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TEACHING TAX LAW AFTER TAX REFORM

Martin D. Ginsburg*

Abstract: Professor Ginsburg compares the teaching of individual income taxation before and after the extensive statutory revisions of the 1980s. The pervasive question, what is income, remains the central inquiry in the basic tax course, he observes, and the great classifications, personal versus commercial and current versus capital, unavoidably persist. The development in tax law that has most significantly changed the way the subject is taught, he believes, is embodied in the recent enactment of a variety of Internal Revenue Code provisions which, while facially inconsistent in their approach to particular cases, have in common an appreciation of differences in present values. The generalized question that now dominates much of tax teaching, when is income, is explored in his paper, as in the tax course, through a series of hypothetical cases designed to demonstrate that what appear to be disparate problems in fact are variations on a single theme, and that the tax law's seemingly disparate resolutions often reach economically equivalent results.

Basic tax, as everyone knows, is the only genuinely funny subject in law school. It is an appreciation of human greed four morning hours each week.

As a teacher of this funny subject, I deeply regret the passing of the great American Tax Shelter Phenomenon. In a commendable zeal to pay no more tax than the law required, and preferably a good deal less, otherwise sane men and women invested their money, or at least money they had borrowed, in computers obsolescent on the day acquired, films that could not in one's lifetime turn a profit, master recordings to which none would listen, and a scheme delightfully entitled "the Mexican vegetable rollover." As Forbes magazine with rare accuracy suggested a dozen years ago, tax shelter economics were so bad that nineteen out of twenty investments could only be sold to groups of doctors. The twentieth scheme was awful beyond belief and could be sold only to dentists.

* A.B., 1953, Cornell University; J.D., 1958, Harvard Law School. Mr. Ginsburg is Professor of Law at Georgetown University Law Center, Washington, D.C. In a shorter form, this paper was delivered as the 1989 Rembe Lecture at the University of Washington School of Law on May 9, 1989.

Tax shelters are gone, largely,[1] but the extreme prejudice of their termination contributes measurably to the already awesome complexity of the Internal Revenue Code, and no little to the pleasure and challenge of teaching a basic course in 1989, or even 1990, tax law.

Those of you who attended law school at least a decade ago may suspect learning new tax law must be as unsettling as learning new math. There is truth to it, but much remains familiar. It is still nominally and often actually an income tax, a tax on both consumption and net accretion to savings during the year. In most respects the system continues to embrace, as a limitation on the taxation of savings, a realization requirement under which investment gain is not taxed until the investment is disposed of and the proceeds consumed or reinvested. In less stuffy terms, issues of consumption, of food, clothing, shelter, and riotous living, ordinarily are issues of "now or never" in the tax law; issues pertinent to the savings or investment component of income ordinarily are issues of "sooner or later." Today as in olden days, in perhaps all law schools, the basic tax course opens with "now or never" disputes but, as before, timing issues in the end command greater attention. Indeed, timing issues today dominate every income tax course, basic or advanced, for we have come to appreciate that in an income tax system questions of timing, characterization, and even complete exemption from tax are wonderfully intertwined. Mysteriously intertwined, I might have said, for much of it to most of us is anything but intuitively obvious. But it can be learned, and to a large extent this is what teaching tax law today is about.

When you went to law school, last week or last year or thirty years ago, odds are your first case in federal income taxation was *Washburn v. Commissioner*[2] or something like it. Mrs. Washburn was sitting at home one spring evening in 1941 when the telephone rang. "Congratulations, Mrs. Washburn." Suspiciously, "What for?" The voice responded, "Haven't you been listening to your radio? You have won the Pot O'Gold." Within a half hour a telegraph messenger—there were such prompt folk in those days—brought Mrs. Washburn a bank draft for $900 together with a telegram announcing it was an "outright cash gift with our compliments" from "Lewis Howe Company, Makers of Tums."[3]

Having done nothing to "earn" the money, never having munched the product, and selected for the prize solely by chance, Mrs. Wash-

1. *See* I.R.C. § 469 (West 1989), added to the Internal Revenue Code by The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2233.
2. 5 T.C. 1333 (1945).
3. *Id.* at 1334.

burn reported no income. The Commissioner of Internal Revenue felt differently but the Tax Court, able to "conclude without difficulty that the $900 received by the petitioner was an outright gift, without any of the earmarks of income," held Mrs. Washburn quite right to have volunteered no tax on a receipt which, after all, derived neither from her capital nor from her labor.[4]

Years ago an unreasonable number of students would demonstrate that they, too, could be taken in by this nonsense. Students are less foolish these days, and there is seldom opportunity to ask one why he thought it reasonable to grant Mrs. Washburn a free ride while taxing heavily the $900 received by her neighbor for two weeks' back-breaking labor in the local salt mine. In 1989 as in 1949, an income tax course must ask "what is income?" But now unlike then, virtually every student knows, bred in the bone, that what dominantly matters (unless Congress wills it otherwise) is not the source of the benefit,[5] capital or labor or a wager or a treasure-trove, but rather the benefit itself.[6] Mrs. Washburn surely is no less well off in her $900 than is her sweaty neighbor. She will either add the $900 to her savings or expend it on a couple of nights on the town. Either way, saving or consumption, reason supports no tax exemption and current tax law affords none.[7] *Washburn,* the Tax Court in its youth notwithstanding, was an easy case. The benefit was received in cash unrestricted in use or enjoyment. Hence, no potential conflict as to valuation and no problem discovering the proper taxable year: it was 1941 or it was never.

Every tax teacher, as far as I know, promptly turns to arrangements in which, by circumstance or choice, receipts are in kind and not in cash. No more than two or three tedious stops along the way and we arrive at that First Circle of the fiscal nether region: fringe benefits. There is much that is interesting, and more than a little that is not, in the inclusion or exclusion of fringe benefits from an employee's gross income. I have no doubt the fellow who tried to teach me tax more than thirty years ago said the same, and rightly so, although the technical rules then were nothing compared to their number, nature, length, and complexity in current law. It would be cruel as well as

4. *Id.* at 1335.

5. I.R.C. § 61(a) (West 1989) defines gross income for the purpose of federal income taxation: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . . ."

6. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

7. *See* I.R.C. § 74. Except for certain prizes and awards transferred to charity and qualified scholarships, gross income includes amounts received as prizes and awards.

foolish to rehearse detail, but there are I believe a few points worth making.

Mrs. Washburn's prize spotlights horizontal equity—treating equals equally—as a goal to which a rational tax law ought to aspire.[8] Fringe benefit arrangements spotlight that horizontal equity goal, as well as a number of other systemic considerations, such as efficiency. I find students frequently surprised to learn that efficiency is an important consideration in designing and operating an income tax. The airline employee who regularly vacations about the globe "space available" at no charge surely is better off, all else being equal, than the neighbor whose salary, medical coverage, and pension plan are the same but who enjoys no other fringe benefit. But would it make sense for the tax law to impute substantial gross income to the free flyer if, as a natural and expected consequence, the airline employees stay home and the plane flies with empty seats?[9]

The Code today abounds with provisions, most currently viable, some recently terminated, under which identified or described fringe benefits are excluded from, or less often included in, an employee's gross income. Employee discounts not too gross[10] and company cafeterias that do not positively lose money[11] are tax favored. Tuition remission for the children of law professors and other admirable academics, once tax favored,[12] deplorably may be no longer.[13] Students

8. Horizontal equity contemplates that persons with equal income will pay equal amounts of tax regardless of the sources or uses of their income. Vertical equity contemplates that persons with greater incomes will pay greater amounts of their income in tax. Together these concepts are said to make up the notion of tax equity. *See* M. GRAETZ, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 17 (1988).

