within the *Corn Products* rule.[292] In such a case, the loss should be capital instead of ordinary.

For administrative simplicity, taxpayers should determine gain or loss on the disposition of a trade unit under a last-in-first-out (LIFO) method of identifying the units disposed of.[293] In other words, the last units acquired would be considered the first used. Under the LIFO method, gain or loss from fluctuations in the value of trade units would be limited to those years in which more units were used than acquired. In all other years, members could simply attach a statement to their tax returns, listing income and deduction in terms of trade units, with only the bottom line net profit or loss figure—stated in

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the taxpayer's trade or business where no investment purpose was apparent. The taxpayer in the ruling sold a personal automobile immediately before departing a foreign country, receiving foreign currency which he converted into U.S. dollars. After the sale of the automobile but before the exchange of the currency, the foreign currency underwent a devaluation, so that the taxpayer received fewer dollars than would have been payable under the rate of exchange prevailing on the date the auto was sold. The Service held that the loss incurred in exchanging the devalued foreign currency was not deductible under section 165. A trade exchange member or employee who exchanges devalued trade units for personal goods or services is easily distinguishable. In the ruling, the transaction in which the taxpayer acquired the foreign currency was a personal transaction, whereas in the trade exchange setting the initial acquisition of units occurs in the ordinary course of the member's or employee's trade or business. Moreover, one could argue that the Service was wrong in denying the taxpayer the loss deduction in Revenue Ruling 71-134. Since currency can never be held for personal use, a more reasonable view would treat the acquisition and exchange of foreign currency as a transaction entered into for profit under section 165(c)(2). *See supra* notes 182-91 and accompanying text.

292. *See supra* notes 274-77 and accompanying text.

293. The LIFO convention for identifying inventory assumes that the most recently acquired goods are the ones sold. *See generally* 4 BITTKER, *supra* note 20, ¶ 105.4.3 (FIFO and LIFO).

terms of trade units—translated into dollars.[294] Taxpayers would convert trade units into dollars by using the trade unit valuation computed by the Trade Exchange for the year in question. Only if more units were expended than acquired would the taxpayer be required to include an additional computation for "exchange rate" gain or loss.

For example, assume that member *A* received 5,000 units for services performed in 1982, *A*'s first year in the exchange, and that *A* used 3,000 of those units to acquire currently deductible goods and services, retaining the other 2,000 units for future use. If, in 1982, a trade unit was worth eighty cents, *A*'s bartering income would be $1,600 (net income of 2,000 units x 80¢/unit). If *A*'s receipts and expenditures of trade units were the same in 1983, but a unit had dropped in value to seventy cents, *A*'s bartering income for 1983 would drop to $1,400. Finally, if in 1984, when a trade unit was worth sixty cents, *A* received only 2,000 units but expended 6,000 trade units (including the 4,000 units accumulated from 1982 and 1983) on currently deductible business items, *A*'s bottom line figure would be a net bartering loss of 4,000 units, or $2,400 when converted into dollars. Furthermore, in 1984, *A* would have incurred an "exchange rate" loss of $600 for the year, a loss of $400 on the 2,000 1982 units[295] and a loss of $200 on the 2,000 1983 units.[296]

2. *The Taxation of the Barter Exchange*

In general, the conclusions reached in the prior section with respect to the taxation of an exchange member apply equally to the Exchange itself. That is, the Exchange should recognize income as soon as trade units are credited to its account; those trade units should be included at the average

294. This is closely analogous to a method approved by the Internal Revenue Service for taxing foreign branches of U.S. companies. *See* Rev. Rul. 75-107, 1975-1 C.B. 32; Costello, *Tax Consequences of Currency Fluctuations: For U.S. Businesses Conducting Operations Abroad Through Branches or Subsidiary Corporations,* 32 INST. ON FED. TAX'N 1707, 1713-14 (1974).

> Under the so-called profit/loss method the U.S. taxable income attributable to a foreign branch is determined by taking the net profit shown on the branch's foreign currency profit/loss statement for the year and translating it into dollars at the exchange rate in effect at the end of the year. Where remittances have been made to the home office during the year, they are translated into dolars at the rate in effect on the date remitted, and only the balance of the profit, if any, is translated at the year-end rate.

Id. at 1713.

