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# Taxing the Promise to Pay

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## Article

# Taxing the Promise To Pay

Gregg D. Polsky<sup>†</sup> and Brant J. Hellwig<sup>††</sup>

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In the late 1990s, executive compensation skyrocketed, primarily as a result of the bull market and its effect on compensatory stock options.<sup>1</sup> As option values escalated higher and higher, tax advisors became intent on devising a strategy that would shelter these gains from federal income tax. Eventually, these advisors came up with a shelter that they believed would defer tax on these gains for as long as an executive desired. Pursuant to this tax shelter, which ultimately became known as the Executive Compensation Strategy, or ECS,<sup>2</sup> a participating executive would sell options to a family limited partnership in exchange for the partnership's long-term, unsecured promissory note.<sup>3</sup> If successful, this shelter would allow the executive to defer stock option gains for the term of the note.

Use of the ECS shelter was pervasive among corporate executives. The Internal Revenue Service (the IRS) has already identified more than 100 senior executives at 42 leading public corporations that participated in the transactions in an attempt to defer \$700 million of stock option gains.<sup>4</sup> The IRS suspects

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1. See, e.g., Mark Gimein, *You Bought. They Sold*, FORTUNE, Sept. 2, 2002, at 64; Gretchen Morgenson, *Option Pie: Overeating is a Health Hazard*, N.Y. TIMES, Apr. 4, 2004, § 3, at 1.

2. The shelter transaction is also referred to as the Compensatory Option Sale Shelter (COSS). See Alvin D. Lurie, *That Newtime Religion: Breaking Another False Idol—The COSS*, 57 TAX LAW. 593, 593 (2004).

3. See JOINT COMM. ON TAXATION., 108TH. CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 661 (Comm. Print 2003) [hereinafter ENRON INVESTIGATION REPORT] (describing the shelter); Lee A. Sheppard, *Dissecting the Compensatory Option Sale Shelter*, 98 TAX NOTES 871, 871-72 (2003) (describing the shelter).

4. See I.R.S. News Release IR-2005-17 (Feb. 22, 2005), available at <http://www.irs.gov/newsroom/article/0,,id=135596,00.html>. (declaring that the IRS had "identified 42 corporations, many more executives and unreported income of more than \$700 million"); Lynnley Browning, *I.R.S. Offers Lower Pen-*

that hundreds more executives used the shelter, resulting in the loss of at least \$1 billion of federal tax revenue.<sup>5</sup> Given the widespread use of the shelter, it was not surprising to learn that it was aggressively marketed by almost all of the leading public accounting firms,<sup>6</sup> with now-defunct Arthur Andersen considered the premiere seller of the shelter.<sup>7</sup> Among buyers of the ECS shelter from Andersen was none other than L. Dennis Kozlowski, the infamous and indicted former CEO of Tyco International, who bought the vehicle in an attempt to shelter \$208 million of stock option gains.<sup>8</sup>

Faced with the widespread use of and publicity<sup>9</sup> about the ECS shelter, the IRS has fought back and is now aggressively challenging the multitude of ECS transactions that have occurred.<sup>10</sup> While the IRS views the ECS shelter as legally

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*alty if Shelter Abusers Confess*, N.Y. TIMES, Feb. 23, 2005, at C2 (reporting that the IRS had already identified "more than 100 senior executives"); Rob Wells & Jonathan Weil, *IRS Identifies Option Tax Shelter Involving Major Accounting Firms*, WALL ST. J., Feb. 23, 2005, at D2 (noting that "IRS Commissioner Mark Everson said the agency has identified 42 corporations, including many 'that are household names'").

5. See Browning, *supra* note 4.

6. See Wells & Weil, *supra* note 4 (reporting that the ECS was sold by Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP and Arthur Andersen LLP). The only major public accounting firm not implicated in the ECS scheme appears to be Deloitte & Touche LLP.

7. See David Cay Johnston, *I.R.S. Disallows a Shelter Intended To Delay the Tax on Stock Options*, N.Y. TIMES, July 2, 2003, at C1.

8. See Johnston, *supra* note 7; Miles Weiss, *IRS Probing Kozlowski's Taxes*, Bloomberg News, NAT'L POST (Toronto), July 27, 2002, at FP4.

9. The ECS shelter has been extensively and prominently reported in the popular press. See, e.g., Ken Brown & John D. McKinnon, *IRS Later Opposed Tax Strategies Sold by Auditor*, WALL ST. J., Feb. 6, 2003, at A3; David Cay Johnston, *Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income*, N.Y. TIMES, June 20, 2002, at A1; Johnston, *supra* note 7; Weiss, *supra* note 8, at FP4. The technical tax literature also has discussed and analyzed the ECS shelter. See, e.g., Lurie, *supra* note 2, at 593; Diane M. McGowan & A. Thomas Brisendine, *Selling Stock Options*, 14 BENEFITS L.J. 89 (2001) [hereinafter *Selling Stock Options*]; Diane M. McGowan & A. Thomas Brisendine, *Selling Stock Options Revisited in Light of Notice 2003-47*, 16 BENEFITS L.J. 94 (2003) [hereinafter *Selling Stock Options Revisited*]; Lee Sheppard, *Compensatory Option Sale Shelter Resolved*, 39 TAX NOTES 123 (2003); Sheppard, *supra* note 3.

10. See I.R.S. Notice 2003-47, 2003-30 I.R.B. 132. In late 2004, the IRS released a coordinated issue paper addressed to all industries concerning the ECS shelter transaction. See IRS Coordinated Issue Paper, *Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons* (Oct. 15, 2004), available at [www.irs.gov/pub/irs-utl/compensatory\\_final.pdf](http://www.irs.gov/pub/irs-utl/compensatory_final.pdf) [hereinafter IRS Coordinated Issue Paper]. Shortly before this Article went to press, the IRS announced an offer of amnesty to executives who participated in the shelter.

flawed,<sup>11</sup> litigation on the issue is pending and no court has weighed in on the matter as of yet. Prior commentators who have analyzed the strategy have concluded that its likelihood of success depends on the factual question of whether the sale of the options from the executive to the family partnership was made at arm's-length.<sup>12</sup> While it is true that the ECS shelter will fail to produce the intended tax benefits if the sale of the options to the partnership is not viewed as arm's-length, the issue of whether this sale can be fairly described as an arm's-length transaction is a factual one on which reasonable minds may perhaps differ.<sup>13</sup> This Article will illustrate that, even if the executive's sale of the stock options to the partnership is considered to be at arm's-length, the ECS shelter nonetheless fails.

For the ECS shelter to provide the sought-after tax deferral, the partnership's promissory note cannot constitute "property" for purposes of § 83 of the Internal Revenue Code.<sup>14</sup> If the promissory note constitutes property under § 83, then the executive is taxed immediately upon its receipt.<sup>15</sup> Promoters of the ECS shelter argue that the partnership's promissory note is not property because it constitutes an "unfunded and unsecured promise to pay money in the future," which is explicitly carved out of the definition of property under the § 83 regulations.<sup>16</sup> As is typical of tax shelter promoters,<sup>17</sup> their interpreta-

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See I.R.S. Announcement 2005-19, *Executive Stock Options Settlement Initiative*, (Feb. 22, 2005), available at <http://www.irs.gov/pub/irs-drop/a-05-19.pdf>. In general, the offer requires the executive to recognize compensation income equal to the fair market value of stock options used in the ECS. *Id.* at 1-2. The primary benefit to the executive of participating in the amnesty program is that it would reduce the civil tax penalty from 20% to 10% on the understated income. *Id.* at 4.

11. I.R.S. Notice 2003-47, 2003-30 I.R.B. 132; see also J. Christine Harris, *IRS Officials Explain Recent Guidance on ISOs, FLP Notes*, 100 TAX NOTES 452 (2003).

12. Compare *Selling Stock Options*, *supra* note 9, at 95-96 (concluding that the ECS may be viewed as an arm's-length transfer), with Sheppard, *supra* note 3, at 873 (concluding that the ECS cannot be viewed as an arm's-length transfer).

13. *Selling Stock Options*, *supra* note 9, at 93; Sheppard, *supra* note 3, at 873 ("No rational person would make a 30-year bet on interest rates with a purchaser whose ability to pay was contingent on resale of the property.").

14. See I.R.C. § 83 (2000).

15. See *Selling Stock Options*, *supra* note 9, at 97-101.

16. Treas. Reg. § 1.83-3(e) (as amended in 1985); see also Draft Opinion Letter from Arthur Andersen to Mr. Client (1999), in ENRON INVESTIGATION REPORT, *supra* note 3, app. D, at 336-40 [hereinafter Arthur Andersen Opin-

tion is overly literal, ignoring entirely the history, context, and purpose of the regulatory definition. Instead, this Article argues that the exclusion for an unfunded and unsecured promise to pay applies only to a promise to pay issued by the recipient of the taxpayer's services (second-party promise). If the promise to pay is issued by a party external to the service relationship (third-party promise), such a promise constitutes property for purposes of § 83.<sup>18</sup> Accordingly, the receipt of a third-party promise to pay in connection with the performance of services is always immediately taxable to the service provider, regardless of the nature of the promise.<sup>19</sup>

Though the proliferation of the ECS shelter served as the stimulus for this Article, the issue addressed in this Article—whether compensatory third-party promises to pay are taxable upon receipt—is an important one in the larger context of deferred compensation.<sup>20</sup> It is also apparently one that many commentators believe is an open question. For example, Martin D. Ginsburg and Jack S. Levin have identified the question in their authoritative treatise as one that “has long been an unresolved issue.”<sup>21</sup> Furthermore, the issue is one that has caused a fair amount of confusion in the courts.<sup>22</sup> We hope that this Arti-

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ion Letter].

17. See Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 27 (2004) (noting that the courts' use of “textualism embolden[s] tax shelter advisors to push the limits”).

18. Executives who used the ECS shelter would be cash method taxpayers. Accordingly, for purposes of this Article, it is assumed that any recipient of a third-party promise is a cash method taxpayer. Accrual method taxpayers would generally be taxed at the time the right to payment accrues, regardless of whether the right to payment emanates from a second party or third party. For a further discussion of the distinction between the cash and accrual methods of accounting, see text accompanying notes 112–13.

19. If our analysis is correct, then the third-party promise issue is a silver bullet for the ECS shelter. For the shelter to succeed, the executive must argue that the sale of the options is an arm's-length transaction because fair market value was received for the options. See *Selling Stock Options*, *supra* note 9, at 93–96; Arthur Andersen Opinion Letter, *supra* note 16, at 335–38. If the partnership's promise is immediately taxable to the executive, then the executive is taxed on the fair market value of the promise, which must, in an arm's-length transaction, equal the value of the options. As a result, the sought-after deferral is lost, as the executive is taxed immediately on the fair market value of the options.

20. See 3 MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS*, Ch. 1502.1.1 at 15–25 n.21 (June 2003 ed.) (noting that the issue is important in the deferred compensation context).

21. *Id.*

22. Two cases that have failed to appreciate or understand the distinction

cle proves that the law is not nearly as unclear as is commonly believed.<sup>23</sup>

This Article proceeds in four parts. Part I describes in more detail the mechanics of the ECS shelter and the tax issues it generates, focusing on the tax treatment of the partnership's promise to pay. Part II describes the taxation of compensatory promises to pay under general tax principles that preceded the enactment of § 83 of the Code, emphasizing that tax law has traditionally drawn an important distinction between second-party promises, which are generally not immediately taxable, and third-party promises, which are. Part III then argues that neither the enactment of § 83 nor the promulgation of its regulations should be understood to have changed this traditional tax treatment of compensatory promises. Therefore, Part III concludes that compensatory third-party promises, like the partnership's promise to the executive in the ECS transactions, are always immediately taxable. Finally, Part IV explains how the immediate taxation of third-party promises is justified by policy considerations.

## I. THE ECS SHELTER

### A. THE MECHANICS OF THE SHELTER

While the hallmark of many tax shelters is transactional complexity,<sup>24</sup> the ECS shelter is remarkably straightforward. It involves the sale by the executive of compensatory stock options to a limited partnership owned by the executive and members of his family (commonly referred to as a family limited partnership).<sup>25</sup> The partnership would have been previously capitalized by the partners with an amount of cash equal to 10% of the

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between a second-party promise and a third-party promise in determining the timing of income recognition are *Childs v. Commissioner*, 103 T.C. 634 (1994), and *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985). These cases are discussed in Part III.C.2.

23. At least one commentator shares our view that the issue is unambiguous. See GEORGE L. WHITE, ACCOUNTING METHODS—GENERAL PRINCIPLES, at A-64 (BNA Tax Mgt. Portfolio No. 570, 1996) (“When the transfer is of obligations of a third party, they are ‘property.’”).

24. Many tax shelters consist of a Byzantine array of financial transactions. See, e.g., *ACM P’ship v. Comm’r*, 157 F.3d 231 (3d Cir. 1998); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004).

25. See Arthur Andersen Opinion Letter, *supra* note 16, at 319–20; *Selling Stock Options*, *supra* note 9, at 90; Sheppard, *supra* note 3, at 871–72.

value of the options to be transferred.<sup>26</sup> In consideration for the options, the partnership transfers to the executive a long-term (typically fifteen to thirty years), unsecured, and nonassignable balloon note with a face amount equal to the value of the options.<sup>27</sup> The promissory note would require that interest be paid to the executive on an annual basis.<sup>28</sup> Immediately after the sale, the family limited partnership would exercise the options, sell the underlying stock, and invest the proceeds in other investment assets.<sup>29</sup>

The primary goal of the strategy is tax deferral.<sup>30</sup> Proponents of the shelter argue that, as a result of these transactions, the executive does not realize any income (apart from annual interest payments received from the partnership) until he receives the balloon payment of principal under the promissory note.<sup>31</sup> According to this view, the interim exercise of the stock options by the partnership carries no tax consequences to

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26. See Arthur Andersen Opinion Letter, *supra* note 16, at 319–20; Sale of Executive Options Technique—Advantages and Disadvantages, in ENRON INVESTIGATION REPORT, *supra* note 3, app. D, at 310 [hereinafter Sale of Executive Options Technique]. Presumably, the capitalization of the partnership with 10% cash was intended solely to bolster the argument that the sale of the options was an arm's-length transaction. For a discussion of the arm's-length issue, see text accompanying notes 74–82.

27. Sheppard, *supra* note 3, at 872.

28. See Arthur Andersen Opinion Letter, *supra* note 16, at 320; *Selling Stock Options*, *supra* note 9, at 94. Marketing materials indicated that the partnership note would bear a "marketable rate" of interest. See Sale of Executive Options Technique, *supra* note 26, at 311. A draft Arthur Andersen opinion letter indicated that the partnership note would bear interest at 8%. Arthur Andersen Opinion Letter, *supra* note 16, at 320. Based on these materials, it appears that the promoters intended that the note bear interest at a rate greater than the pertinent applicable federal rate as set forth in I.R.C. § 1274(d)(1) (2000). For a discussion of the effect of the interest rate on the success of the shelter, see note 82 and accompanying text.

29. See Sheppard, *supra* note 3, at 872; Sale of Executive Options Technique, *supra* note 26, at 310 (stating that "executive gets the opportunity to diversify his/her portfolio without having an immediate tax payment due from exercising the options").

30. See Lurie, *supra* note 2, at 594. A second goal of the ECS shelter might be to convert the character of any subsequent appreciation of the options from ordinary income to capital gain. However, marketing materials for the ECS indicated that, in the usual case, the partnership would immediately exercise the options and sell the underlying stock, foreclosing the possibility of this character shift. See Sale of Executive Options Technique, *supra* note 26, at 312.

31. See Arthur Andersen Opinion Letter, *supra* note 16, at 340; *Selling Stock Options*, *supra* note 9, at 90; Sheppard, *supra* note 3, at 872.



the executive.<sup>32</sup> However, while the executive treats the sale of the options to the partnership in exchange for the balloon note as a nonevent for tax purposes, the partnership claims a purchase cost basis in the options.<sup>33</sup> As a result, the partnership realizes no gain when the options are exercised and the underlying stock is sold.<sup>34</sup>

The mechanics of the ECS shelter can be illustrated using a simple example. Assume that an executive has options to buy stock with a current fair market value of \$6 million at an aggregate exercise price of \$500,000. Assume further that the fair market value of these options is \$5.5 million.<sup>35</sup> Pursuant to the

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32. Arthur Andersen Opinion Letter, *supra* note 16, at 335–36; Lurie, *supra* note 2, at 596–97.