9. The notion of tax efficiency requires that the tax interfere as little as possible with the allocation of goods and services that would occur in a market economy in the absence of taxes and that would presumably produce the greatest consumer satisfaction. *Id.*

I.R.C. § 132 excludes from the gross income of an employee any fringe benefit which qualifies as a "no-additional-cost service" to the employer (i.e. is offered for sale to customers in the ordinary course of the employer's business and can be provided to the employee at no substantial additional cost).

10. *See* I.R.C. § 132(a)(2), 132(c) (excluding from gross income "qualified employee discounts" which do not exceed either the employer's gross profit margin in the case of goods or 20% of the price at which the employer offers its services to customers).

11. *See id.* § 132(a)(4), 132(e) (excluding from gross income "de minimis fringe" benefits which have a value so small as to make accounting unreasonable or administratively impractical, such as employee eating facilities located on or near the employer's premises which do not operate at a loss).

12. *See* Treas. Reg. § 1.117-3(a) (as amended in 1985) (final sentence).

13. I.R.C. § 117, affording special tax treatment to scholarships and fellowship grants, was substantially revised in The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2122, 2506, 2450. *See* I.R.C. § 117(d)(3) (exclusion from gross income of qualified tuition reduction unavailable if plan discriminates in favor of highly compensated employees); Prop. Treas. Reg.

risk death by drowning in detail. But some fairly reliable unifying themes do emerge. One, present in a minor way in earlier law and elevated to the first rank in recent tax legislation, relates to discrimination or, more significantly, the absence of it. Nearly all of the approved fringe benefits are available tax free or tax favored to highly compensated employees only if the benefit plan is not seen to discriminate in favor of highly compensated employees.[14] The rules are wonderfully complex and, it currently appears, politically unstable.[15] It also is less than clear whether fringe benefit democracy is the best way for a tax law to distinguish excludable, in-kind employee benefits from those that ought to be included in the employee's gross income.

Anyone who has filled out an income tax return likely appreciates, if only dimly, that an exclusion and a deduction perform the same beneficent function. While the exclusion reduces gross income and the deduction is subtracted a bit further down the arithmetic line, both have the same reductive impact on taxable income. Historically, nonetheless, tax teachers normally devoted the early weeks of the course to gross income and probably did not mutter the word "deduction" until the school term was at least one-third gone. Many casebooks retain that cabined approach, but most teachers today, I believe, quite early point out the exclusion-deduction equivalence and promptly go on to note a great practical asymmetry. Exclusions from gross income ordinarily are complete, but Congress all too frequently subjects deductions to limitations—floors, ceilings, dollar amounts, percentages, offset limitations—of all sorts.[16] If, for example, medical care is fur-

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§ 1.117-3(f), 53 Fed. Reg. 21688, 21690 (1988) (termination effective 1987 of prior favorable Treas. Reg. § 1.117-3(a), *supra* note 12).

14. *See, e.g.*, I.R.C. §§ 79(d), 105(h), 117(d)(3), 120(c)(1), 124(c)(1), 125(b), 129(d), 132(e), 132(h)(1), 133(b)(3)(B) (providing for the inclusion in gross income of benefits under discriminatory employee benefit plans). In The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2494, Congress enacted as I.R.C. § 89 overarching employee benefit plan nondiscrimination rules which speedily and vocally were viewed by small business interests as complex and burdensome in the extreme. In reaction to rather intense political pressure, earlier reflected in a decision of the Internal Revenue Service to postpone enforcement, Congress first announced in Pub. L. No. 101-136, § 528, 103 Stat. 783, 816 (1989), that government funds would not be used during fiscal year 1990 to enforce the rules of I.R.C. § 89 and, shortly thereafter, in Pub. L. No. 101-140, § 202(a), 103 Stat. 830, 830–32 (1989), retroactively repealed I.R.C. § 89 as if it never took effect. In general, the nondiscrimination rules of the Internal Revenue Code applicable before the enactment of I.R.C. § 89 (see the provisions cited in the first sentence of this footnote) were reinstated by Pub. L. No. 101-140, § 203, 103 Stat. 830, 830–32 (1989).

15. That political instability was subsequently confirmed by the retroactive repeal, later in 1989, of I.R.C. § 89. *See supra* text accompanying note 14.

16. *See, e.g.*, I.R.C. § 165(c)(3), (h) (on personal casualty loss, deduction floor of $100 per occurrence and 10% of adjusted gross income for the aggregate of all such net loss during the

nished under a non-discriminatory plan at the employer's cost, all is excluded from the employee's gross income.[17] But if instead the employee must devote part of her cash compensation to paying the doctor's bills, she can deduct only the amount, if any, of total medical expenses that exceeds seven and one half percent of her adjusted gross income.[18]

Before saying more of the reasons and ways Congress elects to restrict deductions, we should recall the limitations that are imposed by—that is, are intrinsic to—any income tax system. One relates to personal expenses; the other to capital expenditures.

If you pay Smith $100 to clean your law office, that is an expense you incur in earning legal fees—your clients are in theory happier when the place is less filthy—and you are allowed a deduction.[19] If, on the other hand, you pay Smith $100 to clean your house after a wild Saturday night social, that is a personal expense. Along with food, clothing, and shelter, it is a basic consumption item, and consumption expenditures sensibly are not deductible in calculating taxable income.[20] To the contrary, with rather few exceptions consumption is what we *do* tax, or at least it is what the system *should* tax. An unavoidable task in any system, accordingly, is distinguishing nondeductible personal expenditures,[21] on the one hand, from deductible business[22] or investment expenses[23] on the other. Recent tax enactments have tinkered somewhat with the classifying rules, but this is an ongoing affair and not interesting enough to detain us.[24]

taxable year); *id.* § 170(b) (ceiling limitation on maximum charitable contribution deduction); *id.* § 1211(b) (offset limitation on allowable capital losses).

17. *Id.* §§ 105(b), 106.

18. *Id.* § 213.

19. I.R.C. § 162(a)(1) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

20. I.R.C. § 262(a) disallows deduction of personal, living or family expenses.

21. Personal expenditures relate to those activities which either satisfy the taxpayer's personal needs or are entered into for pleasure-seeking rather than profit-seeking purposes. It is by no means easy to tell the difference.

22. *See* I.R.C. § 162 (providing for deduction of ordinary and necessary trade or business expenses).

23. I.R.C. § 212 provides a miscellaneous itemized deduction for ordinary and necessary expenses incurred: (1) for the production or collection of income; (2) for the management of income producing property; and (3) in connection with the determination, collection or refund of any tax. I.R.C. § 67(a) provides that in the case of an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds 2% of adjusted gross income.

