Redefining Debt: Of Indianapolis Power and Fictitious Interest

Glenn E. Coven

William & Mary Law School

1991
REDEFINING DEBT: OF INDIANAPOLIS POWER AND FICTITIOUS INTEREST

Glenn E. Coven*

TABLE OF CONTENTS

I. INTRODUCTION 588

II. THE CONFLICTING DEFINITIONS OF DEBT 592
   A. The Judicial Test 592
   B. The Congressional Test 596

III. THE CORRECT DEFINITION OF DEBT 600
   A. The Structure of Income Taxation: A Framework for Analysis 600
   B. Non-Interest Bearing Repayment Obligations 607
      1. The Judicial Approach 607
      2. The Section 7872 Approach 612

IV. EXTENDING THE ANALYSIS 618
   A. Advance Payments 620
   B. Obligations Not Attributable to Receipts 624

V. THE EFFECT OF NON-PAYMENT OF THE OBLIGATION: THE TAXATION OF CONVERTED TRANSACTIONS 630
   A. Converting Debt to Income 631
      1. Failure to Repay Loan Principal 632
      2. Failure to Repay Principal and Interest 634
      3. Failure to Repay Bifurcated Loans 636
      4. Failure to Discharge Bifurcated Future Costs 639
   B. Implications of the Taxation of Converted Debt 640

VI. LOW-INTEREST LOANS 642

VII. THE TAXATION OF THE OTHER PARTY TO THE TRANSACTION 646

* B.A., Swarthmore College, 1963; LL.B., Columbia University, 1966; Tazwell Taylor Professor of Law, College of William and Mary. The author is grateful for the helpful comments provided by Jeffrey Kwall and John Lee on a prior draft of this article.

587
Virginia Tax Review

A. Sources of Imbalance
B. Deductible Obligations
C. Converted Transactions

VIII. Consistency Considerations: Converting Income to Debt
IX. Conclusion: A Proper Definition of Debt

Appendix — Case Illustrations

I. Introduction

In order to allocate income tax liabilities properly, a tax must be imposed at the correct time. An unwarranted deferral of tax results in the permanent undertaxation of transactions, while unwarranted acceleration has an opposite and equally inaccurate effect. Under the current taxing regime, the most significant determinant of the timing of taxation is the classification of a receipt as one entitled to the pattern of taxation applicable to debt rather than the pattern applicable to income. Accordingly, the timing, and thus the accuracy, of taxation is largely controlled by how “debt” is defined for income tax purposes.

This classification issue is one of the most pervasive problems in our current income tax scheme. The benefits of the pattern for taxing debt are claimed not only for conventional loans, but also for such diverse transactions as security deposits, advance payments for goods and services, and obligations to incur future costs. As a result, an incorrect understanding of what should be treated as debt for income tax purposes can produce inaccurate taxation on an extensive scale. However, despite the need for a clear and workable definition of debt, the income tax rules contain two fundamentally inconsistent approaches to the problem. Neither of the approaches is correct. In large part, the failure to properly define debt is attributable to disagreement and confusion over the manner in which the income tax rules should reflect time value of money principles.¹

¹ For useful discussions of the seemingly self-evident proposition that a dollar in the future is worth less than a dollar today, see Fellows, A Comprehensive Attack on Tax Deferral, 88 Mich. L. Rev. 722, 725-728 (1990); Lokken, The Time Value of Money Rules, 42 Tax L. Rev. 1, 10-18 (1986).
Any claim that a receipt ought to be subject to the pattern of taxation applicable to debt is necessarily based upon the recipient having an obligation to incur an economic cost in the future that offsets the accretion to wealth otherwise generated by the receipt. Accordingly, whether a receipt is to be treated as debt for income tax purposes is determined, not by reference to the receipt as such, but by the effect given to that future obligation at the time the receipt is obtained. Debt is defined, therefore, by the extent to which obligations to incur future costs are recognized as offsetting the value of a receipt.

The judiciary, led by the Supreme Court, traditionally has defined debt solely by reference to the quality of the obligation to repay the receipt. This approach does not take into account the time value of money, and requires fully recognizing, or fully ignoring, the repayment obligation. Congress and the Treasury Department, on the other hand, have over the past decade developed a new definition of debt that is primarily based upon the time value of money and generally requires recognizing only a portion of the repayment obligation, while treating the balance as additional interest. In the wake of these legislative developments, it has been suggested that all or portions of the congressional definition of debt should be judicially adopted in a variety of contexts. However, in two recently decided cases, United States v. Hughes Properties, Inc. and Commissioner v. Indianapolis Power & Light

---

1 See generally Popkin, The Taxation of Borrowing, 56 Ind. L. J. 43, 49-65 (1980).
2 That definition is embodied in I.R.C. § 7872. See also I.R.C. §§ 483, 467 and 1274. These statutory definitions are not by their terms comprehensive. Rather, they serve to limit what otherwise would be treated as debt for income tax purposes, and thus presuppose a prior determination that the transaction involves an extension of credit. However, the sections are intended to apply to transactions that might not be treated as loans under the judicial definition of debt. See Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985).
3 To date, this approach has generally been rejected. For example, in Follender v. Commissioner, 89 T.C. 943 (1987), the government argued that the amount borrowed for purposes of the § 465 at-risk rules should be limited to the present value of the repayment obligation. The court, however, concluded that the Internal Revenue Code ("Code") did not require consideration of the time value of money in making that computation. See also Pritchett v. Commissioner, 827 F.2d 644 (9th Cir. 1987). However, in Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3rd Cir. 1989), cert. denied, 110 S. Ct. 260 (1989), the court allowed the taxpayer a basis for property equal to its market value notwithstanding the fact that it was subject to a non-recourse debt in a greater amount. For a critique of that decision, see Johnson, The Front End of the Crane Rule, 47 Tax Notes 593 (Apr. 30, 1990).
4 476 U.S. 593 (1986).
Co., the Supreme Court firmly rejected the congressional approach and reaffirmed its allegiance to a definition of debt that ignores the time value of money. Completing the mosaic, in one significant instance Congress rejected its own definition of debt and sought to blend time value of money considerations with the traditional judicial approach.

This article will examine a variety of contexts in which these inconsistent approaches to the recognition of repayment obligations appear. While elements of each approach should be preserved, this article will argue that neither the judicial nor the congressional scheme appropriately imports time value of money principles into the taxing system. Debt simply cannot be defined properly without reference to the time value of money. In that respect, the judicial approach is fatally defective and continues to result in the inaccurate taxation of a wide range of transactions. Moreover, while the congressional bifurcation approach to debt may appear to be more accurate in measuring the real economic gain realized by borrowers at the time the transaction is initiated, this in fact is not the case. The implementation of time value of money concepts does not require, or justify, the creation of fictitious interest through the bifurcation of a single repayment obligation. The congressional approach is based upon a false analogy to discounted


** See I.R.C. § 461(h); infra text accompanying notes 116-22.

The issue considered here is the proper timing of the inclusion or exclusion of an item from income. The question of what should be treated as debt can arise in a very different context. For example, the troublesome question of whether an investment in a corporation should be treated as debt or as stock normally raises issues concerning the double taxation of corporate profits rather than the timing of taxation. These other issues are not considered herein. An obligation that would be treated as debt under the principles developed here might, quite consistently, be treated as something else for other purposes of the taxing system.

* The perception that the congressional approach is superior is the primary source of pressure on the judiciary to incorporate the congressional definition of debt. See Illinois Power Co. v. Commissioner, 792 F.2d 683, 690 (7th Cir. 1986), in which Judge Posner refers to taxation based upon the present value of a receipt as “analytically sounder” than taxation based upon the likelihood of repayment.
debt and does not produce a result that is consistent with the principles of income taxation. In fact, receipts that are wholly interest-free can be taxed correctly only under the all-or-nothing approach of the judiciary, applied with due regard to the significance of the time value of money. Accordingly, the congressional experiment with the bifurcation of non-interest bearing repayment obligations should be terminated, instead of being extended to other forms of obligations to incur future costs, as some commentators have urged.

After examining the judicial and congressional definitions of debt, Part II of this article will demonstrate the consistencies and inconsistencies of both approaches vis-a-vis the principles of an income tax. That exploration provides a basis for developing, in Part III, a correct and uniform definition of debt and a superior approach to the taxation of obligations bearing below-market rates of interest. The proposed approach to the taxation of debt would not only correctly reflect the time value of money, but would also materially simplify the resolution of numerous classification issues surrounding debt.

Part IV will demonstrate how the principles developed in Part III can be applied not only to conventional loans, but also to such quasi-loan transactions as advance payments and obligations to incur future costs. Part V examines the significance of not repaying the receipt and shows that the congressional bifurcation approach to debt aggravates existing inadequacies in the taxation of debt cancellations. Part VI will demonstrate the proper implementation of the new definition of debt proposed in Part III. Part VII argues that the imperfections in the current taxation of debt are not off-

---

10 Receipts that are offset by repayment obligations that bear a below-market rate of interest must be bifurcated to be taxed correctly, but not in the manner presently required. See infra text accompanying notes 145-52.
12 While the point is not developed here, the traditional judicial approach to the definition of debt, which relies primarily on an open-ended facts and circumstances analysis, is highly complex to administer. See, e.g., Robertson, Daughtrey & Burckel, Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987, 47 Tax Notes 707 (May 7, 1990); Prescott, Customer Deposits: Tax-Free Security or Prepaid Income?, 41 U. Fla. L. Rev. 773 (1989). Classification based upon the financial analysis suggested here would be far easier to administer.
set by the "surrogate" taxation of the other party to the transaction. This section also examines revenue loss attributable to the flawed approach to debt currently in use. Part VIII illustrates how the bifurcation approach contained in section 7872 of the Internal Revenue Code ("Code") is inconsistent with a number of long-standing tax rules.

II. THE CONFLICTING DEFINITIONS OF DEBT

A. The Judicial Test

One of the most recent statements describing the judicial approach to defining debt can be found in the unanimous decision of the Supreme Court in Indianapolis Power.\(^{14}\) The factual setting for Indianapolis Power is particularly significant in that it describes a situation that is quite commonplace. The taxpayer, a public utility furnishing electric power, required approximately five percent of its customers to make cash deposits, in an amount that could not exceed two months' billings, to secure the payment of the customers' utility bills.\(^{15}\) Interest at six percent was only paid on deposits held for more than one year.\(^{16}\) The deposits were refunded to customers who established their creditworthiness by, among other methods, the timely payment of bills for nine months.\(^{17}\) For that reason, the refund of deposits was normally by cash or check, although a customer could request that the refund be credited to his bill.\(^{18}\) However, when a refund was made because of a termination of service, the refund was normally applied against the customer's final bill, although the customer could demand repayment by cash or check.\(^{19}\) Depending upon the year, between fifty-seven and sixty-nine percent of refunds were accomplished by a credit to the customer's bill.\(^{20}\) Refunds of deposits that remained unclaimed after seven years escheated to the State.

\(^{14}\) All references to "section — " in this article are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

\(^{15}\) See supra note 6.

\(^{16}\) 110 S. Ct. at 590-91.

\(^{17}\) Id. at 591.

\(^{18}\) Id.

\(^{19}\) Id.

\(^{20}\) Indianapolis Power, 88 T.C. at 969.
During the years at issue in *Indianapolis Power*, the total amount of deposits held by the utility taxpayer averaged about $1,000,000. That amount was not segregated by the taxpayer, but instead became a part of its operating funds. Thus, the taxpayer had permanent possession of an unrestricted fund of $1,000,000 for which it paid a rate of interest that, quite likely, was well below its cost of other capital. For income tax purposes, the taxpayer treated these receipts as "deposits" subject to the pattern of taxation applicable to loans. The Commissioner treated the entire amount of the deposits as taxable income when received.

In an opinion by Judge Flaum, the Seventh Circuit resolved the dispute by exploring whether the taxpayer had obtained the economic benefits associated with a permanent receipt or the benefits associated with obtaining the proceeds of a loan. Because the taxpayer was required to pay interest on the receipt in an amount that the courts assumed, perhaps erroneously, approximated a market rate of interest, the court concluded that the taxpayer had only obtained the economic benefits of a loan. Thus, the court allowed the taxpayer to exclude all of the deposits from income. While the issue was not before it, the court plainly indicated that, had interest not been paid on the deposit, the deposit would have been taxed in full because then the taxpayer would have obtained the greater economic benefits of an item of income.

The Supreme Court, while affirming the Seventh Circuit, viewed the matter quite differently. Initially, the Court denied that a basis existed for distinguishing between the economic benefits of income and the benefits of loans. While noting that the court below viewed the payment of interest as significant, the Court declined to discuss the relevance of interest payments. Rather, in line with its prior decisions, the Court held that the critical factor in determining whether the deposit should be subject to tax was the degree to

---

[^1]: 110 S. Ct. at 591.
[^2]: Id.
[^3]: Id. at 592.
[^4]: 857 F.2d 1162 (7th Cir. 1988).
[^5]: Id. at 1168.
[^6]: Id.
[^7]: 110 S. Ct. at 593.
which the taxpayer controlled the receipt. Under the tests for income first set forth in the Supreme Court's 1955 ruling in Commissioner v. Glenshaw Glass, receipts over which "taxpayers have complete dominion" constitute taxable income, while receipts subject to "an obligation to repay" do not. Thus, the key to the decision in Indianapolis Power was whether the taxpayer had "some guarantee that he will be allowed to keep the money." Since conceded the customers of the taxpayer were legally entitled to demand the ultimate return of their deposits (although generally they did not), the Court easily concluded that the deposits were not subject to tax. As a result, the entire principal amount of the security deposits became subject to the pattern of taxation applicable to debt.

The opinion of the Supreme Court in Indianapolis Power was entirely consistent with its earlier income tax decisions. In these earlier cases, the question of taxation was resolved solely by reference to the taxpayer's legal entitlement to retain the principal amount of the receipt. If the obligation to repay the receipt was merely a contingent obligation that depended upon future events, the obligation might be ignored entirely and the entire receipt subject to tax. Thus, in North American Oil Consol. v. Burnet, the taxpayer was deemed to have obtained possession of a cash payment in 1917 even though its entitlement to the payment remained in dispute until 1922, when the litigation against the United States was resolved. The Court held that the entire amount of the payment constituted income in 1917 because the taxpayer had acquired the requisite control over the payment. The justices gave no effect to the value of the contingent liability to repay the amount, in the event the taxpayer lost the later litigation. On the other hand, if the receipt were subject to a fixed obligation to repay its face amount, it could not be subject to tax regardless of the likelihood of repayment or the actual value of the repayment obligation.

---

28 Id.
30 110 S. Ct. at 593.
31 Id. at 596.
32 See infra notes 33-7 and accompanying text.
33 286 U.S. 417 (1932).
34 Id. at 423-24.
The rigidity of the Court's historic position has on occasion produced embarrassment and minor doctrinal modification. In Commissioner v. Wilcox,\textsuperscript{38} for example, the Court concluded that an embezzler could not be subject to tax on his ill-gotten gain because of the obligation to repay his employer — an obligation that seemed unlikely to be honored. The Court, of course, was ultimately required to disown that impractical result, but it did so in a manner that preserved its general approach to the definition of debt. To accomplish the taxation of illegally obtained receipts, in James v. United States\textsuperscript{39} the Court modified its definition of repayment obligations entitled to recognition to require a "consensual recognition" of the obligation by the taxpayer.\textsuperscript{37} However, the decision in James was consistent with the decisions in North American Oil and Wilcox in either wholly including or wholly excluding the receipt from income, and in attributing no further significance to the probability or value of repayment.

A similar approach has characterized other recent Supreme Court demarcations of the line between income and loans (or quasi-loans). Just three years prior to the decision in Indianapolis Power, in Hughes Properties\textsuperscript{38} the Court had permitted a taxpayer to exclude receipts from income to the extent that these amounts were subsequently payable to the patrons of its slot machines, even though these repayment obligations were deferred for an unknown period of time. The Court noted that the government had argued that the present tax benefit ignored "the time value of money" but the Court declined to even examine the merits of that assertion.\textsuperscript{39} Similarly, in Commissioner v. Tufts\textsuperscript{40} the Court treated the face amount of a non-recourse debt as entitled to recognition as debt, even though the value of the encumbered property, and thus the value of the obligation to repay the debt, was a vastly smaller sum.

The judicial approach to the definition of debt thus consists of

\textsuperscript{38} 327 U.S. 404 (1946).
\textsuperscript{39} 366 U.S. 213 (1961).
\textsuperscript{37} Id. at 219.
\textsuperscript{38} See supra note 5.
\textsuperscript{39} 476 U.S. at 604. While the Supreme Court certainly assumes the responsibility for its own decisions, a significant share of the blame for the decision in Hughes Properties rests with the government. The government's attempt to justify using time value of money principles was so weak and inept as to lack any persuasive power. See, e.g., Brief for the United States, p. 31.
\textsuperscript{40} 461 U.S. 300 (1983).
two distinct, albeit related, principles. On the one hand, the value of a repayment obligation is relevant only in the sense that the likelihood of repayment affects the value of the obligation and determines whether the obligation will be recognized. Once the court has concluded that the obligation is sufficiently fixed to warrant recognition, the actual value of the repayment obligation, and thus the time value of money, becomes wholly irrelevant. On the other hand, debt is an "all-or-nothing" proposition. If the repayment obligation is entitled to recognition, the receipt may be offset by the entire face amount of the obligation. If the receipt is not entitled to recognition, then no amount of the obligation may offset the taxation of the receipt.

B. The Congressional Test

Beginning in 1964, Congress began to develop a definition of debt distinct from that employed by the Supreme Court. The congressional definition emerged from, and was shaped by, a process that began with a very different objective than that of the courts. As a general proposition, under our income tax laws income derived from different sources has been subjected to substantially different rates of tax. Ordinary recurring income has been subject to the generally applicable marginal rates of tax, which at times have been quite substantial, while gain from the disposition of property held for investment purposes has been eligible for the special, and far lower, rate of tax imposed upon capital gains. During most years in which the income tax has been imposed, therefore, taxpayers had a considerable incentive to disguise ordinary receipts, such as interest, as gain from the sale of a capital asset. Thus, for example, rather than sell an asset for a note in the amount of $1,000, maturing in two years and bearing a market rate of interest of 10%, a taxpayer might purport to sell the asset for $1,210, payable in two years, and treat that full amount as gain from the sale.

