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It Taxes a Village: The Problem with Routinely Taxing Barter Transactions

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SMALL SCHOOL.
BIG VALUE.

IT TAXES A VILLAGE: THE PROBLEM WITH ROUTINELY TAXING BARTER TRANSACTIONS

Sergio Pareja⁺

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“Even in the best of circumstances, it is difficult for any one of us to raise children alone. And when single parents try, they have to perform roles outside their usual repertoire, or get others to take on those roles. Even families with two parents rely on the village for functions that are beyond their scope.”¹

—Hillary Rodham Clinton

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1. HILLARY RODHAM CLINTON, *IT TAKES A VILLAGE* 190 (1996).

I. INTRODUCTION

“Bartering is the trading of one product or service for another.”² It may occur either (1) “on an informal one-on-one basis” or (2) “on a third party basis through a modern barter exchange company.”³ It would include, for example, a babysitting cooperative (co-op) in which members exchange time babysitting each other’s children,⁴ a carpooling group in which members exchange rides to school or work,⁵ a community-based “Hour Dollars” program in which a charitable organization facilitates the exchange of services among community members,⁶ a pet-care exchange program,⁷ a vegetable exchange in which home-grown tomatoes are traded for a neighbor’s home-grown squash,⁸ an academic website through which homes are swapped for vacations and sabbaticals,⁹ a barter club in which legal services may be offered for house painting,¹⁰ an agreement in which original artwork is traded for the artist’s use of an apartment,¹¹ or any exchanges of property¹² or services through a barter-exchange website.¹³

2. Do You Barter?, <http://www.docstoc.com/docs/14125818/Do-You-Barter> (last visited Apr. 13, 2010) [hereinafter Do You Barter?].

3. *Id.*

4. *See, e.g.*, Garden Hills Babysitting Co-Op, <http://gardenhillsbabysittingcoop.org/> (last visited Apr. 13, 2010); How to Create a Neighborhood Babysitting Cooperative, http://www.wkkf.org/Pubs/GreaterBC/Babysitting_coop_00254_02987.pdf (last visited Feb. 18, 2010); Smart Mom’s Babysitting Co-op Startup Kit, <http://www.babysittingcoop.com/?page=1> (last visited Apr. 13, 2010). A simple Internet search reveals an abundance of information regarding babysitting co-ops. Babysitting Co-op—Google Search, <http://www.google.com/search?q=Babysitting+Co-op> (last visited Apr. 13, 2010). *See* BabysitterExchange—Learn More, [http://www.babysitterexchange.com/servlet/Main.jsp?Act=get LearnMore](http://www.babysitterexchange.com/servlet/Main.jsp?Act=get+LearnMore) (last visited Apr. 13, 2010) [hereinafter BabysitterExchange] for an example of an exchange in which community members swap babysitting, errands, pick-ups, drop-offs, pet-sitting, carpooling, personal services, home repair, and tutoring.

5. *See, e.g.*, iCarpool—Carpool Made Easy, <http://www.icarpool.com/en/MainPage.aspx> (last visited Apr. 13, 2010).

6. *See, e.g.*, Hour Dollars Service Exchange Program, <http://hourdollars.com> (last visited Apr. 13, 2010). In this community program, community members exchange services, such as lawn care, for points that may be redeemed for other services, such as babysitting. *Id.* In general, these programs are created with a broad charitable purpose in mind. Kara McGuire, *Who Needs Cash? Barter Can Be Better than Buying*, STAR TRIB. (Minneapolis-St. Paul, Minn.), June 14, 2008, available at <http://www.startribune.com/19943909.html?page=1&c=y>.

7. *See, e.g.*, BabysitterExchange, *supra* note 4.

8. *See infra* note 94 and accompanying text.

9. *See, e.g.*, AcademicHomes.com, <http://www.academichomes.com> (last visited Apr. 13, 2010); HomeLink USA International, <http://homelink-usa.com/index.html> (last visited Apr. 13, 2010).

10. *See* Rev. Rul. 79-24, 1979-1 C.B. 60, at 61–62.

11. *Id.*

12. The term “property” is used interchangeably with the term “goods” throughout this Article; neither is meant to include cash or cash equivalents, such as publicly traded stock.

13. *See, e.g.*, BarterBee.com—The Cheapest Way to Trade Movies, Music, and Games!, <http://www.barterbee.com> (last visited Apr. 13, 2010); Barter Bucks Banc,

Notwithstanding its popularity, there is widespread confusion regarding the tax effect of bartering.¹⁴ This confusion results because the rules on whether a barterer must include property or services received in gross income differ from the rules on whether a company that facilitates bartering has a duty to report barter transactions to the Internal Revenue Service (IRS).¹⁵

The recipient of bartered property or services must treat the fair market value of that property or services the same as cash for federal income tax purposes regardless of whether the recipient was bartering on a commercial basis or merely informally.¹⁶ Thus, if the recipient performed services in immediate exchange for a ring worth \$500, “Time Dollars” worth \$500,¹⁷ or services worth \$500, the recipient will have \$500 of taxable income in the year in which he performed the services regardless of his reasons for performing.¹⁸ Similarly, if the recipient traded a violin for that same ring, “Time Dollars,” or services, he would be treated as if he sold the violin for \$500.¹⁹

However, the rules are different for a company that facilitates bartering. Although the parties to a barter must declare income from an exchange, a company that facilitates a barter has a distinct duty to report the transaction to the IRS.²⁰ This reporting requirement is similar to an employer issuing a W-2 to an employee and the IRS.²¹ It also parallels a real-estate broker sending information regarding a home sale to the buyer, the seller, and the IRS on a

<http://www.barterbucks.us> (last visited Apr. 13, 2010); Do You Barter?, *supra* note 2; Swapthings.com, <http://www.swapthings.com> (last visited Apr. 13, 2010); *see also* Albuquerque Barter Classifieds—Craigslist, <http://albuquerque.craigslist.org/bar> (last visited Apr. 13, 2010).

14. Compare McGuire, *supra* note 6 (“If you’re trading *professional* services, such as a carpenter making cabinets for a dentist who will fill his cavity, the value of those goods and services may be subject to income tax.” (emphasis added)), and Barter Frequently Asked Questions, <http://www.bartertrainer.com/faqs.asp> (last visited Apr. 13, 2010) (“The Internal Revenue Service considers barter income as the same as cash for income tax purposes.”), with Jim Wang, *Four Ways You’re Unknowingly Cheating on Your Taxes*, BARGAINEERING, June 23, 2008, <http://www.bargaineering.com/articles/four-ways-youre-unknowingly-cheating-on-taxes.html> (“If you trade your services with someone else on a contract and *commercial* basis, you have to claim the value of services received on your 1040 Schedule C form So taking turns mowing lawns with your neighbor without claiming the ‘barter income’ is okay.” (emphasis added)).

15. See IRS.gov, Tax Responsibilities of Bartering Participants, <http://www.irs.gov/businesses/small/article/0,,id=188095,00.html> (last visited Apr. 13, 2010).

16. See *infra* Part I.A.

17. This is similar to an “Hour Dollars” program. See *supra* note 6 and accompanying text. See also Vada Waters Lindsey, *The Burden of Being Poor: Increased Tax Liability? The Taxation of Self-Help Programs*, 9 KAN. J.L. & PUB. POL’Y 225, 225–27 (1999) (describing a “Time Dollars” program in Saint Louis, Missouri).

18. See Rev. Rul. 80-52, 1980-1 C.B. 100, at 100–01.

19. See *id.*

20. Treas. Reg. § 1.6045-1(f) (2009).

21. See I.R.C. § 6041(a) (2006); Treas. Reg. § 1.6041-1(e) (2009).

Form 1099.²² The IRS refers to a company that facilitates bartering, confusingly, as a “barter exchange.”²³ According to the IRS,

A barter exchange is any person or organization with members or clients that contract with each other (or with the barter exchange) to jointly trade or barter property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.²⁴

This definition has led many people to either mistakenly believe or assertively argue that noncommercial barter transactions are not taxed.²⁵ This is incorrect. A transaction *does not* have to be connected to a “barter exchange” to be taxable.²⁶ Rather, the definition only triggers a reporting obligation by the person or organization facilitating a barter transaction.²⁷ To avoid a term that is obviously causing a great deal of confusion, this Article will use the term “barter-exchange company” to refer to a person or organization that facilitates barter exchanges.

The reality is that the IRS has not made a significant effort to tax barter transactions other than those that are reported by barter-exchange companies.²⁸ As Professor Bryan Camp has said,

[I]n the absence of cash, taxpayers may not understand they have reportable income and, if they do understand, may have difficulty in setting aside cash from other transactions to pay the resulting tax. Thus, when bartering is done informally and directly between

22. Compare DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-0715, FORM 1099-B: PROCEEDS FROM BROKER AND BARTER EXCHANGE TRANSACTIONS (2010), available at <http://www.irs.gov/pub/irs-pdf/f1099b.pdf>, with DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-0715, FORM 1099-S: PROCEEDS FROM REAL ESTATE TRANSACTIONS (2010), available at <http://www.irs.gov/pub/irs-pdf/f1099s.pdf>. Of course, the facilitator also receives income from its commission or fee, if any, just as a real-estate broker would.

23. See *Do You Barter?*, *supra* note 2. I say “confusingly” because the term could also easily be interpreted to refer to a barter transaction itself.

24. IRS.gov, Bartering Tax Center, <http://www.irs.gov/businesses/small/article/0,,id=187920,00.html> (last visited Apr. 13, 2010) [hereinafter Bartering Tax Center].

25. See, e.g., Barter Exchanges, <http://www.irs.gov/businesses/small/article/0,,id=113437,00.html> (last visited Apr. 13, 2010) (“The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.”); see also Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1, 41 (2007) (“Under the IRS ruling, if a group of co-workers decide to carpool together, they do not have to report the value of the transportation services they receive from each other as income, even though each member of the carpool has received economic wealth from the swap. Similarly, a group of families who swap child-care services are not taxed on the economic wealth they thereby create for each other in the same-service trade.”). Professor Camp and I have a friendly disagreement regarding the taxability of these arrangements. See *infra* Part I.A.2.

26. See *infra* Part II.A.

27. See *infra* Part II.A.; see also Treas. Reg. § 1.6045-1 (2009).

28. See *infra* Part II.A.

taxpayers, there may be a high level of noncompliance in reporting the income received. Since it is very difficult to conduct one's affairs through direct barter, direct bartering occurs at a very low level, peripheral to the economy. Accordingly, with no systemic compliance issue, there is no administrative pressure to police these transactions systemically. Even though a few folks may escape reporting their economic gain as gross income, the leakage is small enough that it does not present significant issues of nonuniformity or incoherence in the law; it does not make suckers out of honest taxpayers.²⁹

The question, then, is: if the IRS is not policing barter transactions other than when they occur through barter-exchange companies, why bother changing the law to nearly eliminate taxation on barter transactions outside of those performed by barter-exchange companies? There are six simple, but important, reasons supporting a change in the law.

First, tax law influences behavior, and our current law focuses on economics at the expense of community-building and the environment.³⁰ Commonly, people barter because they do not have cash or do not want to spend cash to pay for the bartered property or services.³¹ In working-class and poorer communities, it is sensible to trade babysitting services, for example, so that community members can work.³² Likewise, in middle-class families, bartering may serve both as a way to save money and to bring community members together. In this context, people might enter into carpool arrangements to save money on gas, help the environment by reducing air pollution, and build relationships with neighbors. Tax law, whether regularly enforced or not, should not discourage this positive behavior.