33. See Sheppard, *supra* note 3, at 872. Two commentators have argued that, when the executive sells the options to the partnership, the § 453 installment method should apply. See James R. Hamill & Roger W. Lusby, *Intrafamily Installment Sales of Nonqualified Stock Options*, 31 TAX ADVISER 494, 498–99 (2000). However, installment method reporting is not available in this context. In *Sorenson v. Commissioner*, 22 T.C. 321 (1954), the Tax Court determined that the cash and promissory notes received upon the sale of compensatory stock options themselves constituted compensation to the taxpayer. Noting that the predecessor to § 453 did not “in anywise purport to relate to the reporting of income by way of compensation for services,” the court rejected the taxpayer’s claim that the compensation income attributable to the receipt of the promissory note be reported on an installment basis. *Sorenson*, 22 T.C. at 342; see also Sheppard, *supra* note 3, at 873 (discussing the impact of the *Sorenson* decision in this context). The basis for the *Sorenson* decision—that the consideration received in the sale of compensatory stock options itself constitutes compensation income—is maintained under the § 83 regulations. See Treas. Reg. § 1.83-7(a) (1978) (last sentence). Accordingly, the executive selling compensatory stock options pursuant to the ECS shelter would not be entitled to report income resulting from the sale on an installment basis.

34. See Hamill & Lusby, *supra* note 33, at 498. According to proponents, when the partnership sells the underlying stock, it will realize capital gain or loss to the extent of the difference between (i) the sales proceeds and (ii) the sum of (a) the amount the partnership paid for the options and (b) the exercise price paid by the partnership upon exercise. *Id.* If the sale occurs more than a year after the partnership purchased the options, the capital gain or loss would be long-term, otherwise it would be short-term. See I.R.C. § 1222 (2000). In the usual case, the partnership would exercise the options and sell the stock immediately upon receipt of the options; as a result, any capital gain or loss would generally be minimal and short-term. See Sale of Executive Options Technique, *supra* note 26, at 311 (noting that “most partnerships exercise the options and sell the underlying shares immediately”).

35. As discussed below, there are two components of an option that provide value. See *infra* notes 43–48 and accompanying text. The first is the spread, the difference between the current fair market value of the underlying stock and the exercise price. The second is the option privilege, the ability to participate in further appreciation of the stock without risking any capital. See Treas. Reg. § 1.83-7(b)(3) (1978). In the example above, the spread equals

strategy, the executive and his relatives form a limited partnership by contributing \$550,000 in cash. The partnership then purchases the options, issuing a \$5.5 million balloon note to the executive. The note bears 8% interest payable annually and would mature in thirty years. Immediately after acquiring the options, the partnership exercises the options<sup>36</sup> and then sells the underlying stock for \$6 million. Last, the partnership invests the sale proceeds in a diversified portfolio.<sup>37</sup>

Proponents of the shelter argue that the resulting tax consequences are as follows: First and foremost, the executive realizes no income upon the sale of the options to the partnership.<sup>38</sup> The partnership, on the other hand, takes a \$5.5 million basis in the options.<sup>39</sup> Furthermore, when the partnership exercises the options by paying the \$500,000 exercise price, neither the executive nor the partnership realizes any income upon such exercise.<sup>40</sup> This leaves the partnership owning stock valued at \$6 million in which the partnership has a \$6 million basis. Thus, when the partnership sells the stock for its fair market value, the partnership realizes no gain on the sale.<sup>41</sup>

If the strategy is successful, the executive will not realize any income upon the sale of the options to the partnership until the balloon payment is received in Year 30. At that point, the executive will realize \$5.5 million of ordinary income.<sup>42</sup> By comparison, had the executive maintained ownership of the options and exercised them in his individual capacity, this \$5.5 million of ordinary income would have been realized immediately upon such exercise.

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\$5,500,000 and because the fair market value of the options is \$5,500,000, there is no value assigned to the option privilege. This zero value for the option privilege is not entirely unrealistic because, given the large spread, the risk that the stock would drop below the exercise price during the remaining option period may be quite low, especially if the option is to expire shortly.

36. In the example, the partnership has \$550,000 cash on hand to exercise the options. If the entity did not have sufficient cash on hand to pay the option exercise price, it could make a so-called cashless exercise by borrowing money to fund the purchase and then repaying the loan with a portion of the sales proceeds upon the sale of the underlying stock.

37. See *Sale of Executive Options Technique*, *supra* note 26, at 310.

38. See Arthur Andersen Opinion Letter, *supra* note 16, at 340.

39. See *id.*

40. See *id.*

41. See Hamill & Lusby, *supra* note 33, at 498; *Selling Stock Options*, *supra* note 9, at 101.

42. Of course, the executive will have to report the annual interest payments as they are received.

## B. BACKGROUND REGARDING THE TAXATION OF COMPENSATORY STOCK OPTIONS

Before analyzing the specific tax issues raised by the ECS structure, it is helpful first to discuss more generally the nature of compensatory stock options and how they are taxed. A stock option grants the recipient the right, but not the obligation, to purchase a share of stock at a specified price (the exercise price) during a specified period of time (the option period).<sup>43</sup> Upon grant, options can be "in the money," meaning that the fair market value of the underlying stock exceeds the specified exercise price.<sup>44</sup> Even an option that is not currently in the money can be quite valuable because the option holder can participate in any future appreciation of the underlying stock above the exercise price without putting any capital at risk.<sup>45</sup> This opportunity to participate in appreciation without risk is known as the option privilege.<sup>46</sup> This option privilege makes the valuation of options especially difficult,<sup>47</sup> and it is this valuation difficulty that is the rationale for the special tax treatment of compensatory stock options.<sup>48</sup>

The taxation of nonqualified compensatory options is governed by § 83 of the Code.<sup>49</sup> This provision, enacted as part of the Tax Reform Act of 1969,<sup>50</sup> is a broad statute that governs the timing of the taxation of property received in connection with the performance of services. Long before the enactment of

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43. See STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 547 (5th ed. 1999). Technically, the term "option" can refer to options to buy (i.e., call options) or options to sell (i.e., put options). *Id.* at 547, 549. Because this Article deals only with compensatory options, which are always call options, all references to "options" refer to call options only.

44. See *id.* at 547.

45. See Treas. Reg. § 1.83-7(b)(3) (1978).

46. *Id.*

47. The valuation of the option privilege depends on five factors: (1) the length of the option period; (2) the volatility of the underlying stock; (3) the current fair market value of the underlying stock; (4) the exercise price; and (5) prevailing interest rates. ROSS ET AL., *supra* note 43, at 555-57.

48. See Treas. Reg. § 1.83-7(b)(3) (1978).

49. Compensatory options are given drastically different tax treatment under the Code, depending on whether the options constitute either incentive stock options on the one hand, or nonincentive stock options ("nonqualified stock options") on the other hand. See I.R.C. §§ 421-422 (2000). Because the ECS shelter was designed to be implemented with respect to nonqualified stock options, it is assumed for purposes of this Article that all options are nonqualified.

50. Tax Reform Act of 1969, Pub. L. No. 91-172, § 321, 83 Stat. 487, 588-92 (codified as amended at I.R.C. § 83 (2000)).

§ 83, it was clear that, when property is transferred from a service recipient to a service provider, (a) the service provider is taxed on the fair market value of the property, and (b) the service recipient is allowed a deduction, assuming that the payment for services otherwise qualifies for a deduction under the Code.<sup>51</sup> Section 83 was added to clarify precisely the timing of these tax consequences.

Specifically, the provisions of § 83 become important when the transferred property is unvested, meaning that there exists a substantial risk that the service provider may forfeit the transferred property for some reason.<sup>52</sup> In such a case, § 83 provides that the tax consequences arising from the compensatory transfers are realized not when the property is initially transferred, but rather when the property *vests* in the service provider; that is, when the risk of forfeiture lapses.<sup>53</sup> In other words, when unvested property is transferred, § 83 holds the tax consequences of the transfer in abeyance until the property vests, at which time the compensatory transfer is given tax effect.<sup>54</sup>

For example, assume that X Corp. transfers 1000 shares of its stock with a then-existing fair market value of \$10,000 to the executive in Year 1, subject to forfeiture if the executive's employment terminates before January 1, Year 3. The transfer is disregarded entirely for tax purposes until the beginning of Year 3, at which point the transferred stock vests in the executive.<sup>55</sup> At that point, the executive will have ordinary compensation income equal to the then fair market value of the stock.<sup>56</sup>

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51. See 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 60.4.1 (3d ed. 2001) (stating that the general rule of § 83(a) codified propositions that were "as self-evident as any ideas in the law of taxation"). In addition, upon a compensatory transfer of property, the service recipient transferor realizes a gain or loss as if the transferred property were sold for its fair market value. See *United States v. Gen. Shoe Corp.*, 282 F.2d 9, 12 (6th Cir. 1960); *Int'l Freighting Corp. v. Comm'r*, 135 F.2d 310, 313 (2d Cir. 1943); *Riley v. Comm'r*, 37 T.C. 932, 937 (1962), *aff'd*, 328 F.2d 428 (5th Cir. 1964). Where a corporation makes a compensatory transfer of its own stock (or of options to purchase its own stock), any such gain or loss is not recognized. I.R.C. § 1032(a) (2000).

52. See I.R.C. § 83(a) (2000).

53. See *id.* § 83(a), (h).

54. See *id.*; see also Treas. Reg. § 1.83-4(a) (1978).

55. See I.R.C. § 83(a).

56. See *id.*

In addition, X Corp. will take a deduction in the same amount at that time.<sup>57</sup>

Under the general principles of § 83, the receipt of compensatory stock options theoretically should be taxable to the recipient at grant or, if the options are unvested, at the time they vest. The amount of compensation income would equal the fair market value of the options, which, as discussed above, can be difficult to ascertain. Because of this difficulty, Congress specifically mandated that, as a general rule, § 83 would apply to compensatory stock options only upon exercise of the options and not upon their grant to the taxpayer.<sup>58</sup> In other words, just as § 83 effectively ignores the transfer and receipt of unvested property until the property vests, that section also disregards the receipt and transfer of compensatory stock options, taxing the options only upon exercise.<sup>59</sup>

For example, if X Corp. grants the executive an option to purchase 2000 shares of its stock (then having an aggregate value of \$20,000) for an exercise price of \$20,000, § 83 does not apply to the option grant.<sup>60</sup> For § 83 purposes, the option grant is disregarded entirely—it is simply treated as a “tax nothing.”<sup>61</sup> Only upon exercise of the option does § 83 apply to the transaction.<sup>62</sup> If the executive later exercises the options when the underlying stock is worth \$100,000, the executive would report \$80,000 of ordinary compensation income, the difference between the \$100,000 stock (property received in connection with services) he received and the \$20,000 he paid for the stock.<sup>63</sup>

Now suppose the option is not exercised by the service provider but rather is sold or otherwise disposed of in an arm’s-length transaction. Consistent with the theme of treating com-

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57. *See id.* § 83(h).

58. *See id.* § 83(e)(3).

59. *See id.* § 83(a).

60. *See id.* § 83(e)(3).

61. *See* Treas. Reg. § 1.83-7(a) (1978). When we say that the option is treated as a “tax nothing,” we mean that the receipt of the option has no significance from a tax perspective (i.e., it is disregarded); instead, the latter receipt of property with respect to the option—whether pursuant to an exercise of the option or a sale of the option—is the significant tax event. This latter receipt of property would trigger compensation income to the extent of the fair market value of the property at the time it was received, reduced by any amounts paid to acquire the property.

62. *See id.*

63. *Id.*

pensatory stock options as "tax nothings," § 83 applies to the consideration received in the sale, just as if that consideration was received directly by the service provider in exchange for services.<sup>64</sup> This receipt of consideration, taxable as ordinary income, would close the application of § 83 with respect to the option.<sup>65</sup> The purchaser of the option would take a fair market value basis in the option<sup>66</sup> and, as is the rule with respect to purchased (i.e., noncompensatory) options,<sup>67</sup> would realize a gain or loss only upon the sale or other disposition of the underlying stock after exercise of the option.

However, the rules are quite different if the option is disposed of in a transaction that is not at arm's-length, such as a gift or a part-sale/part-gift transaction. Gratuitous transfers do not close the application of § 83 with respect to the service provider.<sup>68</sup> Thus, not only will the service provider realize compensation income to the extent of the consideration received on the initial disposition of the options (as in a part-sale/part-gift transaction), the service provider will also realize additional compensation income when the transferee exercises the options.<sup>69</sup> This additional compensation income will be equal to the fair market value of the stock when the option is exercised, reduced by the exercise price paid by the transferee and by any amounts the service provider has previously included in gross income on account of the options.<sup>70</sup>

### C. TAX ISSUES RAISED BY THE ECS SHELTER

Recall the example above where the executive transfers his options worth \$5,500,000 with an aggregate exercise price of \$500,000 to a family limited partnership (previously capitalized with \$550,000 cash) in exchange for a \$5,500,000 balloon promissory note.<sup>71</sup> To achieve the ECS shelter's primary goal of deferring the executive's ordinary income that would normally oc-

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64. *See id.*

65. *Id.*

66. I.R.C. § 1012 (2000).

67. *See* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 214 (5th ed. 2004).

68. Treas. Reg. § 1.83-7(a) (1978).

69. *Id.*

70. *See* Priv. Ltr. Rul. 2000-05-006 (Nov. 1, 1999). "Amounts the service provider has previously included in gross income on account of the options" would include the amount realized by the transferor in the initial part-sale/part-gift transaction. Priv. Ltr. Rul. 94-21-013 (Feb. 23, 1994) at 29.

71. *See supra* text accompanying notes 35-37.

cur upon exercise of the option, two conditions must be satisfied. First, the transfer must be considered "arm's-length" under the § 83 regulations.<sup>72</sup> Second, the receipt of the partnership's promissory note must not be immediately taxable to the executive.<sup>73</sup>

### 1. The Arm's-Length Requirement

Under the § 83 regulations, if the transfer of the options to the partnership is not the product of an arm's-length transaction, § 83 still applies to cause the executive to realize ordinary compensation income upon the exercise of the option by the partnership, just as if the executive had held onto the options and exercised them himself.<sup>74</sup> As a result, unless the transfer is deemed to be arm's-length, the ECS shelter would fail to achieve the desired deferral of income that would otherwise be realized upon exercise of the option.

The § 83 regulations do not define what constitutes an "arm's-length transaction."<sup>75</sup> On one hand, the transfer of the options pursuant to the ECS shelter could be considered at arm's-length so long as the transferor received adequate and full consideration for the options (the "fair market value definition").<sup>76</sup> Under this view, the critical issue would be whether the value of the partnership's note equaled the value of the transferred options.<sup>77</sup> On the other hand, the definition of arm's-length could be more restrictive in that it requires that the parties to the transaction be unrelated, i.e., at arm's-length, even if fair market value is exchanged (the "unrelated party definition").<sup>78</sup> Under this view, the ECS shelter would fail be-

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72. See *Selling Stock Options*, *supra* note 9, at 93-96.

73. *Id.* at 97-101.

74. If, in addition to the lack of "arm's-lengthness," the partnership note is immediately taxable to the executive, the ECS strategy would actually leave the executive in a worse position than if he had held onto the option, because the receipt of the note would accelerate ordinary income without any beneficial character shift.

75. Treas. Reg. § 1.83-7 (1978).

76. Arthur Andersen Opinion Letter, *supra* note 16, at 328-31; see *Selling Stock Options*, *supra* note 9, at 93-95.

77. See Arthur Andersen Opinion Letter, *supra* note 16, at 334-35; see also *Selling Stock Options*, *supra* note 9, at 94.

78. See *Selling Stock Options*, *supra* note 9, at 95-96; cf. Arthur Andersen Opinion Letter, *supra* note 16, at 329-31 (suggesting an arm's-length transaction may exist where the transferor received fair market value for the transferred property).

cause, regardless of the value of the note, the option transfer involved two parties that are clearly related.<sup>79</sup>

As one would expect, the promoters of the shelter argue that related parties can enter into arm's-length transactions so long as the consideration that changes hands between the parties is adequate.<sup>80</sup> A number of recent appellate decisions concerning transfers to family limited partnerships in the estate tax context strongly support this view.<sup>81</sup> However, it is beyond the scope of this Article, which focuses on the second condition of the ECS shelter's success, to fully explore how the arm's-

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79. See Arthur Andersen Opinion Letter, *supra* note 16, at 334–35; *Selling Stock Options*, *supra* note 9, at 95–96. In a coordinated issue paper addressing the ECS shelter, the IRS does not maintain categorically that an arm's-length transaction can take place only between unrelated parties. Rather, the IRS adopts an independent third-party investor test, taking into account the entirety of the transaction: "If an independent third party would not have participated in the transaction in the manner in which the related parties participated, the parties did not act at arm's-length." IRS Coordinated Issue Paper, *supra* note 10, at 12.

80. See Arthur Andersen Opinion Letter, *supra* note 16, at 334–35; *Selling Stock Options*, *supra* note 9, at 95–96. The IRS rejects this contention, arguing that payment of fair market value for the options in and of itself does not render the transaction one entered into at arm's-length. IRS Coordinated Issue Paper, *supra* note 10, at 13. Rather, the IRS contends that the arm's-length characterization entails "something broader, incorporating examination of the entirety of the transaction and not just whether fair market value was paid." *Id.* at 14.