24. *See, e.g.*, I.R.C. § 274 (disallowing deductions for certain entertainment and travel expenses); *id.* § 280A (disallowing deduction of certain home office and vacation home expenses);

Departing the personal world for the commercial, not every business or investment expenditure is immediately deductible. If the benefits will last beyond the current period—you purchase the office building in which your law practice is conducted—the expenditure is capital and you cannot deduct it now.[25] Assuming the asset has or is treated as having a determinable useful life—a building does, although the land under it does not—you will be allowed to deduct or "depreciate" your capital investment over that life or perhaps over a shorter one.[26] Recently enacted tax provisions tilt strongly towards more capitalization and less immediate deductibility, but that subject is not pursued deeply in the basic tax course.[27]

The great classifications, personal versus commercial and current versus capital, are dominant features of an income tax, systemic and unavoidable. On the other hand, subclassifications within the commercial world (did a current expense arise in the taxpayer's trade or business of being an employee?[28] Did it arise in some other trade or business activity?[29] Or is it attributable to an investment or profit seeking activity[30] that does not rise to the dignity of a trade or business?) are merely the wondrous products of the congressional mind. Add to this the grand reality that some *personal* world costs and expenses are by statute deductible at least in part—victims in particular are the blessed children of the tax law, witness the deduction, however circumscribed, awarded medical expenses,[31] personal casualty

id. § 280F (limiting investment tax credit and depreciation deduction for luxury automobiles and personal property not used primarily for business purposes).

25. I.R.C. §§ 263, 263A disallow deduction and require capitalization of the cost of acquiring or making permanent improvements to property used by the taxpayer in the conduct of his or her trade or business or for profit seeking activities. *See, e.g.*, United States v. Akin, 248 F.2d 742 (10th Cir. 1957) (requiring capitalization of an expenditure that secures an advantage to the taxpayer which has a useful life longer than one year), *cert. denied*, 355 U.S. 956 (1958); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir.) (requiring capitalization of an expenditure that adds something of permanent use or value to taxpayer's business), *cert. denied*, 302 U.S. 722 (1937).

26. I.R.C. §§ 167, 168 authorize as a depreciation deduction an allowance for the exhaustion, wear and tear and obsolescence of property used in the taxpayer's trade or business or held for the production of income.

27. See I.R.C. § 263A, added to the Internal Revenue Code by The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2350.

28. *See* I.R.C. § 62(a)(2) (permitting the deduction of employer-reimbursed expenses paid or incurred in connection with the taxpayer's performance of services as an employee).

29. *See id.* § 62(a)(1) (permitting the deduction of all current period expenses attributable to the conduct of the trade or business).

30. *See supra* note 23.

31. I.R.C. § 213 provides for deduction of medical expenses not compensated for by insurance or otherwise to the extent that such expenses exceed 7.5% of a taxpayer's adjusted gross income.

losses,[32] nonbusiness bad debts[33]—and you have a glimpse of the student's conception of Hell's Third Circle. I proffer a portion, only a modest portion, of our classroom dissection of the tax law's current treatment of what once was the uncomplicated deduction of interest expense.

—Personal interest expense, the charge for late payment of your credit card or federal income tax bill, is not deductible unless it is "qualified residence interest."[34]

—Qualified residence interest, more familiarly "home mortgage interest," up to a very high debt limit is fully deductible.[35]

—Interest on indebtedness properly allocable to the trade or business of performing services as an employee is not deductible.[36] If you buy a car on credit and use it mainly or even exclusively to perform services for your employer as a traveling salesman, every penny of interest you pay is "personal interest" and not one cent is deductible. Since it requires a more than usually diligent searching of the Internal Revenue Code to discover this, one may wonder how many employees, inadequately warned by the words "personal interest," will claim the deduction anyway and never suffer the misfortune of audit.

—Interest on indebtedness properly allocable to a trade or business other than performing services as an employee is deductible in the

32. *See* I.R.C. §§ 165(c)(3), 165(h) (permitting deduction of unreimbursed personal casualty losses in excess of $100 each to the extent that the aggregate of such losses exceeds the sum of personal casualty gains for the taxable year, plus 10% of the adjusted gross income of the individual taxpayer).

33. *See id.* § 166(d) (permitting an individual taxpayer to deduct nonbusiness debt which has become totally worthless only as a short term capital loss; aggregate net capital loss is available only as an offset against capital gains plus $3,000 of ordinary income per year under I.R.C. § 1211(b)).

34. I.R.C. § 163(h)(1) disallows a deduction for personal interest expense, but I.R.C. § 163(h)(2)(D) excludes "qualified residence interest" from the definition of "personal interest."

35. I.R.C. § 163(h)(3)(A) defines "qualified residence interest" as any interest which is paid or accrued during the taxable year on "acquisition" or "home equity" indebtedness with respect to any "qualified residence".

I.R.C. § 163(h)(3)(B) defines "acquisition indebtedness" as any indebtedness incurred in acquiring, constructing or substantially improving any "qualified residence" which is secured by such residence, subject to a $1,000,000 aggregate limitation on indebtedness incurred after October 13, 1987.

I.R.C. § 163(h)(3)(C) defines "home equity" indebtedness as any indebtedness (other than "acquisition" indebtedness) secured by a "qualified residence" to the extent that the aggregate amount of such indebtedness does not exceed the fair market value of such "qualified residence", reduced by the amount of "acquisition" indebtedness with respect to such residence, up to $100,000.

I.R.C. § 163(h)(4) defines "qualified residence" as the taxpayer's principal residence and one other residence which is not rented at any time during the taxable year.

36. I.R.C. § 163(h)(2)(A) achieves this result through a parenthetical exception that turns the expenditure into personal interest expense.

period to which it relates,[37] unless it is taken into account in computing income or loss from something called a "passive activity"[38] of the taxpayer. Subject to a variety of special and definitional rules that turn the mind to mush, passive activity loss can be offset only against passive activity gain and cannot be deducted against active income (whatever that may be) from a trade or business or against investment income.[39] All of this is part of the tax law's recently rearmed, recently effective war on tax shelter activity. It is important stuff and, in class, receives a fair measure of attention. Mercifully, in this paper it receives almost none.

—Investment interest, paid or accrued on indebtedness properly allocable to property held for investment, is deductible in any year only against net investment income.[40] Excess investment interest expense carries forward, as long as you live, to offset investment income realized in later years.[41] But, of course, there is more to it.

—If the investment is in municipal bonds, securities that generate nontaxable income,[42] interest expense on indebtedness incurred to purchase or carry those bonds is not deductible, either now or later.[43]

—If you incur or continue debt to purchase or carry an investment in market discount bonds—bonds you are able to buy at less than original issue price, perhaps because general interest rates in the market have gone up—a portion of your interest expense, otherwise deductible this year, will be postponed to a later year in which you include the market discount income in your income.[44]

37. I.R.C. §§ 162(a), 163(a), 163(h)(2)(A), 263A(f).

38. Under I.R.C. § 469(c), passive activity includes, in general, rental activity and the conduct of any trade or business in which the taxpayer's involvement is not regular, continuous and substantial.

39. I.R.C. § 469.

40. *Id.* § 163(d)(1).

41. *Id.* § 163(d)(2).

42. *Id.* § 103(a) exempts from taxation interest on state and local bonds, with the exception of certain private activity bonds (*see* § 141), arbitrage bonds (*see* § 148), and any bond not in registered form (*see* § 149).

43. I.R.C. § 265(a)(2).

44. I.R.C. § 1277(a) limits the deduction for net direct interest expense with respect to any market discount bond to that amount by which that expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer.

I.R.C. § 1277(b) permits an "up to" deduction of disallowed interest expense in any taxable year in which there is net interest income with respect to any market discount bond.