During the early years of the income tax laws, taxpayers were

---

1 Cf. Popkin, supra note 2, at 46.
2 See supra notes 29-30 and accompanying text.
not required to charge interest on deferred payments or characterize any portion of a deferred receipt as interest.\textsuperscript{44} Eventually, Congress became aware of the tax avoidance potential of concealed interest payments and in 1964 enacted section 483 of the Code\textsuperscript{46} to address the matter. Under section 483, if a sale of property for deferred payments did not provide an adequate stated rate of interest, then a portion of the selling price would be recharacterized as unstated interest.

In arriving at its result, section 483 required the bifurcation of the sale proceeds by identifying and taxing separately an amount that represented interest on the deferred payment.\textsuperscript{46} That interest component was identified by first computing the present value of all payments to be made under the contract of sale, using a prescribed interest rate.\textsuperscript{47} That computed amount presumably represented the price for which the property would be sold in an arm's length transaction for an immediate cash payment; the amount would also represent the principal amount of a note that would have been issued in exchange for the property if the note bore stated interest at the prescribed rate. Accordingly, only that computed principal amount of the deferred payment was to be treated as the proceeds from the sale of the property, and thus made eligible for the rate of taxation applicable to capital gains.\textsuperscript{48}

Scheduled note payments that exceeded the computed present value of the repayment obligation were characterized as compensation to the seller for deferring the receipt of the sale proceeds.\textsuperscript{49} This amount was not treated as additional gain from the sale, and therefore was characterized as interest. Under section 483, it is so characterized for all tax purposes.\textsuperscript{50} With refinements reflecting the continuing sophistication of the Treasury Department in measuring the time value of money,\textsuperscript{51} the basic pattern of section 483

\textsuperscript{45} Pub. L. No. 88-272, § 224(a) (1964).
\textsuperscript{46} See I.R.C. § 483(a).
\textsuperscript{47} Under current law, the interest rate used is the "applicable federal rate" determined under I.R.C. § 1274(d).
\textsuperscript{49} See I.R.C. § 483(a)-(b).
\textsuperscript{50} See I.R.C. § 483(a).
\textsuperscript{51} Under § 1274, which today applies to larger sales of property for a deferred payment.
continues to serve as the Code method for identifying the element of interest in sales for deferred payments.

While section 483 had long addressed the issue of identifying interest upon the transfer of property for a deferred payment, no provision of the Code addressed the related question in the context of a transfer of cash for a deferred repayment. In that statutory vacuum, taxpayers began to realize the tax advantages of making "interest-free" loans.\(^{112}\) The government’s attempt to persuade the courts to find an element of interest in such transactions met with no success until the issue finally reached the Supreme Court in 1984.\(^{113}\) Although not addressing the rather messy — but ultimately unavoidable — issue of valuation, in *Dickman v. Commissioner*\(^{114}\) the Court approved in principle the treatment of the foregone interest in an interest-free loan as taxable for gift tax purposes. While it seemed certain that the principle of *Dickman* would be extended to income taxation, Congress was determined to avoid that lengthy and uncertain process, and enacted section 7872 in the same year.\(^{115}\)

Under section 7872, a cash receipt purporting to be the proceeds of a loan is divided into two portions: one portion treated as a loan for income tax purposes, and the other treated as a functionally unrelated payment,\(^{116}\) the tax consequences of which are dependent upon the relationship between the borrower and the lender.\(^{117}\) In common with section 483, the portion of the receipt that is to be treated as the principal amount of a loan, and thus excluded from

---

\(^{112}\) High bracket parents, for example, wishing to shift the tax consequences of the receipt of investment income to their lower bracket children could do so through the making of an interest-free loan to the children that could then be invested by them. Similarly, the shareholders of closely held corporations wishing to withdraw cash without immediate tax consequences could do so through loans. The failure to charge interest on such a loan would avoid the counter-productive return of cash (and taxable income) to the corporation.

\(^{113}\) See, e.g., *Commissioner v. Greenspun*, 670 F.2d 123 (9th Cir. 1982); *Dean v. Commissioner*, 35 T.C. 1083 (1961).


\(^{116}\) See I.R.C. § 7872(a)(1).

\(^{117}\) Thus, for example, the unrelated payment may be a non-taxable gift or contribution to the capital of a corporation. It could also be taxable compensation or a dividend.
income, is determined by computing the present value of the repayment obligation using a prescribed rate of interest that represents a pre-tax market rate of return.\footnote{See I.R.C. § 7872(d)(1)-(2). The test rate is derived from taxable federal obligations having maturities similar to the maturity of the loan in issue. See I.R.C. § 1274(d)(1)(C).} The excess of the receipt over that computed amount is treated as an unrelated payment (either taxable income or a gift).\footnote{See I.R.C. § 7872(a)-(b),(e).} The amount payable on the maturity of the loan in excess of the amount treated as the principal of the loan represents the interest that would have been paid on an arm's length loan,\footnote{See I.R.C. § 7872(a)-(b).} and is so treated for all purposes of the Code. The amount treated as interest will equal the amount initially treated as being other than the proceeds of a loan.\footnote{See I.R.C. § 7872(a)-(b). For example, if the applicable federal rate were 10%, the present value of a six year, $10,000 loan would be $5,640. Thus, the initial unrelated payment would be $4,360. If the $10,000 were repaid at maturity, out of that amount $4,360 would be treated as interest. In this example and all examples used in this article, present value is determined by compounding annually. Under § 7872, however, compounding must be semiannual.}

Section 7872 thus consists of several distinct elements. First and foremost, the amount taxed (or remaining untaxed) is determined by reference to value rather than face amount. Second, in application of that principle, a portion of the initial receipt is recharacterized so as not to be treated as the proceeds of a loan, and thus is normally taxable. Third, an equivalent portion of the repayment obligation is recharacterized as interest, rather than principal, and thus is normally made deductible. The net effect of the application of section 7872, therefore, is to impose a tax on a portion of an interest-free receipt that is subsequently offset by the grant of a deduction for an identical amount.

Section 7872 does not, of course, alter the underlying economic arrangement of the parties. The total amount received by the lender will not exceed the amount originally transferred. The interest created by bifurcating the receipt is entirely artificial; economically the transaction remains interest-free. While similar in form to section 483, section 7872 thus plays a very different role. The earlier provision was designed to identify an interest component that was thought to exist but to have been concealed; section 7872, by contrast, was designed to create an element of interest that clearly did not exist before.
With the adoption of section 7872 in 1984, therefore, the bifurcation analysis that earlier had been employed by section 483 to distinguish interest from sale proceeds evolved into a definition of the amount of a receipt that would be treated as a loan. Indeed, in the extension of the principles of section 483 that are presently embodied in section 1274, the computation of the present values of payments to be made is characterized as resulting in the “imputed principal amount” of the deferred payment. Thus, the process begun in section 483 has today evolved into a congressionally adopted bifurcation approach to the definition of debt.

III. The Correct Definition of Debt

A. The Structure of Income Taxation: A Framework for Analysis

A system of taxation consists of an array of sub-systems that prescribe different rules for the taxation of different transactions. For a correct burden of taxation to be achieved, transactions must be assigned correctly to the sub-system that governs the taxation of that form of transaction. Just as a personal residence will not be taxed correctly if it is classified, for example, as a hospital, likewise a loan will not be correctly taxed if it is classified as a form of income. The most important sub-systems, for purposes of this article, are those that control the timing of the taxation of receipts and those that specify the pattern for taxing debt and income.

The primary rules imposed by these sub-systems are well understood, even though their full implications frequently are not appreciated. Because an income tax is only imposed upon a gain or increase, the receipt of the proceeds of a loan is not taxable.

---

62 The first use of the bifurcation approach to define debt appeared in regulations proposed under § 385 which authorized the Treasury to issue regulations distinguishing between stock and debt. See Treas. Reg. §§ 1.385-3(a), (b)(1)(ii) (1980). In an adaptation of § 483, the regulations limited the maximum amount of the investment characterizable as debt to the present value of the repayment obligation of the purported debt security, rather than the face amount of the security. The excess over that amount was classified as an equity investment. While that regulation was ultimately withdrawn, its bifurcation analysis was subsequently codified in § 7872 and in the extension of § 483 contained in § 1274.

63 See I.R.C. § 1274(b)(1).

64 The classic theoretical definition of income is the sum of the taxpayer's consumption and net change in wealth between two points in time. See, e.g., Simons, Personal Income Taxation, p. 50 (1938).
receipt is offset by the obligation to repay the loan and thus the transaction does not result in gain. What "obligation to repay" means is, of course, the main focus of this article. Similarly, to the extent that the repayment of a loan is regarded as the mere return of the original amount borrowed, the repayment does not produce income tax consequences. However, to the extent that the payment is treated as a payment of interest to compensate the lender for the use of the loan proceeds, then it is deductible (subject, of course, to an increasing list of exceptions).

On the other hand, if the proceeds of a loan are in fact not repaid by the borrower, the transaction will result in an increase in net worth and that gain will become taxable at the time the offsetting liability is discharged. For income tax purposes, the transaction is viewed as if the borrower first obtained an economic receipt equal to the amount of the indebtedness forgiven, and then later used that (constructive) receipt to repay the loan. The income tax consequences of this constructive receipt and disbursement parallel the consequences of an actual receipt and disbursement. Thus, the receipt will be taxable only if an actual receipt would have been taxable. Meanwhile, the disbursement will have no tax consequences to the extent it constitutes a repayment of principal, although it may be deductible if it represents a payment of interest.

By contrast, if a receipt is treated as taxable income when received, because the existence of an offsetting obligation was unknown or disregarded, the receipt will be subject to immediate tax-

---

66 See generally Popkin, supra note 2, at 43.
67 See Vukasovich, Inc. v. Commissioner, 790 F.2d 1409, 1413-1414 (9th Cir. 1986).
68 The deduction is generally allowed by § 163(a), but it is subject to numerous limitations. These include § 265(a)(2) (allocable to tax-exempt income), § 163(d) (investment interest), and § 163(h) (personal interest).
69 See United States v. Kirby Lumber Co., 284 U.S. 1, 2-3 (1931); Treas. Reg. § 1.61-12(a).
71 See Crane v. Commissioner, 331 U.S. 1, 4 n.6 (1947). Under current law this result is achieved by not taxing the cancellation of a liability, the payment of which would be deductible. See I.R.C. § 108(e)(2). The net effect of this provision is the same as if the income were taxed, but the constructive payment of the liability deducted. Compare I.R.C § 108(e)(2) with I.R.C. § 357(c)(3)(A)(i) and Coven, Liabilities in Excess of Basis: Focht, Section 357(c)(3) and the Assignment of Income, 58 Or. L. Rev 61, 66-67 (1979).
ation. However, if the previously taxed receipt actually must be repaid, that repayment will be deductible when made.\textsuperscript{72}

These primary rules for the sub-systems governing the taxation of debt and income can thus be seen to be rules of timing as much as they are rules of inclusion or exclusion. If the receipt is retained, the borrower ultimately will be subject to tax on the amount of the receipt, regardless of how the receipt was initially treated. If the receipt is not retained, the borrower will not be taxed on that amount, again, regardless of the initial treatment. Thus, the net effect of the initial assignment of a transaction to the sub-system for taxing debt or the sub-system for taxing income is not to include or exclude a receipt from income, but rather to control the timing of when increases in wealth are taxed.

While the primary impact of the sub-system assignment of a transaction may be upon the timing of a receipt’s taxation, that assignment nonetheless will have a material effect upon the overall burden of taxation imposed. The significance of that timing effect, and thus the propriety of assigning a transaction to the sub-system for taxing debt or income, is best seen through illustration.\textsuperscript{73}

**CASE ONE**

Abbie, a key employee of Distributor, Inc., has obtained a $10,000 loan from Distributor, giving in exchange her personal note. The note matures in six years and bears interest at a market rate of 10\%, payable annually. However, at Abbie’s option, the note can at any time be applied to reduce outstanding accounts receivable due Abbie for the Distributor’s purchase of goods from her. Both Abbie and Distributor are subject to a marginal rate of tax of 30\%, and both can earn a 10\% pre-tax return on their investments.

Under current law, of course, this transaction would be governed by the bifurcation approach of section 7872.\textsuperscript{74} Absent that section, however, the consequences of the transaction would be controlled by the definition of debt employed by the Supreme Court. Because


\textsuperscript{73} Note that this case illustration, along with others that appear later on, can also be found in an appendix to this article. This is provided so as to facilitate cross-referencing in passages that demand a review of the case descriptions.

\textsuperscript{74} See I.R.C. § 7872(c)(1)(B). Section 7872 also contains a series of de minimis exceptions to its application that are ignored herein. See I.R.C. §§ 7872(c)(2), (c)(3), (d)(1).
of Abbie's control over the principal of the receipt, under the latter approach the receipt might be treated as income when Abbie receives it, notwithstanding the market rate of interest paid by Abbie while the note remained outstanding. It is important to understand exactly why this characterization of the transaction would produce an incorrect result.

Because the repayment obligation bears a market rate of interest,77 the present value of the obligation is equal to the amount of the receipt.78 Accordingly, Abbie's transaction has not produced an economic gain and, under the principles of income taxation, should not be subject to tax, at least not in year 1. That result is achieved by fully recognizing her repayment obligation in year 1, and thus assigning the receipt to the sub-system for taxing debt.

The importance of not taxing Abbie on her receipt (that is, on an amount greater than her actual increase in net worth) can be demonstrated by an examination of the after-tax economic consequences of the transaction. If Abbie reinvests the receipt, obtaining a market rate of return, and ultimately repays the loan, the overall transaction will produce neither a net gain nor a loss; Abbie will return or pay over to the lender principal and interest precisely equal to the amount she receives. Since the transaction does not change her economic position, there is simply no occasion for the imposition of tax. Accordingly, no net income tax burden should be imposed upon the transaction. Such a result is achieved under the pattern of taxation applicable to debt. In this situation, neither the receipt nor the repayment of the receipt has any income tax consequences, and the deductions for the payment of interest will offset the tax imposed upon the return that derived from investing the receipt.

Conversely, under the pattern for taxing income, an economic receipt is immediately taxed in full. Had Abbie simply received compensation in the amount of $10,000, for example, she would have been subject to a tax of $3,000 and thus would only be able to reinvest the $7,000 in after-tax proceeds of the receipt. Since the

77 The analysis in this section ignores the impact that the likelihood of repayment may have upon the current taxation of the receipt. That issue is addressed in the text accompanying notes 126-44 but does not alter the conclusions reached here.

receipt would not be offset by a repayment obligation (including any obligation to pay interest), Abbie would retain the entire return generated by the reinvestment of her after-tax proceeds. That return, however, would be subject to income taxation. Under the sub-system for taxing income, both the initial receipt and the income generated by the investment of the receipt are subject to tax. As a result, after six years Abbie's after-tax income would have increased to $10,500.

The pattern of income taxation that Abbie's case exemplifies has sometimes been referred to as the "double taxation" of income from capital, a phenomenon that has been characterized as defective in principle. Whether this is an accurate assessment is not presently important. Defective or not, the immediate taxation of receipts and the income generated therefrom is a fundamental characteristic of income taxation and thus constitutes the "ideal" burden of an income tax. To the extent that the taxation of the initial receipt is deferred, or the income derived from the investment of the receipt untaxed, this normal burden of the income tax is avoided and the transaction is subsidized.

In Case One, however, subjecting Abbie's receipt to this sub-system for taxing income, as might occur under the judicial approach to debt, would produce an incorrect result. If a tax were imposed on the receipt of the $10,000 loan, Abbie would only be able to

---


The primary consequence of the "double" taxation of investments is that, over time, the effective rate of tax on an investment will be greater than the nominal rate of tax. Assume, for example, a world without taxation in which a taxpayer receives $1,000 of compensation at the end of year 0 that can be invested at a 10% return. After two years this investment would grow to $1,210. It might be supposed that, following the introduction of a 30% tax, a taxpayer (assuming no change in interest rates) should be left with 70% of $1,210, or $847. Under the existing structure of the income tax, however, that is not the correct result. The initial receipt would be subject to tax which would only allow the investment of $700. Since the return on that investment would also be subject to current taxation, that amount would grow at a 7% after-tax rate of return and thus would produce only $801 after two years.

Under other systems of taxation, this effective increase in the nominal rate of tax can be avoided. In particular, under a consumption tax, the salary and the return from the investment of the salary would not be subject to tax until it was withdrawn from investment and consumed. Thus, after two years the taxpayer would have accumulated $1,210. Subjecting that amount to a 30% tax at the end of year 2 would, of course, preserve the nominal rate of tax on the overall transaction.

invest, and thus earn a return, on the after-tax proceeds of the receipt. At a 30% tax rate, Abbie would only be able to invest $7,000 and thus would derive a pre-tax annual return of $700. However, she still would be required to pay interest to Distributor on the full $10,000. As a result, Abbie would be required to pay out $1,000 in interest annually — $300 more than she was able to earn.\(^79\) The imposition of an immediate tax on the proceeds of the loan would convert a transaction that had previously been economically neutral into one generating an after-tax economic loss.\(^80\) That result, so fundamentally inconsistent with the goal of taxing only gains in wealth, would be plainly incorrect.

This initial overtaxation of Abbie will not be corrected by permitting her to deduct the repayment of the $10,000 in year 6: All other things remaining equal, the tax benefit from that deduction will precisely offset the amount of the tax burden imposed upon her in year 1.\(^81\) However, that benefit will not adequately compensate Abbie for the premature imposition of tax. The deduction in year 6 will not reverse the harm that Abbie suffered as a consequence of losing the opportunity to invest an amount equal to the tax paid in year 1 over the six year period that the transaction remained open. Thus, even though her transaction was economically neutral prior to taxation, Abbie will still suffer an after-tax loss.\(^82\)

The fundamental error in taxing Abbie's receipt thus becomes

\(^79\) Of course, if the borrower reinvests the proceeds at a different rate of return than the interest rate charged by the lender, the borrower will obtain an economic gain, or loss. That profit or loss, attributable to the management of the funds by the borrower, will produce taxable income or loss. Thus, any economic changes experienced by the borrower will be reflected in his income tax.