81. In *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), the Fifth Circuit addressed the question of whether a transfer of property to a family limited partnership in exchange for a beneficial interest in the partnership (heavily discounted for valuation purposes) constituted a "bona fide sale for an adequate and full consideration for money or money's worth" sufficient to avoid the application of § 2036. *Id.* at 261. The district court opinion had suggested that the "bona fide sale" aspect of the exception required a transaction between unrelated parties. See *Kimbell v. United States*, 244 F. Supp. 2d 700, 704 (N.D. Tex. 2003), *vacated by* 371 F.3d 257 (5th Cir. 2004). The Fifth Circuit soundly rejected this interpretation, stating that "just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide." *Kimbell*, 371 F.3d at 263 (citations omitted). If an individual can enter into a bona fide sale with a family-owned partnership, then, by analogy, one would assume that the parties could enter into an arm's-length transaction. On that note, in addressing the same issue arising under § 2036 in *Estate of Thompson v. Commissioner*, 382 F.3d 367 (3d Cir. 2004), the Third Circuit commented that an arm's-length transaction provided good evidence of a bona fide sale, "especially with intrafamily transactions." *Id.* at 381. The *Kimbell* and *Thompson* decisions therefore support the notion that a transaction between an individual and a partnership formed by the individual and his family members can be described as an arm's-length transaction, provided the consideration is adequate.



length issue should be resolved in this context. Nevertheless, we note that even under the less restrictive fair market value definition, the ECS shelter is extremely vulnerable on the arm's-length issue because the interest rate on the partnership's note is likely insufficient to compensate the executive for the partnership's risk of default.<sup>82</sup>

## 2. The Taxation of the Receipt of the Partnership's Note

The second condition for the ECS shelter's success is that the receipt of the partnership's note must not be immediately taxable to the executive.<sup>83</sup> This condition depends on whether the note constitutes "property" for § 83 purposes. Although at first glance it might appear that § 83 does not apply to the partnership's note because it is issued in exchange for the options rather than "in connection with the performance of services,"<sup>84</sup> this provision does in fact apply. Treasury Regulation § 1.83-7(a) provides that, when an option is transferred in an arm's-length transaction (as proponents of the ECS shelter assert), § 83 applies to the consideration received in the transfer, just as if the consideration had been paid directly by the service recipient.<sup>85</sup> In other words, this regulation treats the option sale consideration as having been transferred in connection

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82. See Sheppard, *supra* note 3, at 873 (stating that "it is difficult to argue that the note issued by [the family limited partnership] has any value at all" and that "[n]o rational person would make a 30-year bet on interest rates with a purchaser whose ability to pay was contingent on the resale of the property"). On the other hand, in *Kimbell*, the Fifth Circuit signaled that it might not be particularly vigilant in examining the adequacy of consideration that transferred hands between an individual and a family limited partnership. 371 F.3d at 257-67. In that case, the court held that an individual's transfer of property to a family limited partnership in exchange for partnership interests valued by the individual's estate at roughly 50% of value of the contributed property constituted "a bona fide sale for an adequate and full consideration in money or money's worth" that was excepted from the application of § 2036 in the estate tax context. *Id.* at 267. In describing the consideration necessary to satisfy the "adequate and full consideration" aspect of the exception, the Fifth Circuit stated that the executive need only receive property having a value "roughly equivalent" to the value of the transferred property. *Id.* at 262. Given the Fifth Circuit's liberal interpretation of what constitutes "roughly equivalent," perhaps courts would not intensely scrutinize whether the partnership note bore sufficient interest in determining whether the option sale constituted an arm's-length transaction.

83. See Arthur Andersen Opinion Letter, *supra* note 16, at 336-42; *Selling Stock Options*, *supra* note 9, at 97-101.

84. I.R.C. § 83(a) (2000).

85. Treas. Reg. § 1.83-7(a) (1978).

with the performance of services, which is entirely consistent with the regulation's treatment of options as "tax nothings."<sup>86</sup>

Because § 83 applies to the partnership's note, the characterization of the note as either "property" or "not property" for § 83 purposes is critically important. If it is property, then the note will be immediately taxable to the executive to the extent of its fair market value (i.e., \$5.5 million) and the shelter will fail.<sup>87</sup> If it is not property, then the executive will realize income only if, when, and to the extent that principal payments are made on the thirty-year balloon note.<sup>88</sup>

The § 83 regulations define the term "property" extremely broadly to include "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."<sup>89</sup> The exclusion of an unfunded and unsecured promise to pay from the definition of property means that the receipt of such a promise carries no current tax consequences under § 83; rather, the tax consequences are deferred until cash or property is received pursuant to the promise.

The critical question, therefore, is whether the partnership's promissory note constitutes an unfunded and unsecured promise to pay within the meaning of the § 83 regulations. Taking a literal view of the regulations, proponents of the ECS shelter argue that the partnership's note fits within the exclusion to the definition of property, emphasizing that the partnership note is not secured or funded in any way.<sup>90</sup> Under this view, the fact that the obligor on the note (i.e., the partnership) is not a party to the service transaction that gave rise to the stock options is completely irrelevant.<sup>91</sup> We argue otherwise, concluding instead in Part III below that the identity of the obligor is a critical factor in determining whether a promise to pay constitutes property for purposes of § 83. In our view, a compensatory promise to pay received from a party that is not the recipient of the taxpayer's services always constitutes property for § 83 purposes.<sup>92</sup>

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86. See *supra* text accompanying notes 60–62.

87. See I.R.C. § 83(a); see also Arthur Andersen Opinion Letter, *supra* note 16, at 340; *Selling Stock Options*, *supra* note 9, at 97.

88. See *supra* note 87.

89. Treas. Reg. § 1.83-3(e) (as amended in 1985).

90. See Arthur Andersen Opinion Letter, *supra* note 16, at 340; *Selling Stock Options*, *supra* note 9, at 97–98.

91. See *supra* note 90 and accompanying text.

92. As previously discussed in text accompanying notes 64–67 *supra*,

## D. THE GOVERNMENT'S RESPONSE

After its widespread reporting in the national newspapers, the IRS identified the ECS shelter as a "listed transaction" through the issuance of Notice 2003-47 (the Notice).<sup>93</sup> The Notice also asserted the IRS's view that the ECS shelter was ineffective because (a) the ECS transactions "rarely, if ever, reflect terms that would be agreed to between unrelated parties dealing at arm's-length," and (b) the note was immediately taxable upon receipt by the executive.<sup>94</sup> Concurrently with the issuance of the Notice, the Treasury promulgated Temporary Regulation § 1.83-7(T), which provides that a sale of compensatory options between related persons (as defined in the temporary regulation<sup>95</sup>) will never close the application of § 83, regardless of the terms of the sale.<sup>96</sup> The impact of the temporary regulation, which is effective for transactions that occur after July 1, 2003, is that a related-party sale will never be treated as an arm's-length transaction.<sup>97</sup> The temporary regulations were made final on August 10, 2004, and they now appear as part of Treasury Regulation § 1.83-7(a).<sup>98</sup>

There are three important aspects of the government's response. First, the regulation destroys the utility of the ECS shelter for transactions occurring after the effective date. Because a related-party sale will never close the application of

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though formally the partnership's promise might not be viewed as a compensatory promise because it was given in exchange for options rather than services, the § 83 regulations appropriately treat the promise as a compensatory promise. For further discussion of this point, see *infra* note 241.

93. I.R.S. Notice 2003-47, 2003-30 I.R.B. 132. A listed transaction subjects the promoter and investors to a host of disclosure requirements. See I.R.C. § 6111 (2000) (requiring a tax shelter organizer to register the shelter with the IRS); *id.* § 6112 (requiring shelter promoters to maintain lists of investors); Treas. Reg. § 1.6011-4 (as amended in 2003) (requiring investor to file a statement disclosing participation in shelter).

94. I.R.S. Notice 2003-47, 2003-30 I.R.B. 132.

95. See Temp. Treas. Reg. § 1.83-7(T)(a)(1) (2003) (incorporating the related-party rules of §§ 267(b) and 707(b)(1) but reducing the threshold percentage to 20%). The definition of a person related to the service provider within the meaning of the temporary regulation is quite broad. For example, a partnership in which the taxpayer and the taxpayer's spouse own a combined 20% capital interest is considered a party that is related to the taxpayer for purposes of the temporary regulation. See *id.*

96. T.D. 9067, 2003-32 I.R.B. 287 (adding Temp. Treas. Reg. § 1.83-7(T)(1) (2003)).

97. Temp. Treas. Reg. § 1.83-7(T)(a),(a)(1) (2003); see also *Selling Stock Options Revisited*, *supra* note 9, at 102-03.

98. T.D. 9148, 2004-37 I.R.B. 460.

§ 83, the executive will be unable to defer taxation of the options past the point at which they are exercised by the partnership.

Second, the Notice and the new regulation suggest that the government's view of the definition of arm's-length is the fair market value definition, not the unrelated party definition,<sup>99</sup> which is consistent with the view held by the ECS promoters.<sup>100</sup> Therefore, the government's response actually appears to help the ECS shelters implemented before the temporary regulation's effective date, at least on the arm's-length issue. Accordingly, for pre-July 1, 2003 transactions, it would appear that the only issue remaining to be litigated on the question of "arm's-lengthness" is simply whether the value of the partnership's note is equal to the value of the options.<sup>101</sup>

Third, while the Notice clearly asserts the government's view that the note is immediately taxable upon receipt by the executive, it provides no authority or reasoning to support this conclusion.<sup>102</sup> One can surmise that the rationale is based on the third-party promise issue discussed in this Article,<sup>103</sup> but the Notice itself simply provides no guidance on this issue.

## II. COMMON LAW TAXATION OF PROMISES TO PAY

As previously noted, the critical issue in determining whether a compensatory deferred payment obligation is currently taxable to the service provider is whether the payment

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99. For instance, Notice 2003-47 indicates that the application of § 83 (for transactions occurring before the effective date of the temporary regulation) closes only after a transfer that "reflect[s] terms that would be agreed to between unrelated parties dealing at arm's-length." I.R.S. Notice 2003-47, 2003-30 I.R.B. 132 (emphasis added). In addition, the effect of the temporary regulation is to treat all related-party transactions as non-arm's length, which would be superfluous if the unrelated party definition applied to the old regulation. Temp. Treas. Reg. § 1.83-7(T)(a)(1) (2003).

100. See *supra* text accompanying notes 75–82.

101. Lurie, *supra* note 2, at 598.

102. See I.R.S. Notice 2003-47, 2003-30 I.R.B. 132.

103. See ENRON INVESTIGATION REPORT, *supra* note 3, at 662 (concluding that "whether this obligation is unfunded and unsecured could be challenged based on the practical meaning and application of the 'unsecured and unfunded' language of the section 83 regulation in the context of a third-party note as opposed to an obligation of an employer"). Although it did not elaborate on its reasoning in Notice 2003-47, the IRS in an internal memorandum recently concluded that the partnership note under the ECS transaction constitutes property for purposes of § 83. See IRS Coordinated Issue Paper, *supra* note 10, at 16–18.

obligation constitutes property for purposes of § 83. While the regulations under § 83 define property broadly as all real and personal property other than an “unfunded and unsecured promise to pay money or property in the future,”<sup>104</sup> the regulations provide no guidance as to the precise meaning of the terms “unfunded” and “unsecured.” Nonetheless, it is widely recognized that the exclusion under § 83 for an unfunded and unsecured promise to pay was intended to preserve the well-developed body of case law and administrative rulings governing the tax treatment of deferred payment obligations under the cash method of accounting that preceded the enactment of the statute.<sup>105</sup> As a result, the term “property” in § 83 should be construed in such a manner so as to preserve this existing body of law. The state of the law before § 83 therefore is critical to understanding the scope of the limited exclusion from the statute’s definition of property.

#### A. GENERAL CASH METHOD PRINCIPLES

Under the cash receipts and disbursements method of accounting, a taxpayer realizes income upon the receipt of cash, property, or services.<sup>106</sup> The definition of property for this purpose has been construed extremely broadly to include all tangible and intangible property, regardless of whether the property is illiquid or does not have a readily ascertainable fair market value.<sup>107</sup> The one caveat to this broad conception of property

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104. Treas. Reg. § 1.83-3(e) (as amended in 1985).

105. See WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 5.02(1), at 5–6 n.20 (3d ed. 1997).

It seems clear that unfunded and unsecured rights to future payment were excluded from the § 83 definition of “property” to prevent § 83 from swallowing the cash method of accounting and thereby subjecting traditional nonqualified deferred compensation arrangements to immediate taxation. As broadly applicable as it is, § 83 was not intended to supplant the substantial body of law governing deferred compensation arrangements.

*Id.* (citations omitted); see also BITTKER & LOKKEN, *supra* note 51, ¶ 60.4.2, at 60-41 (“The exclusion of unfunded and unsecured promises preserves the long-standing principle that these commitments are not taxed when made to employees and contractors using the cash method of accounting.”).

106. Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1997).

107. 4 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 105.3.2, at 105-48 (2d ed. 1992) (“[A] taxpayer receiving an automobile or share of stock as compensation for services must include its fair market value in income for the year of receipt, not some later time when the automobile may be converted into cash by a sale.”).

concerns a taxpayer's receipt of vested<sup>108</sup> contractual rights to future payments. Common examples of these rights would include trade account receivables and rights to wages for past-performed services. Though it is abundantly clear that such payment rights constitute property under state law, that fact does not conclusively determine that such rights constitute property for purposes of federal taxation.

The essential issue thus is whether deferred payment obligations are treated as property under the cash method. If so, then the receipt of an obligation to pay would trigger immediate taxation.<sup>109</sup> If not, then only the receipt of a cash payment pursuant to the obligation would trigger taxation.

The answer to this critical tax accounting issue has been well-established in cases where the deferred payment obligation received by the service provider is one on which the service recipient is the obligor—i.e., where the service provider has received a second-party promise. In these cases, the receipt of the promise does not trigger immediate tax consequences. As succinctly stated by the Board of Tax Appeals in the 1928 case of *Zittel v. Commissioner*,<sup>110</sup> “[t]axpayers on a [cash] receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more.”<sup>111</sup>

The clear purpose of this exception to the broad conception of property is simply to keep the cash method separate from the accrual method.<sup>112</sup> If a second-party promise constituted property (and thus was immediately taxable) for cash method purposes, then the creation of a standard trade account receivable or a vested right to a payment of wages would give rise to cur-

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108. By “vested,” we mean that the right to payment is earned; in other words, the right to payment is not contingent on the requirement that the taxpayer perform any additional services or any other contingencies.

109. If the receipt of the promise were immediately taxable, the receipt of cash pursuant to the promise would be treated as a recovery of after-tax dollars (except to the extent of the interest portion).

110. 12 B.T.A. 675 (1928).

111. *Id.* at 677; see also *Edwards v. Keith*, 231 F. 110, 113 (2d Cir. 1916) (“[N]o instructions of the Treasury Department can enlarge the scope of this statute so as to impose the income tax upon unpaid charges for services rendered . . .”); *United States v. Christine Oil & Gas Co.*, 269 F. 458, 459–60 (W.D. La. 1920) (“[W]here the effect of the transaction is a mere promise to pay, and not an actual payment, it cannot be said to be income, until it has been actually received, and is not subject to be taxed as such until its actual receipt.”).

112. See BITTKER & LOKKEN, *supra* note 51, ¶ 60.2.1, at 60-3 to 60-17.

rent taxation, which is contrary to the core principles of cash method accounting. Indeed, such a rule would functionally eliminate the fundamental distinction between the cash and accrual methods of accounting, thereby placing every taxpayer on the accrual method.

The notion that, by immediately taxing second-party promises, the cash method would merge into the accrual method is a critical one for the argument in this Article. In any service arrangement, a payment obligation automatically arises once the contract services have been performed—at that time, no further action by the parties is required to create the service provider's legal right to payment. As the right to income accrues upon the creation of the payment obligation, the transaction generates tax consequences under the accrual method of accounting.<sup>113</sup> However, under cash method principles, accounting for these transactions awaits the payment of cash pursuant to the payment obligation. To keep these methods separate, ordinary second-party promises cannot constitute property for cash method purposes.