I.R.C. § 1277(c) defines net direct interest expense as the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, minus the aggregate amount of interest (including original issue discount) included in gross income for the taxable year with respect to such bond.

We have by no means reached the end of the Code's current catalog of provisions that disallow or delay a deduction for interest expense. But one can hear a discordant melody even though the full orchestra does not play. In class we select one theme or another and ask what evil the identified rule is crafted to address, and whether that evil might not be addressed, as well or better, in a less chaotic way. Quite often we conclude with a firm "yes," and wonder at the considerations that led Congress to follow the rockier path.

Rather early in the basic tax course, about the time students have begun to appreciate exclusions and deductions as functional substitutes, we like to expose a second relationship, different and powerful, linking a deduction and an exclusion: Assuming stability of tax rates and investment yields, deduction at initiation of the cost of an investment is the equivalent of excluding from gross income the taxpayer's future annual return on her investment.[45]

Since that insight may not sound as great as it is, and may not even sound like English, it is time for an example. Assume for convenience of calculation a 40% tax rate and a 10% pre-tax yield rate. In year-0, Ms. *A* has surplus income of $10,000 which, after tax of $4,000, she can elect to consume or save. If she invests her $6,000 for a taxable 10% return, each year she will receive $600 before a tax of $240 and, thus, will retain after tax $360, a net after-tax return of 6%. Dismayed, Ms. *A* elects to invest her $6,000 in a tax free municipal bond fund. Each year beginning in year-1 she receives a distribution of $600, 10% of her $6,000 investment, and because that $600 is municipal bond interest it is excluded from her gross income and she pays no tax on it.[46] Thus, net return of 10%, $600 on $6,000.

Assume instead that in year-0 Ms. *A* invests $10,000 in an oil drilling fund which, miraculously, allows her to deduct the entire $10,000 at initiation.[47] As a result, she is not obliged to pay $4,000 tax in that year on her $10,000 "surplus income." Assuming she is some day able to cash in her drilling fund investment for $10,000, the government will at that time receive its $4,000 tax since the entire sale proceeds then will be included in Ms. *A's* gross income. In the meanwhile, each

45. Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 309–10 (1948), *reprinted in* Musgrave & Shoup, *Readings in the Economics of Taxation*, in C. SHOUP, PUBLIC FINANCE 302 n.20 (1969).

46. I.R.C. § 103(a).

47. *See id.* § 263(c); Treas. Reg. § 1.612-4(a) (1965) (permitting optional deduction as an expense of intangible drilling and development costs incurred by an operator in the development of oil and gas properties).

year commencing year-1 Ms. *A* will receive from the drilling fund a cash distribution of $1,000, equal to 10% of the $10,000 she contributed in year-0. The annual $1,000 will attract annual tax of $400 leaving Ms. *A* each year $600 to consume or reinvest.

The equivalence, front end deduction and perpetual yield exclusion, ought now be clear. Ms. *A* has $6,000 to invest on her own behalf—the other $4,000 is, sooner or later, the government's money—and, investing her $6,000 in a municipal bond fund for a 10% tax free return, she will properly pocket $600 each year. Alternatively, if she invests in a way that is fully deductible at inception, she will in fact receive and retain the same net $600 each year. Measured against her real $6,000 investment, $600 is a 10% "pre-tax" return, as the alternative municipal bond fund investment result amply confirms.

Wearied, no doubt, by unfamiliar modes of thought, the student in today's basic tax course is in for much more. She is now sensitized, in at least a modest way, to considerations of time value—it is better to deduct early and pay tax later—and appreciates the difference between a pre-tax and an after-tax rate of return. Somewhere between these rudimentary beginnings in about the third week of the course, and confident co-existence with the original issue discount rules[48] in the fourteenth week, the harried instructor—who probably is not that good at arithmetic either—must lead or at least herd the students, plank by plank, across the dismal swamp of math anxiety and overcome the terror that is reflected in nearly every shining face when the teacher or the text book announces, "we consider now the time value of money."

My own approach is devoid of magic. Beginning rather early in the course, I try to present time value issues, usually in the form of jolly hypothetical cases, not all at once but rather as we go along speaking mainly of other things. The hypothetical cases are related, although that may not at first be apparent, and they are intended to be progressive and mutually supportive although that may not always be apparent either.

It is at this point not a digression, I trust, to remove the ball from its hiding place and identify the common or unifying concern underlying the tax reform provisions of the Code that deal in disparate ways with the time value of money. Simply put, it is all about the taxation of

48. I.R.C. §§ 1271–1275, 483.

interest, real interest on real loans and, surprisingly often, disguised interest on disguised loans.[49]

In a tax age in which low rates, few rate brackets, and the Kiddie Tax—on passive income, we now tax the kid at the parent's rate[50]—have all but eliminated assignment of income as a serious subject in the basic tax course, and in which elimination of the long-term capital gain tax rate preference[51]—at least for the moment—has robbed that subject of much of its classroom excitement, time value of money occupies a main place in the curriculum. I propose to rehearse the teaching of it by presenting to you, with a bit of analysis appended, a small selection from among the hypothetical cases I use in the classroom more or less in the order in which, over a dozen weeks, I inflict them upon the students. At the outset we should embrace a few common conventions.

—With respect to all components of taxable income, both income received and deductions allowed, unless I announce something different a taxpayer is assumed to be in the 40% federal income tax bracket. State income tax is ignored. I know as well as you there is no 40% federal tax bracket today—28% is it most of the time—but I am quite terrible at arithmetic, through daily practice have mastered multiplying by 40%, and will not attempt to employ 28% in a public place.

—Income received by an exempt person, a pension plan or a charity, for example, is not taxable to the entity.[52]

—As section 104(a)(2) of the Code mandates, personal injury damages received by a tort victim, whether in a lump sum or over time, are excluded from the victim's gross income.

—All taxpayers report on the calendar year and, unless I say no, are on the cash method of tax accounting.

—So that the time value comparisons are somewhat more comprehensible than otherwise they might be, we will forget withholding tax and estimated tax and April 15. Instead, we pretend that each year's

49. *See* Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986); *see also* I.R.C. § 7872.

50. Under I.R.C. § 1(i), net unearned income of a child under the age of 14 is taxed to the child at the parents' applicable rate, subject to a de minimis exclusion equal to $500 plus the greater of the amount of expenses incurred in producing such income, or $500 of the standard deduction. Earned income is taxed to the child independently, but the child is not entitled to a separate personal exemption if claimed as a dependent on the parents' return.

51. I.R.C. §§ 1(j), 1202 (repealed by Pub. L. No. 99-514, Title III, § 301(a), 100 Stat. 2085, 2216 (1986), effective for tax years beginning after December 31, 1986).

52. *See* I.R.C. § 501(a), 501(c)(3) (exempting certain charitable organizations from federal income tax); *id.* § 501(a), 501(c)(18) (exempting certain employee pension plans from Federal income taxation).

tax liability, generated by the transaction under review, is payable at year end and not many months later when the tax return is due.

—Finally, a most important assumption. Unless otherwise stated, the pre-tax rate of return on investment is 10%. That is true in our hypothetical world whether the taxpayer is a lender or a borrower. It is not true in the real world, of course, but for simplifying calculations it is marvelously convenient.

Let us begin with prepayment.