Second, the unenforced illegality of the failure to report barter transactions results in additional violations of and disrespect for the law. When informed of the tax effect of bartering, some people will prefer to "come clean" and report the value of exchanged property or services. However, others upon audit, may disclose bartering transactions to the IRS agent. Still others,

29. Camp, *supra* note 25, at 32–33 (footnotes omitted). Given the widespread modern use of babysitting co-ops, carpool arrangements, house-sitting arrangements, and home vacation exchanges, as well as websites such as www.craigslist.com and www.swapthings.com to informally trade personal items, I believe that Professor Camp underestimates the pervasiveness of bartering in our modern society. Certainly, technology has made it easier for an individual to replace regular economic activity with barter. That said, Professor Camp is generally correct—informal direct bartering still represents a relatively small fraction of each person's economic activity and of the nation's overall economic activity.

30. See *infra* Part IV.

31. See Robin Kaufman, "Living on the Cheap," *Is Barter Better?: Revenue Rulings and a Selective Analysis of the Effect of TRA 84 on Barter Transactions*, 37 U. FLA. L. REV. 641, 641 (1985). In this situation, the bartering is not "replacing" a regular taxable transaction. Absent the ability to barter, the transaction likely would not occur at all.

32. See generally Lindsey, *supra* note 17, at 226.

perhaps the vast majority of people, likely will not report the activity. If they know that they technically should report the activity and that a failure to report will go unpunished, they may conclude that, if that is the law, then “[t]he law is a[n] ass—a[n] idiot.”³³ This disrespect for an unenforced law is likely to encourage other less innocuous forms of tax evasion.

Third, taxation provisions can be used for political purposes. For example, if the press or a rival political candidate learns that a candidate for public office or for political appointment has engaged in a taxable activity without reporting it, regardless of how common nonreporting may be, that information may be used against that candidate for political advantage.³⁴

Fourth, taxation of informal barter transactions favors those who try to take advantage of the tax system. For example, it creates an added incentive to report barter income for those who barter solely to qualify for the Earned Income Credit.³⁵

Fifth, although revenue may be gained by taxing barter transactions, monitoring informal exchanges involving services and low-value personal assets would be an administrative nightmare.³⁶ The greatest difficulty would be valuing the services and the assets.³⁷

Finally, people who prepare or give advice with respect to tax returns, such as accountants and lawyers, have legal and ethical duties to state the law as it is without considering whether an audit will be conducted. For example, the American Bar Association explains that lawyers have an ethical duty to refrain from using “any colorable claim on a tax return to justify exploitation of the . . . audit selection process.”³⁸ Similarly, accounting rules prevent accountants from taking a return position to exploit the audit lottery.³⁹ The Treasury Department rules that apply to tax practitioners also provide that “[t]he possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.”⁴⁰ In addition, the Internal Revenue Code (Code) imposes penalties on a tax-return

33. CHARLES DICKENS, *OLIVER TWIST* 413–14 (M.A. Donohue & Co. 1950) (“‘If the law supposes that,’ said Mr. Bumble, squeezing his hat emphatically in both hands, ‘The law is a[n] ass—a[n] idiot. If that’s the eye of the law, the law is a bachelor; and the worst I wish the law is, that his eye may be opened by experience—by experience.’”).

34. Cf. Claudia Wallis, *The Lessons of Namygate*, *TIME*, Feb. 22, 1993, at 76.

35. See *infra* Part I.C.

36. See *infra* Part I.A.2.

37. See *infra* Part I.A.2.

38. ABA Comm. on Prof’l Ethics, Formal Op. 85-352 (1985). The opinion notes that Rule 1.2(d) of the Model Rules of Professional Responsibility mandates that “[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent” MODEL RULES OF PROF’L CONDUCT R. 1.2(d) (2008).

39. STATEMENT ON STANDARDS FOR TAX SERVICES No. 1, Tax Return Positions ¶¶ 3–4, at 9 (Am. Inst. of Certified Pub. Accountants 2000) (current version at STATEMENT ON STANDARDS FOR TAX SERVICES No. 1, Tax Return Positions ¶¶ 5–8, at 10 (2009)).

40. 31 C.F.R. § 10.34(d)(1) (2007).

preparer who understates a client's tax liability based on an unrealistic position, or who willfully understates a client's tax liability on a tax return.⁴¹ In short, because all bartering creates taxable income under the law, lawyers and accountants must advise clients and prepare returns in conformity with this.

This Article proposes that Congress should amend the Code. First, the Code should immediately tax the exchange of *services* for either property or other services *only if* the taxpayer's performance of those services constitutes or is in connection with a "trade or business" of that taxpayer. Second, in general, the Code should require the taxpayer to immediately recognize gains on the exchange of *personal property* for either services or other property *only if* (1) that property is held for investment or in connection with a trade or business and (2) the exchange does not qualify for nonrecognition under a currently existing nonrecognition provision.⁴² This special nonrecognition rule should not apply to transfers of real property.

If, in a barter that qualifies for nonrecognition under the proposed new rule, the taxpayer receives *property*, any gain should be deferred until a later sale of that property, if any, by the recipient. On the other hand, if the taxpayer in a nonrecognition barter receives *services*, the receipt of those services should be completely tax-exempt. The reason for different treatment is explained below.⁴³

This Article is divided into four parts. Part I analyzes how tax law currently treats bartering. It explains the problems with our current law, including the potential for abuse by taxpayers. Part II discusses the current reporting requirement applicable to barter-exchange companies. Part III discusses my proposal in detail. Part IV concludes that the adoption of this proposal would help communities, improve taxpayer compliance, reduce the potential for abuse of power by the government, decrease the risk of tax fraud by taxpayers, simplify tax administration, and require attorneys and accountants to advise clients that they do not need to report informal noncommercial barter transactions on income tax returns.

II. IS THERE A TAXABLE EVENT?

A. The Law

For federal income tax purposes, "gross income means all income from whatever source derived," except as otherwise provided by law.⁴⁴ This

41. I.R.C. § 6694(a), (b) (2006 & Supp. 2007–2008). The penalty is the greater of \$5,000 or fifty percent of the income the preparer received from preparing the claim. I.R.C. § 6694(b) (Supp. I 2007–2008).

42. See *infra* notes 239–50 and accompanying text.

43. See *infra* text accompanying notes 230–31.

44. I.R.C. § 61 (2006).

definition is liberally construed “in recognition of the intention of Congress to tax all gains except those specifically exempted.”⁴⁵ The Treasury Regulations provide, in part, that “[g]ross income includes income realized in any form, whether in money, property, or services.”⁴⁶ The Treasury Regulations further provide that if services are purchased with anything other than cash, “the fair market value of the property [or services] taken in payment must be included in income as compensation.”⁴⁷

The Code requires that an “item of gross income shall be included in the gross income for the taxable year in which [it was] received by the taxpayer, unless such amount is to be properly accounted for as of a different period” under the method of accounting used by the taxpayer to compute taxable income.⁴⁸ The Treasury Regulations clarify this rule by requiring that items “be included in gross income for the taxable year in which they are actually *or constructively* received by the taxpayer.”⁴⁹ The effect of these provisions is best explained by example: a person who babysits for another’s child through a babysitting co-op likely will have an immediate right to receive return services;⁵⁰ accordingly, that person constructively receives income when she performs those services unless otherwise provided by law.⁵¹

There are two ways the law may provide that property or services received through a barter are not includible in the recipient’s income. First, the Code might expressly exclude the received item from being considered income.⁵² Second, operational or administrative limits may prevent the government from treating an item as within the recipient’s gross income.⁵³ I will discuss each in turn.

1. Express Exclusion in the Code

Express exclusions to gross income are found in Code Sections 101 through 150. Of these, the express exclusion of gifts from income is the provision that could most plausibly be read to exclude property or services received through bartering.⁵⁴ In certain situations, it is possible that a transaction that appears to be a barter may really be a gift. In the landmark case of *Commissioner v. Duberstein*, the United States Supreme Court defined a nontaxable gift as a transfer made with “detached and disinterested generosity.”⁵⁵ One can easily

45. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429–30 (1955).

46. Treas. Reg. § 1.61-1 (2009).

47. Treas. Reg. § 1.61-2(d)(1).

48. I.R.C. § 451(a) (2006).

49. Treas. Reg. § 1.451-1(a) (2009) (emphasis added).

50. See Smart Mom’s Babysitting Co-op Startup Kit, *supra* note 4.

51. See I.R.C. § 61(a) (2006).

52. See, e.g., I.R.C. § 102 (2006).

53. See Camp, *supra* note 25, at 21–44 (discussing operational limits).

54. I.R.C. § 102(a).

55. *Comm’r v. Duberstein*, 363 U.S. 278, 285 (1960).

imagine a situation in which the neighbor of a single working mother offers to babysit while the mother goes to work. The mother might offer to provide a home-cooked meal for the neighbor in exchange. Assuming the neighbor planned to babysit with or without the meal, this is likely a gift rather than a taxable exchange because the offer is truly made out of “detached and disinterested generosity.”⁵⁶

The gift exclusion, however, would not apply to any organized or intentional barter transactions. In the case where a person tells his neighbor, “If you babysit my daughter tonight, I will mow your lawn this week,” the gift exclusion would not apply.⁵⁷ There is no “detached and disinterested generosity” in such an arrangement.⁵⁸ Likewise, and perhaps more importantly, whenever there is any exchange of points, such as in a babysitting co-op or an “Hour Dollars” or “Time Dollars” program, the gift exclusion does not apply.⁵⁹ The parties in such a program are performing services on the express and measurable condition of receiving services in return.

2. Operational Limits

Professor Camp correctly notes that, apart from express exclusions from income in the Code, there are operational, or administrative, limits that also prevent certain items from being included in a recipient’s taxable gross income.⁶⁰ He specifically describes these limits, or exceptions, as income that is (1) “priceless,” having “no ascertainable fair market value”; (2) “unrealized,” resulting from appreciation in unsold property; and (3) “imputed,” “[arising] from self-benefiting activity or the use of self-owned property.”⁶¹ This description of the operational limits is generally accurate, although I disagree with Professor Camp on the applicability of the last of these limits to barter transactions.

Professor Camp first describes the “priceless” concept to mean that even though one may be enriched by certain events in his or her life, such as “[w]atching one’s daughter tie her shoes for the first time,” those events do not produce taxable income because they do not have a fair market value.⁶² This

56. *See id.* This parallels the “bargain” principle in contract law, stating that a binding contract requires “consideration,” which is a negotiated and sought-after item. *See, e.g.,* Whitten v. Greeley-Shaw, 520 A.2d 1307, 1309–10 (Me. 1987); RESTATEMENT (SECOND) OF CONTRACTS §§ 17, 71 (1981).

57. However, the operational limits, discussed *infra* Part II.A.2, might apply to this situation.

58. *See Duberstein*, 363 U.S. at 285.

59. *See* I.R.C. § 102(a). For an excellent analysis of the potential applicability of the gift exception to a charitable community-based “Time Dollars” program, see Lindsey, *supra* note 17, at 240. Professor Lindsey concludes that the gift exception does not apply. *Id.*; *see also* I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995), at 28.

60. *See* Camp, *supra* note 25, at 21–44.

61. *Id.* at 25.