#### B. CASH EQUIVALENCY DOCTRINE

Although receipt of a second-party promise to pay generally does not trigger immediate taxation under the cash method, two important exceptions exist. The first exception involves cases where the courts have determined that a second-party promise is the functional equivalent of cash and therefore immediately taxable upon receipt. The leading case that has applied this “cash equivalency” doctrine is the Fifth Circuit's decision in *Cowden v. Commissioner*.<sup>114</sup>

In *Cowden*, the taxpayer executed a mineral lease in favor of an oil company in 1951. Through supplemental agreements executed along with the lease, the oil company agreed to make

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113. Under the accrual method of accounting, income is generally included “for the taxable year when all events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.” Treas. Reg. § 1.446-1(c)(1)(ii)(A) (as amended in 1997). On the deduction side, an obligation to pay automatically arises when services have been performed for the benefit of the taxpayer. If such an obligation to pay were treated as “property” for cash method purposes, the deduction would be allowed when the services were performed—the same time as under the accrual method, which generally allows deductions when all events have occurred that fix the obligation to pay and the amount of the obligation can be determined with reasonable accuracy. *See id.*

114. 289 F.2d 20 (5th Cir. 1961).

certain "bonus" payments to the taxpayer in the approximate aggregate amount of \$500,000, \$250,000 due in 1952 and the remaining \$250,000 due in 1953.<sup>115</sup> The oil company's deferred payment obligations were unconditional; they did not depend on any rate of production or even on the oil company's continued ownership of the leasehold interest.<sup>116</sup> Later in 1951, the taxpayer assigned the 1952 bonus payment to a bank (of which the taxpayer was a director) for a discount that implied interest at the prevailing market rate.<sup>117</sup> Similarly, in 1952, the taxpayer assigned the bonus payments due in 1953 to the bank at a similar discount.<sup>118</sup>

The Tax Commissioner determined that the fair market value of the bonus payments was properly included in the taxpayer's gross income for 1951, the year in which the obligations were received.<sup>119</sup> The Fifth Circuit agreed with this approach. The court rejected the taxpayer's argument that only a negotiable instrument could be taxed as a cash equivalent, reasoning as follows:

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in the like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.<sup>120</sup>

Thus, under the cash equivalency doctrine, the receipt of a second-party promise to pay that can be readily liquidated can give rise to current taxation under the cash method.<sup>121</sup>

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115. *Id.* at 21.

116. *Id.* at 22.

117. *Id.*

118. *Id.* The taxpayer's apparent goal in structuring the transaction in this manner was not only to defer taxation of the bonus payments, but also to attempt to convert ordinary income into long-term capital gain. *See id.*

119. *Id.* Because the payment obligations were not interest bearing, the Tax Commissioner applied a 4% discount in determining the present value obligation to be included in gross income upon receipt. *Id.*

120. *Id.* at 24 (footnotes omitted).

121. Although the *Cowden* decision arose in the context of a lease of property, its reasoning is equally applicable to the receipt of a promise to pay for services rendered.



*Cowden* may appear to suggest that the fundamental justification for the cash method's ordinary nontaxation of second-party promises relates to the general illiquidity of such promises. However, the precepts of the cash method of accounting cannot be explained in terms of liquidity.<sup>122</sup> The receipt of property that cannot be readily liquidated (e.g., stock in a closely held corporation, undeveloped real property) nonetheless gives rise to current taxation under the cash method. The lack of a market on which property can be readily disposed does not bear on the timing of inclusion; rather, to the extent facts relating to the liquidity of the property have any relevance at all, they bear on the measure of inclusion.<sup>123</sup>

The cash equivalency doctrine is best understood as a very narrow exception to the general rule that a second-party promise is not taxable upon receipt under the cash method. By immediately taxing promises to pay that can be readily liquidated to cash, the doctrine is consistent with the principle that the receipt of cash is always taxable. Because of the rarity of compensatory promises that could be readily liquidated, such treatment does not impinge unduly on the traditional scope of the cash method.

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122. Rather, the deferred taxation of second-party promises to pay under the cash method is best understood as a concession to simplicity. By ordinarily delaying taxation until actual cash receipt on these very common promises, the cash method avoids the complexities associated with: (a) determining precisely when a right to payment accrues; (b) valuing the right to payment; and (c) reconciling the cash amount actually received (if any) with the amount previously included in income. While it is true that the realization event under the cash method often coincides with a liquidity event, this is properly considered an incidental benefit of the cash method—not the driving force behind the cash method—because it is clear that the receipt of illiquid property *does* trigger immediate taxation. See *infra* note 125. Another incidental benefit to the cash method is that the typical individual taxpayer might not conceive that he has realized income until the taxpayer receives actual cash payment pursuant to a compensatory promise to pay. Cf. Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 CONN. L. REV. 75 (2003) (discussing behavioral economics research suggesting that people whose property appreciates do not view themselves as wealthier until the property is liquidated into cash). The cash method therefore comports with and, perhaps, reinforces this unsophisticated view.

123. Fair market value is generally defined as “the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Treas. Reg. § 20.2031-1(b) (as amended in 1965). Issues of liquidity frequently factor into the determination of fair market value under this standard.

### C. ECONOMIC BENEFIT DOCTRINE

The second exception to the rule that the receipt of second-party promises does not give rise to immediate taxation involves the so-called "economic benefit" doctrine.<sup>124</sup> Consistent with the notion that liquidity concerns do not underscore the cash method of accounting, courts have developed this doctrine to tax individuals on vested benefits that they could not currently reduce to cash or otherwise currently consume. While the economic benefit doctrine is best known for its application to "funded" second-party promises to pay, the doctrine has its origins in cases involving third-party promises. The origin and development of the economic benefit doctrine are discussed below.

#### 1. Third-Party Promises To Pay

While the precise origin of the economic benefit doctrine is debatable,<sup>125</sup> the doctrine first appeared to take shape in the 1942 Tax Court case of *Brodie v. Commissioner*.<sup>126</sup> The *Brodie* case concerned a bonus program implemented by Procter & Gamble for the benefit of its executives.<sup>127</sup> Bonuses in the early years were paid in cash.<sup>128</sup> However, in the taxable year at issue, the bonuses took the form of a single-premium annuity purchased by the employer and delivered to the employee.<sup>129</sup> Payments on each annuity were to start when the employee-annuitant attained age seventy.<sup>130</sup> The employees could not

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124. For detailed discussions of the economic benefit doctrine, see Gordon T. Butler, *Economic Benefit: Formulating a Workable Theory of Income Recognition*, 27 SETON HALL L. REV. 70 (1996); John F. Cooper, *The Economic Benefit Doctrine: How an Unconditional Right to a Future Benefit Can Cause a Current Tax Detriment*, 71 MARQ. L. REV. 217 (1988).

125. Many commentators consider the Supreme Court decision in *Commissioner v. Smith*, 324 U.S. 177 (1945), to be the source of the economic benefit doctrine. See Cooper, *supra* note 124, at 221; Patricia Ann Metzger, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525, 550 (1974). In this case, the Supreme Court reasoned that the general statutory rule of inclusion "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." *Smith*, 324 U.S. at 181 (citing *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929)).

126. 1 T.C. 275 (1942).

127. *Id.* at 276-77.

128. *Id.* at 277.

129. *Id.*

130. *Id.* at 278.

surrender the annuity for cash, nor could they assign their rights in the annuity or any payment due thereunder.<sup>131</sup>

The employees who received the paid-up annuities took the position that the receipt of the annuity did not trigger immediate taxation, arguing instead that they should be taxed only when cash payments were received pursuant to the annuity.<sup>132</sup> To support their argument, the employees stressed that they did not have free use of the funds expended to acquire the annuity and further that the annuity contracts could not be assigned or surrendered.<sup>133</sup> In short, the employees argued that the purchase and delivery of the annuity contracts conferred no presently taxable benefit on them.<sup>134</sup> The Tax Court disagreed:

[W]hile we do not think that the doctrine of constructive receipt as it is commonly understood can be correctly applied in these proceedings, it is undoubtedly true that the amount which the Commissioner has included in each petitioner's income was used for his benefit, albeit not at his own direction, in the purchase of an annuity contract, and the contract so purchased was issued in the name of the annuitant and was delivered to him and was part of the plan for his additional remuneration.<sup>135</sup>

After noting the absence of any restrictions or conditions on the annuity relating to taxpayer's continued employment with the company, the court determined that the annuity premium was properly included in each employee's gross income for the year in which the annuity was delivered to the employee.<sup>136</sup>

Shortly after the *Brodie* decision, the same issue was addressed by the Second Circuit Court of Appeals in *United States v. Drescher*.<sup>137</sup> The taxpayer in *Drescher* was an executive of Bausch & Lomb Optical Company, which had implemented a plan to provide for the voluntary retirement of its principal offi-

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131. *Id.* The employer went to some length to find an insurance company who would write a contract containing these restrictions, without which the employer would not have purchased the annuity. *Id.* at 279. Because of the restriction on assignment, the receipt of the annuity would not trigger the cash equivalency doctrine.

132. The doctrine of constructive receipt was not implicated in the case because the taxpayer had no discretion over the manner in which the bonus was to be paid. Specifically, the taxpayer could not elect to receive cash in lieu of the paid-up annuity policy. *Id.*

133. *Id.* at 282.

134. *Id.* at 276.

135. *Id.* at 281-82.

136. *Id.* at 284.

137. 179 F.2d 863 (2d Cir. 1950).

cers.<sup>138</sup> Pursuant to this plan and in each of the taxable years at issue, the company purchased a \$5,000 single-premium, non-forfeitable annuity contract naming the taxpayer as the annuitant.<sup>139</sup> Although the company maintained physical possession of the annuity contract, the taxpayer was irrevocably designated as the annuitant and the taxpayer possessed the exclusive rights over the designation of the beneficiary to receive payments upon his death.<sup>140</sup> The terms of the annuity provided that the taxpayer could not assign the annuity contract or any payment due thereunder.<sup>141</sup> Furthermore, the annuity carried no cash surrender or loan value.<sup>142</sup>

The company deducted the \$5,000 cost of the annuity in the year of purchase, whereas the taxpayer claimed that he did not realize any income on account of the annuity until cash payments were received pursuant to the contract.<sup>143</sup> In relatively short order, the Second Circuit concluded that the employer's purchase of the annuity generated current tax consequences to the taxpayer: "It cannot be doubted that . . . the plaintiff received as compensation for prior services something of economic benefit which he had not previously had, namely, the obligation of the insurance company to pay money in the future to him or his designated beneficiaries . . ." <sup>144</sup> The balance of the opinion was devoted to determining the proper measure of inclusion, wherein the court rejected the taxpayer's claim that the inability to assign the annuity rendered it valueless.<sup>145</sup>

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138. *Id.* at 863-64.

139. *Id.* at 864.

140. *Id.*

141. *Id.*

142. *See id.* (providing details of the annuity contract at issue). However, the starting date of the annuity payments could be accelerated at the election of the annuitant, provided the election was endorsed on the policy by the insurance company. *Id.* Because the company maintained physical possession of the annuities, the taxpayer in this case could not unilaterally elect to accelerate the annuity start date. *Id.* at 866.

143. *Id.* at 864-65.

144. *Id.* at 865. The *Drescher* court's use of the phrase "economic benefit" in this context is potentially misleading. It is clear that all promises to pay made by a solvent obligor, whether issued by a second party or third party, confer an economic or financial benefit upon their holder. However, solely to keep the cash and accrual methods separate, courts engage in the fiction that second-party promises do not provide any economic or financial benefit to their holders.

145. *See id.* However, the court did recognize that the taxpayer could have established a taxable value of the annuity lower than the premium paid by the employer, because the employer's retention of physical possession of the policy

Though not explicit in their analyses, the *Brodie* and *Drescher* courts established a critical distinction between a second-party promise to pay (that is, one made by the service recipient) and a promise to pay received from a third party to the service transaction (for example, one made by an insurance company).<sup>146</sup> In the former context, the receipt of the contractual obligation does not give rise to current taxation except in the rare case that the promise is sufficiently liquid to be characterized as a cash equivalent. However, if the service recipient furnishes the service provider with a third-party promise, that promise—regardless of its liquidity or lack thereof—is always regarded as “property” for purposes of the cash method.<sup>147</sup> Accordingly, these authorities establish that the receipt of a compensatory promise to pay issued by a third party is currently taxable to the service provider to the extent of the fair market value of the promise.

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prevented the taxpayer from exercising the option under the contract to accelerate the annuity starting date. *See id.* at 865–66.

146. As one commentator put it, “This rule dates from the dawn of federal tax law,” WHITE, *supra* note 23, at A-64 n.764, pointing to the 1920 case of *United States v. Christine Oil & Gas Co.*, 269 F. 458 (W.D. La. 1920). Although *Christine Oil* involved a deferred payment obligation issued in exchange for the sale of property, the district court analogized the issue to payment obligations issued in exchange for services in the following manner:

What is . . . said of unpaid services applies with equal force to unpaid purchase money. If a seller accepts the notes of third persons in absolute payment, the rule would be different. But where the effect of the transaction is a mere promise to pay, and not actual payment, it cannot be said to be income, until it has been actually received, and is not subject to be taxed as such until its actual receipt.

*Id.* at 459–60 (emphasis added).

One may argue that the decisions in *Brodie* and *Drescher*, which each addressed annuity contracts issued by insurance companies, do not provide much in the way of guidance on the broader issue of how third-party promises to pay should be taxed on the cash method due to the virtual certainty that the payments called for under the annuity contracts would be made. Yet, an annuity contract of the sort at issue in *Brodie* and *Drescher* represents nothing more than the insurance company’s promise to pay the annuitant a periodic sum in the future, a promise that is neither funded by a particular pool of assets nor secured by property. Thus, an annuity contract can be appropriately described as an unfunded and unsecured promise to pay money in the future. *See Childs v. Comm’r*, 103 T.C. 634, 651–53 (1994) (holding that annuity contracts naming the taxpayer as beneficiary were unfunded and unsecured promises to pay). Rather than bearing on the timing of inclusion, the low-risk nature of the annuity is relevant in determining the measure of inclusion.

147. *See Cooper, supra* note 124, at 237 (noting that the doctrine of cash equivalency has no application where a promise of a third party is transferred).

## 2. Funded Second-Party Promises To Pay

While the economic benefit doctrine operated in *Brodie* and *Drescher* to tax the employee upon the receipt of third-party promises to pay that were purchased by the employer, the doctrine is not limited to this context alone. The Tax Court in *McEwen v. Commissioner*<sup>148</sup> illustrated that the doctrine also applied to second-party promises that the service recipient had irrevocably funded.

The employer in *McEwen* promised to pay one of its executives a specified percentage of the employer's profits.<sup>149</sup> Pursuant to this compensation arrangement, the employer annually funded its promise to pay by depositing the requisite profit-sharing amount in a trust created for the employee's benefit.<sup>150</sup> The funding of the trust by the employer was irrevocable—the trust agreement provided that no part of the trust estate could, under any circumstances, revert to or in any way inure to the benefit of the employer.<sup>151</sup> Accordingly, the corpus was not subject to the claims of the employer's creditors.<sup>152</sup> In addition, the trust agreement contained spendthrift provisions that precluded the employee from assigning his beneficial interest in the trust, whether voluntarily or involuntarily.<sup>153</sup>

Relying on the Supreme Court's decision in *Commissioner v. Smith*,<sup>154</sup> the Tax Court determined that tax consequences of the transaction turned on the following question: "[W]as 'any economic or financial benefit conferred upon the employee as

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148. 6 T.C. 1018 (1946).

149. *See id.* at 1019.

150. *See id.* at 1021–23. The trust agreement provided that the trustee would use the trust asset to purchase government bonds or to purchase single-premium annuity contracts, payments on which would commence when the executive attained age sixty. *See id.* at 1021.

151. *See id.* at 1023.

152. *See id.*

153. *See id.*

154. 324 U.S. 177 (1945). In *Smith*, the Supreme Court addressed the tax consequences of an employee's exercise of compensatory stock option prior to the enactment of § 83. The Court held that even though parties stipulated that the option had no value when it was issued to the taxpayer, the taxpayer realized compensation income when the option was exercised to the extent the fair market value of the stock received exceeded the exercise price. *See id.* at 180–82. In reaching its conclusion, the Court reasoned that the general statutory rule of inclusion "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." *Id.* at 181 (citing *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929)).

compensation' in the taxable year?"<sup>155</sup> The Tax Court resolved this question in the affirmative by holding that the employee was properly taxed on the amounts paid into the trust at the time of such funding.<sup>156</sup> In doing so, the Tax Court placed considerable emphasis on the fact that the trust estate could not revert back to the employer.<sup>157</sup> Accordingly, the *McEwen* case established that the economic benefit doctrine applied when the service recipient created a separate fund to provide for the future benefit of the taxpayer, so long as the transfer of money or property into the fund was irrevocable—meaning that the fund assets could never be paid to or for the benefit of the transferor.<sup>158</sup>

The Tax Court's opinion in *McEwen* laid the foundation for its decision in *Sproull v. Commissioner*,<sup>159</sup> the case most commonly associated with the economic benefit doctrine. In *Sproull*, the employer deposited \$10,500 in a trust for the benefit of its employee near the end of 1945.<sup>160</sup> The trust terms provided that half of the initial trust principal would be distributed to the employee in 1946, with the balance of the trust estate being distributed in 1947.<sup>161</sup> In *Sproull* the Tax Court considered whether the employee was required to include the \$10,500 in gross income in the taxable year in which the employer funded the trust, or whether the employee could defer taxation until cash payments were received from the trust.<sup>162</sup>

In resolving the issue of whether taxation could be deferred, the Tax Court again started with the question of whether any economic benefit had been conferred upon the employee in the year the trust was created.<sup>163</sup> The court noted that the trust principal was fixed and irrevocably paid out for the employee's benefit in that year and that the employee did not

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155. *McEwen*, 6 T.C. at 1026 (quoting *Smith*, 324 U.S. at 181).