I. PREPAID COLLEGE TUITION

Mr. *A's* little darling Clementine, Clem for short, is about to depart for college. Tuition currently is $10,000 per year and the college has announced that tuition will not be raised, or lowered, during the next four years. The first year's tuition for Clem is now due and Mr. *A* pays it. He accurately calculates that if today he sets aside $25,000 at 10% interest, out of that principal sum and the interest earned on it he will be able to pay Clem's next three $10,000 tuition bills on time, and the payment of the last of those bills will exhaust the fund. Of course, Mr. *A* will be taxed on the $5,000 of aggregate interest income as it is earned. Religiously averse to the payment of unnecessary tax, Mr. *A* makes the following deal with the college. In prepayment and discharge of the next three years' tuition bills, he delivers to the college $25,000 today. The payment is not refundable; whether Clem makes it through, flunks out, or skips town, the college keeps the money. During the next three years the college for its own account invests the $25,000 and, each year, withdraws $10,000 from the investment pool.

Who pays tax on the $5,000 of investment income? Apparently, no one pays the tax.[53] Certainly the "benefit" flows to Mr. *A*; he has laid out $25,000 and with it has purchased tuition of $30,000 for the apple of his eye. Technically, on the other hand, the $5,000 is "reportable" by the college, replacing $5000 of tuition it will not receive, and instinctively students suppose that the tax avoidance resides in shifting $5,000 of investment income from Mr. *A*, a taxpayer, to the tax exempt college.

The instinctive reaction is, however, surprisingly wide of the mark. The next example indicates why.

53. I.R.C. § 7872 imputes interest, both payment and receipt, on a variety of below-market loans, but contains no provision that would likely be found to recharacterize as a loan, or otherwise subject to interest imputation, the tailored arrangement described in the text; *cf.* Priv. Ltr. Rul. 89-01-027 (Sept. 30, 1988), TAX NOTES, May 9, 1988, 676–79 (Michigan tuition prepayment program); Priv. Ltr. Rul. 89-52-001 (undated) (refundable deposit to insurance company held a tax avoidance loan under I.R.C. § 7872(c)(1)(D)).

II. AN ART COLLECTOR

Mr. *A*, an art collector as well as a fond father, wishes to purchase a sculpture by Mr. *B*, who sculpts famously. On January 1, 1988 Mr. *A* commissions Mr. *B* to create an impressionistic brass gargoyle of some size representing Man's View of the Internal Revenue Code. It will take Mr. *B* about one year to create this monstrosity and delivery is scheduled for December 31, 1988. Mr. *B's* standard price for monstrosities is $110,000 payable on delivery. At Mr. *A's* suggestion, a different arrangement is made. On the first day of 1988 Mr. *A* pays Mr. *B* $100,000 in "full prepayment" for the sculpture. Mr. *B* immediately invests the $100,000 in a debt obligation which comes due on December 31, 1988 and pays Mr. *B* a total of $110,000 at that time.

In the Prepaid College Tuition case, in real world terms no one paid tax on the $5,000 of investment income. In our Art Collector case, again in real world terms, no one pays the tax on $10,000 of investment income. This is so even though neither party is tax exempt. In a formal sense Mr. *B* reports and pays tax of $4,000 on the $10,000 of investment income. But Mr. *B* includes in his 1988 income only $100,000 of sale proceeds,[54] down by $10,000 from the $110,000 Mr. *B* would have received had payment on delivery, and not prepayment, been the deal.

Of course, Mr. *A's* cost basis in the obscene sculpture is only $100,000, also down by $10,000 from the cost basis Mr. *A* would have enjoyed had he paid in full on delivery. But Mr. *A* rightly conceives reduced basis, in a collector's item he never intends to resell, and probably could not in any event, an insignificant price to pay for deflecting $10,000 of interest income and thereby eliminating $4,000 of tax liability.

The students at this point are confused, always a good sign. Do the tuition and the art collector examples really work this way? Why doesn't everyone do it?[55]

54. Compensation for services, including fees, commissions, fringe benefits and similar items is included in the definition of gross income under I.R.C. § 61(a)(1).

55. I.R.C. § 7872, which is not applicable to the tuition example, also appears inapplicable to the art collector example. *See supra* note 53. I.R.C. § 7872(c)(1)(B)(ii) encompasses a below-market loan directly or indirectly between an independent contractor and a person for whom the contractor provides services, but while the term "loan" in this statute is interpreted broadly by the Treasury Department, the prepayment arrangement described in the text should not qualify as a "loan" for purposes of I.R.C. § 7872. *See* Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553, 33557 (1985); *cf.* Prop. Treas. Reg. § 1.7872-2(b), 50 Fed. Reg. 33553, 33557 (1985). A longer term prepayment arrangement might, however, under the cited provisions of the proposed regulations, qualify as an indirect below-market loan.

III. AN ART DEALER

In the College Tuition and Art Collector examples, Mr. *A* was conducting his affairs in the personal, noncommercial world. Prepaying at a discount seemed to provide him an immediate benefit, offset either by no tax detriment at all (Clem's tuition) or by at most some future tax detriment of insignificant present value (increased capital gain on resale of the gargoyle).[56] What happens if Mr. *A* is operating in the commercial world? Let us assume that Mr. *A* is a dealer in objects of pornographic art, not a collector. On December 31, 1988, the day he receives the brass gargoyle from Mr. *B*, Mr. *A* resells the thing to a cash customer for a price not less than $110,000.

Now Mr. *A's* loss of $10,000 of cost basis in the sculpture matters. His 1988 ordinary income on resale is $10,000 higher than otherwise it would have been. The scheme has availed Mr. *A* nothing. His 1988 tax liability, reduced by $4,000 through deflection of investment income, is increased by $4,000 attributable to the reduced basis of the dealer property he has resold.[57]

A real feeling of relief wells up among the students: Just another tedious example of the divergent ways the tax system operates in the personal world and in the commercial world. It is not so. This first Art Dealer example was irreducibly simple only because all events occurred in a single taxable year.

In class I have a license to inflict pain. I do so by widening the time horizon and increasing the delivered price: Delivery in two years at a delivered price of $121,000 or at a two year prepaid price of $100,000.

If we are allowed to postpone taxing Mr. *B* until the delivery date—and trust me, for reasons I leave to a footnote we are so allowed[58]—he should be indifferent as between full payment of $121,000 on delivery and prepayment of $100,000 coupled with tax-deferred investment at

56. I.R.C. § 1001 provides for the recognition of gain or loss on the sale or other disposition of property equal to the difference between the amount realized therefrom (the sum of any money received plus the fair market value of any property received) and the adjusted basis. *See* I.R.C. §§ 1011, 1012, 1016 (West 1989).

57. *Id.* § 1001.

58. *See id.* § 446; Rev. Proc. 71-21, 1971-2 C.B. 549 (for the purpose of reconciling the tax and financial accounting treatment of certain advance payments, an accrual method taxpayer who, pursuant to an agreement, receives a payment in one taxable year for services which are required to be performed prior to the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services in the next succeeding taxable year). Thus, with regard to the basic $10,000, the plan works in the example if Mr. *B* is an accrual method taxpayer and he delivers the sculpture on or before the last day of year-2.