62. *Id.* at 25–26.

particular operational limit does not apply to most barter transactions because property or services that are bartered generally will have an ascertainable market value.⁶³ There is some dispute as to how to compute the value of certain bartered property and services. Specifically, Professor Robert Keller would use the cash price that the recipient would have paid for the item.⁶⁴ Professor Joel Newman, on the other hand, would discount that value because “participants enter into barter transactions precisely because they are unable to sell their goods and services for cash.”⁶⁵ Despite divergent opinions, however, difficulty ascertaining the value of property or a service does not necessarily make that property or service priceless.⁶⁶

The second exception, “realization,” as an administrative rather than constitutional limit,⁶⁷ generally is associated with the seminal case of *Commissioner v. Glenshaw Glass Company*.⁶⁸ Professor Camp describes the “realization” limit to mean that income is not taxable until an event “sufficiently ‘locks in’ an objectively measurable increase in wealth.”⁶⁹ The exchange of services for property or for past, present, or future services is a realization event, and the resulting “income” is taxable when the taxpayer has the right to receive the property or services.⁷⁰ Likewise, the exchange of property for other property or for services is also a realization event.⁷¹ The most common modern reasons offered for the realization requirement are (1) liquidity concerns; (2) administrative impossibility of annual valuation of assets; (3) political impossibility of repealing the realization rules; and (4) popular desire to tax capital gains, but not “paper gains.”⁷²

63. If the bartered property or service did not have any ascertainable value, people would not be willing to trade for it.

64. Robert I. Keller, *The Taxation of Barter Transactions*, 67 MINN. L. REV. 441, 451 (1982–1983).

65. Joel S. Newman, *Determining Value in Barter Transactions: A Response to Robert Keller’s The Taxation of Barter Transactions*, 68 MINN. L. REV. 711, 712 (1984).

66. See Camp, *supra* note 25, at 25–28.

67. *Eisner v. Macomber*, 252 U.S. 189, 218–19 (1920) (holding that, as a constitutional matter, Congress lacked the power to tax unrealized income). It is now widely accepted, however, that such a constitutional limitation does not exist. See WILLIAM D. POPKIN, INTRODUCTION TO TAXATION 42–43 (5th ed. 2008). Regardless, the realization requirement continues to exist because of administrative concerns.

68. 348 U.S. 426, 432–33 (1955); see also *Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554, 566 (1991) (“[A]n exchange of property gives rise to a realization event so long as the exchanged properties . . . embody legally distinct entitlements.”); Treas. Reg. § 1.61-1(a) (2009).

69. Camp, *supra* note 25, at 29–30.

70. Rev. Rul. 83-163, 1983-2 C.B. 26 (“[S]ervices received in advance for services to be rendered in the future is taxable at the time of receipt.”); see also *Schlude v. Comm’r*, 372 U.S. 128, 136–37 (1963); Treas. Reg. § 1.61-2(d) (2009); Rev. Rul. 79-24, 1979-1 C.B. 60, at 60–61.

71. Treas. Reg. § 1.1001-1(a) (2009); see also I.R.C. § 1001 (2006).

72. See Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 355–56 (2004). Professor Schenk’s paper offers a general critique of these four common

As mentioned, I disagree with Professor Camp's application of the imputed-income limit to barter transactions.⁷³ "Imputed income" has been defined as "a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf."⁷⁴ In other words, imputed income is the value of everything that one does for himself. For example, if a man washes his own car and it generally costs \$10 to have somebody else wash his car, he effectively has been enriched by \$10. It is no different, economically, than if he worked an extra hour at his job to earn \$10, and then used that \$10 to pay to have his car washed. If imputed income were taxable, he would have imputed taxable income of \$10 when he washed his own car. Imputed income would also include the rental value of property that the taxpayer owns and occupies, such as his or her personal residence.

The Code does not expressly exclude imputed income from gross income, but the IRS has never tried to tax it.⁷⁵ As Professor Camp correctly notes, "the sheer volume of small dollar transactions would create an administrative nightmare for taxpayers and the IRS alike."⁷⁶ The primary issues that the IRS would encounter are valuation difficulties⁷⁷ and administrative intrusiveness into people's lives.⁷⁸ In addition, "taxing self-provided services (and self-

reasons. *See id.* It is worth noting that additional reasons for a realization limitation on determining taxable income, although less common, are often given. *See id.* at 350 n.15.

73. *See supra* note 62 and accompanying text.

74. Donald B. Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514, 514 (1943). This definition is not without controversy, however. Professor Joseph Dodge correctly notes:

The term "imputed income" as used in the tax literature is not entirely without ambiguity. The principal meanings, which overlap somewhat, appear to be: (1) the flow of satisfactions obtained by a taxpayer (which would include not only the value of satisfactions derived from owning and spending but also the value of leisure, sleep, a happy marriage, etc.), and (2) the market-price equivalents of non-market *economic* activity (such as the value of self-grown crops and the rental value of self-owned assets, and possibly the value of self-performed services). . . . The second definition is more useful because it focuses on a particular kind of "economic benefit," namely, the *hypothetical*, cash income that *would* be obtained if the person, contrary to fact, entered the market and sold or rented her services, self-created goods, or self-owned assets.

Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 5 FLA. TAX REV. 685, 691-92 (2000) (footnotes omitted).

75. *See Morris v. Comm'r*, 9 B.T.A. 1273, 1278 (1928) ("If products of a farm consumed thereon are income to the producer, it would seem to follow that the rental value of the farmer's home, the gratuitous services of his wife and children, and the value of the power derived from draft animals owned by the farmer and used without cost should also be considered. It is obvious that such items are comparable to the rental value of a private residence, which has never been regarded as income or as a factor in the determination of tax liability.").

76. Camp, *supra* note 25, at 38.

77. Imputed value is not "priceless," but it is difficult to determine.

78. Camp, *supra* note 25, at 41-42.

created personal use assets) would tend to be regressive, because these activities are more likely to be engaged in by low-income groups.”⁷⁹

Professor Camp states that although the IRS has expressly ruled that commercial barter transactions are taxable to the bartering parties,⁸⁰ it “has refused to extend the Revenue Ruling to bartering arrangements involving ‘the informal exchange of similar services on a noncommercial basis’ where there is no ‘creation of contractual rights and obligations among members.’”⁸¹ I respectfully disagree with Professor Camp’s characterization of the IRS’s inaction as a refusal. He quotes from Private Letter Ruling 96-08-009 in support of this statement, but I believe that ruling is unhelpful for two reasons: first, the Revenue Ruling is not limited on its face to “commercial” transactions;⁸² second, perhaps more importantly, the Private Letter Ruling does not involve the taxation of the bartering parties and it does not discuss whether they will be taxed.⁸³ Instead, the Private Letter Ruling involves the characteristics of a barter-exchange company involved in a Time Dollar program.⁸⁴ As mentioned, this is an altogether different issue. Very significantly, the Private Letter Ruling specifically states: “No opinion is expressed about the tax consequences of the program under any [provision of the Code other than Section 6045, which deals with reporting requirements for brokers]. Specifically, no opinion is expressed concerning whether a member earns income as a result of the member’s participation in the program.”⁸⁵

Professor Camp asserts that when taxpayers swap the same services, say in a babysitting co-op or a carpool arrangement, it is no different from performing those services for themselves.⁸⁶ Thus, he would argue, such barterers are not taxable because they are “simply enhanced self-created benefits,” subject to the same “valuation and administrative intrusiveness” concerns as standard imputed income.⁸⁷

Professor Camp’s arguments are excellent from a broad policy standpoint, but they are based on his own extension of the imputed-income concept to the bartering of identical services. To my knowledge, they are not founded on any

79. Dodge, *supra* note 74, at 702.

80. Rev. Rul. 79-24, 1979-1 C.B. 60, at 60–61.

81. Camp, *supra* note 25, at 41 (quoting I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995)).

82. Rev. Rul. 79-24, 1979-1 C.B. 60, at 60–61. Although the two examples used in the ruling happened to be commercial transactions, the ruling does not indicate one way or another whether it applies to noncommercial transactions. *Id.*

83. See I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995).

84. *Id.* Although, with the Private Letter Ruling the IRS did not expressly extend Revenue Ruling 79-24 to apply to noncommercial transactions, by stating that it has “refused to extend” the ruling, Camp, *supra* note 25, at 41, Professor Camp makes it sound as if the IRS was asked to extend and said “no.” The Private Letter Ruling simply has nothing to do with the taxation of the bartering parties, whether commercial or noncommercial.

85. I.R.C. § 6045 (2009); I.R.S. Priv. Ltr. Rul. 96-08-009, at 3.

86. Camp, *supra* note 25, at 42.

87. *Id.*

IRS ruling or on any binding authority. Although I would make his arguments if my client were being audited, I would not advise a client that formalized swaps of identical services, such as in a babysitting co-op or a carpool arrangement, do not produce taxable income.

Assuming *arguendo* that Professor Camp is correct when he extends the imputed-income concept to noncommercial bartering, it is critical to note that he only extends it to exchanges of identical services.⁸⁸ Many barter transactions, whether formal or informal, involve exchanges of property or exchanges of different services rather than simple exchanges of identical services. For example, in the “utopian commune” of Twin Oaks in central Virginia, community members do what they are good at; in return they receive work credit for their labor, which allows them to purchase services from other members who are also doing what they are good at.⁸⁹ Less dramatically, it is common for people to informally exchange personal property. Professor Adam Chodorow has produced a useful discussion of the imputed-income issue using informal personal-property exchanges as an example. In his example, there exist two neighbors, one who grows tomatoes, the other squash.⁹⁰ Accepting the premise that the grown, unsold crops are nontaxable imputed income, Professor Chodorow explains that “[a]s soon as the growers sell the produce, . . . they have entered the market and have received value for their services, goods, or both.”⁹¹ The reason for this is simple; at the point of sale, the policy rationale for exempting from tax the imputed income dissolves.⁹² The growers have received real income and, consequently, must pay tax on the sale.⁹³

Professor Chodorow continues:

Similarly, if the neighbors trade tomatoes for squash, they will be subject to tax, based on the fair market value of the produce each receives. *Simply exchanging imputed income in one's hands for imputed income in another's hands does not convert the gain into imputed income.* Rather, by engaging in barter, people have entered the market, received real income, and under current tax law must be subject to taxation.⁹⁴

This tax issue also arises in the context of charitable programs such as “Hour Dollars” and “Time Dollars.” In these self-help, community-based programs sponsored by nonprofit community organizations, “[e]ach hour of service

88. *Id.*

89. Miriam Sagan, *Bountiful Harvest*, SAGE: ALBUQUERQUE J. MONTHLY MAG. FOR WOMEN, Sept. 2008, at 7.

90. Adam S. Chodorow, *Ability to Pay and the Taxation of Virtual Income*, 75 TENN. L. REV. 695, 728 (2008).

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* (emphasis added).

provided . . . entitles the participant to receive one [hour of credit for another person's services]."⁹⁵ The driving principle behind these programs, which are often supported by grants from charitable foundations, is community reciprocity.⁹⁶ The imputed-income exclusion does not apply to bartering that occurs through these programs because, as Professor Vada Waters Lindsey has correctly noted, when "a Time Dollars volunteer can expect to receive tangible benefits in the form of services or property upon providing services or property to other participants the rationale supporting the imputed income exclusion does not apply."⁹⁷

In short, I believe that true barter transactions,⁹⁸ whether formal or informal, generally are taxable under current law. However, the IRS does not routinely or uniformly enforce the taxation requirement on these transactions.⁹⁹ Further, although creative arguments can be made for exempting these transactions from the current law when the services exchanged are identical,¹⁰⁰ to my knowledge these arguments have never been accepted by any court or IRS ruling. There certainly are good policy arguments for not taxing most noncommercial barter transactions, but these arguments are not reflected in the current state of the law; rather, they describe why the law should be changed. The foremost policy argument is the "ability to pay."