\(^80\) Under some circumstances, the improper tax burden resulting from the imposition of this tax could be offset by extending to the lender an immediate deduction in the amount of the loan. The resulting tax benefit to the lender might then eliminate the burden on the borrower, viewing the parties together. Such "surrogate" taxation is discussed in the text accompanying notes 155-57. The possibility of this "two wrongs can make a right" approach to taxation does not detract from the text's conclusion that taxing the borrower is improper.

\(^81\) That is, the $3,000 reduction in her tax liability produced by deducting the repayment will equal the $3,000 tax imposed upon the receipt.

\(^82\) The detriment to Abbie can be expressed differently. The present value of the tax benefit in year 6, discounted over the six years of the transaction, will be significantly less than the immediate burden of the tax in year 1. The difference between the present value of the tax benefit and the nominal value of the tax burden represents the present value of the income that could be earned investing an amount equal to the tax paid. It thus equals the present value of the loss sustained by Abbie.
apparent from an examination of the income generated by the reinvestment of the receipt. Imposing a tax on the receipt is erroneous not merely because the tax would violate an abstract principle barring taxation in the absence of, or in advance of, an accretion to wealth. Rather, taxation is improper because the imposition of tax would deprive the taxpayer of the ability to fund the obligation to make payments of interest on the offsetting liability. Since that deprivation is inconsistent with the very concept of income taxation, the imposition of tax is improper. The critically important corollary to this observation, developed below, is that taxing Abbie's receipt is not improper merely because the receipt was offset by a repayment obligation; the repayment of that obligation was fully funded by the deduction available in year 6.

It remains to be considered, of course, whether these conclusions would be altered if Abbie in fact failed to repay the receipt. That possibility appears to be a substantial factor in the test applied by the Supreme Court in Indianapolis Power, with its focus upon the borrower's control over repayment. An analysis of the conversion of loan proceeds to retained income, and of the tax imposed at that time, appears below. Assuming for the moment, however, that the transaction is concluded in accordance with its terms, it seems improper to impose tax on a receipt during the period that the receipt is offset by a repayment obligation bearing a market rate of interest.

Analysis of the simplest case of receipts that are offset by obligations of equivalent value demonstrates, at least in one context, that the definition of debt employed by the Supreme Court is inadequate. To secure a correct burden of tax on Abbie's transaction, her receipt must not be subject to tax. Under our income tax system, that result should be achieved by recognizing the repayment obligation and classifying her receipt as the proceeds of a loan. Under the judicial definition of debt, however, that classification is not assured. In Indianapolis Power, the borrower's control over repayment was deemed far more significant than the interest rate, and this suggests that the repayment obligation might be ignored and the receipt currently taxed. However, as Case One illustrates, that result would be incorrect as long as Abbie in fact pays a market rate of interest.

See supra notes 29-31 and accompanying text.
B. Non-Interest Bearing Repayment Obligations

The impropriety of imposing a current tax upon a receipt offset by a repayment obligation bearing a market rate of interest would not be controversial were it not for the doubt repeatedly cast upon that principle by the Supreme Court.\textsuperscript{84} Similarly, the taxation of receipts that are not offset by any repayment obligation — while not always followed in practice — is really not debated in principle.\textsuperscript{85} Rather, what has proven to be surprisingly elusive is determining the proper taxation of receipts that are offset by a non-interest bearing repayment obligation.

CASE TWO

Like Abbie, Bob is employed by Distributor and obtains a $10,000 loan from his employer. The note given by Bob in exchange for the loan also matures in six years but does not bear any stated interest. Bob is also subject to a marginal tax rate of 30% and can earn a 10% pre-tax return on his investments.

With the tools available under present law, there are three possible income tax consequences of such a transaction to Bob. Under the judicial approach to debt, the receipt might be (1) entirely excluded from income, by respecting the parties’ characterization of the transaction; or (2) entirely included in income, by recharacterizing the receipt as disguised compensation. The third possible outcome would involve the bifurcation of the receipt as required by section 7872. In fact, under current law section 7872 would preempt the judicial approach and the transaction would be bifurcated. Nevertheless, it is instructive to examine the consequences of applying the Supreme Court’s “all-or-nothing” approach.

1. The Judicial Approach

Under the decision in Indianapolis Power, Bob’s receipt might very well be excluded from his income because it constituted the proceeds of a loan. His receipt is offset by an unconditional obligation to repay the entire amount borrowed. Under the Court’s reasoning, the absence of stated interest appears to be of little rele-

\textsuperscript{84} See supra notes 27-41 and accompanying text.
vance. However, unlike Abbie's receipt, Bob's receipt is not offset by an obligation of equivalent value. Because his obligation is non-interest bearing, the value of that obligation to Distributor will be considerably less than the nominal principal amount of the obligation. In fact, the value of the obligation will be equal to the present value of the repayment obligation, discounted at Bob's after-tax interest rate. That is, the actual present burden of the obligation is equal to the funds that Bob would be required to invest today to produce $10,000 in six years, after reinvesting the after-tax return on that amount.\footnote{Because the repayment of the $10,000 principal amount of the loan to Bob would not be deductible to any extent, an accumulation of the full $10,000 would be required to repay the loan.} That figure, $10,000 discounted over six years at 7%, presently would be only $6,667. Accordingly, at the time of the initial receipt, Bob derived an increase in net worth equal to the amount by which the actual receipt of $10,000 exceeded the present value of the repayment obligation of $6,667. Bob, therefore, realized a gain of $3,333 at the time of the initial receipt.

Just as it would have been incorrect to tax Abbie in the absence of an increase in her wealth, it is necessary to impose an immediate tax on Bob's increase in wealth. The failure to do so would result in the material undertaxation of his transaction relative to Abbie's. In principle, the impropriety of not taxing Bob's increase in wealth at the time it occurs, and the magnitude of that impropriety, is well understood. The failure to currently tax an economic receipt that produces an accretion to wealth is equivalent to exempting from tax the income earned from investing that receipt.\footnote{See Fellows, supra note 1, at 732-33.} That relationship can best be seen by comparing the results of a single year under the alternative treatments, as shown by the table below. Under the first regime, corresponding to the correct application of the sub-system for taxing income, the receipt is fully taxed but deducted at the end of the period. Under the second, corresponding to the failure to tax Bob's $3,333 increase in wealth, the receipt is not taxed until the end of the period.
The highlighted figures reveal that the after-tax investment return derived from investing the pre-tax proceeds of the receipt ($233) is equal to the pre-tax investment return derived from investing the after-tax proceeds ($233). Therefore, it may be observed that the overall economic effect of not taxing an economic receipt is equivalent to not taxing the income produced by the receipt. Accordingly, to the extent that Bob’s increase in wealth is not taxed, he would obtain a tax preference. This preference would be equivalent to exempting from tax the income derived from investing the $3,333 increase in wealth over the period that the transaction remained open. Under an income tax, it simply is wrong not to tax either a receipt that produces an economic gain or the income from investing that receipt. When the transaction remains open for a long period of time, that improper benefit, or tax subsidy, can be quite substantial.

While a proper burden of taxation could be achieved by subjecting Bob to a current tax on his $3,333 gain at the time of the initial receipt, an identical result can be obtained in an easier fashion. The same burden of taxation would be achieved by taxing the entire amount of the non-interest bearing receipt when received, and permitting a deduction for the repayment of that amount when paid. Thus, immediate taxation of the entire receipt would burden Bob with a $3,000 tax (30% of the $10,000 receipt). However, deducting that same amount in year 6, when the receipt is actually repaid, would produce a tax benefit with a present value of $2,000 (after being discounted at Bob’s after-tax rate of interest). Accordingly, in present value terms, the net burden of tax imposed upon the overall transaction would be $1,000. On the other hand, impos-
ing an immediate tax on Bob's initial gain of $3,333 would result in an identical $1,000 net tax burden.

Because of this relationship, a proper burden of taxation can be imposed upon Bob without incurring the complexity of computing the present value of, or ascertaining the actual maturity of, the repayment obligation. A proper tax burden will be achieved if a non-interest bearing receipt is subject to immediate taxation, provided that a deduction is allowed for the entire amount of the repayment, if and when made. Subjecting Bob to current taxation on the entire $10,000 amount of the receipt initially might have appeared to produce an improper result because Bob would be taxed on an amount greater than his $3,333 actual increase in net worth. However, because the combination of a current tax and a deferred deduction produces the same result as the current taxation of the actual increase in wealth, a correct burden is in fact achieved.

Subjecting Bob's receipt to immediate taxation in full, notwithstanding the existence of a non-interest bearing repayment obligation, is the result that would be achieved under the judicial definition of debt if Bob's repayment obligation were wholly disregarded. Ignoring that obligation would result in the characterization of the receipt as disguised compensation and the assignment of the receipt to the sub-system for taxing income. As in the analysis of Abbie's case, the propriety of that result can most readily be observed from an examination of the economic consequences of investing the receipt.

What distinguishes Bob's receipt from Abbie's, of course, is that he does not have the economic burden of paying interest on the receipt. In Abbie's case, that burden required the deferral of tax on the receipt to allow her to fund the obligation to pay interest. In Bob's case, that justification for assigning his receipt to the sub-system for taxing debt is wholly lacking. Accordingly, if Bob's receipt is to be treated as the proceeds of a loan, that result must be justified by the existence of the non-interest bearing repayment obligation itself. However, the mere presence of a non-interest bearing repayment obligation does not justify the deferral of tax upon a receipt.

If Bob's $10,000 receipt were taxed when it was obtained, he would be left with only the $7,000 after-tax proceeds of the receipt. Upon the investment of that amount, those proceeds would grow at an after-tax rate of return to $10,500 over the six year maturity
of the loan. However, if Bob were then required to return the initial receipt, he would obtain a tax benefit of $3,000 upon the deduction of the $10,000 payment. The after-tax burden of the repayment would then be $7,000. Accordingly, Bob would be able to return the entire principal amount of the receipt, while retaining the full $3,500 after-tax profit from investing the receipt for six years. Thus, if a repayment obligation is ultimately honored, the taxpayer will be fully compensated for the initial taxation of the receipt by the deduction obtained for the full amount of that repayment in the year in which it occurs. Accordingly, the mere existence of Bob's repayment obligation does not justify the deferral of the taxation of his receipt.

The net result of taxing the initial receipt, and granting a deduction for the repayment, is simply to limit Bob's investment over the six years to the after-tax proceeds of his receipt, while permitting the retention of the entire after-tax return on that investment. This result, of course, corresponds precisely to the burden of taxation imposed by the sub-system for taxing income. Indeed, the $3,500 after-tax profit that Bob would retain under this pattern of taxation represents the after-tax yield on the six-year investment of the $10,000 receipt.

Imposing a current tax on Bob's receipt thus leaves Bob in the same economic position as one who derived a $10,000 item of fully taxable income for the six years over which Bob retained his receipt. That result is entirely sound. Bob obtained an interest-free receipt, and thus was entitled to retain the full amount of the after-tax return from investing the receipt. Since Bob obtained the economic benefit of the receipt of income while the transaction remained open, subjecting his transaction to the sub-system for taxing income is entirely appropriate.

On the other hand, treating Bob's receipt as the proceeds of a loan is unjustifiable and produces an incorrect result. Under the sub-system for taxing debt, Bob would be able to invest the entire $10,000 pre-tax receipt. Because he is not obligated to pay interest on that receipt, he would retain the entire after-tax return on that investment. Thus, at the end of six years, Bob's investment would have grown to $15,000. Upon the discharge of his repayment obligation, which would not have income tax consequences, Bob would retain an after-tax profit of $5,000 on his transaction. This is $1,500 more profit than the $3,500 profit that Bob would derive
under the sub-system for taxing income. This additional profit represents Bob's return on a six-year investment of an amount equal to the $3,000 tax payable on his receipt, under the sub-system for taxing income. Thus, it reflects the value of the deferral of that tax.

Under this pattern of taxation, Bob would avoid one of the levels of tax imposed by the sub-system for taxing income, even though he obtains the economic benefits of the receipt of income. As a result, Bob would have obtained the benefits of deferring taxation of his receipt (as extended by the sub-system for taxing debt), even though he was not subject to the economic burdens that would justify such a deferral. Accordingly, Bob would have achieved an after-tax result more favorable than that extended by a proper application of either the sub-system for taxing income or the sub-system for taxing debt. That benefit would constitute a significant and unwarranted tax preference.

The broader principle that emerges from this comparison of Bob's transaction with Abbie's is that the justification for the deferral of tax provided by the sub-system for taxing debt lies not in the repayment obligation itself, but rather in the obligation to pay a market rate of interest on that obligation. Absent the economic burden created by that interest expense, the justification for the deferral of tax disappears. Instead of resulting in a correct allocation of tax liabilities, applying the sub-system for taxing debt to a receipt that is offset by a non-interest bearing obligation results in the material undertaxation of the recipient. Therefore, the judicial approach to debt errs to the extent that it would recognize the full principal amount of a non-interest bearing repayment obligation as offsetting the tax otherwise applicable to a receipt. Whether any portion of such a receipt should be recognized as "debt" depends upon the propriety of the congressional approach to debt.

2. *The Section 7872 Approach*

The other approach to the taxation of Bob's receipt under current law would be the bifurcation approach of section 7872. Under section 7872, the transaction is wholly reconstructed and treated as if Bob received a discounted loan bearing interest at the market rate of 10%, as well as an amount of taxable compensation. The non-taxable principal amount of the discounted loan is quite prop-
erly computed by discounting the nominal amount of the repayment obligation of $10,000 by a pre-tax interest rate to determine the amount of interest that would in fact be paid at the maturity of such a loan. Under that approach, Bob would be treated as receiving a discounted loan in the amount of $5,640 that ultimately would require the payment of $4,360 in interest. In addition, Bob would be treated as receiving immediately taxable income of $4,360. The taxation of the discounted loan would be controlled by the usual rules of the Code governing discounted interest. Thus, Bob would be entitled to accrue an annual interest deduction, computed under compound interest principles, that would equal the income that could be earned by investing the loan’s $5,640 proceeds at the same rate of interest. Because of that deduction, the $5,640 will increase at Bob’s pre-tax rate of return and in six years will equal the $10,000 required to repay the receipt.

If Bob had in fact received compensation of $4,360 and a discounted loan of $5,640, the overall burden of taxation imposed by section 7872 would clearly be correct. However, that is not what Bob received, and the section 7872 result is incorrect. The analogy to the receipt of a discounted loan plus an unrelated payment is false, and results in the material undertaxation of the recipients of interest-free receipts.

Under section 7872, taxpayers are treated as the recipients of discounted loans because that reconstruction is thought to be the most accurate reflection of the borrower’s theoretical income. Working backwards from the amount the borrower is obligated to repay, the pre-tax present value of the repayment obligation clearly represents the principal amount of the loan that could have been obtained for that repayment, on the maturity date, and at the assumed rate of interest. Accordingly, it is concluded, that computed amount represents the market value of the repayment obligation and is thus the portion of the receipt that does not re-

---

**I.R.C. § 163(e) (1988).**

**It is not surprising that there are different ways of recharacterizing, and thus taxing, an interest-free receipt. A non-interest bearing “loan” does not reflect commercial reality and thus must be reconstructed to bring the transaction into conformity with its economic substance. Not uncommonly under the tax laws, in such a situation there will be two or more competing potential characterizations, each having different income tax consequences. See Levmore, Recharacterizations and the Nature of Theory in Corporate Tax Law, 136 U. Pa. L. Rev. 1019 (1988).**
present a gain. As such, it should not be subject to tax.

The fallacy in this justification for the section 7872 approach is that the recipient of an interest-free loan is not in the same legal or economic position as the borrower on a discounted loan, and thus the reconstruction does not reflect the market value of the repayment obligation. Had Bob in fact received a discounted loan of $5,640, the lending Distributor would be entitled to be repaid that amount, free of tax, plus interest of $4,360, which would be fully taxable. Because that interest would be taxed as it accrued, Distributor’s investment in Bob would grow at an after-tax rate of interest, as would any other normally taxed investment. Thus, upon repayment in full, Distributor would be left with $8,460 after the payment of all taxes, not $10,000. For that reason, a true discounted loan may be terminated at any time, without prejudice to either party, for a payment of the original amount loaned plus interest accrued to that date. Assuming that Distributor could reinvest that amount at the same return, the investment would continue to grow at an after-tax rate of interest and would produce $8,460 by the end of year 6.

The maker of an interest-free loan, however, is entitled to receive $10,000 at the end of year 6 free of all taxes. Accordingly, to terminate the transaction without prejudice would require that Bob pay Distributor an amount that would grow, after taxes had been paid currently on the return from that amount, to $10,000 — not merely $8,460. That is, Bob would be required to pay an amount equal to $10,000, discounted to the date of termination at an after-tax rate of interest. As seen above, the amount that would be $6,667, not $5,640. In fact, therefore, Bob is not in the same position as if he had received a discounted loan. The legal and economic relationships established by an interest-free loan are quite different from the relationships established by the receipt of an interest-bearing, discounted loan. It follows that the approach of section 7872 cannot be justified by analogy to a discounted loan.

Indeed, the result reached under section 7872 cannot be justified at all; as shown above, the correct amount for which Bob should be taxed in year 1 is $3,333, not $4,360. Moreover, after excluding the $6,667 from income in year 1, Bob should not be entitled to any

---

*See supra text accompanying note 86.*
further tax benefit from the repayment of the receipt, because the exclusion would fully compensate Bob for the burden of the repayment obligation. Thus, Bob may set that $6,667 aside and in year 6, after accumulating the after-tax return on that amount, he would have the $10,000 required to repay the receipt. Section 7872 is therefore in error in two related respects: the recipient is overtaxed upon the commencement of the transaction, while in future years the recipient is undertaxed by the amount of the deductions allowed for the artificially created interest. As shall be seen, the net effect of section 7872 is to materially undertax the recipients of interest-free receipts.