10% per annum compounded.[59] But, in our example case, Mr. *A* will care. Assume Mr. *A* resells on delivery date at a resale price of exactly $121,000. Payment of $121,000 to Mr. *B* on delivery, and almost simultaneous recovery of that same amount on resale, leaves Mr. *A* $112,360, equal to his original $100,000 plus two years' interest compounded at a 6% "after-tax" rate. The $100,000 prepayment scheme, on the other hand, will charge Mr. *A* with resale gain of $21,000 before tax, and will leave him with $112,600 after tax. He is exactly $240 ahead.

Why will prepayment increase Mr. *A's* retained earnings by $240?

Not licensed to inflict pain in the State of Washington, I rush to answer. In the prepayment case, $240 of the net return to Mr. *B* is attributable to an unwarranted tax saving. As in the drilling fund illustration we earlier reviewed, postponing until the end of year-2 the taxation of Mr. *B's* year-1 interest income results in permanently exempting from tax Mr. *B's* net year-2 *reinvestment* return (that is, the interest earned in year-2 on the interest earned in year-1). Again as in the drilling fund illustration, that untaxed amount is $600 and at a 40% rate the tax permanently saved is thus $240. Had Mr. *B* not captured this saving from the fisc, to keep him even and happy Mr. *A* would have been required to make the payment. In other words, and other words may help here, in the prepayment case Mr. *A* is ahead $240 because no one pays tax on $600 of reinvestment interest.

How might the tax law sensibly approach prepayment cases?

Our last illustration, the two year prepayment, is in fact too easy. Mr. *B*, the sculptor, received a $100,000 prepayment in year-1 but, we assumed, deferred all of his tax liability until the end of year-2. If Mr. *B* were required to pay tax in year-1 on his year-1 receipt, he would have less to invest in year-2, would come up short at the end of year-2, and would never agree to Mr. *A's* prepayment proposal. Therefore, simply tax Mr. *B* when he receives the cash. As a matter of fact, don't we do that now?

Yes, we do if Mr. *B* is on the cash method.[60] But if Mr. *B* is on the accrual method with respect to his art commissions, commits to deliver before the end of year-2 and honors his obligation, the tax law

59. Mr. *B* might, for example, promptly invest in a market discount obligation which matures, or which Mr. *B* will dispose of, at the close of year-2. While current tax law requires annual accrual of original issue discount income, accrued market discount is reportable (as ordinary income) when the debt obligation is paid or disposed of. *See* I.R.C. § 1276; *cf. id.* § 1277 (deferral of interest deduction allocable to accrued market discount).

60. *Id.* § 451(a); Treas. Reg. § 1.451-1(a) (as amended in 1978). Under the cash method, income is reported in the year in which actually or constructively received.

rewards Mr. *B* with tax deferral.[61] Mr. *B's* tax accountant likely pointed this out long ago.

Any prepayment case can, however, be viewed as an interest-bearing loan on prepayment day followed by payment in full on delivery date. In the Art Collector case, for example, Mr. *A* could be regarded as having loaned $100,000 to sculptor *B*. In turn, that prepayment-day loan would yield interest of $10,000, taxable to Mr. *A* and deductible by Mr. *B* against the $10,000 of "real" interest he earns investing Mr. *A's* $100,000. Mr. *A* would be treated as having purchased the brass gargoyle on delivery date for $110,000. The net tax results to both parties would be exactly what those tax results would have been had Mr. *A* made no prepayment or loan and simply paid full price on delivery. Applied to the Prepaid College Tuition case, the imputed loan approach charges $5,000 of interest income to Mr. *A*, the correct taxpayer, over three years, and no *net* interest income to the college, which is not a taxpayer at all.

Did the tax law follow this path prior to tax reform? Certainly not. Does it do so now that we have reformed the Internal Revenue Code? Sometimes it does. Sometimes it does not.

The pertinent statute[62] is less than crystalline in application. I could be wrong, but I think that until the tax law is revamped at least one more time, Mr. *A* wins in all of our prepayment examples.[63] Only slightly groggy, the students welcome the opportunity to discuss the failings of the tax legislative process.

Having come this far, and for most it has been an arduous journey, the students are not yet sure whether the concern identified in the prepayment arena—the discovery and correct treatment of interest income—is special to that set of cases or represents a unifying concern common to all time value of money issues in the tax law. The next lesson, *deferred* payment transactions, arrives with a full measure of what passes for humor in the tax academy.

IV. STRUCTURED SETTLEMENTS

X Corporation, on the accrual method, from time to time runs over small children in the ordinary course of its trade or business, an activity it has elected to self-insure. In 1980 *X* ran over Little *D* inflicting grievous bodily harm. In 1982 the dispute was settled this way. *X* agreed that beginning in 1982 it would pay Little *D* $100,000 each

61. *See supra* note 58.
62. *See* I.R.C. § 7872 (West 1989).
63. *See supra* notes 53 & 55.

year for thirty consecutive years, a total of $3 million. In 1982, I should point out, the corporate tax rate on successful enterprises was 46%, and a pre-tax interest rate of 13.5% was conveniently obtainable. I use those numbers because they make the case so well.

Federal income tax law always seems kind to victims. No part of the $3 million Little *D* will receive over the next thirty years will be included in her taxable income.[64]

Prior to recent reform legislation, in this case the 1984 Act,[65] federal income tax law appeared hardly less solicitous of tortfeasors. In 1982 *X* Corporation claimed, and may well have been allowed under the tax law then in effect,[66] a deduction of $3 million, the "undiscounted" total *X* will pay Little *D* over the next thirty years. In the 46% bracket, a 1982 deduction of $3 million is worth $1,380,000 to *X* Corporation in immediate tax saving. If *X* promptly invests that $1,380,000 to return 13.5% before tax, annual pre-tax income will be $186,300. After tax calculated at the 46% rate, *X* will have in hand $100,602. *X* uses $100,000 to meet its annual payment obligation to Little *D* and pockets the excess.

Obviously, *X* Corporation did one thing very wrong in its 1982 negotiation. It should have held out for annual payments of $100,000 to Little *D* for the next *forty* years, not merely thirty. Over that extended term *X's* after-tax profit from the venture, as long as high interest rates last, would have been $34,136 each year, not the meager $602 that attends a thirty year payout.

Absolute nonsense, is it not? It is important to understand, however, that while the problem—current deduction of an undiscounted future payment obligation—is exacerbated by Little *D's* complete tax exemption, as in the Prepaid College Tuition case the core concern lies elsewhere. A less extraordinary illustration will make the point, and serve to introduce a range of potential solutions.

64. I.R.C. § 104(a)(2) and Treas. Reg. § 1.104-1(c) (as amended in 1970) provide that whether by suit or agreement, and whether as a lump sum or periodic payments, the amount of any tort damages received on account of personal injuries or sickness is excluded from gross income.

65. Pub. L. No. 98-369, § 91(a), 98 Stat. 494, 598 (1984) amended I.R.C. § 461 and added § 461(h) which, in general, disallows deduction with respect to tort liability until the taxable year in which payment to the injured party is made.

66. Prior to the enactment of Pub. L. No. 98-369, § 91(a), *supra* note 65, it would appear that a taxpayer on the accrual method of accounting would have been permitted to deduct as an expense the full undiscounted amount of a future tort liability obligation once all the events had occurred to determine the fact of the liability and the amount thereof with reasonable accuracy. *See* Treas. Reg. § 1.461-1(a)(2) (as amended in 1967); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).