B. Ability to Pay

There is a widespread belief that our tax system embodies the notion that taxes should be assessed in accordance with each taxpayer's "ability to pay."¹⁰¹ Despite this highly appealing and apparently simple philosophy, "[o]pinions differ crucially as to the best measure of ability to pay."¹⁰² This difficulty is nothing new. As Professor Alfred G. Buehler said in the 1940s, "[l]ike such popular slogans as 'social security' and 'full employment,' [the term 'ability to pay'] suggests a program of action with sufficient vagueness that almost everyone, if he can define the term in his own language, will feel that he can

95. See Lindsey, *supra* note 17, at 229 for a general description of one Time Dollars program.

96. *Id.*

97. *Id.*

98. By "true barter transactions," I am referring to exchanges that do not involve a gift component. These are exchanges in which both parties enter the exchange only because each is receiving a quid pro quo for his goods or services.

99. Camp, *supra* note 25, at 32–33.

100. See *supra* notes 73–87 and accompanying text (discussing Professor Camp's imputed income argument).

101. See Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 867–68 (2002).

102. *Id.* at 869.

endorse it.”¹⁰³ The crux of the issue regarding “ability to pay” is tied to the concept of liquidity.¹⁰⁴ Does the taxpayer have cash to pay taxes?¹⁰⁵

The phrase “ability to pay,” although used in tax discussions for hundreds of years,¹⁰⁶ was popularized by the prominent tax law scholar, E.R.A. Seligman of Columbia University.¹⁰⁷ Professor Seligman viewed the income tax as the culmination of American society’s “broad demand for tax justice,” and “ability to pay” as the “touchstone of enlightened tax policy.”¹⁰⁸ Although Professor Seligman did not view income as the only measure of ability to pay,¹⁰⁹ he thought it was “a desirable tax base because it [could] easily be measured.”¹¹⁰ Unfortunately, the definition of “income” itself is subject to much variation.

Our current tax law generally accepts the Haig-Simons denotation of individual income (“Haig-Simons concept” or “Schanz-Haig-Simmons concept”), which is the sum of a person’s accumulation and consumption over a given period of time.¹¹¹ This definition is notable because it does not consider whether the taxpayer has cash to pay taxes. Professor Joseph Dodge rejects a cash-based approach to measuring income, arguing that “the dominant paradigm is ‘changes in wealth.’”¹¹² This is correct. Taxes are imposed in many situations in which taxpayers do not have cash, such as taxes on treasure troves and property swaps.¹¹³ Notwithstanding the fact that the prevailing definition of income for federal income tax purposes does not consider a taxpayer’s liquidity, many people equate the concept of “income” with cash receipts,¹¹⁴ and sometimes taxes are exempted or deferred because of

103. Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 243, 243 (1945).

104. *See id.*

105. Chodorow, *supra* note 90, at 738. Professor Chodorow has said, “Liquidity concerns are simply a weak form of the concern regarding a taxpayer’s ability to pay.” *Id.*

106. Buehler, *supra* note 103, at 243.

107. *See* Utz, *supra* note 101, at 911.

108. *Id.* at 912.

109. *Id.* at 913. (“[Seligman] acknowledges that equal amounts of money revenue or the equivalent may not necessarily reflect equal ability to pay, because of difference in ‘social demands,’ philanthropic impulse, family needs, and so forth.”).

110. *Id.*

111. Specifically, Henry Simons, a University of Chicago economist, advanced the following definition of “personal income” in 1938: “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). Robert Haig and George Schanz had already advocated this basic idea and, thus, their names are often included in the shorthand for concept. *See* JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 37–38 (3d ed. 2004). It is worth noting that Simons rejected the “ability to pay” tradition. Utz, *supra* note 101, at 915.

112. Dodge, *supra* note 74, at 690–91.

113. *See* Schenk, *supra* note 72, at 361.

114. Professors Zelenak and McMahon have said that the income tax is “all about” the receipt of cash. Lawrence A. Zelenak & Martin McMahon, Jr., *Taxing Baseballs and Other*

legitimate liquidity concerns.¹¹⁵ In sum, liquidity is generally not considered when determining a taxpayer's taxable income, although there are a few limited exceptions to this rule.¹¹⁶

These exceptions are rooted in practical concerns, including valuation difficulties¹¹⁷ and liquidity issues.¹¹⁸ These concerns are legitimate and valid reasons for deviating from the Haig-Simons "norm."¹¹⁹ As Professor Dodge has correctly said,

[A]ccommodation to practical considerations should not be viewed as a "retreat" from "principle," but rather as a "shift" to a *different kind* of principle, namely, a "legal" (as opposed to "economic" or "fairness") principle. Legal issues that are relevant to the present discussion include: (1) whether or not rules that can rarely be enforced, or which are enforced at the whim of officials, are "rules" worth having, and (2) whether various distinctions among tax categories are coherent and intelligible. Admitting legal norms into tax policy debates should not be a cause for embarrassment.¹²⁰

I submit that barter transactions, except to the extent that the bartering is in connection with a taxpayer's trade or business, fall into Professor Dodge's first category. Specifically, other than barter through barter-exchange companies, the current rules regarding taxation of barter transactions "can rarely be enforced" and they have the potential to be "enforced at the whim of [government] officials."¹²¹ This arbitrariness problem, combined with liquidity concerns, makes for a terrible tax law governing the treatment of barter transactions. Similarly, Professor Camp observed the following

Found Property, 84 TAX NOTES 1299, 1304–05 (1999). With respect to taxing virtual income, Professor Chodorow argues "that the ability to pay is a function of a taxpayer's ability to cash out." Chodorow, *supra* note 90, at 736.

115. See Schenk, *supra* note 72, at 363–64. For example, Congress has decided "not [to] tax[] a family farm until [it is] transferred outside the family," which "can be explained as a response to legitimate liquidity concerns." *Id.* As Professor Chodorow has recognized:

[O]ne of the justifications offered for retaining the realization requirement is that taxing unrealized appreciation may lead to taxpayer liquidity issues and difficulties in paying taxes due on such appreciation. Liquidity concerns are also one of the justifications offered for not taxing the receipt of gifts and inheritances. Thus, even though property appreciation and the receipt of gifts or an inheritance clearly constitute measurable accessions to wealth, and are therefore income under that formulation, we nonetheless exclude them from the tax base.

Chodorow, *supra* note 90, at 738 (footnotes omitted).

116. See Schenk, *supra* note 72, at 363–64.

117. See Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 661 (2008). This is commonly used as a justification for the exclusion of imputed income. See *supra* text accompanying notes 75–78.

118. See Dodge, *supra* note 74, at 693.

119. See *id.*

120. *Id.* (footnotes omitted).

121. *Id.*

regarding our tax system in general: “This system will break down when it demands taxpayers report income that is unreportable, pay tax on ‘phantom’ income which has produced no means of payment, or makes suckers out of compliant taxpayers by imposing requirements that are practically unenforceable against noncompliant taxpayers.”¹²² The current taxation of barter transactions fits this description perfectly because the income from barter transactions is difficult, if not impossible, to ascertain, and because private barter transactions are virtually undetectable by law enforcement.¹²³ In addition, because the current law is so difficult to enforce, it is not only subject to enforceability problems on the government’s end, but also to serious abuse by taxpayers.

C. Potential Abuse by Taxpayers

A married couple or a single person with “earned income” and at least two qualifying children could claim a maximum Earned Income Credit (EIC) of \$4,824 for taxable years beginning in 2008.¹²⁴ The EIC is a “refundable credit,” which indicates that the person claiming the credit can get money from the government even if he or she does not pay any taxes.¹²⁵ The meaning of “earned income” is the same both for determining whether an individual taxpayer qualifies for the credit and for assessing the phaseout of the credit.¹²⁶ “Earned income” specifically includes the following three types of income:

1. Wages, salaries, tips, and other taxable employee pay. Employee pay is earned income only if it is taxable. Nontaxable employee pay, such as certain dependent care benefits and adoption benefits, is not

122. Camp, *supra* note 25, at 22–23.

123. *Cf. id.* at 33 (describing the IRS’s response to complex bartering and bartering clubs).

124. Rev. Proc. 2007-66, 2007-2 C.B. 970. These are figures for use in preparing 2008 individual income tax returns for people having two or more qualifying children. To claim the maximum EIC, the married couple must have earned income for the year falling in the range of \$12,060 to \$18,740, and the single person must have earned income for the year falling in the range of \$12,050 to \$15,750. *Id.* To claim the EIC, the couple or person must meet all the other EIC requirements found in I.R.C. § 32. Specifically, anybody claiming the credit for tax year 2008 (1) must have a valid Social Security Number, (2) cannot be filing as “married filing separately,” (3) must be a U.S. citizen or a resident alien all year, (4) cannot file Form 255 or Form 2555-EZ for foreign earned income, (5) must have investment income of no more than \$2,950, and (6) must have income that qualifies as “earned income.” DEP’T OF THE TREASURY, IRS, PUBLICATION 596: EARNED INCOME CREDIT (EIC) FOR USE IN PREPARING 2008 RETURNS 1 (2009), available at <http://unclefed.com/Tax-News/2009/p596.pdf> [hereinafter 2008 IRS PUBLICATION 596]. See generally I.R.C. § 32 (2006). Although the EIC is available for people without children, the amounts are drastically smaller without at least one qualifying child. See, e.g., Rev. Proc. 2007-66, 2007-2 C.B. 970 (listing a maximum amount of \$4,824 for two or more qualifying children, and \$438 for no qualifying children). For information regarding who is a “qualifying child,” see 2008 IRS PUBLICATION 596, *supra*, at 12–20 (giving rules for and providing examples of qualifying children).

125. See POPKIN, *supra* note 67, at 20–21.

126. See I.R.C. § 32(a), (c)(2); Treas. Reg. § 1.32-2(c)(2) (2009).

earned income. But there is an exception for nontaxable combat pay, which [a taxpayer] can choose to include in earned income

2. Net earnings from self-employment.

3. Gross income received as a statutory employee.¹²⁷

“Earned income” does not “include interest and dividends, pensions and annuities, social security and railroad retirement benefits (including disability benefits), alimony and child support, welfare benefits, workers’ compensation benefits, unemployment compensation, . . . nontaxable foster care payments, and veterans’ benefits.”¹²⁸ In addition, “[n]ontaxable workfare payments are not earned income” for EIC purposes.¹²⁹ Workfare payments are defined as “cash payments . . . receive[d] from a state or local agency that administers public assistance programs funded under the federal Temporary Assistance for Needy Families (TANF) program in return for certain work activities such as (1) work experience activities . . . or (2) community service program activities.”¹³⁰

The IRS has identified significant government overpayments of the EIC to taxpayers.¹³¹ Although it is impossible to know whether noncompliance is due to fraud or inadvertent error, the noncompliance rate was roughly twenty-seven to thirty-two percent for Tax Year 1999.¹³² If a taxpayer receives an overpayment of the EIC, resulting in an underpayment of his taxes, the IRS has the power to impose a twenty percent penalty if the underpayment was a product of negligence or disregard of the rules,¹³³ and a seventy-five percent penalty for underpayment due to fraud.¹³⁴ In addition, if an EIC claim is deemed improper because of “intentional disregard of the rules,” the IRS may disallow future EIC claims for two years.¹³⁵ If the EIC claim is deemed improper, because of fraud, the IRS may disallow future EIC claims for ten years.¹³⁶

127. 2008 IRS PUBLICATION 596, *supra* note 124, at 9. Net earnings from self-employment are determined with regard to the self-employment tax deduction (that is, one-half of the amount of self-employment taxes may be deducted). CCH EDITORIAL STAFF, 2010 U.S. MASTER TAX GUIDE 480 (2009).