The attempt to justify section 7872 by analogy to a discounted loan is simply circular. Computing the present value of the repayment obligation using a pre-tax rate of interest would be correct only if the obligor were entitled to interest deductions that would offset the income produced by investing the receipt, thereby allowing the investment to grow free of tax (that is, at the pre-tax rate). However, the obligor would only be entitled to those deductions if the transaction were reconstructed as an interest-bearing loan. Thus, the analogy to a discounted loan is simply a restatement of the erroneous result produced by section 7872.

More importantly, perhaps, the burden of taxation imposed on Bob by section 7872 is inconsistent with the principles of the sub-system for taxing debt and the sub-system for taxing income. It was observed above that the failure to impose any current tax on Bob's receipt was incorrect, because it allowed Bob to earn and retain a return on his temporary investment that was greater than the $3,500 that would result from the proper application of the sub-system for taxing income. Section 7872, however, produces precisely the same preferential tax burden with respect to the portion of the receipt that remains untaxed. Thus, under that provision, Bob is entitled to retain an amount equal to the amount for which he was initially subject to tax, plus the return thereon. After six years, this would amount to $4,578 — a result that is too favorable to the taxpayer.  

---

*1 Alternatively, Bob could transfer the same amount to the lender in year 1 and by year 6 the lender would have the same $10,000.

*2 The reinvestment of the amount treated as a loan, increasing at a pre-tax rate of return, will be sufficient to repay the $10,000 after six years. The after-tax proceeds of the
Under the reconstruction of the receipt required by section 7872, the transaction is divided into two portions, only one of which is taxed. Upon the conclusion of the transaction, the borrower will have repaid an amount exactly equal to the amount of the initial receipt. Of that repayment, the borrower will be entitled to a deduction equal to the portion of the receipt originally taxed. However, the borrower will not be entitled to deduct an amount equal to the portion that was received without tax. Thus, ignoring the complex recharacterization mandated by section 7872, the taxpayer is treated as receiving two separate receipts, each of which is offset by a non-interest bearing repayment obligation. One of these receipts is subject to immediate taxation and thus is properly taxed under the rules of the sub-system for taxing income. However, the other receipt — while economically identical to the first — is not properly taxed, but instead is granted the deferral benefits of the sub-system for taxing debt. Because this receipt is not interest-bearing, however, it should not be entitled to that treatment.

As may be observed, the net effect of section 7872 is to extend to one portion of the receipt exactly the same pattern of taxation as would be extended to the entire receipt under a tax-free application of the judicial approach. Section 7872 improves upon the judicial approach by imposing a partial tax, but fails to achieve a correct level of taxation for the overall transaction. The burden of taxation imposed remains more favorable than the result that would be achieved under either the sub-system for taxing debt or the sub-system for taxing income.

The economic reality of Case Two is that Bob borrowed $10,000, repaid the loan, and was able to retain all of the income generated by his investment of the $10,000. Any reconstruction of that transaction that seeks to treat a portion of the receipt as offset by an interest-bearing obligation cannot achieve a correct result, because the repayment obligation is in reality not interest-bearing. Rather, because Bob could retain the entire amount of income generated amount treated as income, 70% of $4,360 or $3,052, would grow to $4,578, all of which Bob would retain.

In fact, even the taxable portion of the receipt is treated too favorably. Because the repayment of that portion of the receipt is treated as a payment of interest, Bob would be entitled to accrue annual deductions aggregating that amount. In fact, Bob should not be entitled to that deduction until repayment actually occurs.
by his investment — thus obtaining the economic benefits of earning income during the six years the transaction remained open — a correct tax result can only be achieved by subjecting the entire amount of the receipt to current taxation.

Section 7872 is the result of a too casual extension of the principles of section 483 and the notion that any deferred payment necessarily contains an interest factor. Under that view, since Bob's receipt must contain interest, the receipt must be recast to reveal that interest factor and thus the "real" amount that was loaned. The problem is that Bob's receipt did not contain interest and the real amount on loan was the entire amount of the receipt. This does not lead ineluctably to the conclusion that the receipt must be recast to include interest. Rather, it should lead to the conclusion that the transaction should not be treated as a loan for income tax purposes at all. Because Bob was not required to fund any obligation to pay interest, his entire receipt should be taxed under the sub-system for taxing income. Bifurcation under section 483 is a useful analytical tool for identifying the character of a gain realized by a taxpayer; the use of that tool to create interest, however, produces an incorrect income tax result because it converts an element of income into a tax-exempt receipt.

The foregoing analysis of Case Two demonstrates that the recipients of interest-free receipts are not correctly taxed under the congressional approach to debt embodied in section 7872. The creation-of-interest concept underlying that provision is simply erroneous. Interestingly, however, interest-free receipts might be correctly taxed under the all-or-nothing judicial approach. Wholly disregarding the repayment obligation and subjecting the entire amount of the receipt to current taxation would produce the correct result. This would occur if time value of money principles were used to determine whether an obligation should be respected or ignored, rather than used to bifurcate a single transaction.

---

84 See Lokken, supra note 1, at 11 (describing this notion as the "first premise" of the time value of money).

85 While the undertaxation of receipts should not be tolerated when a likelihood exists that the payment will not be deductible, it is not at all clear that the overtaxation of a receipt would be equally offensive to sound income tax policy. Advocates of the bifurcation approach would regard the full inclusion of an interest-free receipt in income as overtaxation of borrowers, notwithstanding the arguments to the contrary made herein. However, that result lies within the control of the parties.
Our analysis of section 7872 suggests several further conclusions regarding the kind of repayment obligations that should be recognized for income tax purposes. Plainly, receipts should only be treated as the proceeds of a loan to the extent they are offset by repayment obligations that bear a market rate of interest. Moreover, for the purpose of computing that rate of interest, only actual interest stated by the parties should be taken into account. Fictitious interest does not support the recognition of repayment obligations. Accordingly, for income tax purposes, the definition of debt should be limited to receipts that are offset by repayment obligations that bear stated interest at a market rate.

IV. EXTENDING THE ANALYSIS

While the primary significance of the sub-system for taxing debt lies in the treatment of conventional loans, the rules of that sub-system are applicable to a far broader range of transactions. Throughout the history of the income tax, taxpayers have sought to exclude from income receipts that were either subject to various fixed or contingent obligations to repay, or that forced the taxpayer to incur analogous costs in the future. In some cases, they have prevailed. Indianapolis Power, for example, involved cash deposits to secure the customer's obligation to make future payments for services. The decision not to impose a tax on the receipt when received essentially involved a decision to subject the deposit to the pattern of taxation applicable to debt. Similarly, in American Automobile Ass'n v. United States the taxpayer sought to escape the current taxation of payments for services to be rendered in fu-

The parties to the kinds of transfers considered in this article will always be able to secure a proper pattern for taxing their transaction by charging a commercially reasonable rate of interest. If the parties choose to proceed in a different manner, the fact that their transaction may be overtaxed does not seem to be of particular importance. In effect, the parties have chosen to accept a heavier pattern of taxation as the price for engaging in a transaction that does not conform to a standard of commercial reasonableness. That burden of taxation, therefore, cannot be viewed as unfair in any important sense. Accordingly, in the present context, if a choice must be made between the undertaxation or the overtaxation of receipts, the overtaxation of the recipient would represent far sounder income tax policy.

See supra note 15 and accompanying text. See also City Gas Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982). Compare Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968, 970 (6th Cir. 1942) (rent deposit was not taxable income) with Gilken Corp. v. Commissioner, 176 F.2d 141, 145 (6th Cir. 1949) (rent deposit was taxable income).

ture years. Had the taxpayer prevailed, the receipt would have been taxed under the sub-system for taxing debt. Since the pattern for taxing traditional loans has never been questioned, most judicial decisions defining the type of transactions subject to the sub-system for taxing debt have involved such quasi-loan transactions.

Moreover, while the sub-system for taxing debt normally is viewed in its role of excluding a receipt from income, it also controls the timing of deductions. Since the effect of a deduction is merely to shelter an equivalent amount of income from tax, the effect of applying the sub-system to an expenditure is identical to its application to a receipt. For example, in *Mooney Aircraft, Inc. v. United States* the taxpayer, a seller of aircraft, issued a "Mooney Bond" in the principal amount of $1,000 to each purchaser of an aircraft. The bond would be redeemed by the taxpayer upon the permanent retirement of the aircraft from service. The taxpayer sought to deduct from income the face amount of the Mooney Bonds in the year of sale. Had that position been sustained, the taxpayer would have avoided tax on $1,000 of otherwise taxable income, and the receipt would have been taxed under the sub-system for taxing debt.

Paralleling the judicial approach to the definition of debt in the context of conventional loans, the courts have not analyzed these tax deferral claims by reference to economic consequences. Nevertheless, when deferral is extended, the effect is to extend to these transactions the pattern of taxation used in the sub-system for taxing debt, not income. Because the deferral of tax on a receipt — whether achieved by an exclusion or a deduction — has the effect

---

96 Of course, that result would not be reached by characterizing the receipt as debt. For example, the legal issue presented in *American Automobile* was whether the Commissioner's authority to require the use of an accounting method that clearly reflected income could prevail over the requirements of the accrual method of accounting. See *American Automobile*, 367 U.S. at 690-92. In any such situation, the receipt will be subject either to the sub-system for taxing debt or the sub-system for taxing income.

97 Even fully non-recourse debt is in general subject to the sub-system for taxing debt, although that treatment is sometimes controversial and has to some extent been altered by statute. See I.R.C. § 465 (tax deductions limited to amount at risk).

100 420 F.2d 400 (5th Cir. 1969).
101 Id. at 402.
102 Id.
of treating the receipt as if it were the proceeds of a loan, the principles developed above for determining when such treatment is appropriate are equally applicable to the classification of all such receipts.

A. Advance Payments

In Case Two, Bob's receipt could have been a payment by the Distributor to Bob for goods to be delivered in year 6. Notwithstanding that modification of the facts of Case Two, however, Bob's economic position would remain unchanged. He would be in possession of a $10,000 receipt that must be returned in year 6, albeit through the delivery of goods in kind rather than the repayment of cash. Bob might then seek to defer the taxation of that receipt to the year in which the amount of the receipt was earned by the delivery of the goods. Alternatively, Bob might seek to offset the income generated by the receipt in year 1 by the amount of the costs that he would incur in fulfilling his obligation to deliver goods in year 6. In either event, should Bob prevail, the timing of the taxation of the receipt would be governed by the rules of the sub-system for taxing debt. That is, no tax would be imposed upon the receipt when received; rather, a tax would only be imposed later, when the receipt was no longer returnable and thus was converted to taxable income.

Because this transaction's economic effect would be identical to the economic effect of the receipt of loan proceeds, whether the deferral of tax on such an advance payment will produce a correct income tax burden on the receipt must be determined by the same principles that control the taxation of conventional loans. Thus, if the recipient is not required to pay interest on the advance payment, the failure to impose a full tax at the time the receipt is first obtained would result in the undertaxation of the recipient. Over the six years in which the transaction remained open, the recipient would be able to invest the pre-tax amount of the receipt, notwithstanding the fact that he was not required to pay any interest on the receipt. As demonstrated above, this is simply an incorrect re-

---

104 This approach has been tried by taxpayers in a number of cases. See, e.g., Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968).

The reason for obtaining an interest-free receipt is completely irrelevant to the economic effect of possessing the receipt, and thus has no bearing on the proper timing for taxation of the receipt.\textsuperscript{106} As in the original version of Case Two, because of the absence of interest, the amount of the receipt exceeds the present value of the obligation to deliver goods. This results in an immediate increase in Bob's net worth that should be subject to tax. However, as derived above, an equivalent and far more conveniently computed burden of tax can be achieved by subjecting the entire amount of the receipt to current taxation and allowing a deduction for the ultimate repayment.\textsuperscript{107} Thus, the full amount of a non-interest bearing advance payment must be subject to tax upon receipt.\textsuperscript{108}

On the other hand, if interest is payable on the advance payment, the immediate taxation of the receipt would result in the overtaxation of the recipient. The investment of the after-tax proceeds of the receipt would not yield a sufficient return to permit the payment of a market rate of interest on the entire amount of

\textsuperscript{106} In practice, the taxation of advance payments has become ensnared in a variety of accounting doctrines, including the requirements of accrual accounting and the desire to reflect income and associated expenditures in the same period. See generally Malman, Treatment of Prepaid Income — Clear Reflection of Income or Muddied Waters, 37 Tax L. Rev. 103 (1981). It is, of course, legitimate to inquire as to what rule Congress has prescribed and whether this rule conforms to a theoretically correct outcome. The issue here, however, is not what rule Congress has provided, but rather what rule would be correct in principle. Concerns over accrual accounting and the matching of income and expense are not relevant to this issue. As in Case Two, taxing a receipt, while not allowing a deduction for the future costs of earning the receipt, may appear to impose a tax on an amount greater than the actual increase in net worth (and thus mis-match income and expense). However, since taxing the receipt when obtained, and allowing a deduction for costs as they are discharged, is equivalent to taxing the excess of the receipt over the present value of the future obligation, a correct burden of taxation in fact would be achieved.

\textsuperscript{107} Normally, an advance payment will not actually be repaid. This can be viewed two ways. First, upon the delivery of the goods, the loan transaction could be viewed as closed by the constructive repayment of the full amount of the loan, the proceeds of which would be returned to the seller in payment for the goods. That repayment of the loan would generate a deduction that would be offset by the receipt of the taxable proceeds of the sale. Second, and more simply, the retention of the advance payment might be viewed as the failure to repay the loan, in which event no tax deduction would be generated. Either view produces the correct tax result.

\textsuperscript{108} Relatively few decisions have permitted the deferral of tax on advance payments. See Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968). It follows from the demonstration in the text that these decisions were incorrectly decided from the perspective of sound income tax policy.
the advance payment. Thus, as in Case One, the immediate taxation of an interest-bearing advance payment would improperly convert an economically neutral transaction into one that produced an after-tax economic loss. Since that result is erroneous, the imposition of tax must be deferred until interest is no longer payable on the receipt.109

While in principle the analysis of how to tax advance payments is identical to the analysis of conventional loans, in practice the taxation of advance payments raises nearly insoluble factual and administrative issues. When a cash receipt must be repaid in cash, any interest contained in the transaction will be evident. However, when an advance payment in cash is received in exchange for the future delivery of goods or services, it may be impossible to actually determine whether interest is payable on the advance. If so, it becomes impossible to determine the correct pattern of taxing the advance. In Case Two, for example, the $10,000 advance payment would not be interest-bearing if Bob were to charge the same $10,000 for the goods, regardless of whether payment was received in year 1 or year 6. Conversely, the payment would be interest-bearing if Bob were obligated to deliver, in year 6, goods that had a value of $15,000. However, without independent evidence of the value of the goods to be delivered, the existence of an interest factor in the transaction would be too difficult to establish in the routine administration of the taxing system.

Under section 483, the difficulties created by the lack of information regarding the taxation of deferred property payments are resolved by deeming all such payments to contain an interest component.110 By first computing and taxing the interest element in the transaction, section 483 renders the independent value of the property sold irrelevant. While a similar approach could be taken to advance payments, that approach would not produce an acceptable result. The foregoing analysis of conventional loans demonstrated that treating a portion of an otherwise non-interest bearing receipt as interest effectively exempts from tax the balance of the receipt — and thus undertaxes the recipient. Just as the extension of section 483 principles in section 7872 produced an incorrect re-

110 See I.R.C. § 483(c).
result, the application of those principles to advance payments produces a similarly incorrect result.\textsuperscript{111}

If the sound administration of the taxing system precludes the creation of interest in advance payments when the presence of actual interest is lacking or uncertain, the most appropriate method for taxing such receipts follows a clear path. Unless the taxpayer is able to demonstrate, clearly and convincingly, that retaining the advance is contingent upon the delivery of goods having a value that exceeds the advance by an amount at least equal to a market rate of interest, the advance must be treated as non-interest bearing and thus subject to immediate taxation in full.\textsuperscript{112} The effect of

\textsuperscript{111} By contrast, the application of § 483 to deferred payments will protect revenues from the manipulations of taxpayers entering into transactions that do not conform to commercial standards, principally by ensuring that interest is taxable to the seller at ordinary income rates.

In addition, for the transactions governed by § 483, the factual assumption that the purchase price includes an interest factor is far more reasonable than would be the case with advance payments. Nevertheless, in principle, sales of property for deferred payments should be governed by the principles developed here, instead of being bifurcated. Thus, if the value of the property is in fact equal to the amount of a non-interest bearing deferred payment, interest should not be created. Instead, the tax benefits to the purchaser of the property (e.g. depreciation), and the gain taxable to the seller, should be entirely deferred until an actual payment is made.

\textsuperscript{112} When a taxpayer is able to demonstrate that an advance payment bears a market rate of interest, a theoretically correct burden of taxation may be impossible to achieve. Analytically, such a transaction represents a loan from the buyer to the seller, maturing on the date of delivery of the goods, and containing a discounted interest factor. Upon the delivery of the goods, that loan is constructively repaid together with the discount interest. That full amount is then returned by the buyer to the seller in payment for the goods delivered. Had the transaction involved an actual loan, the receipt of the proceeds would not have been subject to tax. While the loan was outstanding, the seller-borrower would have been entitled to accrue annual deductions for the discounted interest, which would have offset the tax payable on the return generated by the investment of the advance. The repayment of the loan would not have any income tax consequences, yet the receipt of the purchase price for the goods would have been fully taxed.

To apply these concepts to an interest-bearing advance payment would thus require not taxing the initial receipt, extending annual deductions to the seller during the years prior to delivery, and subjecting the seller to tax in the year of delivery on an amount equal to the sum of the initial receipt plus the annual deductions claimed. Moreover, the buyer would obtain no deduction at the time of the initial payment, would be taxed annually on the discounted interest income, and would obtain a deduction in the year of delivery for an amount equal to the sum of the initial payment plus the income previously taxed to him.