295. A loss of 20 cents per unit on 2,000 units.

296. A loss of 10 cents per unit on 2,000 units.

value of a unit during the taxable year in question; and the disposition of units should produce deductions (where appropriate) equal to their value, and should result in gain or loss only if there has been a fluctuation in the value of the trade unit itself. This section considers only those additional tax issues relevant to the Exchange itself.

a. Technical Advice Memorandum 8216010[297]

The National Office of the Internal Revenue Service has twice issued technical advice to District Directors on questions relating to the taxation of Barter Exchanges. One of these memoranda adds little to the previous discussion. Technical Advice Memorandum 7945009[298] simply concludes that an Exchange owner, a sole proprietor, had income on commissions earned in trade units as soon as those units were "added to [his] account in the normal course of events."[299]

The other, Technical Advice Memorandum 8216010, deals with the taxation of a Barter Exchange that issues trade units in excess of those earned by it as commissions.[300] It can be more easily understood by introducing hypothetical numbers to illustrate the general facts set forth by the Service in its memorandum. Assume, for example, that at all relevant times a trade unit is worth $1.00,[301] and in its first year of operation,[302] Barter, a trade exchange owner, earns 10,000 units as commissions. In that same year, Barter issues 40,000 trade units, using its currency creating powers to produce the excess,[303] to acquire $40,000 worth of goods and services from its members.[304] Of the goods and services acquired, Barter uses half currently in its business, and places the other half in its showroom for retrade to members.[305] The facts in Barter's second year of oper-

297. LTR 8216010, *supra* note 174.

298. LTR 7945009, *supra* note 174.

299. *Id.*

300. *See supra* notes 187-98 and accompanying text.

301. In fact, the memorandum notes that "[i]f trade units are sold for cash, it has been represented that trade units are exchanged at the rate of x per trade unit". LTR 8216010, *supra* note 174.

302. The year 1977 in the Technical Advice Memorandum.

303. *See supra* notes 187-98 and accompanying text.

304. The assumption that a trade unit will always buy $1 worth of goods and services is erroneous, but is used here for simplicity. *See supra* notes 205-08 and accompanying text.

305. The Technical Advice Memorandum states that some of the acquired goods were used in Barter's own business, and the rest for retrade. No breakdown comparable to the one given in the text was, however, provided by the Service.

ation are the same as in the first year.

Based on these facts, Barter, in its first year of operation, reports a $10,000 net loss from its activities. More specifically, Barter includes $10,000 as commission income on the receipt of the 10,000 trade units[306] and claims a $20,000 deduction for the 20,000 units used to acquire goods and services for its own current business benefit.[307] Barter, however, does not report any income as a result of receiving $30,000 worth of goods and services in exchange for the newly issued trade units (40,000) in excess of those earned by Barter as commissions (10,000) and included in income.[308]

According to the Service, Barter made two interrelated errors in its computations. First, it failed to report in income the $30,000 worth of property received in exchange for the newly created trade units which had cost Barter nothing.[309] Second, having never reported that property in income, it nevertheless claimed a deduction when it used such zero basis property to meet its business needs.[310] On these facts, the Service's position was that Barter should have both reported the income and claimed the deduction. That is, Barter should have reported $40,000 of gross income (consisting of the $10,000 worth of trade units received as commissions plus the $30,000 worth of property received for newly issued units) and claimed a $20,000 deduction for the goods and services it used for current business

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306. Technical Advice Memorandum 8216010 states that, in 1977, Barter's first year of business, it "reported income on trade units earned as commissions from barter transactions between members." It notes that "Barter assigned a value of x per trade unit which is multiplied by the total number of trade units received as commissions in order to calculate gross income." LTR 8216010, *supra* note 174.

307. "Under the method used in 1977, Barter would treat as a business expense those goods and services which it obtained in a barter transaction and used in its trade or business." *Id.*

308. *Id.*

309. The Service noted that "Barter has no cost related to the creation or issuance of trade units," and trade unit balances of members are "not liabilities of Barter." *Id.*

310. Even were Barter correct, initially, in not reporting the receipt of the property in income, it nevertheless would be required to report the income when it used zero basis property to acquire a deductible item. *See, e.g.,* United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), *cert. denied,* 365 U.S. 843 (1961); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Solon v. Commissioner, 39 TAX CT. MEM. DEC. (CCH) 1245 (1980); Bellows v. Commissioner, 26 TAX CT. MEM. DEC. (CCH) 978 (1967). "Where property is used to pay for an item of deductible expense, the transaction gives rise not only to a deduction but also to the realization of income on such use of the property." *Bellows,* 26 TAX CT. MEM. DEC. (CCH) at 980. *See also supra* notes 106-36 and accompanying text.

purposes. This would give Barter a net income of $20,000, rather than the net loss of $10,000 Barter claimed. The $20,000 worth of goods retained in the showroom would presumably take a $20,000 basis[311] and would have to be inventoried by Barter.[312] Barter would be required to use the accrual method of accounting with respect to the purchase and sale of such inventory.[313]

In its second year,[314] Barter changed its method of reporting income and deductions to what it termed the "barter accounting method." Under this method, it reported income, not when trade units were credited to its account, but only when it disposed of the units to acquire goods and services that it used in its trade or business.[315] As in its first year, for tax purposes, Barter took no account of goods acquired and retained by it for retrade. Using this "barter accounting method," Barter reported neither overall gain nor loss for the year. It simply included in gross income the $20,000 worth of property it received and used for its business purposes, but claimed the same amount as a business deduction.