V. DEFERRED COMPENSATION

Mr. *A*, in addition to collecting obscene art and loving his children, is a highly compensated, very valuable executive employed in the business of Ms. *E*. At the close of 1988 Ms. *E* is going to make one sort of bonus award or another. Either she will pay Mr. *A* a cash bonus of $100,000 immediately or, alternatively, Ms. *E* will undertake to pay a larger bonus to Mr. *A* one year later, at the end of 1989. While Mr. *A* is on the cash method Ms. *E*, in her business activity, is an accrual method taxpayer. Sensibly, how much will the deferred, "grossed-up" bonus be if the parties elect to go that route?

Begin by thinking about what the tax and after-tax results to each party would be if Ms. *E* paid Mr. *A* a current cash bonus of $100,000 in 1988, the year-1 in our story.

Simply stated, at the end of 1988 Ms. *E* would be out of pocket $60,000; a $100,000 current compensation deduction saves her $40,000 in taxes otherwise payable. Sensibly, if the bonus payment is deferred, Ms. *E* will be prepared to pay later an amount that will place her in the same after-tax position, no better perhaps but certainly no worse.

If Mr. *A* receives a $100,000 cash bonus in 1988, in the 40% bracket he will incur 1988 tax liability of $40,000 and will retain after tax $60,000. Investing that sum at 10% interest, he will earn $6,000 in 1989, pay 1989 tax of $2,400 on the income, and retain after tax $3,600. At the end of 1989, therefore, Mr. *A* will have in pocket, after tax, a total of $63,600. If instead his bonus payment is deferred until the end of 1989, he will expect to receive a "grossed-up" amount sufficient to produce for him at the end of 1989, after tax, at least $63,600, preferably more but certainly no less.

The amount of the deferred bonus Ms. *E* can afford to pay and Mr. *A* will be prepared to receive at the end of 1989 is determined by when and how the parties reflect the arrangement in their respective tax calculations. At the close of 1988 Ms. *E* commits to pay Mr. *A*, next year, a bonus of not less than $100,000. If, as in the 1982 structured settlement tort case, we allow Ms. *E* to accrue and deduct in 1988 the $100,000 future payment, she will have in hand and available for 1989 investment a surplus $100,000. Invested by Ms. *E* at 10% interest, that sum will produce, pre-tax, an additional $10,000 in 1989. Ms. *E* thus can pay Mr. *A*, at the end of 1989, a "grossed-up" bonus of $110,000, provided that last $10,000 will be deductible by Ms. *E* in 1989 to offset the $10,000 of "excess" investment income Ms. *E* has earned in 1989. In that circumstance, payment of a deferred $110,000

bonus will impose on Ms. *E* an after-tax cost of $60,000, exactly the cost she was prepared to incur had she in 1988 paid Mr. *A* a current bonus of $100,000.

While Ms. *E* on the accrued method breaks even, cash method Mr. *A* is a great winner. In the 40% bracket, receipt at the end of 1989 of a $110,000 bonus will attract tax liability of $44,000. Mr. *A* thus will retain after tax $66,000. That sum is $2,400 more than the $63,600 Mr. *A* would have retained, at the end of 1989, had he received a current bonus in 1988 of $100,000, paid tax on it, reinvested the after-tax amount, and paid 1989 tax on the investment income. In each case Mr. *A's* investment base is $60,000; in each case the issue is whether the 1989 investment of that amount for the benefit of Mr. *A* will yield a tax-free $6,000 or only an after-tax $3,600, that is, a 10% pre-tax return or a less attractive 6% after-tax return.

The deferred compensation case thus exactly parallels the Art Dealer two year prepayment case earlier reviewed. That is comforting. It suggests that finding and properly taxing disguised interest income provides a way to resolve all sorts of cases which on first view are not obviously susceptible of common analysis.

How might the deferred compensation case be handled?

A. "Economic Performance": Impose the Cash Method on the Payor

An ancient remedy in the tax law, when the propriety of an accrual method deduction is in question, has been to shift the payor to the cash method for the troubling item.[67] This is in fact the standard solution in deferred compensation cases when the employee is on the cash method and the accrual method employer is not tax exempt.[68] Denied a $100,000 deduction in 1988, Ms. *E* must pay additional tax of $40,000 in that year. Now able to invest for Mr. *A's* benefit only $60,000 in 1989, she can distribute to him at the end of that year only $106,000. After 40% tax he will retain $63,600, exactly the amount he would have had in hand at the end of 1989 if the $100,000 bonus had been paid to him in 1988.

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67. *See* North American Oil Consol. v. Burnet, 286 U.S. 417 (1932); I.R.C. § 461(f) (West 1989) (contested liabilities); *see also id.* § 267(a)(2) (placing an accrual method taxpayer on the cash method of accounting with respect to the deduction of an amount to be paid to a related cash method payee, that is, deferring the deduction until the payee includes the payment in gross income).

68. *Id.* §§ 404(a)(5), 83(h); *see also* Rev. Rul. 60-31, 1960-1 C.B. 174 (granting unfunded, deferred compensation agreements their intended effect for tax purposes, and thereby not taxing the employee until cash is received).

In this circumstance the tax law, by depriving Ms. *E* of an expense accrual, has chosen to over-tax her as a surrogate for correctly taxing Mr. *A*. It "works" well for the fisc if he and she are in the same tax bracket. It would not work well if Ms. *E* were in a lower bracket, and it does not work at all if Ms. *E* is a tax exempt institution.

B. Payor Accrues Present Value Deduction

The tax law could allow Ms. *E* to accrue a deduction in 1988, the commitment year, in an amount equal to the discounted present value of the total future payment. The discount rate, let us assume, is the after-tax rate, 6% in our example, and the accrued present value deduction will be the only deduction allowed Ms. *E* for the bonus in question. Arithmetic confirms that Ms. *E*, willing to go out of pocket $60,000 but no more, can agree to pay Mr. *A* at the end of 1989 no more than $106,000. Once again he will net the correct $63,600, not the exorbitant $66,000.

C. Toll Charge on the Privilege of Early Deduction, Exclusion, or Deferral

Ms. *E* could be allowed a 1988 deduction of the total undiscounted future payment, but required to pay interest to the government in 1989 on the 1988 tax saving. If the interest is calculated at our standard 10% pre-tax rate and if it is deductible in computing 1989 tax liability, to remain even Ms. *E* can pay Mr. *A* a 1989 bonus of only $106,000. Once again Mr. *A* will net the "correct" $63,600 after tax. Of course, if Ms. *E* can not deduct the 1989 interest charge, she can not afford to pay $106,000 and adopting a deferred compensation plan will make no economic sense.

D. Impose the Accrual Method on the Payee

Rather than concentrate on Ms. *E*, a surrogate taxpayer, the tax law could focus its unwelcome attention on Mr. *A*, forcing him onto the accrual method with respect to the compensation. Ms. *E* at the end of 1989 can afford to pay Mr. *A* a bonus of $110,000 if in 1988 she accrues a deduction of $100,000—present value calculated at a 10% pre-tax discount rate—and deducts the remaining $10,000 in 1989, the payment year. But, forced to accrue and report the same not-yet-received $100,000 as income in 1988, the borrowing cost (if it is deductible) associated with his increased 1988 tax liability will reduce Mr. *A's* net after tax yield, at the end of 1989, to the "correct" $63,600.