While such a pattern of taxation is theoretically correct, it would be intolerably complex and utterly mystifying for both parties. It is clear that a simpler, if less accurate, solution is required. If the constructive loan were ignored and the income tax consequences of an interest-bearing advance payment simply deferred until the transaction was closed and interest no longer accrued on the advance, the net effect upon the parties would be to defer the
such a rule would be to resolve the administrative problems created by lack of information against taxpayers who enter into ambiguous transactions. This presumption seems particularly appropriate to the extent that the parties are able to secure loan treatment for advance payments by expressly providing for stated interest at a market rate.\textsuperscript{113}

**B. Obligations Not Attributable to Receipts**

A liability need not arise from an initial receipt. Taxpayers routinely incur current obligations to perform services or deliver goods in the future. Since the costs incurred in the performance of those obligations generally are deductible, the income tax analysis of the proper treatment of such future costs has focused upon the timing of deductions rather than upon the proper definition of debt. Nevertheless, the analysis of the proper timing of the deductions attributable to future costs is identical to the analysis of how to properly time the taxation of receipts.\textsuperscript{114} A logically developed system of taxation should treat both forms of obligation alike. The facts of Case Two can be modified to illustrate this identity.

---

annual income and deductions attributable to the discounted interest until the conclusion of the transaction. While imperfect, no other solution is apparent.

\textsuperscript{113} The parties could, of course, seek to achieve a deferral of the tax on an advance payment by merely pretending to pay a market rate of interest. For example, A might make a payment of $100 at the end of year 0 for services to be rendered at the end of year 2. If the parties treated the value of the services as $121, although they were actually worth only $100, the advance would be treated as interest-bearing — even though it actually was not — and thus would be improperly excluded from income. The utility of that evasion, however, would be limited.

The deferral of tax to the seller would be matched by the offsetting deferral of tax benefit to the purchaser. If the purchase price were deductible, the deception would not result in a reduction of the overall tax imposed on the transaction. The pretense would thus be useful only if the tax burden to the purchaser were less than the tax benefit to the seller, so that deferral would produce more benefit than harm. However, casting the advance as a loan would result in the creation of taxable interest income of $21 to the purchaser — income that would not be created by a non-interest bearing advance payment. If the purchase price were not deductible, that income would not be offset, at least immediately, and thus would result in increased taxation of the transaction that would offset the net tax reduction from deferral.

\textsuperscript{114} Some commentators have recognized this identity. See, e.g., Halperin, The Time Value of Money, 23 Tax Notes 751 (1984).
CASE TWO (DEDUCTION)

Distributor allows Bob to use its real property as a site for a World's Fair, but on the condition that at the conclusion of the Fair, Bob will restore the site to its original condition. Restoration will occur in six years and can be predicted to cost $10,000. Bob remains subject to a 30% rate of tax and can earn a pre-tax return of 10% on his investments.

Bob's economic position in this modification of Case Two is identical to his position in the original version; his assets are offset by a non-interest bearing obligation to pay, either to Distributor or to someone else, $10,000 in six years. Under prior law, if Bob were an accrual method taxpayer, he might well have been entitled to a deduction for the full $10,000 in year 1, since his obligation to restore the property was fixed and the cost was reasonably determinable.118 If that deduction were allowed, Bob could thereby shelter $10,000 of his income from current taxation. He thus would be in the same after-tax position as if he were allowed to offset the entire amount of a non-interest bearing obligation against a receipt. It is therefore not surprising that the courts would allow Bob to accrue this deduction well in advance of an actual payment. The deduction would be entirely consistent with the all-or-nothing judicial approach to debt, to the extent it completely ignores the time value of money.

Whether allowing Bob to accrue this deduction would result in the undertaxation of his transaction depends upon the treatment of the other party to the transaction, a matter examined below. However, just as it was clearly improper not to impose any tax on Bob's receipt of an interest-free loan in the original Case Two, allowing Bob to deduct the entire $10,000 in year 1 of the modified Case Two would also be improper. As was the case with the taxation of interest-free receipts, however, establishing the correct treatment of such non-interest bearing future costs has proven difficult.

During the same period in which Congress was developing the bifurcation approach of section 7872 as a means of addressing the

tax reduction potential of interest-free receipts, consideration was given to creating a mechanism for eliminating the similar problems posed by the undertaxation of future costs. However, the commentators remain sharply divided over how to devise a pattern for allowing deductions.\textsuperscript{116} The Treasury Department argued that the correct pattern would be to allow a deduction in year 1 for an amount equal to the present value of the obligation, discounted over the deferral period at an after-tax rate of interest, and that no further tax benefit should be allowed.\textsuperscript{117} Under this approach, in year 1 Bob would be entitled to a deduction of $6,667, which would result in an immediate tax benefit of $2,000. However, since that tax benefit would be equivalent, in present value terms, to not allowing any deduction in year 1 while allowing a deduction for the full $10,000 in year 6, the Treasury advocated the simpler approach of completely deferring the deduction until the year of performance.\textsuperscript{118} Under this approach, which is now contained in section 461(h) of the Code,\textsuperscript{119} Bob would be entitled to a deduction in year 6 of $10,000, producing a tax benefit of $3,000, the present value of which in year 1 would be $2,000.

Other students of taxation, however, contended that the correct treatment would be to allow a deduction for the present value of the obligation when it was incurred, computed at a pre-tax rate of return, and to allow subsequent deductions for the increase in that present value over time.\textsuperscript{120} Those annual increases would equal the return on the present value of the obligation and, over the period in which the transaction remained open, would aggregate the difference between the present value of the obligation and its face amount. Accordingly, by the time the obligation was discharged,
the taxpayer would have deducted the entire face amount of the obligation. Under this approach, Bob would be entitled to a deduction in year 1 of $5,640 and deductions aggregating $4,360 over the succeeding six years.

As may be observed, these two approaches to the treatment of future costs are the mirror images of the two approaches to the taxation of interest-free receipts analyzed above. The position primarily adopted by Congress in section 461(h) corresponds to the outcome obtained under the all-or-nothing judicial approach to debt: full inclusion of the proceeds of the receipt in income. Curiously, then, the position generally rejected by Congress, but urged by some commentators, corresponds to the bifurcation approach of section 7872.

For precisely the same reasons that led to the conclusion that the proceeds of an interest-free receipt should be fully included in income and not subject to bifurcation, the full deferral approach of section 461(h) produces the correct pattern for deducting future costs. Since Bob will be entitled to retain the entire amount of the after-tax return from investing income not dedicated to the payment of his six-year obligation, during that period this income should be subject to the rules of the sub-system for taxing income, rather than the sub-system for taxing debt. Thus, Bob's deduction should be entirely deferred until year 6.

On the other hand, the bifurcation approach would produce a manifestly incorrect result. Under that approach, Bob would be entitled to deduct the entire amount of the future cost over a period of years, and would be entitled to that series of deductions in advance of any actual economic detriment. Under an income tax, however, permitting a tax benefit in advance of an equivalent economic loss is always improper. Since the general

---

121 This rejection was less than complete. For a limited category of deductions, Congress did adopt a bifurcation approach. See I.R.C. § 467; infra note 168.

122 Where the future cost is in the nature of a capital expense or negative salvage value, the bifurcation approach would mean that the pre-tax present value of the cost would be depreciated rather than deducted. See Cunningham, supra note 116, at 591.

123 As demonstrated above, permitting an accelerated deduction for the present value of the future cost would not be improper. However, under the bifurcation approach, the taxpayer would be entitled to deduct not only the present value of the future cost, but also the annual increase in that present value. Accordingly, that stream of deductions would unavoidably exceed the present value of the future cost and thus would be improper. Indeed, those annual deductions effectively shield the income from the investment of the untaxed
effect of a deduction is identical to the effect of an exclusion from income, the acceleration of those deductions is equivalent to excluding an economic receipt from income. As noted above, that result is equivalent to excluding from tax the untaxed receipt’s return, and thus is improper.

Stated differently, allowing Bob a deduction for funds not yet transferred would permit Bob to make an investment of untaxed receipts. However, allowing the investment of a pre-tax receipt is improper unless the receipt is offset by a repayment obligation that bears a market rate of interest. When the receipt is offset in this manner, the recipient must be permitted to fund the obligation to pay interest through the investment of the pre-tax receipt. When the obligation is for a future cost, however, no such obligation to pay interest exists. Bob will be entitled to retain the entire return from the investment of his receipts prior to the discharge of the future cost. Accordingly, Bob should be subject to the sub-system for taxing income, not the sub-system for taxing debt.

Those favoring the bifurcation approach could surmount this problem by engaging in an analysis that replicates the justification for section 7872. Since Bob is obligated in year 1 to incur a cost of $10,000 in year 6, he might be viewed as the obligor on a discounted, and thus interest-bearing, loan in that amount. Under this view of Bob’s position, it becomes appropriate to exclude from income the $5,640 principal amount of the interest-bearing obligation, and to permit the further exclusion of an amount equal to the interest accruing annually on the principal amount. But that analogy to a discounted loan is no more valid in connection with future costs than it is in connection with interest-free receipts. If the obligor is to be viewed as the debtor on a loan, he must also be viewed as having discharged the future cost for a present payment that is returned to him as a discounted loan. However, that obligation could not be discharged in year 1 for a payment equal to the present value of the obligation, discounted at a pre-tax interest rate.

For example, assuming for the sake of analysis that Distributor would be fully subject to tax on the receipt of the $10,000 in year 6, the after-tax net benefit to be obtained by Distributor would be $7,000. Therefore, if Bob desired to discharge his obligation in year amount from taxation — the effect associated with an improperly accelerated deduction.

124 See supra text accompanying notes 105-6.
1, rather than in year 6, he could do so only by transferring $6,667 to Distributor in that year. After being taxed on that amount, Distributor would be left with $4,667 to invest. In six years, that amount would grow, after current taxes, to the $7,000 that Distributor would have obtained had it waited until year 6 to receive payment. Accordingly, the present value of Bob's obligation in year 1 is $6,667, and it would be appropriate to grant him a deduction for that amount in year 1. No further deduction would be granted, since the obligation is thereby treated for tax purposes as discharged. On the other hand, Bob could not discharge his obligation for a payment equal to $5,640, the pre-tax present value of the obligation. Accordingly, the analogy is false and it is not correct to view Bob as the obligor on a discounted $10,000 loan.

Viewed differently, if Bob had discharged his obligation by a payment in year 1, the payee would have been subject to tax. Thus, the amount that could be loaned back would be the full amount of Bob's payment reduced by income taxation. By treating Bob as obtaining a discounted loan equal to the full pre-tax amount of Bob's constructive payment, the bifurcation approach ignores one level of income taxation and would undertax obligors. This result is not surprising. The bifurcation of future costs is analytically identical to the bifurcation required by section 7872; both avoid one level of taxation and thus undertax borrowers.

Because a deduction serves the same role in an income tax as an exclusion from income, the proper treatment of deductions is subject to the same principles that govern the treatment of receipts. Since obligations to discharge future costs normally do not bear a stated interest, the proper pattern for deducting those liabilities is the pattern for taxing non-interest bearing receipts. Thus, the obligation should not be given any effect, for income tax purposes, until it is discharged by incurring an economic detriment. In this context, the judicial approach to debt — with its disregard of the time value of money — does not produce the correct result. The same is true of the congressional bifurcation approach. By contrast, the congressional scheme in Code section 461(h) does reach the correct result by using the all-or-nothing approach to defer the tax benefit of future costs in response to time value of money considerations.

---

128a Granting Bob a $10,000 deduction in year 6 is the equivalent of granting him a $6,667 deduction in year 1.
V. THE EFFECT OF NON-PAYMENT OF THE OBLIGATION: THE TAXATION OF CONVERTED TRANSACTIONS

Not uncommonly, transactions conclude in a manner that does not accord with the original terms established by the parties. A transaction that was initiated, and properly treated for income tax purposes, as a loan may later be altered by the parties in a manner that requires treating the receipt as income and subjecting it to tax. That is, the receipt will have been converted from debt to income. The cancellation of a traditional loan produces such a result. While originally taxed as a loan, the transaction will no longer be eligible for taxation under the sub-system for taxing debt once the obligation to repay is cancelled. The taxpayer thereby obtains an increase in net worth which must be subject to tax. A similar conversion commonly occurs in connection with quasi-loans, such as the security deposits involved in Indianapolis Power, that initially were treated as debt. Such receipts often are not repaid and thus are taxed to the borrower upon conversion.

In applying the definition of debt employed by the Supreme Court, factors bearing on the repayment of receipts assume a critical, perhaps controlling, importance. In the Court's view, the key factor in determining whether to tax a receipt under the sub-system for taxing debt or income is whether the lender or the borrower controlled the repayment of the receipt. It has already been demonstrated that, ignoring the possibility of non-payment, the key to determining whether the receipt and possession of an amount should be subject to current taxation is whether the receipt is offset by an obligation that requires the actual payment of a market rate of interest. This section addresses the impact of the possibility that the receipt will not be repaid.

In designing a pattern of taxation applicable to a transaction, it is entirely appropriate to examine the taxation of that transaction's conclusion. The overall burden of taxation imposed is as much a function of the tax imposed at this later time — whether the conclusion is in accord with the original terms of the transaction or not — as it is a function of the initial treatment. Indeed, examination of the conclusion assumes special importance when a

110 See Indianapolis Power, 110 S. Ct. at 591.
117 See supra text accompanying notes 28-31.
118 See supra text accompanying notes 64-95.
material likelihood exists that a transaction will not be concluded in accordance with its terms. An inadequate burden of taxation on the conversion of the transaction would create an obvious avenue for taxpayer manipulation.

A. Converting Debt to Income

The failure to repay the principal amount of a loan results in the borrower gaining cancellation of indebtedness income on the date he is relieved of the repayment obligation. The amount of tax imposed, however, is wholly unaffected by whether the borrower has also failed to pay interest on the loan. If the borrower has in fact currently paid a market rate of interest on the loan, the failure to repay the principal will result in a correct burden of taxation. However, to the extent that the borrower is also excused from the making of interest payments, the tax imposed will result in the substantial undertaxation of the borrower.

CASE THREE

Carrie has borrowed $10,000 on a note that matures in six years and bears a market rate of interest of 10%. The proceeds of the note have been reinvested by Carrie, also at a 10% return. Carrie is subject to a marginal tax rate of 30%.

Clarifying some aspects of this transaction will prove helpful. The receipt of the $10,000 will not be subject to tax if the transaction is respected as a loan, because the receipt is offset by a repayment obligation of equivalent value. That repayment obligation can be viewed as consisting of separate obligations to pay interest and to repay principal. As discussed above in connection with Bob’s obligation, the present value of the obligation to repay the $10,000 principal is $6,667, discounted at Carrie’s after-tax rate of return of 7%. Thus, Carrie could invest $6,667 today and in six years that amount, compounded annually at her 7% net return, would grow by $1^{1/2}$ times to $10,000. Since the repayment of the principal of a loan does not have income tax consequences, that $10,000 would be exactly sufficient to permit repayment of the entire receipt.

In this scenario, the present value of the obligation to pay interest is approximately $3,333. Since that interest payment would have been deductible by Carrie, her annual net burden would have
been 70% of the $1,000 interest payment, or $700. Thus, the present value of the obligation to repay interest would be the present value of an annuity for six years of $700, or $3,333. That is, if Carrie had invested the $3,333 at the same 10% return, yielding 7%, after-tax, the investment would produce a sufficient amount to make a net payment of $700 (the after-tax burden of the interest payable on the loan) at the end of each of the next six years, at which time the investment would have been consumed.

Under the conditions of Case Three, the transaction would not result in any economic change either before or after income taxes. The gain from reinvesting the proceeds would be paid in interest to the lender in each year and the entire receipt would be returned at the end of the period. Similarly, the tax on the investment return would be exactly offset by the interest deduction, and the borrowing and repayment would have no income tax consequences. By contrast, if the receipt were not offset by any repayment obligation and thus treated as taxable income when received, the $10,000 would have been subject to a tax of $3,000, leaving $7,000 to invest. At the end of six years, that amount would have grown to $10,500.

1. Failure to Repay Loan Principal

The sub-system for taxing debt operates correctly when a taxpayer, who has been paying interest currently at a market rate, fails to repay the principal amount of the loan. At that point, the taxpayer is subject to tax on the amount of the proceeds retained under the usual cancellation of indebtedness principles. For income tax purposes, the transaction is viewed as if the borrower received an economic gain equal to the amount of the debt cancelled and used that gain to repay the loan. In a normal commercial transaction, the constructive receipt would be taxable, while the repayment of the loan would not be deductible.¹²⁹ Thus, the net effect would be to subject the borrower to tax on the amount of the debt cancelled.

This result appears intuitively correct because imposing such a tax, at that time, accurately reflects the taxpayer's change in net

worth. Moreover, this result can be shown to be correct because the resulting burden of taxation is identical to the burden that would have been imposed had the amount not repaid been taxed as income when first received. Assume, for example, that in Case Three Carrie pays interest currently, but at the end of year 6 the obligation to repay the loan is cancelled. To the extent that proceeds are permanently retained, the taxpayer should be subject to the same burden of taxation as would occur if the receipt had been treated as income when received. However, if such a retroactive tax could be imposed with the benefit of hindsight, it would not be imposed on the entire amount of the receipt. Her receipt would remain subject to the obligation to repay interest, which has a present value of $3,333, and thus she should not be subject to tax on that amount. Rather, it would only be appropriate to tax her on the $6,667 difference between her $10,000 receipt and the value of the obligation to pay interest. That amount, of course, equals the present value of the obligation to repay principal which, with hindsight, we know will be cancelled. Thus, a proper burden of taxation will be imposed upon this converted transaction if it were possible to tax Carrie on $6,667 in year 1. However, exactly the same burden of taxation will be achieved by taxing $10,000 in year 6 as by taxing $6,667 in year 1.