156. *See id.*

157. *See id.*

158. *See Cooper*, *supra* note 124, at 232–33 (enumerating the requirements of the economic benefit doctrine).

159. 16 T.C. 244 (1951).

160. *See id.* at 245.

161. *See id.* Although the employee in the case served as president of the corporate employer, the trust arrangement was neither initiated by the employee nor taken pursuant to his direction. Thus, the employee could not be viewed as having constructively received the amount used to fund the trust in 1945. *See id.* at 246.

162. *See id.* at 245.

163. *See id.* at 247.

have to perform any further obligations to establish or maintain his rights under the trust.<sup>164</sup> Under these facts, the court concluded that in 1945 the employee possessed a "vested valuable interest in the trust fund" that warranted current taxation.<sup>165</sup>

Following *McEwen*, *Sproull*, and other similar cases, the IRS laid out its approach to the taxation of compensatory promises to pay under the cash method by addressing a variety of deferred payment scenarios in Revenue Ruling 60-31.<sup>166</sup> In examples 1 and 2 of the ruling where the deferred payment obligation consisted only of a contractual obligation on the part of the employer to pay compensation to the employee in the future, the IRS concluded that the receipt of the promise did not constitute a current taxable event.<sup>167</sup> Rather, the IRS acknowledged that "[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the meaning of the cash receipts and disbursements method."<sup>168</sup> In this manner, the IRS simply reiterated the rule

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164. *See id.*

165. *Id.* at 248. Despite its close association with the economic benefit doctrine, the *Sproull* decision is not the strongest authority for the doctrine. Unlike the trust at issue in *McEwen*, the trust agreement in *Sproull* contained no restriction on the employee's ability to assign his beneficial interest therein. Given that the trust principal was being held by a corporate trust company, the result in *Sproull* could just as easily have been justified in terms of the cash equivalency doctrine. *See* Butler, *supra* note 124, at 87 n.90 (noting that some commentators view *Sproull* as a cash equivalence case).

166. 1960-1 C.B. 174. This ruling has been characterized as the "fountainhead of learning on the subject of nonqualified deferred compensation." BITTKER & LOKKEN, *supra* note 51, ¶ 60.2.1, at 60-3.

167. Rev. Rul. 60-31, 1960-1 C.B. 174, 178-79 (holdings in examples 1 and 2).

168. *Id.* at 177 (citations omitted). The IRS's articulation of the rule exempting second-party payment obligations from current taxation introduced some new concepts. First, the ruling made a distinction between promises that are not evidenced by promissory notes and those that are. While the bright-line rule of treating any promise to pay that is memorialized in a promissory note as currently taxable comports with Treas. Reg. § 1.61-2(d)(4) (1957), which provides that "[n]otes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer," the bright-line rule is not consistent with the cash equivalency doctrine as articulated by the Fifth Circuit in *Cowden*. *See* *Cowden v. Comm'r*, 289 F.2d 20, 24 (5th Cir. 1961) (stating that a promissory note, negotiable in form, is not necessarily a cash equivalent that warrants current taxation). Treas. Reg. § 1.61-2(d)(4) can be reconciled with the *Cowden* decision only if the scope of the regulation is limited to promissory notes that constitute cash equivalents under the *Cowden* test. *See* A. THOMAS BRISENDINE ET AL., DEFERRED COMPENSATION ARRANGEMENTS, at A-37 (BNA



that the receipt of a mere second-party promise did not result in immediate taxation.<sup>169</sup>

However, consistent with the economic benefit doctrine, the IRS ruled that a funded second-party promise was immediately taxable. In example 4 of the ruling, the employer paid a signing bonus of \$150x to an escrow agent pursuant to an agreement that called for the agent to distribute such amount in installments over five years.<sup>170</sup> If the taxpayer died prior to the five-year term, the remaining payments were to be made to his estate.<sup>171</sup> Citing *Sproull*, the IRS concluded that the \$150x bonus constituted income to the taxpayer in the year in which the employer unconditionally placed such amount in escrow.<sup>172</sup>

### 3. Reconciling the Economic Benefit Cases

Upon close reflection, it is apparent that the two strands of economic benefit doctrine cases—purchased third-party promises versus funded second-party promises—do not differ in any meaningful respect. In *Brodie* and *Drescher*, the service recipient compensated its service provider by purchasing an annuity

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Tax Mgmt. Portfolio No. 385-4th, 2002) (suggesting this interpretation).

The statement in Rev. Rul. 60-31 also introduced the notion that the receipt of a promise to pay that was “secured in any way” was not entitled to deferral. The precise origin of this requirement is unclear, as it was not expressly mentioned in the economic-benefit cases that the ruling cites. However, the identical phrase appeared in *United States v. Christine Oil & Gas Co.*, 269 F. 458 (W.D. La. 1920), where the court held that the deferred payment obligations therein, described as “not represented by notes or secured in any way,” were not taxable upon receipt. *Id.* at 458. Although the authority for, and meaning of, the requirement that the obligation not be secured in any way is not clear, the requirement is consistent with the holdings of *McEwen* and *Sproull*, wherein the taxpayers had elevated their status above that of a general unsecured creditor of the service recipient.

169. A similar rule concerning second-party promises to pay was later articulated by the Tax Court in *Centre v. Commissioner*, 55 T.C. 16, 19–20 (1970):

The naked promise of an employer to pay compensation at some future date for services currently rendered is not income to a cash basis employee. This is true even where the employer currently procures insurance on the life of the employee to fund future compensation payments. Where the insurance remains an asset of the employer to which all creditors have rights and the employee acquires no immediate rights thereto, he realizes no income from the payment of premiums on the insurance.

*Id.*

170. Rev. Rul. 60-31, 1960-1 C.B. 174, 176–77.

171. *Id.* at 177.

172. *Id.* at 180.

that irrevocably obligated a third-party insurance company to make payments to the employee. In *McEwen* and *Sproull*, the service recipient funded its obligation to pay the service provider by transferring assets to a trust or escrow account. Thus, in both lines of cases, the service provider's right to future payments emanates from a third party such that the right was not subject to the service recipient's bankruptcy or insolvency risk.<sup>173</sup> The only distinction between the two lines of cases relates to the extent to which the third party is a passive investment vehicle that can be viewed as an agent or extension of the service recipient, as opposed to an active business entity wholly unrelated to the service recipient. Yet regardless of how one labels or distinguishes between the various economic benefit cases, one critical fact is common to all: the service provider's right to payment is insulated from the risk of the service recipient's subsequent insolvency or bankruptcy.

The government itself may view these two strands of economic benefit cases as overlapping. In Revenue Ruling 69-50,<sup>174</sup> the IRS addressed the tax consequences of a physician's receipt of a deferred payment obligation from a health insurer in consideration for services performed for the benefit of an insured patient. These promises were not funded in any manner through the use of a trust or escrow arrangement. Nevertheless, the IRS ruled that the physician was immediately taxable on the fair market value of this promise, focusing on the fact that the physician's right to payment from the insurer "emanate[d] from the medical services that he has rendered to [the patient]."<sup>175</sup>

This conclusion would appear to be supported simply by the principle set forth in *Brodie* and *Drescher* that third-party promises are property per se for purposes of the cash method. However, in reaching its conclusion, the IRS used language suggesting that it believed that the insurer's promises constituted funded promises, asserting: "In effect, [the patients] have funded their obligations to the participating physician with the corporation, and, in so doing, they have conferred an economic or financial benefit on the participating physician."<sup>176</sup> Fur-

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173. In other words, the promise to pay is made by someone other than the service recipient. Therefore, if the service recipient thereafter became insolvent, it would have no impact on the likelihood of payment.

174. 1969-1 C.B. 140.

175. *Id.*

176. *Id.* (emphasis added).

thermore, the ruling cited to *McEwen* and *Sproull*, the famous funded promise cases, in addition to the classic third-party promise cases of *Brodie* and *Drescher*.<sup>177</sup>

Revenue Ruling 69-50 thus suggests that the government may consider any compensatory promise that provides the service provider with a right to payment that would not be affected by the bankruptcy or insolvency of the service recipient to be a "funded" promise, regardless of whether the payments will emanate from a separate business entity as opposed to a trust or escrow account. Courts, on the other hand, appear to be of the view that promises made by third-party business entities are per se property as opposed to funded promises. The issue, however, is purely semantic. Regardless of the labels employed, a service provider's contractual right to payment that is not subject to the credit risk of the service recipient is considered property under the cash method and, as such, is taxable upon receipt.<sup>178</sup>

### III. TAXING THE PROMISE TO PAY UNDER SECTION 83

#### A. DEFINITION OF PROPERTY UNDER SECTION 83

The previous part illustrated that, under the economic benefit doctrine, third-party promises or funded second-party promises constitute property for purposes of the cash method and therefore are immediately taxable when received. The question then arises whether the enactment of § 83 in 1969 has any impact on this conclusion. This section by its terms explicitly deals with compensatory transfers of "property."<sup>179</sup> Does the statute's conception of property simply incorporate existing law regarding the definition of property for cash method purposes or was its enactment intended somehow to change this view?

Because § 83 does not define the term property, it can be inferred that Congress intended that the existing definition of property, as clarified through years of case law and government

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177. *Id.*

178. In other words, under either view, a compensatory promise to pay that would be unaffected by the service provider's bankruptcy or insolvency (either because the obligor is a different party altogether or because the service provider has "funded" its obligation through the use of an escrow or trust vehicle) constitutes property under the cash method and, therefore, is taxable upon receipt.

179. I.R.C. § 83 (2000).

rulings, applied. There is no indication whatsoever in the statute or its legislative history that, by enacting § 83 to deal with unvested property, Congress intended to overturn or upset long-standing court decisions such as *Brodie*, *Drescher*, *McEwen*, and *Sproull*, or the highly influential Revenue Ruling 60-31. To the contrary, the statute is best understood as codifying this existing law, because the statute itself builds upon this conception of property.<sup>180</sup>

Consistent with the notion that § 83 codified the well-established case law and government rulings defining property for cash method purposes, the regulations promulgated by the Treasury in 1978 defined the term as follows:

For purposes of § 83 and the regulations thereunder, the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor . . . .<sup>181</sup>

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180. See *supra* note 105. In particular, § 83 was viewed as codifying the common law economic benefit doctrine. See Tech. Adv. Mem. 93-36-001 (May 12, 1993) ("Section 83 of the Code is generally believed to be a codification of the economic benefit doctrine as it applies to transfers of property as remuneration for services."); Constance M. Hiatt, *Nonqualified Deferred Compensation Plans*, SJ013 ALI-ABA 457, 468 (2003) (describing § 83 as "the Code's reflection of the economic benefit doctrine"); Metzger, *supra* note 125, at 552 ("Section 83 both codifies and expands the common law notions of economic benefit as they relate to property transferred in connection with the performance of services."). Furthermore, Congress enacted legislation in 1978 specifically providing that the taxation of private deferred compensation arrangements was to be determined "in accordance with principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978." Revenue Act of 1978, Pub. L. No. 95-600, § 132(a), 92 Stat. 2763, 2782. In that regard, the final regulations under § 83 were not published until July 24, 1978. See T.D. 7554, 43 Fed. Reg. 31,911 (July 24, 1978).

181. Reg. § 1.83-3(e) (1978). When the regulations interpreting § 83 were first issued in proposed form earlier in 1971, property was defined broadly to include "both reality and personality other than money and other than an unfunded and unsecured promise to pay deferred compensation." Prop. Treas. Reg. § 1.83-3(e), 36 Fed. Reg. 10,791 (June 3, 1971). While the definition of property contained in the final regulation was altered to avoid reliance on the sometimes vague notion of deferred compensation, the reference to deferred compensation in the first proposed regulation evidenced the Treasury's view that the exception to property for purposes of § 83 was limited to deferred payment obligations issued by the service recipient.

After the final regulation was promulgated, questions were raised regarding whether an unsecured and unfunded promise to pay something other than money in the future gave rise to current taxation under § 83. See William L. Sollee, *Final Section 83 Regs Will Have Major Impact on Compensatory Prop-*

The themes of the common law conception of property are apparent in this definition. The first sentence of the definition provides an extremely broad definition of property, appearing to carve out only mere promises to pay that would not be captured by the economic benefit doctrine. The second sentence seems redundant in that the beneficial interest to which it refers would appear to constitute a funded promise. Nevertheless, the sentence shows the Treasury's intent to incorporate economic benefit notions—pursuant to which the service provider, to achieve deferral, would be required to remain a general unsecured creditor of the service recipient—in the definition.

This regulatory definition of property, however, is not perfectly drafted. Its terms, interpreted literally, leave the door ajar for an argument that an unfunded and unsecured promise of a third party does not constitute property under § 83. If so, the receipt of such a promise by a cash method taxpayer would not be immediately taxable; rather the taxpayer would pay tax only as cash was received pursuant to the promise. This argument is analyzed below.

#### B. TAXATION OF THIRD-PARTY PROMISES UNDER SECTION 83

Having explored the origin and development of the economic benefit doctrine, the codification of such doctrine in § 83, and the regulatory definition of “property” for purposes of that statute, we can now address the proper tax treatment of compensatory third-party promises under current law. Although the exclusion from the definition of property under Treasury Regulation § 1.83-3(e) for an “unfunded and unsecured promise to pay money or property in the future” can be read literally to cover any and all such promises to pay, whether issued by the service recipient or some external third party, the conclusion that the exclusion is limited to promises issued by the service recipient is virtually inescapable.<sup>182</sup>

Consistent with the notion that § 83 was not intended to upset the traditional conception of property that had been extensively developed by courts and government rulings, the en-

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*erty Payments*, 49 J. TAX'N 258, 258–59 (1978). Any such doubt was removed by a clarifying amendment to Treas. Reg. § 1.83-3(e) in 1985 that expanded the exclusion to an unfunded and unsecured promise to pay “money or property” in the future. See T.D. 8042, 1985-2 C.B. 30–31 (amending Treas. Reg. § 1.83-3(e)).

182. See *infra* Part IV.B. That being said, this fundamental distinction has in fact escaped a number of courts.

tire purpose behind the unfunded and unsecured promise exclusion is to preserve the tax treatment of contractual deferred payment obligations that existed prior to the enactment of § 83.<sup>183</sup> This pre-existing law clearly provided that, while mere promises of the service recipient to pay were not immediately taxable in the hands of a cash-method taxpayer (i.e., they were not considered “property”), third-party promises always were.<sup>184</sup> Thus, while the Treasury could have drafted a more precise regulation by expressly limiting the exclusion to mere promises of the service recipient, it is certainly understandable that the Treasury would have thought such an express limitation unnecessary. Based on years of case law and government rulings, the limitation simply went without saying.<sup>185</sup>

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183. See *infra* notes 184–86 and accompanying text.

184. See *supra* Part II.C.1.

185. See Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487, 515–16 (2002) (recognizing implicitly that the unfunded and unsecured promise to pay must emanate from the service recipient to be excluded from the § 83 definition of property).

If the exclusion for an unfunded and unsecured promise to pay under Reg. § 1.83-3(e) could properly be interpreted as including a promise from a party external to the service relationship, then Congress, aided by the Treasury, would have unwittingly opened the floodgates on deferred compensation arrangements beyond their already permissive bounds. A literal reading of Regulation § 1.83-3(e) to encompass a third-party promise would allow deferral where an employer compensates an employee by purchasing an annuity from an insurance company and transferring it to an employee. Yet there is nothing to indicate any intent on the part of Congress, in enacting § 83, to expand the bounds of deferred compensation by legislatively overruling *Brodie*, *Drescher*, and their extensive progeny. To the contrary, Congress at the time viewed the realm of deferred compensation as having already gotten out of hand. In its report accompanying the Tax Reform Act of 1969, the House commented as follows:

It is anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation. An employee who receives additional compensation in the form of a promise to pay him that compensation in the future made by a large, financially sound corporation, is probably as likely to receive the compensation as an employee whose deferred compensation is placed in trust. Your committee believes that the possibility of shifting income to taxable years after retirement when the marginal tax bracket is expected to be lower should not be available to employees who are in a position to bargain for deferred compensation arrangements and to rely on the unsecured obligation of their employers, when such benefits are not available to other employees.