All of this is fascinating, tax teachers firmly believe, but if Congress in the deferred compensation area has chosen the first approach—allow the employer a deduction only when payment is made—why force students to explore alternative solutions? Because Congress in dealing with a myriad of other time value discontinuities has at one place or another embraced any and every solution outlined above and variations and permutations besides. The students, discovering for themselves the points of economic equivalence and difference in the varying approaches, as the term goes on face additional time value challenges, if not with confidence then surely with extreme courage.

First, the so-called "structured settlement" exemplified by *X* Corporation, employer of bad drivers, and Little *D*, the miserable tort victim. Essentially, Congress has placed *X* Corporation on the cash method.[69] Agreeing to pay Little *D* $100,000 each year for 30 years, *X* will be allowed to deduct $100,000 each year, at the time of payment but not earlier. Denied any accrual deduction, *X* is over-taxed, a surrogate for Little *D* who, under the statute, is not taxed on the interest component of the $3 million she will receive over time.[70] Under the congressional solution, then, interest income does not escape tax, as it did in the days *X* Corporation could accrue up front a $3 million deduction and ran negligent trucks as a profit center. The interest, however, is not taxed to Little *D*, the right taxpayer; rather, it is taxed to *X*, the wrong one. Reformed tax law is less than perfect. While we allow Little *D* to retain an up-front lump sum payment tax free, it hardly follows that she should effectively receive the interest on that sum tax free as well.

Next, a new example: nuclear decommissioning expenses. If you fire up a nuclear power plant, you know that down the road at great expense the reactor must be decommissioned. If that time is thirty years hence and the estimated cost $30 million, deferring the entire deduction thirty years does not seem sensible. The tax law, happily, allows the power company to accrue currently a deduction equal to the present value of the future expenditure.[71] Present value is determined applying an after-tax discount rate, 6% in our illustrations, and no deduction is allowed the taxpayer after the initial accrual. If you care, the current, one time only deduction is $5,220,000.

69. I.R.C. § 461(h).

70. *Id.* § 104(a)(2).

71. *See id.* § 468A, added to the Internal Revenue Code in 1984 by Pub. L. No. 98-369, § 91(c)(1), 98 Stat. 494, 604 (1984)); Treas. Reg. § 1.468A (1988).

Third, an installment sale.[72] If I sell for cash investment property worth $100 million that has a zero basis in my hands, I must promptly pay tax of $40 million.[73] Investing the retained $60 million at 10% interest, I will next year derive $6 million before tax, $3,600,000 after tax. If, however, I sell for a $100 million installment note bearing 10% interest, my net yield next year will be $6 million. The reason is by now known to all. Under the installment method none of my $100 million gain is included in income this year, and hence, I obtain the buyer's note at no initial tax cost.[74] As we earlier learned, deduction or exclusion at the inception of the full cost of an investment is the equivalent of excluding from gross income the taxpayer's future annual return from that investment.[75] It is the oil drilling fund illustration all over again.

Under recent tax reform legislation, the 1988 Act this time, I am as before allowed the sale-year exclusion in full but, until I pay tax on the deferred gain, I must each year pay interest to the government on a computed part of the tax I avoided in the sale year.[76] It would be a right answer were I able to deduct the annual interest payment. As an individual taxpayer, however, it appears I cannot,[77] and that is a wrong answer. Imperfect tax reform once again.

When does the tax law impose the accrual method on the payee? More often than you might think. For example, if in the deferred compensation case Ms. *E* were a tax exempt institution and thus indifferent to the timing of her deduction, the tax law would disregard her and force income accrual upon the employee.[78] But the pervasive

72. I.R.C. § 453(b)(1) defines an installment sale as a disposition of property if at least one payment is to be received after the close of the taxable year in which the disposition occurs. I.R.C. § 453(b)(2) excepts dispositions of personal property included in inventory and "dealer dispositions," a term defined in I.R.C. § 453(l).

73. I.R.C. § 1001.

74. I.R.C. § 453(c) provides that under the installment method, income recognized for any taxable year from a disposition of property is that proportion of the payments received in that year which gross profit bears to total contract price. See Treas. Reg. § 15A.453-1(b)(2) (as amended in 1981) for the definition of gross profit and total contract price. In the example, since I receive no payment in the sale year no sale gain is recognized by me in that year.

75. *See supra* note 45 and accompanying text.

76. I.R.C. § 453A requires that interest be paid on deferred tax liability with respect to any obligation which arises from the disposition of any property under the installment method if the sale price of such property exceeds $150,000 and the face amount of all such obligations held by the taxpayer, which arose during and are outstanding as of the close of the taxable year, exceeds $5 million. In any event, however, $5 million of the total obligations does not attract the interest charge; that is, in the $100 million sale example, only tax deferred on $95 million of the total sale attracts the interest charge.

77. I.R.C. § 163(h) disallows deduction of personal interest. Interest on a personal tax deficiency is personal interest. I.R.C. § 163(h).

78. *Id.* § 457(f).

example is the original issue discount rules,[79] applicable to a wide variety of disclosed and disguised loans in which too little stated interest is paid or interest is paid too slowly. The debt holder, whatever her regular method of tax accounting, normally is forced onto the accrual method and required, each year, to take into income interest calculated at a constant yield to maturity.[80] The original issue discount rules, sound in concept and gloriously complex in many aspects, would work far better were every debt holder a taxpayer. In fact, hoards of them are exempt from tax on interest income—pension plans,[81] charities,[82] and foreign investors[83]—and to that extent the rules do not seem to work at all.[84]

Tax reform is far from over.

And that I assure you is a great truth and an ultimate concern. There is an old adage that no man's life, liberty or property is safe while the legislature is in session, and when it comes to federal tax enactments the legislature seems never to be out of session. It is neither fun nor profitable to teach the detail of the day. Either to correct last year's legislative error or in hostile reaction to the taxpayer's new and clever response to latest amendment, Congress or the Treasury will change the rules again.

Tax students today, I believe, value concepts and work at them, distrust minute detail, and affirm allegiance to the church of Roger Traynor, the great California Chief Justice, who long ago instructed us that "[o]ne hesitates to plead for reforms in the name of common sense . . . for we belong to a profession that prides itself on not throwing chaos lightly to the winds."[85]

79. *Id.* §§ 1271–1275.

80. *Id.* § 1272(a).

81. *Id.* § 501(a), (c)(18).

82. *Id.* § 501(a), (c)(3).

83. *Id.* §§ 871(h), 881(c) (interest on portfolio debt investments). Provisions of various bilateral income tax treaties to which the United States is a party further extend the tax exemption.

84. Congress reacted to the problem of asymetric impact with the The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7202(a), 103 Stat. 2106, 2330. Effective in general for instruments issued after July 10, 1989, the Act imposed special limitations on the deductibility by the issuer of original issue discount on certain high yield discount obligations. *See* I.R.C. § 163(e)(5), (i). The new rules, staggeringly complex, are analyzed and explained to the best of the authors' ability in M. Ginsburg & J. Levin, *Mergers, Acquisitions and Leveraged Buyouts*, F3 Tax Transactions Library (CCH) ¶ 1303A (1990).

85. R. Traynor, *Comment on Courts and Lawmaking*, in LEGAL INSTITUTIONS TODAY AND TOMORROW, 48 at 56 (Paulsen, ed. 1959).