If Carrie were taxed upon the cancellation in year 6, she would be subject to tax on the $10,000 proceeds retained. At her 30% tax rate, such a tax would leave $7,000 in her hands. On the other hand, had she been taxed in year 1 on $6,667, Carrie's 30% tax rate would have left her with $4,667 of that amount to invest. Over the six years, that amount would grow by \(1 \frac{1}{2}\) times to $7,000 — precisely the same amount as if the $10,000 amount of the loan were not taxed until year 6. Indeed, taxing cancellation of indebtedness income, when a market rate of interest is paid, is one application of the principle that the same tax burden results from the taxation of an amount in the future as from the present taxation of the present value of that amount, discounted at an after-tax market interest rate.\(^{130}\) Because $6,667 is the present value of $10,000,

---

\(^{130}\) For an application of this principle in a different context, see Coven, Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept, 74 Calif. L. Rev. 41, 68-69 (1986). See also Warren, The Timing of Taxes, 39 Nat'l Tax J. 499 (1986).
discounted at Carrie's after-tax interest rate of 7% over six years, taxing $6,667 in year 1 is the equivalent of taxing $10,000 in year 6. The results just observed are largely fortuitous; they certainly do not indicate that the taxing system has evolved an appropriate method for taxing the forgiveness of the principal amount of a debt. Thus, for example, if in year 1 the lender forgave the repayment of principal but not the payment of interest, Carrie would also be subject to tax on the face amount of the cancelled indebtedness, or $10,000. However, her receipt would remain offset by the present value of the obligation to pay interest. On these assumed facts, Carrie would be overtaxed; her increase in wealth was only $6,667, not $10,000. Nevertheless, when interest has been currently paid on a receipt and the obligation to repay the receipt or further interest is cancelled, the borrower's accretion to wealth is in fact properly taxed. This fortunate result should have substantial implications for designing the taxation of the initial receipt.

2. Failure to Repay Principal and Interest

An equitable tax burden is not achieved, however, if the borrower completely fails to make any repayments on the receipt. Returning to Case Three, assume that Carrie not only does not repay the $10,000 principal amount of the receipt upon maturity, but also does not pay any interest over the six years. On these facts, Carrie has in effect converted the character of the entire receipt from that of a loan to taxable income. Accordingly, if it were known in year 1 that Carrie would not make any repayments of the receipt, she quite properly would have been taxed on the entire $10,000 in that year. In retrospect, the obligation to repay was illusory; Carrie in fact obtained a $10,000 increase in her net worth in year 1.

The foregoing analysis suggests that, if in fact Carrie is not subject to tax until year 6 because her failure to make any repayments...
was not known in year 1, the correct tax will be achieved if she is taxed on $15,000 in year 6. As was the case when Carrie paid interest and only failed to repay loan principal, taxng $10,000 in the future is the equivalent of taxing $6,667 in the present, and taxing $15,000 in the future is the equivalent of taxing $10,000 in the present.

This result, however, is not achieved under the current taxing system. Instead, despite the fact that Carrie has not made any payments of interest, she will nevertheless only be subject to tax on $10,000 in year 6. This is precisely the same burden of taxation that would be imposed if she had paid interest on the receipt currently and had only failed to repay the principal. In this scenario, Carrie might be viewed as receiving a taxable economic benefit from the cancellation of the obligation to pay either principal or interest and, constructively, using that amount to repay the lender. However, even if Carrie were taxed on an amount equal to the full interest and principal cancelled, under such a reconstruction of the transaction she would be entitled to a deduction for the interest constructively paid. As a result, the net amount subject to tax on the cancellation would only equal the $10,000 principal amount of the receipt.

Under an income tax, failure to pay interest is logically not treated as gain but rather as the avoidance of loss, and thus is not subject to tax. Nevertheless, the net result of applying the sub-system for taxing debt to unpaid interest is to substantially undertax borrowers on the cancellation of their obligations to pay principal or interest.

The magnitude of this flaw in the sub-system for taxing debt is

---

132 See Allan v. Commissioner, 856 F.2d 1169 (8th Cir. 1988) (the principal amount of a mortgage, plus the unpaid interest accrued thereon, constituted the amount realized upon the transfer of the encumbered property to the lender in lieu of foreclosure). In Allan the propriety of an offsetting constructive deduction was not at issue because the accrual method borrower had previously deducted the interest as it accrued — deductions that were not challenged by the Commissioner.

133 Under current law this result is achieved by ignoring the cancellation of indebtedness income produced by the cancellation of an obligation, the actual payment of which would have been deductible. See I.R.C. § 108(e)(2). Cf. Del Cotto & Joyce, Double Benefits and Transactional Consistency Under the Tax Benefit Rule, 39 Tax L. Rev. 473, 492 (1984). The Code rule was required because the judiciary generally overlooked the point. See, e.g., Schrott v. Commissioner, 57 T.C.M. (CCH) 981 (1989).

readily apparent. Carrie would have obtained $10,000 in year 1 without incurring any tax and thus could have reinvested that full pre-tax amount. At her after-tax rate of return of 7%, the $10,000 would grow to $15,000 after six years. Upon payment of a $3,000 tax in year 6 on the unpaid principal amount of the loan, Carrie would be left with $12,000. By contrast, had the initial receipt been subject to tax, she would only have been able to invest the after-tax proceeds of the receipt, and in year 6 that amount would have grown to $10,500. Carrie, therefore, would gain $1,500 as the result of the initial characterization of her receipt as a loan, rather than taxable income, even though in retrospect the receipt was the economic equivalent of income. This result is significantly more favorable to Carrie than the outcome produced by either the sub-system for taxing debt or the sub-system for taxing income.

The net result of all this is to extend to Carrie the income tax benefits of the sub-system for taxing debt, even though she did not bear the burdens that would justify that pattern of taxation. Thus, while she derived the benefits of the receipt of taxable income from the initiation of the transaction, she was able to defer the taxation of the receipt. Indeed, the $1,500 benefit derived by Carrie represents her return for investing the $3,000 tax payable on the receipt over the six years the transaction remained open. In fact, Carrie would obtain exactly the same tax preference as Bob would have obtained in Case Two had he not been subject to any tax on his interest-free receipt. This result is hardly surprising; the failure to pay interest is actually the equivalent of obtaining an interest-free loan in the first instance.

3. Failure to Repay Bifurcated Loans

Interest on a loan, of course, need not be paid currently. Debt may be issued for an amount less than the amount to be repaid at maturity, in which event the element of discount represents an interest factor that will be paid at maturity.136 When interest is not paid, the undertaxation of the borrower occurs regardless of whether the unpaid interest was payable currently or discounted. However, because the payments of interest on a discounted loan

---

136 For a recent example of such an instrument, see Prabel v. Commissioner, 882 F.2d 820, 821 (3d Cir. 1989).
will not be made until the obligation to repay principal matures, the failure to repay the loan inevitably will extend to interest as well as principal. Accordingly, upon the failure to repay a loan bearing discounted interest only, the borrower almost certainly will be undertaxed.

Under the definition of debt adopted by Congress, if the value of the repayment obligation is less than the amount of the receipt, the transaction is bifurcated, thereby creating a discounted loan. \(^{136}\) Thus, by its terms, section 7872 produces the type of loan that will result in the undertaxation of borrowers if the loan is not fully repaid. Accordingly, applying the congressional approach to debt creates a tax avoidance opportunity.

Case Two examined an interest-free loan which, under section 7872, would be reconstructed as if it consisted of compensation in the amount of $4,360 and a discounted loan in the amount of $5,640. Assuming, for the sake of analysis, that the section 7872 reconstruction is correct, Bob would be properly taxed if he repaid the entire amount of the $10,000 receipt. However, if in year 6 the employer forgave the obligation to repay the receipt, Bob would not be properly taxed. Under general principles of taxation, Bob would have cancellation of indebtedness income in the form of $10,000 in compensation. Of that amount, $5,640 would be attributable to the cancellation of the obligation to repay the principal amount of the loan and $4,360 would represent a recapture of the interest deductions previously claimed. \(^{137}\)

As a result, the net amount upon which Bob would be taxed

\(^{136}\) See I.R.C. § 7872(b).

\(^{137}\) Under § 7872, the debt portion of the receipt is treated as a discounted loan for which interest must be accrued annually. See I.R.C. § 163(e)(1). The failure to repay amounts for which a deduction has been claimed would result in income under tax benefit principles.

Normally it would not matter whether the amount representing interest was taxable under cancellation of indebtedness or tax benefit principles; the tax imposed would be the same. However, when the debtor's economic benefit from the cancellation would not be taxable, the characterisation of the transaction would matter. Under tax benefit theory, the restoration of the prior deductions would be taxable. That would arise when a shareholder cancels a corporate obligation to repay principal and accrued interest. The issue has divided the commentators. Compare Eustice, supra note 129, at 252 (favoring the imposition of the tax under tax benefit theory) with Bittker & Thompson, Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co., 66 Calif. L. Rev. 1159, 1180-81 (1978) (favoring no taxation under the cancellation theory). Congress correctly decided to impose the tax. See I.R.C. § 108(e)(6); S. Rep. No. 1035, 96th Cong., 2d Sess. 19 n.22 (1980).
would be only $5,640; the cancellation of his obligation to pay interest would not have any net income tax consequences. Bob would thereby derive a benefit from the undertaxation of his transaction identical to the benefit Carrie derived by failing to repay principal or interest in Case Three. As in Case Three, that benefit would equal the deferral of tax on $5,640 of the receipt over the six years the transaction remained open. Because of this undertaxation of converted debt (and notwithstanding the adoption of section 7872), Bob's employer can confer a significant after-tax economic benefit on him by disguising a portion of his compensation as an interest-free loan.

Even in the unlikely event that this strategic non-repayment does not occur, unplanned defaults are far more likely under section 7872 than in the case of arm's-length commercial loans. The transactions subject to section 7872 are loans between related parties (i.e., members of a family or shareholders in closely held corporations), in which the parties' fundamental objective is to transfer an economic benefit to the borrower at a minimum income and transfer tax cost. The repayment of such a loan will occur only if repayment is consistent with the mutual income tax or estate planning objectives of the parties, and is not compelled by considerations of honest dealing or the need to maintain a sound credit rating. Since the primary purpose of the transaction is to confer an economic benefit upon the transferee, it can be anticipated that repayment quite commonly will not occur.

Furthermore, if this bifurcation approach were to be applied to quasi-loan transactions (as exemplified by the deposit system involved in Indianapolis Power), the likelihood of undertaxation would be equally great. Receipts such as security deposits and advance payments generally do not conclude in a repayment. In Indianapolis Power, for example, it was conceded that over one-half of all deposits were applied by the customers to the payment of their...

---

138 Bob's benefit is actually greater than this. Because he was entitled to accrue deductions for discounted interest annually, he has in effect accelerated deductions in that amount in exchange for the deferred tax, upon his failure to pay interest. Thus, Bob will benefit from this additional tax deferral.

139 Whether the transaction as a whole will be undertaxed is a function of the taxation of the other party, a topic addressed below. See infra text accompanying notes 153-72.
utility bills. Similarly, intuition suggests that most deposits treated as loans, such as those securing the payment of the last month's rental, are not actually repaid but rather are applied in satisfaction of the secured rental. In connection with some categories of receipts, such as advance payments for goods, the clear intention of both parties to the transfer is that the receipt will not be repaid.

There is, therefore, a material likelihood that non-interest bearing receipts will not in fact be repaid. If these receipts have been characterized under the tax laws as discounted loans, failure to repay will result in the undertaxation of the borrower. This aspect of the sub-system for taxing debt should also have substantial implications for the design of the initial taxation of the receipt.

4. Failure to Discharge Bifurcated Future Costs

As previously noted, some have suggested that the taxation of obligations to incur future costs should mirror section 7872, and that the taxpayer should therefore be granted a series of deductions in anticipation of the actual economic outlay. In practice, of course, many such obligations will not actually be met. When this occurs, the transaction will have absolutely no economic consequences. For example, in the deduction modification of Case Two, if Bob did not in fact restore the property to its original condition at the conclusion of the World's Fair, the anticipated future cost would not actually be accompanied by a change in the financial position of any party.

The undertaxation that occurs when a bifurcated loan is not repaid is far more abusive when the obligation is attributable to incurring a future cost, rather than to a receipt. Under the bifurcation approach to deductions, the taxpayer would have been entitled to deductions equalling the full face amount of the obligation prior to the deadline for discharge of the obligation. Upon the ultimate failure to discharge that liability, the taxpayer would of course be subject to a recapture tax on an amount equal to the deductions previously claimed. However, the combination of deductions in early years and income in subsequent years results in a

\[^{140}\text{See supra note 20.}\]

\[^{141}\text{See supra text accompanying notes 120-21.}\]
material after-tax economic benefit. The taxpayer would have de-
ferred income taxes on an amount of income equal to the deduc-
tions claimed over the period of time that the transaction re-
mained open. Accordingly, in this instance the net effect of
bifurcating future costs that are not actually incurred is to convert
a transaction that had no pre-tax economic effect into one that
produces an after-tax benefit. Such a negative rate of tax is plainly
improper.

B. Implications of the Taxation of Converted Debt

The foregoing analysis strongly confirms the conclusions reached
thus far concerning the taxation of the initial receipt. A correct
burden of taxation will be achieved only if the tax rules discrimi-
nate between those receipts that are offset by obligations bearing a
market rate of interest and those receipts that are not.

Whether or not the receipt is repaid, a borrower that is paying a
market rate of interest on the obligation to repay a receipt will be
taxed appropriately under the rules of the sub-system for taxing
debt. Thus, in Case One, as long as Abbie actually paid the stated
market rate of interest on her obligation, she would be properly
taxed regardless of whether she repaid the loan or permanently re-
tained the proceeds. Accordingly, there is simply no reason to per-
mit the taxation of the initial receipt to be altered as a function of
the likelihood of repayment. For an interest-bearing loan, factors
concerning the repayment of the principal amount of the loan are
wholly irrelevant to the proper taxation of the initial receipt; a cor-
rect overall taxation of the transaction is assured in either event.

At the same time, the injection of factors bearing upon repay-
ment into the initial characterization of the receipt is not merely
pointless. If the exclusion from income of such an interest-bearing
receipt were successfully challenged, and the receipt recharacter-
ized as income at a time when the taxpayer remained subject to an
obligation to pay interest, an improper burden of taxation would
be imposed. Because the taxpayer's increase in wealth did not
equal the full face amount of the receipt, the resulting tax would
be excessive and the borrower would be overtaxed.

It follows, therefore, that the definition of debt employed by the
Supreme Court is fundamentally flawed. Drawing upon its prior
decisions, in Indianapolis Power the Court placed extreme empha-
sis upon the taxpayer's control over the repayment of the principal
amount of the receipt, and thus upon the potential for an actual repayment, while discounting the significance of the payment of interest. That analysis is simply backward, for it is the presence of a market rate of interest that should be of controlling importance. Thus, even if it were certain in Indianapolis Power that the security deposits would not be repaid, a proper burden of taxation would be achieved by imposing tax in the year that the deposit was converted to a payment for services and interest no longer accrued to the customer.\textsuperscript{142} It is clearly a waste of administrative and judicial resources to seek to characterize such a receipt as immediately taxable income, rather than the proceeds of a loan.\textsuperscript{143}

On the other hand, if neither the principal nor interest on a receipt is repaid, that fact is of substantial importance to the initial taxation of the receipt. Under these conditions an incorrect burden of taxation is produced, and the recipient will be materially undertaxed. This source of undertaxation is deeply ingrained in the sub-system for taxing debt, and cannot be avoided under the existing income tax regime.\textsuperscript{144} While any form of loan may result in the non-payment of both principal and interest, that possibility is most pronounced when the interest appears in the form of a dis-

\textsuperscript{142} This assumes, as did the Court, that the interest paid was at a market rate.
\textsuperscript{143} Evidence that interest stated on a loan might not be paid, however, would be relevant to the characterization of the receipt. If the borrower does not in fact intend to pay interest on a loan, the "loan" should be treated as non-interest bearing and fully included as income at the time of receipt. That inquiry, however, assumes that the payment of interest, and not the likelihood that the receipt's principal will be repaid, will be of paramount importance.
\textsuperscript{144} This improper allocation of the income tax burden, resulting from the complete cancellation of the repayment obligation, could be eliminated by a modification of the income tax rules. Thus, the benefit to Carrie of the six year deferral of her tax liability could be eliminated by imposing a statutory interest charge on the tax arising from the cancellation of her loan for the period in which the loan was outstanding, but interest was not paid. While such an approach would be correct in principle, it does not appear to be feasible.

A statutory interest charge would prove far more complex to design and administer than might at first appear. It would only apply to the extent that the borrower had not actually paid a market rate of interest on the cancelled loan. Thus, the charge would have to be designed to take account of whatever interest was in fact paid on the loan, giving due effect to any tardiness in payments. Thus, the computation of such an interest charge would be highly complex. Secondly, it would be improper to increase the effective tax burden on the borrower without simultaneously decreasing the effective tax burden on the lender. Thus, the imposition of a statutory interest charge on the borrower would require the making of an identical, and equally complex, refund of tax to the lender. However, lenders would only be entitled to relief to the extent that they would have been entitled to a tax benefit from the failure to obtain a repayment of the loan. That determination, too, would be both factually and legally complex.
count payable only on the maturity of the loan. Accordingly, sound income tax policy would be to avoid, rather than encourage, the creation of discounted debt.

If it were ever appropriate to treat a receipt that is offset by a non-interest bearing obligation as a discounted loan, it would be necessary to include within the definition of debt a subjective evaluation of the likelihood that the debt would be repaid, a test not unlike that applied today by the Supreme Court. Unlike interest-bearing receipts, ignoring the possibility of non-payment would create too great a potential for tax avoidance. The administration of such a test, however, would be difficult and uncertain. Even where successful, the test would not eliminate the undertaxation of borrowers who did not in fact repay principal or interest, even if they initially had intended to do so.

A vastly superior result would be reached, however, if the taxation of receipts that are offset by non-interest bearing repayment obligations were not deferred at all. The conversion of debt to income through the non-repayment of the receipt cannot result in undertaxation if either the full amount of the receipt were included in income at the time of the initial receipt, or if the entire deduction for a future cost were deferred until payment.

Following through the income tax consequences of applying the section 7872 approach to debt therefore confirms the conclusions reached above. A superior overall tax burden is achieved by the full inclusion of interest-free receipts in income rather than by bifurcating the receipt and treating a portion as a discounted loan. Indeed, even if it were concluded that the initial receipt would be as correctly taxed under the bifurcation approach as it would be under full inclusion, bifurcation would nevertheless be the inferior solution because of the tax avoidance resulting from the failure to repay such a receipt.