H.R. REP. NO. 91-413 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1738. If Congress was troubled by the deferred taxation of a second-party promise to

A revenue ruling issued by the IRS contemporaneously with the promulgation of the § 83 regulations (seven years after § 83 was enacted) confirms this view. In the ruling,<sup>186</sup> the IRS addressed virtually the same factual scenario it had previously analyzed in Revenue Ruling 69-50,<sup>187</sup> namely whether a physician who renders services to a patient is currently taxed upon the receipt of a promise to pay issued by the patient's insurer. The only additional fact in Revenue Ruling 77-420 was that the physician's right to future payment from the corporation was subject to a substantial risk of forfeiture.<sup>188</sup> In concluding that the inclusion of a substantial risk of forfeiture did not operate to defer taxation of the payment obligations from the corporation beyond their receipt, the ruling reasoned as follows:

The conclusion of Rev. Rul. 69-50 is based on the fact that the physician's income arises out of the physician's acquisition from the patient of a right to payment from the corporation. Because the agreement between the corporation and the physician is independent of the dealings between the patient and the physician, the inclusion of a substantial forfeiture provision in the agreement does not alter the relationship by which the patient-subscriber has conferred an economic or financial benefit on the physician.<sup>189</sup>

Revenue Ruling 77-420 thus supports the view that the second-party versus third-party distinction in determining the tax treatment of deferred payment obligations retained its fundamental importance after § 83 was enacted.

### C. POTENTIAL COUNTERARGUMENTS

In Part II we explained that prior to the enactment of § 83, courts drew a distinction between second-party promises to pay, which were not generally taxable upon receipt, and third-party promises to pay, which were. Thus far in Part III, we have argued that this disparate tax treatment was codified by the enactment of § 83 and its definition of property as articulated in Treasury Regulation § 1.83-3(e). This subpart addresses the possible counterarguments to this view.

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pay from a financially sound employer, then surely it had no intention of expanding the instances of deferral to promises to pay from third-party insurance companies.

186. Rev. Rul. 77-420, 1977-2 C.B. 172.

187. For a discussion of Revenue Ruling 69-50, see *supra* text accompanying notes 174-80.

188. Rev. Rul. 77-420, 1977-2 C.B. 172, 173.

189. *Id.*

### 1. Use of the Term "Transferor" in the Section 83 Regulations

In addition to relying on an overly literal reading of the unfunded and unsecured promise exclusion in the § 83 regulations,<sup>190</sup> some commentators have suggested that the sentence immediately following the unfunded and unsecured clause in Treasury Regulation § 1.83-3(e) supports the view that the identity of the obligor of a promise is irrelevant. This sentence provides: "The term [property] also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the *transferor*, for example, in a trust or escrow account."<sup>191</sup> According to these commentators, "the term 'transferor,' if taken literally, could refer not only to service recipients but also to third parties that are in no way related to either the service recipient or the executive."<sup>192</sup> This use of the term "transferor" rather than "service recipient," the argument goes, suggests that the regulation is wholly unconcerned with the identity of the party issuing the promising to pay.

This argument is unconvincing. When third-party promises are made in connection with services, it is always the service recipient who in substance transfers the promise, even if, as a strictly formal matter, the third-party promise is delivered directly to the service provider. Simply put, the third-party obligor has no relationship with the service provider, and is clearly issuing its promise to pay on behalf of, and at the direction of, the service recipient. The term *transferor* in the regulation thus will always refer to the service recipient.<sup>193</sup>

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190. For a rebuttal of the argument that Reg. § 1.83-3(e) should be interpreted in this literal manner, see *supra* text accompanying notes 182-89.

191. Treas. Reg. § 1.83-3(e) (as amended in 1985) (emphasis added).

192. *Selling Stock Options*, *supra* note 9, at 99.

193. *Cf.* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (holding that where employer discharges its employee's debt, it is treated as if payment was made directly to the employee, who then discharges his own debt). Further support for this proposition is found in other § 83 regulations. Treas. Reg. § 1.83-6(d)(1) provides that, if a shareholder of a corporation transfers property to the corporation's service provider in connection with the performance of services for the corporation, the transaction should be treated as a capital contribution of the property by the shareholder to the corporation followed by a compensatory transfer of the property to the service provider by the corporation. Therefore, even though the shareholder formally makes the compensatory transfer, the corporation/service recipient is properly treated as the transferor of the property to the service provider for tax purposes.

However, some might argue that the last sentence of Treas. Reg. § 1.83-1(a), which provides that § 83 applies to compensatory transfers even where



For instance, in the *Brodie* case, it appears that the annuity contracts purchased by the employer were issued directly to the employees.<sup>194</sup> Despite the fact that the annuities were technically transferred by the insurance company to the employees, the court concluded that the employer, through the purchase of the annuities, had provided the employees additional compensation. Accordingly, the employer was viewed as the transferor of the promise even though it was not the obligor under such promise. Any argument that the term “transferor” as used in Treasury Regulation § 1.83-3(e) supports the view that third-party promises do not constitute property is thus misguided.

## 2. Case Law Supporting Deferred Taxation of Third-Party Promises

In addition to relying on the literal text of the § 83 regulations, some commentators have pointed to the Tax Court case of *Childs v. Commissioner*<sup>195</sup> to support the notion that naked third-party promises do not trigger immediate taxation. The Ninth Circuit decision in *Minor v. United States*<sup>196</sup> might also support this view, though it has not previously been mentioned by commentators. Both cases are discussed below.

### a. *Childs v. Commissioner*

In *Childs*, the Tax Court concluded that a promise to pay from a party other than the service recipient did not constitute property for § 83 purposes.<sup>197</sup> However, due to the extremely complicated facts in the case, the Tax Court in *Childs* did not appear to recognize that the promise in question was from a third party.

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“the transferor is not the person for whom such services are performed,” suggests that the term “transferor” as used in the § 83 regulations refers to only the formal transferor (i.e., the person who actually transfers the property in question). This is an improper inference because Treas. Reg. § 1.83-1(a) deals only with the general application of § 83 and is not, unlike Treas. Reg. § 1.83-3(e), concerned with the definition of property for § 83 purposes. In addition, the last sentence in Treas. Reg. § 1.83-1(a) was simply intended to reinforce the clear principle that § 83 applies to all transfers of property made in connection with the provision of services, regardless of whether the service recipient or another party is the technical transferor of the property.

194. *Brodie v. Comm’r*, 1 T.C. 275, 281 (1942) (describing the annuity contract as having been “issued in the name of the annuitant and . . . delivered to him”).

195. 103 T.C. 634 (1994).

196. 772 F.2d 1472 (9th Cir. 1985).

197. 103 T.C. at 653.

The taxpayers in *Childs* were members of a law firm that had executed a contingent fee agreement with a client pursuant to which the law firm would provide legal services in connection with various tort claims.<sup>198</sup> The fee agreement provided that, upon settlement of the claims, the law firm would be entitled to a specified percentage of the recovery.<sup>199</sup> The client who retained the firm was a widow whose husband had been killed by an explosion caused by the accumulation of gas in their home, which also seriously injured the client's minor child. The client hired the law firm to prosecute her husband's wrongful death claim as well as her child's personal injury claim.<sup>200</sup>

The child's claim was settled first. Both the client, on behalf of the child, and the attorneys accepted a structured settlement providing that the child would receive his damage award, and the attorneys their fees, over time.<sup>201</sup> In implementing this settlement, the defendant's casualty insurance carrier (Insurance Company) promised to make specified periodic payments to the attorneys.<sup>202</sup> In exchange for a lump sum fee paid by the Insurance Company, another company, First Executive Corporation (First Executive), agreed to assume the liability for making these periodic payments; however the Insurance Company remained secondarily liable for the payments.<sup>203</sup> First Executive then purchased an annuity from a life insurance company, Executive Life Insurance Company (Executive Life), naming the attorneys as beneficiaries.<sup>204</sup> Nonetheless, First Executive remained the owner of the annuities and had the unrestricted power to change the beneficiaries.<sup>205</sup>

The wrongful death claim was settled shortly thereafter in a similar manner.<sup>206</sup> The attorneys again received a promise by Insurance Company to make specified periodic payments.<sup>207</sup> Insurance Company then purchased an annuity from Manufacturers Life Insurance Company (Manufacturers Life), naming the attorneys as beneficiaries, though Insurance Company re-

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198. *Id.* at 637-38.

199. *Id.* at 637.

200. *Id.*

201. *Id.* at 640-42.

202. *Id.*

203. *Id.* at 640-41.

204. *Id.* at 643.

205. *Id.* at 643-44.

206. *Id.* at 645.

207. *Id.* at 645-46.

mained the owner of the annuity with unrestricted power to change the beneficiaries.<sup>208</sup>

The main issue in *Childs* was whether the attorneys realized income immediately to the extent of the fair market value of the Insurance Company's promises that they received or, alternatively, whether the attorneys realized income only as they received actual cash payments.<sup>209</sup> Resolution of this issue, of course, turned on the question of whether these promises constituted property for purposes of § 83.<sup>210</sup>

Despite the complicated facts in *Childs*, the answer to this question should have been obvious. The attorneys performed services for their client, not for the Insurance Company or any of the other obligors to which they could look for payment. As a result, the attorneys received a third-party promise, which is always immediately taxable.<sup>211</sup>

Indeed, the facts of the *Childs* case are strikingly similar to those of *Brodie* and *Drescher* where the taxpayers therein, in exchange for services provided to their employers, received promises to pay from unrelated insurance companies.<sup>212</sup> Yet neither of these cases was mentioned by the Tax Court in *Childs*, and the importance of the identity of the party issuing the promise was completely missed. Instead, the Tax Court focused entirely, and erroneously, on whether the third-party promises themselves were funded or secured, concluding ultimately that they were neither.<sup>213</sup> As a result, the Tax Court

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208. *Id.*

209. *Id.* at 636.

210. *See id.* at 648–49.

211. *See* Butler, *supra* note 124, at 116–20 (explaining why this should have been the result in *Childs*).

212. *See id.* The identity of a third-party obligor is not relevant to the question of whether the promise is immediately taxable. While this would impact the valuation of the promise, it should not have any impact on the issue of whether the third-party promise is property in the first place. We mention the similarity of obligors only to make clear how preposterous it was for the *Childs* court to ignore completely these opinions.

213. *Childs*, 103 T.C. at 649–53. Even the Tax Court's "secured or funded" analysis was flawed. In each of the structured settlements, there was more than one obligor to whom the taxpayers could look for payment. In other words, even pretending that the Insurance Company was a party to the service transaction, the taxpayers still had the benefit of third-party promises. With regard to the structured settlement entered into on behalf of the child, the taxpayers could look to First Executive for payment in addition to Insurance Company. *Id.* at 640–41. Likewise, in the client's settlement, the taxpayers could look to Manufacturer's Life for payment in addition to Insurance Company. *Id.* at 646. As a result, Insurance Company's contractual obligations

held that the attorneys realized income only as cash payments were made.

The Tax Court's fundamental error was caused in part by the IRS, which failed to argue the third-party promise issue at all. Ironically, while the taxpayers in their initial brief actually raised the issue, arguing that the identity of the obligor was irrelevant,<sup>214</sup> the IRS in its response brief inexplicably ignored the issue.<sup>215</sup> This enabled the taxpayers to assert in their reply brief that the IRS apparently conceded that the identity of the obligor of a promise to pay is irrelevant for purposes of § 83.<sup>216</sup> This failure by the IRS is particularly perplexing because, shortly before the *Childs* case was heard, the IRS issued two private letter rulings on almost identical facts that concluded

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to pay, analyzed in their own right, should have been considered secured and therefore immediately taxable.

The Tax Court, however, was unmoved by the number of potential obligors. The court found the existence of the guarantee to be irrelevant, stating that "[I]t is well settled that a simple guarantee does not make a promise secured, because by definition a guarantee is itself a promise to pay." *Id.* at 652. This analysis may be appropriate where the guarantor is related to and possesses a unified economic interest with the promisor, and thus the identity of the true promisor is difficult to ascertain. *See Berry v. United States*, 593 F. Supp. 80 (M.D.N.C. 1984) (holding that a sole shareholder guaranty of corporate employer's promise to pay did not render such promise "secured" for purposes of § 83). However, the blanket conclusion that any guaranty of a promise to pay is irrelevant for purposes of § 83 is wholly inconsistent with the economic benefit doctrine, which is premised on the notion that the service provider must remain a general unsecured creditor of the service recipient for a service provider to defer income on a contractual right to payment.

214. Brief for Petitioners Richard A. Childs and Mimi P. Childs at 11–12, *Childs* (No. 15639-92); Brief for Petitioners Swearingen and Phillips at 37, *Childs* (No. 15639-92). The taxpayers' arguments here were based entirely on a literal interpretation of Treas. Reg. § 1.83-3(e). To support their view, they noted that § 83 applies to tax the receipt of property by a service provider regardless of the identity of the transferor and that, accordingly, "[i]t is nonsensical to assert that anyone can transfer Section 83 property, but the definition of property in that Section only applies if the service recipient is the transferor." Brief for Petitioners Richard A. Childs and Mimi P. Childs, *supra*, at 12. There are two responses to this argument. First, while it is certainly true that § 83 would apply regardless of the identity of the transferor (for example, if X transfers Microsoft stock to its employee as a bonus, § 83 clearly applies), that does not mean that, with respect to all issues that arise under § 83, the identity of the transferor is unimportant. Second, the transferor in the third-party promise cases is always, in substance while perhaps not in form, the service recipient. In *Childs*, the client is the one who transferred her rights to future payment to the attorneys.

215. Brief for Respondent, *Childs* (No. 15639-92).

216. Reply Brief for Petitioners Richard A. Childs and Mimi P. Childs at 6 n.1, *Childs* (No. 15639-92).

that the deferred payment obligations received by the attorneys were immediately taxable because they involved third-party promises.<sup>217</sup>

In summary, the decision in *Childs* does not provide compelling support for the proposition that a naked promise to pay issued by a party other than the service recipient is excluded from the definition of property for § 83 purposes. The third-party issue was not litigated by the parties—in part as a result of the IRS's error<sup>218</sup>—nor was it analyzed or even considered by the Tax Court.<sup>219</sup>

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217. Priv. Ltr. Rul. 93-36-001 (May 12, 1993); Priv. Ltr. Rul. 91-34-004 (May 7, 1991). Furthermore, in its brief to the Eleventh Circuit in the appeal of *Childs*, the government finally argued that because the obligors were distinct from the recipient of the taxpayer's services, the obligations to pay were immediately taxable. Brief for the Appellant, 1995 WL 17110345, at 24–29, *Childs v. Comm'r*, 89 F.3d 856 (11th Cir. 1996). The Eleventh Circuit affirmed the Tax Court in a decision without reported opinion. *Id.* Thus, the appellate court did not address this argument.

218. Given the almost contemporaneous private letter rulings on the same facts, it is clear that *Childs* should not be viewed as a deliberate concession on the issue either. See *supra* notes 214–17 and accompanying text.

219. McGowan and Brisendine point to another Tax Court case, *Mitchell v. Commissioner*, 65 T.C. 1099 (1976), as support for the view that a compensatory third-party promise is not immediately taxable. See *Selling Stock Options*, *supra* note 9, at 98–99. In that case, which McGowan and Brisendine note predates § 83 and its regulations governing the treatment of nonstatutory stock options, the taxpayer sold nonstatutory stock options to a third party in exchange for that party's promise to make annual payments of \$55,100 in each of the three years following the year of the sale. *Id.* at 98. The issue addressed by the Tax Court was whether the option sold by the taxpayer was properly taxable when the option was granted under old Treas. Reg. § 1.421-6. *Mitchell*, 65 T.C. at 1106. The court concluded that the option was not taxable upon grant. *Id.* at 1113. As a result, the court determined that the taxpayer realized ordinary income from the sale of the options. *Id.* at 1113–14. In addition, in the last sentence of the opinion, the court noted that “since no payments were received in [the year of the sale of the option], and [taxpayer] reported his income on the cash receipts and disbursements method of accounting, [the IRS] has conceded that [taxpayer] realized ordinary income only as payments were received, beginning in [the year following the sale].” *Id.* at 1114. Of course, this is wrong because the purchaser's promise was a third-party promise, which should have been taxable immediately, but the Tax Court never addressed the issue because of the IRS's mistaken concession. Furthermore, the IRS's concession should not be considered as evidence of the government's view that the identity of the obligor is irrelevant, given that the IRS ruled in two contemporaneous Revenue Rulings that third-party promises were immediately taxable. See Rev. Rul. 77-420, 1977-2 C.B. 172; Rev. Rul. 69-50, 1969-1 C.B. 140.

b. *Minor v. Commissioner*

The Ninth Circuit's decision in *Minor v. United States*<sup>220</sup> is another flawed case that could be cited in support of the notion that unfunded and unsecured third-party promises to pay are not property for purposes of § 83. *Minor* involved a physician who had entered into an agreement with Snohomish County Physicians Corporation (Snohomish). Pursuant to this agreement, the physician agreed to provide medical services to members of Snohomish's prepaid medical plan in exchange for specified fees to be paid by Snohomish.<sup>221</sup>

The physician and Snohomish later amended this agreement to provide for the possibility that some of the fees earned by the physician might be deferred.<sup>222</sup> Specifically, the amendment allowed the physician to decide whether to defer between 10% and 90% of the fees before they were earned.<sup>223</sup> If a deferral election were made, Snohomish promised to pay to the physician the deferred amounts, plus an investment return, upon specified future events.<sup>224</sup> In the years at issue, the physician elected to defer 90% of his fees.<sup>225</sup>

To implement this deferred compensation plan, Snohomish set up a trust, with the physician and two other doctors as trustees and with Snohomish as the beneficiary.<sup>226</sup> The fees that the physician elected to defer were deposited into the trust, where they were invested.<sup>227</sup>

The issue in *Minor* was whether, with respect to the deferred amounts, the physician was taxed immediately on the value of Snohomish's promise to pay or whether, instead, the physician would report income only as cash payments were made.<sup>228</sup> In concluding that the physician would report income only as cash payments were made by Snohomish, the Ninth Circuit focused on the fact that Snohomish was the beneficiary of the trust and, as a result, "the assets of the trust remain solely those of Snohomish . . . and subject to the claims of its

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220. 772 F.2d 1472 (9th Cir. 1985).