128. 2008 IRS PUBLICATION 596, *supra* note 124, at 11.

129. *Id.*

130. *Id.* (emphasis added).

131. See DEP’T OF THE TREASURY, IRS, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 10–12 (2002), available at <http://www.irs.gov/pub/irs-soi/competic.pdf>; see also POPKIN, *supra* note 67, at 22 (“There have been considerable compliance problems associated with the earned income credit.”).

132. See Stephen D. Holt, *Keeping it in Context: Earned Income Tax Credit Compliance and Treatment of the Working Poor*, 6 CONN. PUB. INT. L.J. 183, 185 (2007).

133. I.R.C. § 6662(a), (b) (2006).

134. I.R.C. § 6663(a) (2006).

135. I.R.C. § 32(k)(1)(B)(ii) (2006).

136. *Id.* § 32(k)(1)(B)(i).

As mentioned, bartered property and services can result in self-employment income, as though the taxpayer had received cash.¹³⁷ Thus, in the case of an unemployed or underemployed individual or married couple, it would be tempting to barter “services,” report the income as self-employment income, and claim the EIC.¹³⁸

For example, suppose an unemployed married couple with two minor children has no income other than welfare or veterans benefits.¹³⁹ Also suppose this couple lives next door to another couple in the same financial situation. Assuming the two families are close friends, they might agree to exchange a wide variety of “services” solely to reach the minimum amount of earned income necessary to qualify for the maximum EIC. For example, they might exchange watching each others’ homes for burglars, mowing lawns, cooking, cleaning, playing the guitar for each other, transporting children to school, babysitting, or any number of difficult-to-value and difficult-to-track activities. With minimal planning, the two families could set the value of their respective “services” at \$12,050 for the year, allowing each to claim the maximum EIC.

If the two families execute the described plan, each family would report self-employment income of \$12,050, even though neither exchanged a penny of cash nor made any significant efforts; each merely did for its neighbor what it normally does for itself.¹⁴⁰ In this situation, each family would pay self-employment taxes of \$1,702.61.¹⁴¹ Considering each would be eligible to receive, at a minimum, the standard deduction,¹⁴² personal exemptions,¹⁴³ and the deduction for one-half of the self-employment tax paid,¹⁴⁴ the two families are unlikely to owe any income taxes. Each will qualify for the maximum EIC of \$4,824¹⁴⁵ at a cost of \$1,702.61 in self-employment taxes.¹⁴⁶ This yields a

137. See *supra* note 46 and accompanying text.

138. For an excellent discussion of the technique, see Lindsey, *supra* note 17, 233–34.

139. Welfare and veterans benefits do not count as “earned income” for EIC purposes. See *supra* note 128 and accompanying text.

140. This circumvention of the tax code arguably has its benefits because it brings communities together, but it certainly conflicts with the purpose of the EIC. See *infra* note 148 and accompanying text.

141. \$12,050 multiplied by 0.9235, multiplied by 0.153, equals \$1,702.61. This calculation is based on 2008 figures. See I.R.C. § 1402 (2006); DEP’T OF THE TREASURY, IRS, OMB NO. 1545-0074, Schedule SE, at lines 4–5 (2009), available at <http://www.irs.gov/pub/irs-pdf/f1040sse.pdf> [hereinafter Schedule SE].

142. The 2008 standard deduction for a married couple filing a joint return was \$10,900. I.R.C. § 63(c) (2006); Rev. Proc. 2007-66, 2007-45 I.R.B. 970, 974.

143. In 2008, personal exemptions were \$3,500 per family member. I.R.C. § 151(d) (2006); Rev. Proc. 2007-66, 2007-45 I.R.B. 970, 975.

144. This deduction is \$851.31 and is calculated by dividing \$1,702.61 by two. See Schedule SE, *supra* note 141, at line 6.

145. See 2008 IRS PUBLICATION 596, *supra* note 124, at 44–47.

146. This has the added benefit of giving the families credit for purposes of Social Security and Medicare.

net gain of \$3,121.39 per family¹⁴⁷ for the year for doing nothing materially different, with respect to personal effort, than it would have done with no planning. This technique thus appears to thwart one of the key purposes of the EIC—providing work incentives for low-income families.¹⁴⁸

The above hypothetical raises two immediate questions. First, are the families committing tax fraud? Provided that they are actually bartering services, even though they could have performed the services for themselves without any bartering, they should be able to legitimately carry out the plan. As Judge Learned Hand famously said, “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern that will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”¹⁴⁹ Presumably, this same logic would extend to arranging one’s affairs to qualify for a refundable tax credit.

Second, how will low-income taxpayers discover this technique? In all likelihood, the information will come from Refund Anticipation Loan (RAL) providers. RAL providers tend to be located primarily in low-income neighborhoods and have a disproportionately high number of clients who receive the EIC.¹⁵⁰ Return preparation by RAL providers is often linked to “purchases at rent-to-own furniture and appliance stores, car dealers, and other retail outlets.”¹⁵¹ Thus, it is not difficult to imagine that RAL providers might suggest to unemployed potential clients that they could swap services with a friend, neighbor, or family member, or provide services through a service-exchange organization, such as a “Time Dollars” program, and essentially receive free money.¹⁵² The RAL provider would have no incentive to determine if an actual barter really occurred, and would likely keep the bulk of the EIC refund. Creating an incentive scheme that makes RAL providers the

147. This figure is calculated by subtracting \$1,702.61 from \$4,824.00.

148. See U.S. DEP’T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, VOL. 2, at 15 (1984); Jonathan Barry Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. U. L. REV. 41, 55 (1988).

149. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

150. Only seventeen percent of taxpayers are EIC recipients, but fifty-six percent of all RAL borrowers are EIC recipients. CONSUMER FED’N OF AM. & NAT’L CONSUMER LAW CTR., INC., REFUND ANTICIPATION LOANS: UPDATED FACTS & FIGURES 2 (2006), available at http://www.consumerfed.org/elements/www.consumerfed.org/file/main/RAL_2006_Early_info.pdf; see also ALAN BERUBE ET AL., THE BROOKINGS INST. METRO. POLICY PROGRAM, THE PRICE OF PAYING TAXES: HOW TAX PREPARATION AND REFUND LOAN FEES ERODE THE BENEFITS OF THE EITC 9–11 (2002); CONSUMER FED’N OF AM. & NAT’L CONSUMER LAW CTR., INC., 2005 REFUND ANTICIPATION LOAN REPORT: PICKING TAXPAYERS’ POCKETS, DRAINING TAX RELIEF DOLLARS: REFUND ANTICIPATION LOANS STILL SLICING INTO LOW-INCOME AMERICANS’ HARD-EARNED TAX REFUNDS 8–16 (2005).

151. See Holt, *supra* note 132, at 201.

152. See Lindsey, *supra* note 17, at 233.

primary beneficiaries of an EIC “refund” is completely inconsistent with the policy aims of the EIC.¹⁵³

III. REPORTING DUTY

A. Rule

In the 1970s, barter exchange-companies began to widely market themselves as a means by which businesses could avoid paying income taxes.¹⁵⁴ Faced with widespread tax evasion and lost revenue, Congress understandably responded by changing the Code to require barter-exchange companies to report exchanges.¹⁵⁵ Although this did not alter the fact that all bartering is generally taxable, it provided a means for the IRS to force people who used barter-exchange companies to pay taxes. As a result of the reporting requirement, legitimate barter-exchange companies now inform their clients that bartering is taxable.¹⁵⁶

As mentioned, people commonly confuse the rules on the tax effect of bartering between two bartering parties with the reporting requirements applicable to barter-exchange companies.¹⁵⁷ In general, the Code requires “[e]very person doing business as a broker” to make a return, in accordance with the Treasury Regulations, showing the name and address of each customer, as well as details regarding gross proceeds and any other information the Secretary of the Treasury may require.¹⁵⁸ The Code specifically provides that the term “broker” includes a barter-exchange company.¹⁵⁹ It defines a “barter-exchange company” as “any organization of members providing property or services who jointly contract to trade or barter such property or services.”¹⁶⁰

In slightly more detailed language, the Treasury Regulations define a barter-exchange company¹⁶¹ as “any person with members or clients that contract either with each other or with such person to trade or barter property or

153. See *supra* note 148 and accompanying text.

154. See *infra* note 255 and accompanying text.

155. See I.R.C. § 6045 (2006).

156. See, e.g., Barter Frequently Asked Questions, *supra* note 14. Note, however, that many companies, quite possibly in good faith, erroneously report that bartering in a noncommercial context is not taxable. See *id.*

157. See *supra* note 25 and accompanying text.

158. I.R.C. § 6045(a) (2006).

159. *Id.* § 6045(c)(1)(B). The Code actually uses the term “barter exchange” here to refer to what I prefer to call a “barter-exchange company.” *Id.* I add the word “company” because a “barter exchange” could also refer to the transaction itself, not just the facilitator of the transaction.

160. *Id.* § 6045(c)(3).

161. The Treasury Regulations uses the term “barter exchange,” not “barter-exchange company.” Treas. Reg. § 1.6045-1(a)(4) (2009).

services either directly or through such person.”¹⁶² Excluded from this definition are “arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.”¹⁶³

In a Private Letter Ruling, the IRS addressed the issue of whether “a nonprofit organization that . . . supervises a community self-help program” is a barter-exchange company.¹⁶⁴ The IRS carefully noted that volunteers in the program provided services, such as housekeeping, babysitting, and house painting, on an entirely voluntary basis, “with no contractual obligations incurred.”¹⁶⁵ The taxpayers “plann[ed] to establish computerized records of services provided and received through the program.”¹⁶⁶ As part of the program, participants earned credits, which had no monetary value, but instead “serve[d] merely as a means to motivate volunteers.”¹⁶⁷ Ultimately, the IRS concluded that the nonprofit was not a barter-exchange company.¹⁶⁸ In short, this meant that the nonprofit was not required to report the barter exchanges it facilitated.¹⁶⁹ However, the ruling said nothing whatsoever about whether participants had a duty to include services received through the program as income.¹⁷⁰

More recently, in a separate Private Letter Ruling, the IRS addressed whether a nonprofit corporation that sponsored a “Time Dollar” program was a barter-exchange company.¹⁷¹ The IRS noted that “[t]he purpose of the program [was] to strengthen the community and to increase access to services and resources for all in the community.”¹⁷² Under the program, “[a]ll services [were] valued equally” and participants “commonly [provided] services such as housekeeping, babysitting, gardening, and errand running” in exchange for points, which the program managed.¹⁷³ The IRS concluded that this particular nonprofit corporation was not a barter-exchange company because its “operations [provided] a means for the informal exchange of similar services on a noncommercial basis and [did] not result in the creation of contractual rights and obligations among members (or between members and [the nonprofit corporation]) for the exchange of property or services.”¹⁷⁴ The IRS

162. *Id.*

163. *Id.*

164. I.R.S. Priv. Ltr. Rul. 85-36-060 (June 12, 1985).

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *See id.* (defining the reporting requirement under § 6045(a) and finding that the taxpayer is not a barter-exchange company).