VI. LOW-INTEREST LOANS

The discussion to this point has assumed an unrealistically polarized world in which receipts either bore a market rate of interest or none at all. In practice, however, a wide variety of receipts are offset by repayment obligations that do bear a stated rate of interest. However, the stated interest often falls materially short of a market rate of interest. In Indianapolis Power, for example, interest was only paid on deposits after they had been held for over one
year. Thus, the effective interest paid by the taxpayer inevitably fell below a market rate of interest. A principal defect in the all-or-nothing judicial approach to debt is the inability to deal with below-market obligations in a tailored fashion. Thus, regardless of how the receipt is characterized for tax purposes, the tax burden imposed will be partly right and partly wrong. On the other hand, the great advantage of the congressional approach to debt, with its computation of the present value of the repayment obligation, is that any stated interest will automatically affect the computation of the amount that will be respected as a loan.

Low-interest loans cannot be taxed correctly without bifurcating the receipt in some manner. For the same reasons as indicated above, the recipient of a low-interest loan would be overtaxed if the interest obligation were ignored and the receipt fully taxed, yet that same individual would be undertaxed if the inadequate interest caused the entire amount of the receipt to be treated as non-taxable. However, the form of bifurcation adopted in section 7872 is incorrect and does not produce a correct burden of taxation on the receipt. Clearly, the proper taxation of low-interest loans requires a different approach to bifurcation.

It has been shown that receipts will be properly taxed if they are entirely excluded from income, to the extent they are offset by obligations that bear a market rate of interest. Moreover, they will be properly taxed if they are entirely included in income, to the extent they are offset by non-interest bearing obligations. For that purpose, only interest stated by the parties, and not interest artificially created through bifurcation, should be taken into account. If low-interest loans were divided into these two categories, the receipt could be taxed in accordance with the approach outlined here, and thus a correct tax burden could be achieved. In fact, such a division can be readily accomplished.

When a receipt is offset by a repayment obligation that bears a below-market stated rate of interest, the amount of the receipt that should be treated as a loan, and excluded from income, is the...
amount for which the present value of the actual interest established by the parties would represent a market rate of interest. By attributing all stated interest to the computed portion of the receipt, this portion of the receipt becomes offset by an obligation that bears a market rate of interest, and thus is properly excluded from income. Both for income tax purposes and as a reflection of economic reality, the balance of the receipt would continue to be offset by a repayment obligation. However, that obligation would be a non-interest bearing obligation and, under the proposals made here, such a receipt would be subject to taxation in full when received.

The income tax consequences produced under such a revised bifurcation of low-interest loans are best understood through an examination of a few simple illustrations.

Example 1. A loans $10,000 to B for six years and charges no interest, although the market rate of interest would have been 10%. The entire amount of the receipt would be currently taxed to B. Under current law, B would only be taxed on the excess of $10,000 over the present value of $10,000 discounted at 10% over six years, or $4,360.

Example 2. C loans $10,000 to D for six years, charging 6% interest when a market rate would have been 10%. The actual interest paid, $600 annually, represents a market rate of interest on $6,000. Therefore, D would be currently taxed on $4,000; $6,000 of the receipt would be treated as debt. Under current law, D would only be taxed on the excess of $10,000 over the present value of all payment to be made, or approximately $1,744.

Example 3. E loans F $7,384 in exchange for F's non-interest bearing note for $10,000 payable in six years. Discounted interest of $2,616 ($10,000 minus $7,384) would be paid on a loan in the amount of $3,384 if a 10% market rate of interest had been charged. Therefore, F would be currently taxed on $4,000. Under current law, F would be taxed on $1,744 ($7,384 less $5,640, the present value of $10,000).

Example 4. G loans H $10,000 on a demand note and charges 6% annual interest. If a market rate of interest were 10%, H would be currently taxed on $4,000; only $6,000 would be treated as a loan. Under current law, H would be taxed annually on the forgone interest of $400 but would be permitted an interest deduction for the same amount.
This revised approach to the bifurcation of low-interest loans is fully consistent with the current method of taxing wholly interest-free receipts and would impose a correct level of tax. The second example is a perfect illustration. On the receipt, D would be subject to a tax of 30% of $4,000, or $1,200, which would leave $8,800 to invest. Of the $880 pre-tax return on that amount produced by the market rate of 10%, $600 would be required to discharge the deductible obligation to pay interest, leaving $280 subject to tax. Thus, the annual after-tax investment return to D would be $196. That amount is the proper after-tax return on the investment of the after-tax proceeds from the receipt of $4,000 in taxable income. Under this approach, D would not be taxed on an amount sufficient to generate the funds needed to pay the actual interest charged on his loan ($6,000) but would be taxed on the amount of the receipt in excess of that principal amount. Thus, the taxation of D's receipt would have been properly allocated between the sub-system for taxing income and the sub-system for taxing debt.

In addition to producing a correct result, the results reached in these examples represent a substantial practical improvement over present law. The suggested approach to bifurcation is markedly simpler to apply than the extensive reconstruction required by section 7872. The approach is also more sensible and understandable because it conforms far more closely to the actual economic arrangement of the parties. Perhaps more importantly, by not artificially creating interest (the payment of which is deferred until maturity), this approach minimizes the likelihood that interest will not be paid on the portion of the receipt treated as debt. As a result, this method of bifurcating low-interest loans would minimize the undertaxation that occurs upon failure to repay.

Moreover, as example 4 indicates, a secondary benefit of the suggested revision is the ability to treat demand and term loans alike. Under section 7872, demand loans are treated quite differently than term loans. Because the aggregate amount of discounted interest cannot be computed when the maturity of a loan is unknown, interest for demand loans is computed on the entire amount of the receipt and taxed annually to the borrower. One

---

149 $4,000 \times [1-.30] \times .10 \times [1-.30] = $196.
150 Compare I.R.C. § 7872(a) with I.R.C. § 7872(b).
151 I.R.C. § 7872(a)(1).
result of this difference in treatment is that a materially larger artificial interest charge is created for demand loans than for term loans in the identical amount. This disparity constitutes a major conceptual flaw in section 7872. Under the proposed method of bifurcation, however, it is not necessary to compute the term of the loan. Rather, the proportion of the receipt treated as a loan is a function of the ratio of the stated interest to a market rate of interest. Thus, demand and term loans would be taxed consistently. The resulting ability to conform the treatment of these two types of loans would represent a substantial improvement in the rationality of the treatment of debt.

VII. THE TAXATION OF THE OTHER PARTY TO THE TRANSACTION

Imperfect taxation of transactions is not always a critical flaw. If the burden of taxation imposed upon one party to a transaction is balanced by an equal but opposite tax benefit extended to the other party, the imperfection in the pattern of taxation will not result in an incorrect level of taxation for the transaction as a whole. In other words, the error will not have a net revenue effect. Rather, the imperfection will merely shift the burden of taxation from one party to the other. However, in many circumstances, if the tax rules are known in advance, the parties will be able to adjust their transaction to produce the same after-tax economic consequences as would have resulted under a perfect pattern of taxation. When that ability is present, the marketplace will absorb the inequity that the imperfect pattern of taxation otherwise might have produced.

When conditions allow the parties to a transaction to account for an imperfect pattern of taxation, modification of the tax rules may not be productive. The imperfection will not have a revenue effect and will not result in unfairness to taxpayers. On the other hand, amending tax rules creates both costs and risks. Rational amend-

---

ments to the Code are difficult to achieve, can be highly complex, and may not operate properly. On balance, retaining an imperfect pattern of taxation that does not have major ill effects may be preferable to undertaking the revision of the tax rules.

The converse, however, is also true. If the income tax consequences of a pattern of taxation are not balanced by an offsetting impact upon another party, the tax rules will have a revenue effect. The transaction as a whole will be either over- or undertaxed. Moreover, whether the tax consequences are balanced or not, if the parties cannot adjust the form of their transaction to account for the tax system's imperfections, one or both parties will be treated unfairly. Under these conditions, reforming the tax rules to eliminate imperfect patterns of taxation becomes necessary.

In theory, the income tax consequences of the transactions considered in this article will normally be balanced. Under the assumptions employed thus far — that both the borrower and the lender are subject to the same rate of tax; that all funds are invested for the same return — a loan is not a revenue generating transaction. If the income tax burdens imposed on one party to the loan will be precisely offset by income tax benefits available to the other party. Furthermore, this symmetrical result is not altered by the imperfect taxation of the borrower described above. The improper taxation level of the borrower will be precisely offset by corresponding imperfections in the taxation of the lender.

Case Two, for example, involved a $10,000 receipt, offset by a non-interest bearing repayment obligation, that matured in six years. This receipt should have been entirely included in Bob's income when it was received. Since Bob was subject to a 30% tax rate, under that approach Bob would derive $7,000 from the transfer and pay a tax of $3,000. However, Bob's employer would be entitled to an immediate deduction for the $10,000 payment. After reflecting its tax benefit of $3,000, the net cost to the employer of the payment would be the same $7,000 that Bob received, and no net revenue would be generated or lost by the transfer.

It is clear that the failure to impose any tax on the $10,000 receipt in Case Two would result in the undertaxation of the recipient. However, a different tax rule would not necessarily have any

effect upon the transaction’s overall tax burden. If Bob were not to be taxed because the receipt was entirely treated as a loan, the employer would not be entitled to any deduction. As a result, the benefit that Bob would obtain from the deferral of tax would be precisely offset by the employer’s burden of having to defer its own tax benefit. As a result of the new tax rule exempting the receipt from taxation, the net cost to the employer would be the full $10,000 of the payment. Meanwhile, Bob would obtain a full $10,000 economic benefit.

It might appear that the net effect of not taxing the receipt would be to improperly shift the tax burden on Bob’s compensation from Bob to the employer. Indeed, this effect of balanced income tax rules is sometimes referred to as surrogate or substitute taxation. The tax properly attributable to Bob is instead paid by his employer. However, if the parties understand that this element of compensation will be ignored for income tax purposes, they can revise their transaction to retrieve the desired after-tax economic consequences. Here, for example, by reducing the amount of the payment to $7,000, the parties will be left in the same after-tax position as if the payment had been properly taxed. The employer’s net after-tax expenses after the payment would be $7,000 — precisely the amount of Bob’s benefit. If the parties address the desired after-tax consequences of their transaction, normal market forces will cause the parties to make precisely that adjustment and the surrogate tax will be shifted from the employer back to Bob.\textsuperscript{158} Under these conditions, surrogate taxation may actually play a positive role in the taxing system. It may be far simpler, for example, to impose a tax on the employer (by disallowing its deduction) than to impose a tax on Bob.\textsuperscript{158}

If the instances of excessive or inadequate taxation identified thus far were all capable of being offset by the operation of surrogate taxation, reform of the tax rules would be of little consequence. The statutory pattern, while defective in principle, would not result in an improper overall burden of taxation on the trans-

\textsuperscript{158} One way of describing this result is to say that in selecting a tax-exempt source of income, Bob has subjected himself to an implicit tax of $3,000 — which reduces his net after-tax income to $7,000.

\textsuperscript{158} Compare, for example, the provisions of § 274 that disallow deductions to employers for untaxed benefits provided to employees.
action or unavoidable unfairness to a party. Thus, it would not be of much consequence whether the receipt was taxed fully, or not at all, under the judicial approach to debt, or whether it was bifurcated under the congressional approach. However, precisely because the transactions examined by this article contain income tax consequences that generally are not balanced, the propriety of the judicial and the congressional approaches to debt is a matter of concern.

A. Sources of Imbalance

When the tax consequences of a transfer are not balanced, the incorrect taxation of the recipient will not be offset by the surrogate taxation of the payor, and the transaction as a whole will be improperly taxed. Imbalance in the taxation of any transaction may occur for a variety of reasons, the most apparent of which is that the parties may not face the same effective rates of tax. The most significant source of imbalance, however, occurs when the payment, while taxable to the recipient, is not deductible by the payor. Returning to Case Two, under a correct pattern of taxation, the receipt might be fully taxed when received — producing a tax of $3,000. If, however, the payment of the $10,000 were not deductible by the payor at any time, the treatment of the payor would not offset the treatment of the recipient and the transaction would generate a net tax liability of $3,000. Under these circumstances, if the tax rules were changed and a pattern of taxation adopted that wholly exempted the receipt from tax, that change in the rules would have a revenue effect. The revenue generated by the receipt

---

167. Indeed, the significance of § 7872 is confined to circumstances where the payor and the payee do not face the same marginal rate of tax. Thus, if the payor is a corporation and the non-loan portion of the payment would be recharacterized as a dividend, the payor would not be entitled to a deduction while the payee would have taxable income. Similarly, in the context of a gift loan, the payee may well be in a lower income tax bracket than the payor. In general, § 7872 has declined in importance under the current, less progressive income tax structure.

168. This aspect of the taxing system, while not unimportant, lacks the significance today that it once held. Under current law, the rate structure applicable to individuals is far more uniform than during prior periods, and the maximum rates of tax applicable to corporations are roughly equivalent to the maximum rates applicable to other taxpayers. Nevertheless, the ever-present potential for disparities in marginal rates of tax suggests that surrogate taxation and market forces should not be relied upon as cures for the imperfections of the taxing system.
would have been lost through the amendment, but no offsetting revenue would be gained from the correlative treatment of the payor. Thus, under this pattern of taxation, the transaction would receive a $3,000 subsidy as compared to a pattern of taxation imposing an immediate tax upon the receipt.159

A payment may not be deductible for a number of different reasons. A transfer from a corporation to a shareholder that is not respected as a loan may be a non-deductible dividend. Alternatively, the payment may not be deductible because it must be capitalized as part of the cost of an asset with continuing value.160

Thus, even if the payment represented compensation, the treatment of the payor might not balance the treatment of the payee. Quite commonly, however, the payment will not be deductible because it represents an expenditure for consumption by the payor. This was the situation in *Indianapolis Power*. While the utility recipient in that case was, of course, subject to tax on all payments received for providing power, the primarily non-business customers required to make deposits with the utility were not entitled to income tax deductions for the payments they made. As a result, the income tax treatment of the customers did not vary with the characterization of the transaction. Thus, any undertaxation of the receipt by the utility would not be offset by the surrogate overtaxation of the customers.

Because of the wide range of circumstances in which the treatment of the recipient is not balanced by the treatment of the payor, reliance upon surrogate taxation to eliminate the overall undertaxation of transactions is generally unsound. In the context of interest-free receipts, however, surrogate taxation is particularly inappropriate. Non-interest bearing receipts are not random commercial transactions, but instead represent deliberate steps taken by the parties to provide a particular form of economic benefit to the payee. This may occur either because such a benefit is mutually intended, as exemplified by an interest-free loan between related parties, or it may be coerced by the economic power of one

159 This subsidy may be shared by the parties. If, for example, only $8,500 were transferred, the net cost of the payment to the payor would be less, and the net benefit from the payment to the recipient would be greater, than the costs and benefits resulting from a correct pattern of taxation.

party, as occurred in *Indianapolis Power*. In these contexts, income tax consequences are particularly susceptible to taxpayer manipulation. If the recipients of interest-free loans are undertaxed, this method of transferring an economic benefit would be selected by the parties when surrogate taxation did not eliminate all of the tax benefit from the arrangement. Significantly, most of the quasi-loan cases to come before the Supreme Court involved non-deductible consumption expenditures by the payors of the receipts for which exclusion was sought.\(^{161}\) In these instances, surrogate taxation would not work at all.

**B. Deductible Obligations**

Balanced income tax consequences are no less significant when the obligation is not attributable to a receipt but instead represents a future cost.\(^{162}\) If the income tax consequences of the transaction are not balanced and the obligor is undertaxed, the transaction as a whole will be improperly undertaxed.\(^{163}\) In the context of

---

\(^{161}\) See *Hughes Properties*, 476 U.S. at 595 (gambling); *Schlude v. Commissioner*, 372 U.S. 128, 130 (1963) (dancing lessons); *American Automobile*, 367 U.S. at 688 (automobile club).

\(^{162}\) Recalling the modification of Case Two, in year 1 Bob incurred a deductible obligation to make a payment of $10,000 in year 6. On these facts it was observed that Bob would be correctly taxed if his deduction of the full $10,000 were deferred to year 6, as required by § 461(h). In that event, the transfer would be revenue-neutral if Distributor, the other party to the transaction, were required to report the full $10,000 payment in the same year 6. However, the transaction would also be revenue-neutral if Bob were entitled to claim his deduction in year 1, provided that the Distributor was also required to report the payment in year 1. Of course, under that pattern of taxation, Bob would be undertaxed by the value of the accelerated deduction, but the employer would be overtaxed by the same amount.

As in the case of a receipt, if the income tax consequences were known beforehand, the parties could account for the imperfection in the pattern of taxation. The after-tax cost of a payment of $10,000 in year 6, deductible at that time, would be $7,000 and the present value of that amount would be $4,667. Similarly, the year 1 present value of the after-tax benefit to the Distributor of a $10,000 taxable payment in year 6 would be the same $4,667. If instead the payment were deductible in year 1, although still not made until year 6, that pattern of taxation would benefit the payor while equally burdening the recipient. However, the surrogate taxation of the recipient would be shifted back to the payor if the amount of the payment were increased to $12,716. The present value of a payment in year 6 of that amount, less the benefit of a deduction in year 1 for that amount, would equal the net cost of $4,667 that Bob would incur, and the net benefit that Distributor would obtain, under a correct pattern of taxation.

\(^{163}\) See Fellows, Future Costs Reconsidered: A Reevaluation of IRC Section 461(h), 44 Tax Notes 1531, 1532-37 (Sept. 25, 1989) (arguing that the bifurcation approach to future costs is correct and that section 461(h) represents a debatable surrogate taxation of obligors).
future costs, the transaction will be undertaxed if a current tax cannot be imposed upon the recipient in the same period for which a deduction is extended to the obligor.\textsuperscript{164} Because in practice such an inclusion in income cannot be achieved, any approach to future costs that permitted a deduction in advance of payment would often result in an imbalanced pattern of taxation.