221. *Id.* at 1473.

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

general creditors.”<sup>229</sup> Consequently, the court concluded that Snohomish’s promise to pay the physician was unfunded and therefore not property for purposes of § 83.<sup>230</sup>

As in *Childs*, this conclusion was wrong. The court failed to appreciate that Snohomish’s promise was a third-party promise, given that the physician received the promise in connection with the medical services provided to the physician’s patient.<sup>231</sup> Once again, the analogy to *Brodie* and *Drescher* is particularly apt—in those cases, as in *Minor*, the defendants performed services for one party and received a promise to pay from another.<sup>232</sup> Yet, like the Tax Court in *Childs*, the Ninth Circuit never mentioned these cases.

Even more astounding than the court’s failure to apply the third-party promise rule is its treatment of a series of Revenue Rulings that are directly on point and that should have led the court to the proper conclusion. Recall that in Revenue Rulings 69-50 and 77-420, the IRS considered facts entirely identical to those in *Minor*.<sup>233</sup> In the rulings, the IRS ruled that the insurer’s promise was immediately taxable “based on the fact that the physician’s income arises out of the physician’s acquisition from the patient of a right to payment from the [medical plan].”<sup>234</sup> The IRS pointed to these rulings in support of its position that Snohomish’s promises were immediately taxable, but the Ninth Circuit rejected the relevance of the rulings:

Those rulings did involve fact patterns very similar to the instant case. However, those rulings concluded that the physician had effectively obtained the income because his right to immediate compensation emanated from the medical services rendered to patients, independent of his voluntary agreement with the [medical plan] to defer a percentage of payments otherwise due for those services. *The essence of those rulings was that the physician had constructively received the income before assigning it to the deferred compensation program.* As the government has conceded the issue of constructive receipt of income, those rulings are not on point.<sup>235</sup>

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229. *Id.* at 1475.

230. *Id.* at 1475–76.

231. *Id.* at 1473.

232. See *supra* text accompanying notes 126–47 (analyzing *Brodie* and *Drescher*).

233. 1969-1 C.B. 140; 1977-2 C.B. 172.

234. Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 77-420, 1977-2 C.B. 172, 173.

235. *Minor*, 772 F.2d at 1475 n.1 (emphasis added) (citing Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 77-420, 1977-2 C.B. 172, 173).

The court thus interpreted the rulings to be based on notions of constructive receipt and not economic benefit.

This interpretation of the rulings is patently wrong. These rulings focused exclusively on the third-party promise issue, and were based on the fact that the promisors were distinct from the service recipients.<sup>236</sup> The rulings cite *Brodie* and *Drescher*, among other economic benefit cases, but do not cite any constructive receipt cases.<sup>237</sup> Furthermore, both rulings explained that the election to defer a fee was made before the services that gave rise to the fee were performed, a structure that was explicitly exempted from constructive receipt attack in Revenue Ruling 60-31.<sup>238</sup>

If this is not enough, the last paragraph of Revenue Ruling 77-420 proves irrefutably that the third-party issue and not constructive receipt served as the foundation for its conclusion:

This conclusion [that the physicians are immediately taxed upon receipt of the insurer's promise] is not inconsistent with that of Rev. Rul. 69-474, 1969-2 C.B. 105, which holds that a partnership composed of physicians that, pursuant to an agreement, furnishes medical services to a nonprofit medical and hospital service corporation does not derive any gross income by reason of any interest in or right under the corporation's retirement plan provided for the physicians. In Rev. Rul. 69-474, *the corporation was contractually obligated to furnish medical services to its members, the partnership entered into an employment relationship directly with the corporation to provide the services, and the compensation received by the partnership from the corporation was not related to any particular services provided to any specific patients or based on any particular type of service or contractual relationship existing between the patients and the partnership.*<sup>239</sup>

This excerpt demonstrates that the basis for Revenue Ruling 77-420's conclusion was that the promise to pay in question was made by someone other than the recipient of the physician's

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236. Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 77-420, 1977-2 C.B. 172, 173.

237. In fact, the common tax term of art "constructive receipt" was not mentioned in either ruling. Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 77-420, 1977-2 C.B. 172.

238. 1960-1 C.B. 174, 179 (example 3). The IRS will issue advance rulings concerning the application of the constructive receipt doctrine to deferred compensation arrangements only if the service provider elected to defer compensation before the taxable year in which the services were rendered. See Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-2 C.B. 428. However, case law suggests that the doctrine of constructive receipt may apply even where the decision to defer is made later. See *Comm'r v. Oates*, 207 F.2d 711, 713 (7th Cir. 1953); *Veit v. Comm'r*, 8 T.C.M. (CCH) 919, 922 (1949).

239. 1977-2 C.B. 172, 173 (emphasis added).



services. In contrast, Revenue Ruling 69-474 allowed deferral because, under its facts, the promisor was the physician's employer.<sup>240</sup>

It is thus abundantly clear that the Ninth Circuit's attempt to distinguish the case from Revenue Rulings 69-50 and 77-420 was misguided. In fact, the rulings are indistinguishable. As a result of this mistake, the *Minor* court never realized the importance of the critical fact that a third-party promise was involved. Because, like the Tax Court in *Childs*, the Ninth Circuit in *Minor* never considered the third-party promise issue, the decision does not support the view that naked third-party promises are not property for § 83 purposes.

#### D. IMPLICATIONS FOR THE ECS TRANSACTION

The conclusion that a third-party promise to pay constitutes property for purposes of § 83 is by itself sufficient to negate the intended tax benefits of the ECS shelter. Recall that Treasury Regulation § 1.83-7(a) provides that § 83(a) applies to the money or property received by the taxpayer in an arm's-length sale of the stock options in the same manner as § 83(a) would apply to the transfer of property pursuant to the exercise of the option. In other words, the executive is taxed as if the employer had transferred to him the family partnership note in consideration for his services.<sup>241</sup> Accordingly, upon implementation of the ECS shelter, the executive is taxed immediately upon the fair market value of the promissory note which, as previously discussed,<sup>242</sup> the executive must concede equals the

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240. 1969-2 C.B. 105. Put differently, in Revenue Ruling 77-420, the obligor of the promise to pay received by the physician merely indemnified the patients for certain medical expenses that they incurred. 1977-2 C.B. 172. In Revenue Ruling 69-474, the obligor agreed to provide the medical services to the patient and employed the physicians to perform these services. 1969-2 C.B. 105.

241. One commentator has argued that the partnership's promise is a second-party promise received in a sale of the options, not a compensatory third-party promise. See John F. Prusiecki, *Equity Compensation Strategy FLP Note: The Debate Continues*, 98 TAX NOTES 1455 (2003). However, Treasury Regulation § 1.83-7(a) (last sentence) provides that, when the option is sold, § 83 applies to the consideration received in the sale. In other words, consistent with the idea that a nonqualified option constitutes a "tax nothing," the regulation treats the consideration received in a sale of such an option as compensation, not as the proceeds from a sale of property. See Gregg D. Polsky, *How Should an FLP's Note Be Treated? The Debate Continues*, 98 TAX NOTES 1771 (2003).

242. See *supra* text accompanying notes 74-82.

fair market value of the transferred options. Thus, rather than deferring the realization of income as intended, the shelter actually accelerates the realization event.<sup>243</sup>

#### IV. POLICY IMPLICATIONS—THE ECONOMICS OF DEFERRAL

Thus far we have explained that, as a purely doctrinal matter, third-party promises to pay are immediately taxable to service providers upon their receipt. This Part IV explains why the issue is important as a policy matter and why this doctrinal conclusion is supported by policy considerations.

##### A. TREATMENT OF SERVICE PROVIDER

For tax reasons, a service provider would generally prefer to defer tax on compensation income—with interest accruing on the compensation and with the tax on the interest income likewise deferred—rather than realizing the compensation income and interest income as they economically accrue.<sup>244</sup> To illustrate, assume that, in consideration for services performed on Day 1 of Year 1, an employee has the option of receiving \$10,000 immediately or \$11,000 at the beginning of Year 2. Assume further that the prevailing interest rate is 10%.

It should first be recognized that the deferred payment option constitutes the economic equivalent of (1) an immediate payment of the \$10,000 by the employer to the employee, followed by (2) a lending of the money back to the employer at the prevailing 10% interest rate.<sup>245</sup> Therefore, in a world without taxes, the employee's choice would depend entirely on whether to invest his compensation in his employer's debt instrument (by choosing the deferred payment) or in some other investment (by choosing the immediate payment).

In such a world without taxes, if the employee were indifferent about this investment choice, the employee would be equally indifferent about this deferral decision.<sup>246</sup> If the em-

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243. If the executive had maintained ownership of the stock options, he would not have been taxed until the options were exercised.

244. This assumes, of course, that the service provider does not wish to consume the compensation currently but rather wants to save the compensation and consume it later. We make this assumption throughout the ensuing discussion.

245. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 519 (1986).

246. The employee presumably would be indifferent if the risk of default by

ployee chooses to receive the \$10,000 today, he could invest the \$10,000, earning 10%, and would ultimately be left with \$11,000 at the beginning of Year 2, resulting in the same outcome as under the deferred payment option.<sup>247</sup>

If, however, the employee were subject to a 40% income tax and if that tax were imposed using a pure cash method (i.e., by taxing income only upon actual cash receipt),<sup>248</sup> the employee would prefer the deferred payment. If he elects the immediate payment, the employee will have only \$6,000 available after tax to invest and will be able to earn an after-tax interest rate of only 6%. As a result, the employee ends up with \$6,360 at the beginning of Year 2.<sup>249</sup>

Alternatively, if the employee chooses the deferred payment option, the employee would pay tax only when he receives the \$11,000 payment at the beginning of Year 2. As a result, at that time, the employee will have \$6,600 after tax (i.e., \$11,000 less \$4,400), or \$240 more than under the immediate payment scenario.

This disparity may seem strange at first glance because the employee in both scenarios is ultimately paying tax on all of the dollars that he receives. Importantly, however, the timing of tax is very different. In the immediate payment context, the employee is paying an immediate tax as his right to income economically accrues. As a result, the employee is able to invest only an after-tax amount of his compensation (i.e., \$6,000 instead of \$10,000). By contrast, under the deferred payment scenario, the employee effectively invests (by lending the \$10,000 to which he is entitled by virtue of his performance of services) the entire \$10,000. In essence, the deferral allows the

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the employer equals the risk of default on the alternative investment yielding 10%. However, given that insolvency by the employer would likely cost the employee his job, in the interest of diversification of risk, perhaps the employee would choose the alternative investment with all else being equal.

247. The taxpayer would be equally indifferent if he was subject to a consumption tax rather than an income tax. If he was subject to a consumption tax, an amount of income would be taxed only when he used it to purchase personal consumption. Thus, there would be no tax consequences under a consumption tax under either option until the taxpayer consumes.

248. By "pure cash method," we mean that the deferral option will not trigger constructive receipt. *Cf.* Rev. Rul. 60-31, 1960-1 C.B. 174, 178-79 (discussing the doctrine of constructive receipt and ruling that it generally will not be implicated if the choice to defer is made in the taxable year preceding the year in which the services will be performed).

249. The \$6,000 investment would earn \$600 of interest, however, the taxpayer would have to remit \$240 of the interest in taxes.

employee to have the benefit of investing for his own account what would otherwise be the government's money.

What if in the above example, instead of taxing the employee when he actually receives cash, he were taxed on a pure accrual method, so that he realized income when he becomes entitled to it (i.e., when he performs his services)? Under the immediate payment scenario, the conclusion is the same as above, because in that situation payment is made simultaneously with performance.

Under the deferred payment scenario, however, the right to receive \$11,000 in a year would trigger realization of the present value of that amount of \$10,000, requiring the employee to use \$4,000 of his own funds (that he otherwise could have invested in an instrument yielding the prevailing interest rate of 10%) to pay the immediate tax. Therefore, the effect of accrual taxation would be the same as under the immediate payment scenario, because the employee is unable to invest the government's money for his own account.

It is clear that the accrual method is the economically accurate method to tax the employee.<sup>250</sup> Therefore, the conceptually proper tax treatment of the two payment scenarios—which differ only in form and not in economic substance—would result in the employee ending up with \$6,360 at the beginning of Year 2. However, by allowing individuals to report their income on the cash receipts and disbursements method, Congress permits deferral and its concomitant tax benefits with very few limitations or restrictions. Moreover, individuals generally can very easily comply with the restrictions and limitations that do exist.<sup>251</sup> Why is it so easy for employees to obtain the much-desired deferral? One explanation, concerning the tax treatment of payors of deferred compensation, is discussed below.

## B. TREATMENT OF SERVICE RECIPIENTS

Using the same example but viewed this time from the employer's perspective, the employer (just like the employee) would be indifferent regarding the two payment scenarios in a no-tax world. If the employee chooses the immediate payment option, the employer's cost is \$10,000 on Day 1 of Year 1. If the

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250. Halperin, *supra* note 245, at 541-42.

251. To achieve deferral, the only obstacles to avoid are the doctrines of constructive receipt, cash equivalency, and economic benefit, all of which are relatively easy for taxpayers to navigate.

employee chooses the deferred payment option, the employer could take this \$10,000 that he would have otherwise paid, invest it at 10%, and then use the aggregate \$11,000 amount to pay the employee on Day 1 of Year 2. Thus, under either option, the employer's cost would be the same.

By contrast, if the employer were subject to a 40% income tax, and if the employer's realization of the compensation deduction were tied to the time of the cash-method employee's income realization as it is under current law,<sup>252</sup> the employer would prefer the immediate payment scenario. In that situation, the employer's after-tax cost on Day 1 of Year 1 would be \$6,000 (the \$10,000 payment less the \$4,000 value of the \$10,000 deduction). If, however, the employee chooses the deferred payment option, the employer would have to set aside more than this \$6,000 on Day 1 of Year 1 to satisfy the obligation to pay \$11,000 on Day 1 of Year 2. If the employer sets aside only \$6,000,<sup>253</sup> the employer would earn interest at the after-tax rate of 6%. Therefore, on Day 1 of Year 2, the employer would be left with \$6,360 in this fund. Grossing this amount up to compute a pre-tax payment that would leave the employer out-of-pocket by this \$6,360 amount yields a payment of only \$10,600, or \$400 less than what is required. To fund the *entire* \$11,000 payment on Day 1 of Year 2, the employer would have to set aside \$6,226.42, which by Day 1 of Year 2 would grow to \$6,600, which when grossed up would equal the \$11,000 payment.

In other words, in this 40%-tax world, the employer would be indifferent regarding the choice between an immediate payment of \$10,000 or a deferred payment of \$10,600. However, as between an immediate payment of \$10,000 or a deferred payment of \$11,000, the choice for the employer is abundantly clear—the \$10,000 immediate payment—because the \$11,000

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252. See I.R.C. § 404(a)(5) (as amended in 2004) (deferring the employer's deduction for nonqualified deferred compensation until the amount is includible in the employee's gross income); I.R.C. § 404(a)(11) (as amended in 2004) (providing that no amount shall be treated as paid to the employee until it is actually received by the employee); *see also* I.R.C. § 404(d) (as amended in 2004) (providing the same rule in the context of independent contractor relationships).

253. This amount is not grossed up to reflect any tax benefit to the employer from setting the amount aside because under the assumed tax system, the employer's deduction is timed to coordinate with the cash-method employee's income realization, which would not occur until the employee actually receives cash on Day 1 of Year 2.

deferred payment would cost the employer \$226.42 more in after-tax dollars on Day 1 of Year 1. This \$226.42, if invested at the after-tax rate of 6%, would grow to \$240 by Day 1 of Year 2, the precise amount of the after-tax benefit to the employee on that day resulting from the deferred payment scenario.