170. *See id.*; *see also* I.R.C. § 6045 (2006).

171. I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995), at 27.

172. *Id.*

173. *Id.*

174. *Id.* at 28.

concludes its analysis by making clear that it has made no determination “whether a member earns income as a result of the member’s participation in the program.”¹⁷⁵

These Private Letter Rulings are important not only because they clarify the common misconception that the two parties to a barter transaction are subject to the same rules as a barter-exchange company, but also because they provide some insight into what the IRS deems taxable. By requiring barter-exchange companies to report only those barter transactions that occur in the commercial context and create “contractual obligations,” the IRS appears to accept the fact that the vast majority of noncommercial, noncontractually enforceable barter transactions will go unreported.¹⁷⁶ However, the IRS did not go so far as to say that those barter transactions are not taxable.

B. Commercial and Contractually Enforceable

Information on the IRS’s website also emphasizes that a facilitator of barter transactions is a barter-exchange company with a reporting duty if (1) the arrangement is commercial *and* (2) it creates a binding contract.¹⁷⁷ Presumably, this “simple” rule is meant to clarify the law for taxpayers and create a standard that the IRS can readily enforce. However, it fails to do this.

The question, then, is: what does it mean to engage in a barter transaction on a commercial, as opposed to noncommercial, basis? The law is not clear. Presumably, if membership in a formal bartering group requires a membership fee, any barter transactions between members of the group would be considered “commercial,” regardless of what the barterers are trading. The question is more difficult, however, when no monetary membership fee is required to join the barter group. For example, money is usually not required to join a babysitting co-op or a carpool group.¹⁷⁸ Does this automatically mean that those arrangements are noncommercial? The IRS’s rulings do not provide a simple blanket rule. For example, the IRS has stated that barter-exchange companies “do[] not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.”¹⁷⁹ That the IRS would qualify “exchange of similar services” with “on a noncommercial basis” implies that the IRS foresees “informal” barter transactions where the parties “exchange similar services” on a *commercial* basis. Thus, that the IRS has declined to provide a bright-line rule, but has chosen to provide an extremely vague one, suggests that it is possible to have a “commercial” arrangement even where no monetary fees are required.

175. *Id.*

176. See I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995) (“No opinion is expressed concerning whether a member earns income as a result of the member’s participation in the program.”); I.R.S. Priv. Ltr. Rul. 85-36-060 (June 12, 1985).

177. See Bartering Tax Center, *supra* note 24; see also *supra* text accompanying note 24.

178. See, e.g., Smart Mom’s Babysitting Co-Op Startup Kit, *supra* note 4.

179. I.R.S. Priv. Ltr. Rul. 96-08-009 (Nov. 9, 1995), at 28.

Dictionaries do not provide much help, given their broad definition of the word “commercial.” *Webster’s Dictionary*, for example, contains many definitions for “commercial,” including the following: “made or done primarily for sale or profit.”¹⁸⁰ Are carpool groups or babysitting co-ops “made or done primarily for sale or profit”? Assuming “profit” includes receiving something of value in exchange for services, then carpool groups and babysitting co-ops involve “commercial” barter transactions, which would yield taxable income. Then again, this would describe virtually all barter transactions, including a “Time Dollars” program, which the IRS held did not involve a taxable barter-exchange company.¹⁸¹ In short, under current law, it is extremely difficult to determine whether many types of arrangements are “commercial” or “noncommercial.”

The creation of contractual rights and obligations is, perhaps, an even more difficult issue. Many cases deal with the issue of when exchanged promises create a binding contract.¹⁸² However, as the Minnesota Supreme Court said in *Cohen v. Cowles Media Co.*, a contract generally “consists of an offer, an acceptance, and consideration. . . . [H]owever, the matter is not this simple.”¹⁸³ The question, then, for purposes of determining whether a barter transaction yields taxable income, is: do the exchanged promises create a “legal obligation,” which the law will enforce, or merely a “moral and ethical obligation,” which the law will generally not enforce?¹⁸⁴ Complicating the matter, a reasonable person in the offeree’s shoes must have believed that the offeror sought to enter into a binding legal contract.¹⁸⁵ In the case of a babysitting cooperative, for example, the answer is not entirely clear. Do “reasonable” members of a babysitting co-op believe that they have the right to sue if they accumulate babysitting points and the other members refuse to perform? The answer is unclear. It is a fact-sensitive question that depends,

180. WEBSTER’S NEW UNIVERSAL UNABRIDGED DICTIONARY 411 (2003).

181. See I.R.S. Priv. Ltr. Rul. 85-36-060 (June 12, 1985).

182. See, e.g., *James v. McDonald’s Corp.*, 417 F.3d 672, 677–78 (7th Cir. 2005) (discussing whether a participant in a contest agreed to an arbitration clause in the contest’s “Official Rules”); *Pierce v. Clarion Ledger*, 452 F. Supp. 2d 661, 663–64 (S.D. Miss. 2006), *aff’d*, 236 F. App’x 887 (5th Cir. 2007) (discussing reporter-source promise-based contractual obligations); *Cohen v. Cowles Media Co.*, 457 N.W.2d 199, 205 (Minn. 1990), *rev’d*, 501 U.S. 663 (1991) (discussing contractual obligations that arise from a reporter’s promise to maintain a source’s anonymity); *Kabil Devs. Corp. v. Mignot*, 566 P.2d 505, 506–07 (Or. 1977) (discussing whether an enforceable contract may be based on “subjective intentions and expectations rather than on the objective manifestations of mutual assent”); *Lucy v. Zehmer*, 84 S.E.2d 516, 518 (Va. 1954) (same).

183. *Cohen*, 457 N.W.2d at 202.

184. See *id.* at 203.

185. See *Lucy*, 84 S.E.2d at 521.

among other things, on the nature of the relationship among the members and the formality of the arrangement.¹⁸⁶

IV. MY PROPOSAL

A. Overview

The goal behind this proposal is to design a way to allow communities, including online communities, to exchange certain property and services without being constrained by the tax consequences of their actions.¹⁸⁷ Although current tax laws in this area are rarely enforced, people justifiably fear that an IRS agent may arbitrarily enforce the law, or the law may be used for political gain.¹⁸⁸ In short, this proposal attempts to provide taxpayers with clarity and a lower risk of government abuse. However, these advantages must be balanced against the fact that people will use bartering to avoid taxes if given the opportunity to do so.

The only way to provide clarity, while ensuring that people are treated fairly and do not use bartering to evade taxes, is for Congress to amend the Code to expressly exempt certain bartering activities from federal income taxes.¹⁸⁹ These activities should be divided into the following two classes: (1) the exchange of services and (2) the exchange of property. When looking at the exchange from a tax perspective, it is important to analyze each party to the barter transaction separately to determine exactly what that person is exchanging.¹⁹⁰ For clarity, I will use the terms “Barterer *A*” and “Barterer *B*” to refer to two parties to a hypothetical barter transaction.

B. Exchange of Services

1. In General

If Barterer *A* exchanges his services for Barterer *B*'s services, I propose that the services that Barterer *A* receives be expressly excluded from his gross income, unless the services that Barterer *A* performs qualify as his “trade or business.” If Barterer *A*'s services qualify as his “trade or business,” then the fair market value of any services that Barterer *A* receives in exchange should immediately be includable in Barterer *A*'s gross income.

186. My inclination is that most arrangements of this type do not create binding contracts, but the answer is far from clear.

187. Revenue loss from adopting this proposal should be relatively small because there is little enforcement now against taxpayers who barter outside the context of a barter-exchange company. See *supra* note 29 and accompanying text.

188. See *supra* note 34 and accompanying text.

189. The term “federal income taxes” is used broadly and loosely here to include all federal taxes that may be owed directly as a result of earning an income. The term would include, for example, Social Security and self-employment taxes.

190. This is particularly true when the barter involves a combination of goods and services.

If Barterer *A* exchanges his services for Barterer *B*'s *property*, I propose that Barterer *A* take that property with an income tax basis of zero unless the services that Barterer *A* performs qualify as his "trade or business." If the services performed by Barterer *A* qualify as his "trade or business," then he should immediately include, as part of his gross income, the fair market value of any property that he receives in exchange for those services.¹⁹¹

Congress should codify these changes to the law with a new Code section.¹⁹² The term "trade or business" should be interpreted expansively to include the possibility of defining the repeated exchange of a particular service as a new trade or business.

2. Trade or Business

The term "trade or business" has appeared in more than fifty sections and eight-hundred subsections of the Code and in hundreds of places in the Treasury Regulations.¹⁹³ Despite this, neither the Code nor the Treasury Regulations provide a *general* definition of "trade or business."¹⁹⁴ As a result, it is possible to have a trade or business for certain purposes, but not others. For example, the Code explains that "the performance of personal services within the United States at any time within the taxable year" generally will constitute a United States trade or business.¹⁹⁵ The mere performance of personal services, however, does not necessarily translate into a trade or business for purposes of deducting losses and business expenses.¹⁹⁶ Because of this disparity, it is critical that the law clearly define "trade or business" in order to determine whether a barter transaction will be taxable to the person performing the services.

A central purpose of this proposal is to simplify and clarify an ambiguous legal area and to bring average people who occasionally barter in a nonbusiness context into compliance with the law. Therefore, it makes sense to tie the definition of "trade or business" for purposes of taxing barter transactions to the definition of "trade or business" for purposes of determining the deductibility of expenses under Code Section 162.¹⁹⁷ This link to the definition contained in Section 162 is not suggested because of the absolute

191. See *supra* note 70 and accompanying text.

192. The new section should fall somewhere within the range of Code sections 101 to 150, as it would be an express exclusion from gross income. See I.R.C. §§ 101–50 (2006).

193. See *Comm'r v. Groetzinger*, 480 U.S. 23, 27 (1987).

194. See generally F. Ladson Boyle, *What Is a Trade or Business?*, 39 TAX LAW. 737, 738 (1986).

195. I.R.C. § 864(b) (2006). However, there is a de minimus exception for nonresident aliens who do not work more than ninety days in the U.S., do not receive more than \$3,000 as compensation, and serve a foreign person, entity, or office. *Id.* § 864(b)(1).

196. See, e.g., *Higgins v. Comm'r.*, 312 U.S. 212, 217 (1941).

197. I.R.C. § 162(a) (2006).

clarity of that denotation.¹⁹⁸ Rather, it is suggested because the meaning of “trade or business” under that section is relatively well-established and, perhaps more importantly, the link would impart an awareness of a duty to report barter transactions to those who attempt to take business expense deductions under Section 162.