In again determining that Barter had to report $20,000 of net income ($40,000 gross income minus $20,000 of business deductions), the Service used the same analysis it had used in the first year, and, in addition, specifically rejected Barter's contention that it need not report the receipt of trade units as income. As it had previously done in Revenue Ruling 80-52,[316] the Service noted that when Barter received a trade unit as a commission, Barter received "income in the form of a valuable

311. In Technical Advice Memorandum 8216010, the IRS specifically refused to take a position on the basis of the goods acquired for the showroom, but no position other than giving Barter a basis equal to the fair market value of the goods received and reported in income is possible. LTR 8216010, *supra* note 174. Whenever a taxpayer receives property which he is required to include in income, he must be given a cost basis in the property equal to that value. *See supra* notes 66-78 and accompanying text.

312. In its Technical Advice Memorandum, the Service cites section 1.471-1 of the regulations which states, in part, that in order to reflect taxable income correctly, inventories are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor. LTR 8216010, *supra* note 174.

313. Treas. Reg. § 1.446-1(c)(2)(i) (1982) requires that the accrual method be used with regard to purchases and sales in any case in which it is necessary to use inventory.

314. The calendar year 1978.

315. *See supra* text accompanying note 232. It also presumably would have included in income goods that were used by owners for personal reasons.

316. *See supra* notes 221-31 and accompanying text.

right, represented by trade units."[317] In response to Barter's contention that a trade unit had no readily ascertainable value, the Service stated that "Barter has sufficient data available to ascertain [a unit's] value for Federal income tax purposes."[318]

There were two possible arguments that Barter could have made against the result reached by the Service in Technical Advice Memorandum 8216010. The first, actually advanced by Barter and rejected by the Service in the memorandum, was that title to the goods in the showroom remained with the member and, therefore, could not be income on receipt to Barter. Barter's position was based on the fact that a member who transferred goods to Barter could reclaim the goods before they were bartered to other members. On the other hand, the memorandum notes that as soon as a member's goods are placed in Barter's showroom the member is credited with trade units and the member's credit balance is not affected when those goods are later retraded by Barter or used by Barter for its own business purposes. Moreover, if, after having traded goods to Barter, the member should discontinue its membership, the member would not be required to reacquire the goods transferred to Barter (assuming the goods were still available). These facts make it clear that title, in fact, resides in Barter and not the member.

A second argument Barter could have made, but did not, is that, according to the new internal regulation of the IATE on deficit spending,[319] the Service should have treated Barter as having borrowed the units used to acquire the goods for its showroom.[320] Since it had an obligation to repay those units out of future sales and commissions, it realized no income when it used the borrowed units to acquire goods and services. The problem with this argument is that, whatever obligation it may undertake as an IATE member, the Barter Exchange actually has no indebtedness to a third party. Its indebtedness is really to itself and, thus, is no indebtedness at all. While it is true that, under the internal industry regulation,[321] failure to repay the deficit units within a certain period of time can lead to an Exchange's expulsion from the trade association, it does

317. LTR 8216010, *supra* note 174.

318. *Id. See supra* text accompanying note 253.

319. *See supra* notes 192-98 and accompanying text.

320. It would, in effect, be collateralizing the loan with the goods retained in the showroom or warehouse.

321. *See supra* notes 193-94 and accompanying text.

not follow that the units are borrowed and nonreportable when first issued.

D. Conclusions Concerning the Tax Consequences of Bartering Through Trade Exchanges

The tax treatment of Trade Exchanges raises difficult issues from both the viewpoint of administrative enforcement and that of substantive tax law. The requirement in the Tax Equity and Fiscal Responsibility Act of 1982 that Trade Exchanges file information returns with the government detailing the barter transactions of their members will go a long way toward resolving the compliance issue. It also makes it imperative that Exchanges and their members are clearly informed regarding the tax consequences of their bartering transactions.

This Article suggests that, as a matter of substantive law: (i) trade units are taxable when credited to a taxpayer's account; (ii) such units generally should be included by all members at a single value equal to the average value of goods and services acquired by a trade unit during the year; (iii) expending the units for business goods and services should produce a tax deduction equal to the value of the units at the time of disposition; and (iv) in the case of "exchange rate fluctuation," the disposition of a trade unit generally should result in ordinary gain or loss equal to the difference between the basis of the unit exchanged—using a LIFO inventory method—and its value at the time of transfer.