This example shows that, where the employer and employee are subject to the same tax rates, the Code's tying of timing of the employer's deduction to the time of the employee's income realization results in a zero-sum game for both (i) the government, and (ii) the employer and the employee when they are considered in the aggregate. Whatever the employee gains from the deferral of income, the employer loses from deferral of the deduction. As a result, the government is indifferent, assuming tax rate equivalence, and its task could properly be limited to ensuring consistent reporting between the parties as to the timing of the employee's income and the employer's deduction realization.

In other words, with tax rate equivalence, the employee and employer's decision to use a deferred compensation plan would necessarily depend entirely on nontax factors.<sup>254</sup> Because any tax benefit received by the employee would be offset perfectly by a tax burden to the employer, with arm's-length bargaining such a tax benefit should reduce dollar-for-dollar (determined on an after-tax basis) some other form of compensation, such as cash.

In his classic article on the time value of money, Professor Daniel Halperin explains that the zero-sum game phenomenon is driven entirely by the taxation of the investment income on the employee's compensation.<sup>255</sup> In the case of immediate payment, the employee is directly (and appropriately) taxed on the investment income.<sup>256</sup> In the case of the deferred payment, instead of taxing the employee on the investment income (which would be theoretically appropriate because he has economically earned the principal), the employer is taxed on this income.<sup>257</sup>

Thus, in the deferred payment scenario, the employee is undertaxed while the employer is overtaxed.<sup>258</sup> Because the amount of undertaxation and overtaxation offset each other,

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254. See Halperin, *supra* note 245, at 543.

255. See *id.* at 508.

256. See *id.*

257. See *id.* at 523.

258. See *id.*

assuming tax rate equivalence, the taxation of the employer on the investment income is a perfect substitute for the taxation of the proper party, the employee.<sup>259</sup> As a result, as a tax policy matter, if both employer and employee are taxed similarly on their investment income, the tax law could allow the parties simply to elect to defer or not to defer, so long as they report the transactions consistently.<sup>260</sup>

In the real world, however, employers and employees often do not face the same rate of taxation on their investment income.<sup>261</sup> Indeed, the lack of tax rate equivalence and its resulting significant arbitrage opportunities actually drive the development of deferred compensation arrangements.<sup>262</sup>

### C. ARBITRAGE

For various reasons, corporate employers are often able to achieve lower rates of tax on investment income than their employees. As Professor Halperin explains:

Taxable employers may effectively exempt investment income from tax to the extent that they have excess loss carryovers. Alternatively, these employers can invest deferred compensation in securities that pay dividends, which are [generally 70%] exempt from tax. In addition, if the employer invests in its own securities, appreciation in the value of those securities will not be subject to tax if, instead of issuing stock directly to the employee, the employer holds the stock itself for

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259. *See id.*

260. *See id.*

261. *See id.* at 540.

262. *See id.* at 511 (noting that "these transactions are often designed to exploit differences in tax rates"). In addition, the potential for changing tax rates over time may also serve as an impetus for these arrangements. Even if investment income is taxed similarly whether earned by the employee or the employer, the parties would be better off (when considered in the aggregate) under either of the following conditions: (i) the employee's tax rates are expected to decline between economic performance and actual payment, or (ii) the employer's tax rates are expected to rise between economic performance and actual payment. For the typical deferred compensation participants, the first condition (declining tax rates at the employee level) is not likely. Rather, these individuals are, and most likely will be, taxed at the highest marginal rate on their investment income. *See* BRISENDINE ET AL., *supra* note 168, at A-2 (stating that rate smoothing at the employee level is likely more perceived than real). The potential for increasing rates at the employer level, however, may be more realistic. Given the corporate tax sheltering currently available, a corporate employer may reasonably estimate that its marginal tax rates will be higher in the future, believing that the tax shelter opportunities will eventually be foreclosed or at least hindered by legislative, administrative, or judicial action.

the benefit of the employee or provides for a deferred compensation arrangement tied to the value of the stock.<sup>263</sup>

Furthermore, the recent massive proliferation of corporate tax shelters has driven down effective corporate tax rates significantly.<sup>264</sup> As a result, the assumed tax equivalence is an entirely false assumption in many cases in which deferred compensation plans have been developed by corporations.

If a corporation's tax rate on investment income is lower than its employees' individual tax rates on investment income, the opportunity for arbitrage exists. In such a case, a deferred compensation arrangement would allow the employee effectively to invest his compensation through the corporation, thereby obtaining the benefit of these lower tax rates.<sup>265</sup> To show the effects of tax arbitrage, assume in the \$10,000/\$11,000 example above that the employer's investment income was subject to a tax rate of 5%, while all other income (i.e., all of the employee's income and all of the employer's non-investment income) was subject to a tax rate of 40%.

In the immediate payment scenario, the employer's after-tax cost on Day 1 of Year 1 would equal \$6,000, the \$10,000 payment less the 40% tax benefit of the deduction.<sup>266</sup> Keeping that \$6,000 after-tax Year 1 cost constant, the employer could set aside the \$6,000 and earn an after-tax rate of interest of 9.5%. At the beginning of Year 2, the fund will have grown to \$6,570. Grossing this amount up so that the employer's after-tax cost equals this amount yields a \$10,950 payment. Therefore, from the employer's perspective, a payment of \$10,000 on Day 1 of Year 1 has the same cost as a payment of \$10,950 on Day 1 of Year 2.

When the employee receives the \$10,950 at that time, he will owe tax in the amount of \$4,380, leaving him with \$6,570. By comparison, had the employee chosen the immediate \$10,000 payment, he would be left with only \$6,360 after tax on Day 1 of Year 2. Ultimately, as a result of the deferred payment, the employee is better off by \$210 after tax, while the

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263. Halperin, *supra* note 245, at 540 (footnotes omitted).

264. See George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1793-95 (2003).

265. See Halperin, *supra* note 245, at 523, 540.

266. The employer gets a 40% tax benefit because the compensation deduction would be allowed to offset business income, which is assumed to be subject to a 40% tax rate.



employer is no worse off. As Professor Halperin explained, this benefit results from the fact that, in the deferred payment scenario, the 10% interest on the employee's \$6,000 of compensation (after payment of the tax on the compensation) was effectively taxed at the employer's low 5% rate, yielding a tax of only \$30 on the \$600 interest income, instead of the employee's high 40% rate, which would have yielded a tax of \$240 on the interest income.<sup>267</sup>

In this case, the tax arbitrage benefit was captured entirely by the employee because the employer, though not worse off as a result of the deferral, did not improve its economic position through the deferral arrangement. However, it is easy to design a payment structure that would leave the employee in the same position as if he received immediate payment, thereby allowing the employer to capture the entire arbitrage benefit. To leave the employee in the same position, the employee must have \$6,360 after tax on Day 1 of Year 2. Because the employee is subject to a 40% tax rate, the Year 2 payment must equal \$10,600. In such a case, the employee is left in the same position as if an immediate payment of \$10,000 were made, while the employer has \$210 more after tax on Day 1 of Year 2.<sup>268</sup>

These two examples show the extreme cases, where the tax arbitrage benefit goes entirely to one or the other party. However, because cooperation is required between the parties—the employee must be willing to delay receipt of cash and the employer must be willing to delay payment—to achieve the tax arbitrage benefit, it may be reasonable to assume that the arbitrage benefit would ordinarily be split in some manner between the employer and the employee. Thus, instead of a deferred payment of \$10,950 (where all of the benefit goes to the employee) or a deferred payment of \$10,600 (where all of the benefit goes to the employer), the parties could arrange for a deferred payment of \$10,775. This would allow the employee and the employer to capture a \$175 pre-tax (and \$105 after-tax) benefit.

To recapitulate, assuming equivalent tax rates on investment income, a purely elective deferral system, one where the employer and the employee would elect collectively whether to

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267. See Halperin, *supra* note 245, at 509–11.

268. The employer pays only \$10,600, instead of \$10,950, so the employer saves \$350 before taxes. Because this \$350, if paid, would give rise to a deduction worth 40%, the after-tax benefit to the employer in this case is \$350 less ( $0.4 \times \$350$ ), or \$210.

defer income and deduction realization, would work perfectly well as long as the parties maintained consistent reporting. This notion perhaps explains the extremely lax rules regarding deferral and why it is so easy to obtain deferral.<sup>269</sup> However, it is precisely the *lack* of rate equivalency and the resulting arbitrage that drives the development of nonqualified deferred compensation arrangements.

#### D. THE PROBLEMS WITH ARBITRAGE

The arbitrage possibilities described above are troublesome for a variety of reasons. As previously noted, a pure accrual system—or a regime which has effects consistent with such a system—is the theoretically appropriate and economically accurate one.<sup>270</sup> Regardless of whether the employee invests his earned compensation himself or whether the employer invests this compensation on the employee's account, the investment income that flows from this compensation should be taxed the same.<sup>271</sup> The current tax regime strays from this ideal (to the employer's and/or employee's benefit) in cases where the employer's tax rate on investment income is lower than the employee's rate on such income.<sup>272</sup> Because of this departure from the ideal, three adverse consequences result.

First, the employer and the employee, viewed in the aggregate, receive "an unwarranted and unintended subsidy,"<sup>273</sup> which they can divvy up as they see fit. To the extent that the employee captures the benefit, there exists a nontransparent subsidy to a high-income individual. To the extent that the employer captures the benefit, this nontransparent subsidy runs to the corporation.

Second, the arbitrage possibilities substantially reduce the incentive for corporations to set up and fund so-called "qualified" plans.<sup>274</sup> These qualified plans effectively allow investment income to go untaxed.<sup>275</sup> In exchange for this subsidy, the Code requires that these qualified plans provide benefits for low- and mid-level workers; in other words, these plans cannot

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269. See *supra* note 251 (describing lax requirements for obtaining deferral).

270. See *supra* note 250 and accompanying text.

271. See Halperin, *supra* note 245, at 539.

272. See *id.*

273. *Id.* at 541.

274. See *id.* at 539–40.

275. See I.R.C. § 501(a) (2000) (exempting qualified plans from taxation).

discriminate in favor of highly compensated employees.<sup>276</sup> However, as explained above,<sup>277</sup> under the right circumstances, even nonqualified arrangements, which do not have the nondiscrimination requirements of qualified plans, can result in the nontaxation (or extremely light taxation) of investment income.<sup>278</sup> In such circumstances, “employers may choose to provide benefits only for their highly paid employees, thus circumventing the congressional mandate to protect low and moderate wage earners.”<sup>279</sup>

Third, the existence of arbitrage benefits creates significant distortions with respect to the joint decision made by employers and employees whether to pay compensation immediately or in the future. In a no-tax world, the decision would appear to depend mostly on whether employees wish to lend to employers, as opposed to other borrowers, and, vice versa, whether employers wish to borrow from the employees, as opposed to other lenders. It would seem that, in the absence of tax ramifications, employees would ordinarily choose not to overinvest in their employers, and employers would prefer to use traditional lenders.<sup>280</sup> Because of the considerable arbitrage opportunities, however, these nontax factors are entirely swamped in significance. The tax law thus creates overwhelming incentives for the parties to defer payment to high-tax employees, violating the tax policy goal of neutrality.

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276. See *id.* § 401(a)(4) (directing that qualified plans may not “discriminate in favor of highly compensated employees”); see also STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE FUNDING RULES FOR EMPLOYER-SPONSORED DEFINED BENEFIT PLANS AND THE FINANCIAL POSITION OF THE PENSION BENEFIT GUARANTY CORPORATION (“PBGC”) 2–3 (Comm. Print 2003) (describing the nondiscrimination rules). For a critique of the nondiscrimination rules, see Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988).

277. See *supra* Part IV.C (discussing the arbitrage that is possible when the employer’s tax rate on investment income is low).

278. See Halperin, *supra* note 245, at 540–41.

279. *Id.*

280. In addition to these basic financial issues, an employer might prefer to pay some deferred compensation to “promote an employer’s image as socially responsible, or to encourage retirement while making room for younger employees.” *Id.* at 543. However, these concerns would seem to be insignificant in the typical case where the employee receiving nonqualified deferred compensation is a highly compensated executive.

### E. MAINTAINING A FRICTION ON DEFERRAL

Because of the significant tax arbitrage benefits available with respect to nonqualified deferred compensation and the resulting unfortunate policy implications, the economic benefit doctrine serves an important tax policy goal by imposing a non-tax "friction" on parties seeking to engage in arbitrage.<sup>281</sup> By disallowing deferral in cases involving third-party or funded promises, the economic benefit doctrine ensures that to obtain arbitrage benefits, the service provider must face perhaps substantial credit risk; that is, he must remain a general unsecured creditor of the employer, thereby subjecting his deferred compensation to the risks of the employer's business.<sup>282</sup> On the other hand, if third-party or funded promises were not immediately taxable, deferral and its resulting arbitrage would be achieved without any adverse economic consequences, because the parties could insulate the service provider from these risks by either funding trusts or purchasing and delivering annuities to the service provider.

### CONCLUSION

We began this Article by noting that it is commonly understood among tax experts that the tax treatment of compensatory third-party promises is uncertain. We endeavored in this Article to prove otherwise.

For many decades before the enactment of § 83, courts and the IRS drew an important distinction between second-party and third-party promises. Because the immediate taxation of second-party promises would effectively merge the cash method into the accrual method, these promises were not generally considered property, and therefore not immediately taxable, under the cash method. In contrast, third-party promises, the immediate taxation of which would not impinge on the cash

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281. Professors Scholes and Wolfson first used the term "friction" in this context. MYRON S. SCHOLES & MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 7 (1992) (using the term to "mean transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly"). For an extensive discussion of nontax frictions as a tool against wasteful tax planning, see David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 *COLUM. L. REV.* 1312 (2001).

282. Admittedly, this friction might be considered relatively weak, especially in cases where the employer is a large, established company whose credit risk is quite low. Nevertheless, the friction is the only constraint on arbitrage under the current tax regime.

method's traditional scope, were without exception immediately taxable. In enacting § 83, Congress codified this notion when it used the term "property" against the backdrop of this extremely well-developed body of law. The regulatory exclusion from the definition of property for an "unfunded and unsecured obligation to pay money or property in the future"<sup>283</sup> therefore should properly be interpreted as applying only to those promises that are issued by the service recipient. If the promise is issued by a party external to the service relationship, the promise is taxable to the service provider upon its receipt.

The doctrinal conclusion that the receipt of a third-party promise to pay always gives rise to immediate taxation comports with sound tax policy. As described above, the deferred taxation of unsecured and unfunded payment obligations provides an opportunity for tax arbitrage where the service recipient's effective tax rate on investment income is lower than that of the service provider. If the lax deferred compensation rules were extended to unfunded and unsecured payment obligations issued by third parties (such obligations having been purchased by the service recipient), then the floodgates on such arbitrage would be opened, as the service provider would no longer have to be subject to the service recipient's credit risk to benefit from the tax rate arbitrage. Under such a regime, the employee could essentially elect to utilize the employer's tax rate on investment income at the price of nominal transaction costs. Such a regime would therefore impair the ability to tax the return to capital of high-income individuals.

Turning back to the ECS shelter that served as the stimulus for this Article, the partnership's promise issued in exchange for the options is a third-party promise that constitutes property for purposes of § 83. This conclusion undermines the intended tax benefits of the shelter. Recall that Treasury Regulation § 1.83-7(a) provides that if nonstatutory stock options are sold in an arm's-length transaction, § 83(a) applies to the property received on the sale in the same manner that § 83(a) would have applied to the transfer of property pursuant to the exercise of the option. In other words, the seller realizes compensation income to the extent of the fair market value of property received as consideration in the sale. Because the promissory note issued by the partnership constitutes property for purposes of § 83, the seller realizes compensation income equal to

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283. Treas. Reg. § 1.83-3(e) (as amended in 1985).

the fair market value of the note, which the ECS shelter promoters were forced to argue is equal to the fair market value of the transferred options to satisfy the arm's-length standard in the regulations.<sup>284</sup>

Accordingly, rather than achieving the intended deferral of taxation until the long-term balloon note is satisfied, the ECS shelter—when its tax effects are correctly interpreted—actually has the opposite effect of accelerating income.<sup>285</sup> Thus, the ECS shelter turns out to be yet another failed exercise by taxpayers attempting to abuse the tax laws through an overly literal interpretation of relevant statutes and regulations.

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284. See *supra* text accompanying notes 74–82 (discussing the arm's-length standard and concluding that, to qualify, the partnership note must at the very least have a value equivalent to the value of the transferred options).

285. If the ECS structure were not implemented, the executive would generally realize income only upon exercise of the options. See *supra* text accompanying notes 60–65. Under the ECS structure, however, the executive realizes income even earlier, at the time the options are sold to the partnership.