Under current federal income tax law, an individual taxpayer¹⁹⁹ may deduct noncasualty losses²⁰⁰ only if such losses are incurred in a trade or business.²⁰¹ A taxpayer also may deduct ordinary and necessary business expenses (“Section 162 business expenses”), as well as expenses incurred from a transaction entered into for a profit that is not connected with a trade or business (“Section 212 investment expenses”).²⁰² A Section 162 business expense, other than an expense related to the taxpayer as an employee,²⁰³ is generally completely deductible for purposes of computing adjusted gross income.²⁰⁴

Section 212 investment expenses and Section 162 employee expenses are only completely deductible for purposes of computing adjusted gross income in a handful of limited situations. For example, expenses are generally completely deductible only if they (1) are due to a sale or exchange,²⁰⁵ (2) are attributable to royalty-producing property or rent,²⁰⁶ (3) result from a penalty for early withdrawal,²⁰⁷ or (4) are due to the repayment of certain unemployment compensation benefits.²⁰⁸ If a Section 212 investment expense, or a Section 162 employee expense, is not completely deductible under one of these provisions, it generally will be a miscellaneous itemized deduction.

198. See Boyle, *supra* note 194, at 739 (noting that the Section 162 factors started in *Higgins* “have not been uniformly considered or applied and have produced illogical results”).

199. Corporations are not limited to deducting losses and expenses in connection with a trade or business or a transaction entered into for a profit, but if a corporation incurs losses in connection with property that it owns without a profit motive, the loss may be disallowed. See I.R.C. § 274(a)(1) (2006); *Comm’r v. Gilt Edge Textile Corp.*, 173 F.2d 801, 803 (3d Cir. 1949); *Juniper Inv. Co. v. United States*, 338 F.2d 356, 356–57 (Ct. Cl. 1964).

200. A casualty loss is a loss that arises “from fire, storm, shipwreck, or other casualty, or from theft.” I.R.C. § 165(c)(3) (2006).

201. *Id.* § 165(c)(1).

202. *Id.* § 162; see *id.* § 165(c)(2); *id.* § 212 (permitting deductions for expenses in “production or collection of income . . . [or] management conservation, or maintenance of property held for the production of income . . .”).

203. Although this is somewhat counterintuitive, it is well-established that, for federal income tax purposes, “[b]eing an ‘employee’ constitutes a business in itself.” DODGE ET AL., *supra* note 111, at 568.

204. See Temp. Treas. Reg. § 1.62-1T(c)(1) (2009).

205. *Id.* § 1.62-1T(c)(4).

206. *Id.* § 1.62-1T(c)(5).

207. *Id.* § 1.62-1T(c)(10).

208. *Id.* § 1.62-1T(c)(13).

Thus, it will be deductible only to the extent that it exceeds two percent of the taxpayer's adjusted gross income.²⁰⁹

If a taxpayer's objective is to completely deduct an expense, it is preferable to have the activity classified as a "trade or business" under Section 162.²¹⁰ It is, therefore, critical to know what constitutes a "trade or business" under Section 162. According to the United States Supreme Court in the landmark case of *Higgins v. Commissioner*, a Section 162 "trade or business" is determined by the "facts of each case."²¹¹ Years of subsequent case law has somewhat clarified this standard. As Professor F. Ladson Boyle has explained,

In keeping with *Higgins*, the lower courts and the IRS have used four specific criteria to determine if a taxpayer is engaged in a trade or business:

- (1) Good faith intention of making a profit or producing income;
- (2) Extensive activity over a substantial period of time;
- (3) Whether the activity has actually begun; and
- (4) Whether the taxpayer holds himself out "to others as engaged in the selling of goods and services."²¹²

Higgins was the first case in which the Court directly addressed the issue of what constituted a "trade or business" for purposes of Section 162.²¹³

Later cases refined the "facts of each case" standard to provide clarity,²¹⁴ specifically by adding detail to the four-part test described by Professor Boyle.²¹⁵ First, to have a trade or business, the taxpayer must have a profit

209. See I.R.C. §§ 63(a), 63(d), 67(a), 67(b) (2006).

210. Note, however, that classification as a "trade or business" may be disadvantageous for other purposes. For example, I.R.C. § 1401 taxes self-employment earnings of an individual from a trade or business. See I.R.C. § 1401 (2006).

211. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941). When this case was decided, there was "no corollary to current § 212(1) and (2)." DODGE ET AL., *supra* note 111, at 567.

Congressional dissatisfaction with *Higgins* led to the prompt enactment in 1942 of what are now §§ 212(1) & (2) (*expenses* relating to the "production of income"), 167(a)(2) (*depreciation* on property "held for the production of income"), and 165(c)(2) (*losses* on "transactions entered into for a profit").

It is significant that Congress did not address *Higgins* by redefining "business" to include "investment" but instead enacted a set of Code provisions that independently allow investment deductions.

Id. at 567–68 (emphasis added).

212. Boyle, *supra* note 194, at 739 (footnotes omitted).

213. *Higgins*, 312 U.S. at 215–16. In a slightly earlier case, *Deputy v. du Pont*, 308 U.S. 488, 493 (1940), the Court assumed there was a trade or business and addressed the issue of whether an expense was an "ordinary and necessary" business expense.

214. See, e.g., *Whipple v. Comm'r*, 373 U.S. 193 (1961); *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127, 129–30 (1941).

215. See *supra* note 212 and accompanying text.

motive.²¹⁶ This, by its very nature, is a subjective test.²¹⁷ Second, the activity must be extensive.²¹⁸ This generally means the activity must be both continuous and regular.²¹⁹ Third, courts typically consider whether the taxpayer holds herself out to others as engaged in selling goods or services.²²⁰ Although this factor is not generally dispositive, it certainly must be considered.²²¹ Accordingly, if the taxpayer holds herself out as engaged in selling goods or services, she is more likely to have a trade or business. Finally, courts consider whether the activity has actually commenced.²²² In the landmark case *Richmond Television Corp. v. United States*, the United States Court of Appeals for the Fourth Circuit held that a company was not in a trade or business because it had not yet begun its operations.²²³ Other courts, however, have attempted to limit the holding of this case.²²⁴

As Professor Boyle has noted, the “vast majority” of activities easily fit within his four-part test.²²⁵ Although there may be grey areas,²²⁶ the standard is relatively clear, and the IRS is accustomed to determining if there is a trade or business for purposes of Section 162. Additionally, the possibility of obtaining business-expense deductions is an incentive for taxpayers to attempt to classify their activities as a trade or business, and thus an incentive to report barter income.

I propose that whenever Barterer *A* exchanges services for other services or property, Barterer *A* should have no immediate income from the transaction unless Barterer *A*'s services constitute a “trade or business” under the above

216. See *supra* note 212 and accompanying text; see also *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987) (“We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.”).

217. See *Malmstedt v. Comm’r*, 578 F.2d 520, 527 (4th Cir. 1978). The “intent to make a profit” requirement can be met even if the taxpayer never actually makes a profit. *Id.* This requirement is met as long as the taxpayer makes a good-faith effort to make a profit. *Id.*

218. See *supra* note 212 and accompanying text.

219. See, e.g., *McDowell v. Ribicoff*, 292 F.2d 174, 178 (3d Cir. 1961) (noting that the activities of a nonprofessional fiduciary were not sufficiently continuous and regular to constitute a trade or business).

220. See Boyle, *supra* note 194, at 746–48 & nn.63–75. The Supreme Court has said that this is a factor that may be considered, but that it is not dispositive in finding that a trade or business exists.

221. *Groetzinger*, 480 U.S. at 25 (stating that “while the offering of goods and services usually would qualify the activity as a trade or business, this factor . . . is not an absolute prerequisite”).

222. See *supra* note 212 and accompanying text.

223. *Richmond Television Corp. v. United States*, 345 F.2d 901, 909 (4th Cir. 1965).

224. See, e.g., *Blitzer v. United States*, 684 F.2d 874, 880 (Ct. Cl. 1981); *United States v. Manor Care, Inc.*, 490 F. Supp. 355, 359–60 (D. Md. 1980).

225. Boyle, *supra* note 194, at 750.

226. See, e.g., *id.*

four-part test.²²⁷ If Barterer *A*'s services constitute his trade or business, then Barterer *A* will have immediate taxable income.²²⁸ This results regardless of whether he received other services or property in exchange for his service.²²⁹ This rule is necessary to prevent people from using barter transactions primarily to avoid taxes on income derived from services performed as part of their business.

If Barterer *A*'s services do not constitute his trade or business, then any services that Barterer *A* receives in return for his services will be tax-free for Barterer *A*. This rule reflects the current reality that nearly all service-for-service barterers are not arranged through a barter-exchange company.²³⁰ If Barterer *A*'s services do not constitute his trade or business, then any property Barterer *A* receives in return for his services will be tax-free for him as well, but Barterer *A* will take that property with an income tax basis of zero. This is sensible because if Barterer *A* subsequently converts that property to cash by selling it, he should pay taxes on that cash.²³¹ At that point liquidity is no longer an issue, and most people would expect to pay taxes on a sale for cash.²³²

C. Exchange of Property

1. In General

If Barterer *A* exchanges personal property²³³ for other property or services, I propose that a new nonrecognition provision apply to Barterer *A*, unless Barterer *A* held the property for investment or for productive use in a trade or business. Notably, this new nonrecognition provision would not affect the potential applicability of other nonrecognition provisions that currently exist in the Code.²³⁴

The general rule is that *personal* property exchanged for other property or services should receive nonrecognition treatment.²³⁵ However, if the

227. The services or goods received by Barterer *A* should be treated as cash solely for purposes of applying the four-part test. It, therefore, would be possible for a person to have a trade or business solely from frequently bartering those services, even though the taxpayer never receives any cash for his services.

228. See *supra* note 70 and accompanying text.

229. The amount of income is based on the fair market value of the goods or services received. Treas. Reg. § 1.61-2(d)(1) (2006).

230. See *supra* note 29 and accompanying text.

231. The gain would be equal to the sales price minus the basis, which would initially be zero. I.R.C. § 1001(c) (2006). Whether that gain is long-term or short-term will depend on how long Barterer *A* has held those assets. If he has held them for more than one year, the gain will be long-term and taxable at preferential rates. I.R.C. § 1(h) (2006).

232. See *generally supra* note 114 and accompanying text.

233. The term "property" in this proposal means only personal property, not real property.

234. See, e.g., I.R.C. §§ 1031, 1033 (2006).

235. Under current law, I.R.C. § 1031 (2006) does not apply to personal-use assets.

exchanged property is an investment asset or is owned in connection with a trade or business, then it should not receive nonrecognition treatment unless another nonrecognition provision applies to the transaction.²³⁶ The reason for this distinction is that Congress has already decided when nonrecognition should apply to exchanges of property held for investment or business purposes. If the transfer of property does not qualify for nonrecognition under this new rule or under one of the currently existing nonrecognition rules, then Barterer *A* would have to recognize income to the extent that the value of goods or services that he receives exceeds his basis in the property that he transfers to Barterer *B*.

The reality is that this new nonrecognition provision should have very little actual effect, given that most personal property is likely to decline in value. Thus, in most cases, the basis will exceed the fair market value of the property or services received in exchange for the transferred personal property, and no taxes will be owed.²³⁷

2. Nonrecognition Provisions

Under one of the most well-established tax-law principles, gain or loss on the sale or exchange of property must be recognized as taxable income unless a specific nonrecognition rule applies to the transaction.²³⁸ Statutory nonrecognition rules include²³⁹ like-kind exchanges,²⁴⁰ involuntary conversions,²⁴¹ exchange of contracts,²⁴² exchange of government

236. I.R.C. § 1031. “Trade or business” here should have the same meaning as it does with respect to exchanges of services. Thus, the four-part test should be applied to determine whether there is a trade or business. *See supra* note 225 and accompanying text.

237. *See* I.R.C. § 165(c) (2006) (providing that personal losses may not be deducted).

238. I.R.C. § 1001(c) (2006).

239. This is not intended to be an exhaustive list. It is merely a list of certain significant nonrecognition provisions.

240. I.R.C. § 1031(a)(1) (2006). Under this rule, the transferor does not recognize gain or loss upon the exchange of property held for investment or for productive use in a trade or business (other than inventory) if the property received in exchange is “of like kind” and is also held either for investment or for productive use in a trade or business. *See* Treas. Reg. § 103(a)-1 (2009). This rule generally does not apply to stock, bonds, property held primarily for sale (inventory), notes, partnership interests, certificates of trust, beneficial interests, securities, or evidence of debt or interest. I.R.C. § 1031(a)(2) (2006); Treas. Reg. § 1031(a)-1. Nor does it generally apply to personal property. *See* DEP’T OF THE TREASURY, IRS, PUBLICATION 544: SALES AND OTHER DISPOSITIONS OF ASSETS 554 (2008), available at <http://www.irs.gov/pub/irs-pdf/p554.pdf>.

241. I.R.C. § 1033(a) (2006). This applies when property is destroyed, stolen, or condemned (or disposed of under the threat of condemnation) and the taxpayer receives replacement property or money. *Id.*

242. I.R.C. § 1035(a) (2006). “Exchange of contracts” includes exchanges of life-insurance contracts, exchanges of life-insurance contracts for endowment or annuity contracts, exchanges of annuity contracts, exchanges of endowment insurance contracts for annuity contracts, and certain exchanges of endowment insurance contracts. *Id.*

obligations,²⁴³ exchange of stock for stock in the same corporation,²⁴⁴ exchange of stock by a corporation for property contributed to that corporation,²⁴⁵ exchange of property for stock in a controlled corporation,²⁴⁶ exchange of property for partnership interests,²⁴⁷ exchange of property to avoid conflicts of interest,²⁴⁸ certain sales of stock to an employee stock ownership plan (ESOP),²⁴⁹ and property transfers between spouses and former spouses.²⁵⁰

If Barterer *A* exchanges personal property for other property or services and some cash, I propose that the cash be treated the same as boot²⁵¹ received in a Section 1031 exchange. Under that rule, realized gain must be recognized when boot is received, but the amount of recognized gain is limited to the amount of boot received.²⁵²

Additionally, holding periods should be handled as the holding period under Section 1031 is handled. Specifically, Barterer *A* should take any property received in exchange for transferred property with a tacked holding period.²⁵³

D. Earned Income Credit

Because the potential for EIC abuse exists as long as bartering can be used to enable a person to qualify for the EIC,²⁵⁴ the EIC rules of Code Section 32 should be amended. More specifically, that section should expressly address income from bartering. I propose that, for EIC purposes, “earned income” should include property or services received through bartering only if the services that the taxpayer performed qualify as a “trade or business” of that taxpayer under Section 162.

E. Reporting Requirements

There is no question about it—people will, if given the opportunity, use bartering to avoid paying taxes. By the late 1970s, a general “underground

243. I.R.C. § 1037 (2006).

244. I.R.C. § 1036(a) (2006).

245. I.R.C. § 1032(a) (2006).

246. I.R.C. § 351(a) (2006). For this provision to apply, the person transferring property to the corporation in exchange for the corporation’s stock must be in control of the transferee corporation (that is, own at least eighty percent of the voting stock and eighty percent of all other classes of stock) immediately after the transfer. *Id.*

247. I.R.C. § 721(a) (2006).

248. I.R.C. § 1043(a) (2006).

249. I.R.C. § 1042(b)(1)(A) (2006).

250. I.R.C. § 1041(a) (2006).

251. “Boot” means “cash or property that is not like-kind property.” DEP’T OF THE TREASURY, IRS, INTERNAL REVENUE BULLETIN: BULLETIN NO. 2005-7, at 529 (2005), available at <http://www.irs.gov/pub/irs-irbs/irb05-07.pdf>.

252. See I.R.C. § 1031(c) (2006); Treas. Reg. § 1.1031(c)-1 (2009).

253. See I.R.C. § 1223(1) (2006).

254. See *supra* Part I.C.

economy” of tax evaders had grown immensely large²⁵⁵ and the widespread use of barter-exchange companies induced the IRS to begin looking into organized bartering.²⁵⁶

Once Congress became aware of the revenue lost from bartering,²⁵⁷ it took steps to ease IRS monitoring of barter-exchange companies. Specifically, with the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress made barter-exchange companies third-party record keepers under Code Section 7609.²⁵⁸ This meant that a member of a barter-exchange company was entitled to notice of any summons sent to the company requesting that member’s records and, moreover, that the member was allowed to intervene to prevent the company from complying with the summons.²⁵⁹ More importantly, Congress included barter-exchange companies in the definition of “broker” under Code Section 6045.²⁶⁰ With this, barter-exchange companies, like all other brokers, had to file annual information returns, detailing the barter activities of the members, with the IRS.²⁶¹

I heartily endorse the idea of a barter-exchange company reporting requirement. Removing the requirement would be disastrous and would return us to the problems of the 1970s. According to Professor Robert Keller, most members of barter-exchange companies are businesses.²⁶² Assuming this remains true, these members, under my proposal, would still have a duty to include profits from bartering in their incomes.²⁶³ Thus, an unchanged reporting requirement by barter-exchange companies would continue to facilitate tax administration and enforcement efforts of the IRS. Individuals who join barter-exchange companies to barter services that are not their trade, business, or property that qualifies as personal use assets, would have the burden of explaining on their individual income tax returns why the bartering proceeds are not includible in their incomes.

255. See Steve Lohr, *How Tax Evasion Has Grown*, N.Y. TIMES, Mar. 15, 1981, at 1.

256. See DEP’T OF THE TREASURY, IRS, SUPP. 45G-324, INTERNAL REVENUE MANUAL § 1.02 (1982).

257. By the early 1980s, there were nearly 300 barter-exchange companies, with around 60,000 members, exchanging about \$300 million worth of goods and services each year. See Keller, *supra* note 64, at 485.

258. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 311, 96 Stat. 324, 601 (1982) (codified at I.R.C. § 7609(a)(1) (2006)). TEFRA amended I.R.C. § 7609(a)(3) to define a third-party record keeper to include “any barter exchange (as defined in section 6045(c)(3)).” *Id.* (codified at I.R.S. § 7603(b)(2)(c) (2006)). Section 6045(c)(3) defines a “barter exchange” as “any organization of members providing property or services who jointly contract to trade or barter such property or services.” *Id.* (codified at I.R.C. § 6045(c)(3) (2006)).

259. I.R.C. § 7609(b) (2006).

260. I.R.C. § 6045(c)(1) (2006).

261. *Id.* § 6045(a).

262. See Keller, *supra* note 64, at 502–03.

263. See *supra* Parts III.B.1, III.C.1.

With respect to the current reporting requirement, I would only suggest clarification. As discussed, the term “barter exchange” is confusing. Another term, such as “barter-exchange company” or “barter facilitator,” should be used. In addition, the IRS should make it clearer on its website that there is a difference between a barter-exchange company’s reporting requirements and income inclusions of private bartering parties. Finally, the IRS should clarify what “noncommercial” means with respect to the reporting requirement of barter-exchange companies.²⁶⁴ For example, it is not entirely clear whether certain formal arrangements, such as babysitting co-ops, are barter-exchange companies.²⁶⁵

V. CONCLUSION

From a purely economic standpoint, there is no question that every true barter transaction should be treated exactly like an economically equivalent cash transaction.²⁶⁶ If the only consideration in designing tax policy were economic in nature, then income would be taxed accurately and fairly. Unfortunately, tax law is about much more than economics, and this complicates matters. We must also consider the practicalities of taxation, including taxpayers’ respect, or lack thereof, for the tax system. It is fundamental to always be aware of the reality of administering the tax system. In so doing, we must remember that taxpayers will perceive the system as unfair if they are treated as having income when they have not received cash, and will lose respect for the system if they view it as overly intruding into their individual lives.²⁶⁷ The tax laws that currently apply to barter transactions run the risk of these perceptions.

People barter for different reasons. For example, many people join babysitting cooperatives because babysitting services are prohibitively expensive, and they would like a way to occasionally go to a movie without breaking the bank. These people might not give taxes a moment of thought. People may join a work carpool for similar reasons, although they may also be concerned about the environmental impact of millions of people driving individually to work. Again, taxes may not even enter into the decision to carpool. Similarly, people might participate in a program like “Time Dollars” because they think it is a way to bring their communities together by allowing people with less money to help each other.²⁶⁸ In short, none of these barter

264. See Rev. Rul. 79-24, 1979-1 C.B. 61.

265. See *supra* Part II.B.

266. See Keller, *supra* note 64, at 468.

267. See *supra* notes 76–79 and accompanying text.

268. The desire to reinvent community spirit in certain neighborhoods seems to be growing. Hillary Clinton has noted:

In Morningside Gardens, a racially mixed cooperative housing complex in Harlem that is home to almost a thousand families, neighbors make a point of getting to know one another. The complex includes a senior citizen center, a combination day care

transactions, in general, “replace” otherwise taxable market transactions—parents commonly will forego an evening out if they have to pay for babysitting, employees will drive themselves to work, and poorer communities will “make do” with less rather than pay for services that they cannot afford.

In stark contrast to these nontax-motivated barter transactions, many people would, if possible, enter into barter transactions solely to avoid paying income taxes. If an attorney could barter her services for a plumber’s without paying taxes on the value of the plumbing services received, the attorney would likely do it. In this case, the bartering replaces an actual market transaction, because the lawyer would otherwise have to pay for the plumbing services with cash. These types of barterers are most commonly, although not exclusively, done through a formal barter-exchange company.

Others might barter for a combination of tax and nontax reasons. For example, a lawyer may assume that he will get more business if he joins a barter-exchange company in addition to the tax benefits the barter arrangement would provide. If he can do this without paying taxes on his services, he would likely view the arrangement as yielding a double benefit.

Tax law must consider that barter transactions occur for a variety of reasons, some of which the Code should encourage—occasional barter transactions that bring communities together and help the environment, absent a clear intent to evade taxes, should be tax-free. If, however, a person barterers in connection with a trade or business or in connection with assets held for business or investment purposes, the transaction should be taxed like any other business or investment activity. In this case, the risk of tax evasion greatly exceeds the potential community and environmental benefits of the transaction.

It seems that the IRS is already attempting to implement many of this Article’s proposals. By tying the barter-exchange company reporting requirement to contractual obligations in the business context, the IRS is ensuring that most other types of barter transactions will go unreported and therefore untaxed. That said, our current law is subject to discretionary abuse by the government, and it is unfair to the few law-abiding taxpayers that report all barter transactions, even those not associated with a barter-exchange company. It also puts accountants and lawyers in the awkward position of being compelled to report, or to advise clients to report, income that people without accountants and lawyers generally do not report. For these reasons, the law should be changed.

center and nursery school, a bank, and a grocery store. The complex has its own security patrol and a newspaper that spreads word of births, deaths, and other community news. Residents place a special emphasis on giving young people a stake in the life of the community. There are recreation and tutoring programs, and children and teens are recruited for cleanup projects and other neighborhood activities.

Clinton, *supra* note 1, at 135–36.