First, a tax may not be imposed upon a recipient until the recipient can be identified. Thus, for example, Bob might have had an obligation to restore his own land following a strip mining operation. The ultimate beneficiary of that cost would be the general public, but the public will not be taxed at any time on its generalized increase in well-being. Bob might hire a contractor to accomplish the restoration and a surrogate tax might be imposed upon that contractor. However, until the contractor is identified and hired (most likely in year 6), no such tax can be imposed. As a result, in a wide range of circumstances, recipients cannot be taxed prior to the actual discharge of the future obligation.\textsuperscript{165}

Second, even where the recipient can be readily identified, the imposition of an offsetting tax liability may not be permissible under one of the Code rules that defers or exempts the income from tax. On the modified facts of Case Two, for example, Distributor would not derive taxable income from the return of its property in a restored condition — a result that is not unsound.\textsuperscript{166} More generally, one Code rule that would prevent the surrogate taxation of payees is the cash method of accounting.\textsuperscript{167} Under this method of accounting, an identified and fully taxable recipient would not be required to include any amount in income prior to an actual payment. Thus, conforming inclusions in income to deduc-

\textsuperscript{164} Professor Halperin has observed that a correct burden of taxation can be achieved in the absence of temporal matching of income and deduction if the deduction is limited to the present value, using an after-tax rate of interest, of the future cost, while the recipient is taxed on the future value of that amount. See Halperin, supra note 154, at 520-23. In the example used in the text, the transaction would be correctly taxed if Bob was entitled to a deduction for $6,667 in year 1 and Distributor was required to report income of $10,000 in year 6. That treatment would be correct because taxing the Distributor on $10,000 in year 6 is the equivalent of taxing it on $6,667 in year 1. However, when the amount deducted and the amount reflected in income are identical, a correct tax result is only achieved if the items are reflected in the same year.

\textsuperscript{165} See Cunningham, supra note 116, at 614-15.

\textsuperscript{166} See I.R.C. § 109. Under these circumstances, it is not at all clear that Distributor would have derived a gain.

\textsuperscript{167} See I.R.C. § 446(c).
tions in advance of payment would require the virtual repeal of the cash method of accounting. In short, any attempt to implement the taxation of recipients in advance of an actual payment would require an extensive modification of otherwise entirely sound rules of the Code.\footnote{Allowing obligors to claim a series of deductions in advance of an actual payment, under the bifurcation approach, would pose the serious problem of excessive complexity. Both the obligor and the recipient would be required to reflect their transaction over a period of years pursuant to a complex formula. In one specific instance, Congress has required just such a result. Under § 467 of the Code, when certain large rental payments are deferred beyond the year of use, the amount treated as rent is reconstructed under § 7872 principles. Thus, the amount treated as rent is the present value of the payment obligation, and that amount is both deductible and taxable in the year of usage. The difference between that present value and the face amount of the obligation is treated as interest that both parties must reflect annually over the period during which payment is deferred. Examination of § 467 reveals that it is far too complex to be applied to a much broader range of transactions.}

In these circumstances, surrogate taxation cannot justify the acceleration of a deduction for future costs. Indeed, the need for accurately timing the deduction of a future cost is greater than the need for the accurate taxation of receipts. This is so because the inability to impose offsetting treatment upon payees is attributable to insurmountable factual as well as legal obstacles. Accordingly, to prevent an improper subsidy, the tax benefit attributable to an obligation to incur a future cost must be deferred until the obligor sustains a present economic detriment.

C. Converted Transactions

If a market rate of interest has been paid on a loan for which the principal has not been repaid, the conversion to income will be correctly taxed without regard to surrogate taxation. However, if neither principal nor interest is repaid, the borrower will be undertaxed. In a normal lending transaction, the undertaxation of the borrower upon the cancellation of debt will be balanced by the treatment of the lender. Thus, in Case Three, if Carrie made no repayments of principal or interest on her receipt, she would only be subject to a net tax on $10,000 in year 6. That level of taxation is inadequate because, ideally, Carrie should be subject to a burden of taxation equivalent to imposing a tax on the $10,000 receipt in year 1 plus imposing an interest charge for deferring payment of that tax until year 6. However, that undertaxation would be bal-
anced by the overtaxation of the lender. In year 6 the lender would only receive a bad debt loss of the same $10,000 upon which Carrie was actually taxed.169 Under the logic of the taxing system, the lender would not be entitled to any tax benefit attributable to his failure to collect interest during the outstanding period of the loan. This failure to collect income relieves the taxpayer from any tax on the uncollected amount, but does not produce any further income tax benefit.

In retrospect, however, it may be seen that the lender has been left in the same economic position as if he had sustained a loss in year 1 and, from that perspective, has suffered from deferring his loss over the six year period. Ideally, the lender should be entitled to a benefit equivalent to the value of deducting the loss in year 1 and receiving interest on the deferral of the tax benefit to year 6. This would correspond to the ideal burden on Carrie. Under present law, however, the receipt of a lesser loss precisely offsets the benefit derived by Carrie from deferring her tax burden for the same period of time. Thus, as in the case of the imperfect taxation of the initial receipt, the imperfect taxation of the cancellation of the indebtedness may have no revenue effect. Rather, this aspect of the sub-system for taxing debt may only result in the undertaxation of the recipient and the corresponding overtaxation of lenders.170

The balance in the taxation of a debt cancellation, however, will be upset if the lender is not entitled to a loss upon the failure to repay. If the lender's loss is not deductible regardless of the treatment of the borrower, the undertaxation of the borrower will not be offset by the overtaxation of the lender. As a result, taxing the

---

169 As a statutory matter, this result is required by § 166(b), which limits the loss to the taxpayer's tax basis in the debt. In general, that basis would be the principal amount that was loaned. See I.R.C. § 1012.

170 There is, however, an important difference between the imperfect taxation of the initial receipt and the imperfect taxation of the conversion of a transaction. Even if Carrie and her lender knew how the income tax rules would apply to their transaction, they could not adjust their transaction to allow for those rules because they would not know at the inception of the loan that it would not be repaid. As a result, the element of unfairness created by the imperfect taxation of converted transactions cannot be eliminated by private action. The parties could, of course, provide in their original loan agreement that upon a default in repayment, damages in the amount of the tax benefit obtained by the borrower would be paid to the lender. However, since by hypothesis the borrower has failed to repay the principal of the loan, it seems unlikely that such a provision would be fruitful.
cancellation of both principal and interest repayments will translate into an improper revenue loss. For example, the loan to Carrie in Case Three might have been made by a corporation in which she was a principal stockholder. In this scenario, the failure of repayment might be treated as a dividend, taxable to her but non-deductible by the corporate “lender.” Under these conditions, the undertaxation of Carrie will not be offset by the overtaxation of the lender; the lender is merely deprived of a deduction that it could not have claimed in any event.\textsuperscript{171} Accordingly, the undertaxation of borrowers who do not pay interest on cancelled loans results in a subsidy to taxpayers, as well as a material revenue loss if the lender is not entitled to deduct his failure to collect the amount of the loan.

A situation in which a lender could not deduct the loss produced by a failure of repayment would, of course, parallel the circumstances in which the payor would not be able to deduct the initial payment. In \textit{Indianapolis Power}, for example, most of the deposits were not repaid, but instead were applied towards the customer’s electric bill.\textsuperscript{172} Had those deposits been treated as the proceeds of a loan despite earning no interest, the conversion of the deposit would have been taxable to the utility at the time of conversion — thereby undertaxing the utility. However, the non-business depositors would not have been entitled to any deduction with respect to their payments, regardless of the treatment of the utility. Thus, the undertaxation of the utility would not have been offset by the overtaxation of the customers, and the pattern for taxing the transactions would have generated an improper revenue loss.

A similarly troublesome revenue loss accompanies the operation

\textsuperscript{171} Under an ideal pattern of taxation, Carrie would be subject to a tax on the receipt and would be required to pay interest on the deferral of the payment of that tax for six years. However, the corporate lender would not be entitled to any deduction and thus would not be entitled to any interest on the deferral of that deduction. Thus, under an ideal pattern of taxation, the net revenue generated by the complete cancellation of the loan would exceed the tax levied on $10,000 by the amount of the interest paid on that tax.

Under current law, however, Carrie would only be subject to a tax on $10,000 in year 6, and would owe no tax attributable to the cancellation of the obligation to pay interest. Thus, as compared to an ideal pattern of taxation, the net tax paid on the cancellation is less than the correct amount of tax by an amount equal to the interest on the deferred tax liability. Since, by hypothesis, the cancellation does not have any income tax consequence to the lender, the undertaxation of the borrower is not offset by the overtaxation of the lender.

\textsuperscript{172} See supra note 20 and accompanying text.
of section 7872 of the Code. Under the bifurcation approach adopted by that section, a form of discounted debt is created and a failure of repayment is likely to extend to interest as well as principal. If that failure of repayment occurs, the borrower, as has been seen, will be undertaxed. To the extent that the payor would not be entitled to a current deduction for the transfer (or would be entitled to a tax benefit of lesser magnitude than the tax imposed upon the recipient), that undertaxation of the borrower will result in the undertaxation of the transaction as a whole. This will always be the result, for example, with respect to the dividend resulting from a shareholder’s failure to repay a loan from a corporation. To the extent that such loans to shareholders are not in fact repaid, which in all likelihood is a common occurrence, the bifurcation approach of section 7872 will not achieve the proper level of taxation for the transaction as a whole.

Just as surrogate taxation cannot be relied upon in the taxation of receipts, it cannot be relied upon to correct the taxation of the conversion of non-interest bearing debt to income. The systematic undertaxation of discounted debt cancellations too often will not be offset by the overtaxation of lenders. Indeed, a correct level of taxation on interest-free receipts can only be achieved through the avoidance of discounted debt and the taxation of the entire receipt when it is obtained.

VIII. CONSISTENCY CONSIDERATIONS: CONVERTING INCOME TO DEBT

If a taxpayer obtains a receipt that, at the end of the taxable year, appears not to be subject to an obligation to repay, the proceeds will be taxed in the year of receipt. If the taxpayer later becomes obligated to return the receipt and does so, he will then be entitled to a tax deduction in the later year of repayment. The annual accounting system has always been interpreted to prevent reopening the earlier return and claiming the loss against the initial return of income.

Returned receipts, however, are economically identical to loans:

the taxpayer has obtained value, invested it over a period of years, and returned the original receipt — perhaps along with interest computed on the principal amount. Ideally, therefore, the burden of taxation imposed upon a returned receipt should be identical to the burden imposed upon debt. Under present law, however, converted income transactions are subject to a pattern of taxation that is vastly different from that applicable to debt.

CASE FOUR

Pursuant to its established bonus compensation plan, at the end of the year Employer pays Don $10,000. A later review of Don’s performance for that year discloses that he was not entitled to any bonus at all. Six years after the initial receipt, Don returns the $10,000 to Employer. Both Don and Employer are subject to a 30% rate of tax. Don paid a tax of $3,000 on the bonus and invested the balance, obtaining a 10% pre-tax return.

In year 6, if Don not only returned the $10,000 but also paid 10% interest on that amount, he will be seriously overtaxed. Over the six years, his investment will have grown to $10,500 at his after-tax rate of return of 7%. However, the obligation to repay the receipt with interest will amount to $17,700. The tax benefit from deducting that entire amount will be $5,310, producing a net cost of repayment of $12,390. As a result, Don will be required to repay $1,890 more than he derived from the transaction and thus will incur a net economic loss in that amount.

This result is not at all surprising. Don was only able to invest the after-tax proceeds of his bonus, yet was required to pay interest on the pre-tax amount. In Case One, Abbie received similar treatment as a result of her including as income all the proceeds of an interest-bearing loan. In Abbie’s case, taxation converted a transaction that produced an economic wash into one that produced an after-tax economic loss, because the imposition of tax improperly prevented Abbie from funding the obligation to pay interest. For precisely the same reason, imposing the same burden of taxation on Don would be improper. 176

---

176 Since Don cannot be helped by revising the definition of debt, his problem, while serious, is not further addressed here. The appropriate relief for Don would be the ability to carry his loss back to year 1 and obtain interest on the refund of the tax paid in that year. Under current law, however, Don’s only relief is the ability to elect, under § 1341, between
If Don were not required to pay interest on the repayment of his bonus compensation, however, his transaction would resemble not Abbie's but Bob's. Upon repayment of the receipt, Don would be in the same position economically as a taxpayer who obtained and repaid an interest-free loan. Viewing the transaction in retrospect, Don received the equivalent of an interest-free loan maturing in six years, and thus should be subject to the same pattern of taxation used for the recipients of interest-free loans. Under section 7872 of the Code, such a loan would be bifurcated and partially taxed upon receipt.

In Case Four, however, this option would not be available in practice. Since it was not known in year 1 that the receipt would have to be repaid, it would be impossible to apply the section 7872 bifurcation approach to Don on the initial receipt. Thus, if bifurcation were to be applied, it would have to be done retroactively, in a later year in which repayment would be required. Implementing such an approach would require computing in year 6 the amount that should have been treated as a loan in year 1, and granting the taxpayer a refund of the tax paid on that amount, with interest over the six years. While possible in principle, such an approach to the taxation of returned income would not appear to be feasible in practice. The computation of tax liability would be complex — and excessively so, given the relative simplicity of the transaction subject to tax.176 Moreover, granting a tax refund with interest would be significantly more advantageous to taxpayers than a mere deduction, thus creating incentives for taxpayer manipulation. As a result, applying the bifurcation approach to the taxation of returned income simply is not a viable option. The only practical pattern of taxation would involve subjecting the receipt to current taxation in full and allowing Don a deduction for any amount actually repaid in the year of repayment.

claiming a tax credit or a deduction for his repayment.

176 If it were possible to bifurcate such a receipt retroactively as to the recipient, thereby reducing his income tax liability, it would also be necessary to increase retroactively the payor's level of taxation. To the extent that the receipt was treated as a non-taxable loan to the recipient, it would have to be treated as a non-deductible loan by the payor. That treatment of the payor, while entirely correct in principle, would not be sound in practice. In addition to the actual harshness of the imposition of such a tax, the retroactive loss of a deduction would be perceived as a wholly unfair price for demanding the repayment of an amount mistakenly transferred to an employee or other payee.
For the reasons detailed above, treating returned income in this manner is entirely appropriate. The net effect of applying this pattern of taxation to Don would be to subject him to the rules of the sub-system for taxing income over the six years during which he retained the bonus. Since Don was not required to pay interest on the receipt, and thus was entitled to retain the full return from his investment, he derived the economic benefits of income and was not subject to any of the economic burdens of debt. Accordingly, his receipt ought to be subject to the rules of the sub-system for taxing income, not the sub-system for taxing debt. The deduction allowed upon the ultimate repayment of the previously taxed income adequately compensates him for the initial overtaxation.

Subjecting Don's receipt to immediate taxation in full is, of course, the result reached under present law. However, this treatment of returned income is sharply inconsistent with section 7872's bifurcation approach to economically identical receipts of interest-free loans. Such a major inconsistency is undesirable in any taxing system, and should be avoided whenever possible. Accordingly, the treatment of Don's returned income strongly reinforces the conclusion that Bob's interest-free loan should also be subject to immediate taxation, and should not be bifurcated under section 7872 of the Code. The complex reconstruction mandated by that provision is simply inconsistent with other appropriate and long-standing rules of the taxing system.

IX. Conclusion: A Proper Definition of Debt

Characterizing a receipt as a loan, or in the nature of a loan, means that the receipt will be subject to the specialized rules of the sub-system for taxing debt. Of those rules, the most dramatic is the total exclusion from taxable income accorded to the proceeds of a loan. That exclusion, however, is not intended as a tax subsidy for borrowing; it is extended because it is wrong to impose tax on an amount that does not represent an increase in net worth. Diminishing such a receipt through taxation would deprive the recipient of the ability to fund the obligation to pay interest on the receipt, and thus would convert an economically neutral transaction into one yielding an after-tax economic loss.

On the other hand, the failure to impose a tax on a receipt that does represent an increase in net worth is also improper. In this situation, the recipient is able to invest pre-tax funds for his or her
own account and thus can obtain a greater after-tax return than a taxpayer who had been subject to the normal operation of the income tax. Relative to normally taxed receipts, untaxed receipts are preferential and, under an ideal income tax system, improper.

In determining whether a receipt represents an increase in net worth, and the extent of that increase, the repayment obligation must be valued by taking into account the time value of money. The failure to do so would treat a receipt upon which a market rate of interest must be paid as equivalent in value to a receipt upon which no interest must be paid. This is an "equivalence" that plainly does not exist. The non-interest bearing receipt generates a return that may be retained by the taxpayer, while the interest-bearing receipt generates no such return and thus is of substantially lesser value. On the one hand, disregarding the value of an interest-free receipt avoids one of the levels of tax imposed by an income tax, and thus improperly subsidizes interest-free receipts. On the other hand, disregarding the lack of value in an interest-bearing receipt imposes a tax in the absence of gain and thus excessively taxes interest-bearing obligations.

In a wide range of contexts, the courts have been willing to entertain, and sometimes accept, a variety of arguments leading towards the exemption from current taxation of non-interest bearing receipts. It has been demonstrated here that in every context, that result is improper. To achieve a correct allocation of the tax burden, all interest-free receipts — whether in the form of loans, advance payments, or deductions for future costs — must be subject to taxation in full when the receipt is obtained. In other contexts, the courts have been willing to entertain the argument that a receipt bearing a market rate of interest that was actually paid should nevertheless be fully subject to tax. It has also been demonstrated here that such a tax would improperly overtax recipients.

To secure a correct level of taxation on receipts that are offset by obligations of any sort, the Supreme Court must learn to appreciate the significance of the time value of money, while simultaneously ending its reliance on control over the principal amount.

177 See, e.g., Cohen v. Commissioner, 910 F.2d 422 (7th Cir. 1990); Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978).
178 See, e.g., Mason v. U.S., 513 F.2d 25 (7th Cir. 1975).
transferred. Such an economically irrelevant issue should not be the lynchpin of decisions over whether to exclude a receipt from income because of an offsetting obligation. Rather, the pattern of taxation provided by the sub-system for taxing debt must be reserved for receipts that are offset by obligations that actually bear a market rate of interest that the borrower intends to pay in good faith. Moreover, since the conversion of a loan to income is correctly taxed if a market rate of interest has been paid on the receipt, that exclusion should not be affected by the probability that the principal amount of the receipt will actually be repaid. Since income is a question of value, not control, exclusion simply should not be affected by the degree to which the borrower or the lender controls repayment.

Because of the inadequacies contained in the judicial definition of debt, Congress adopted an alternative definition based upon the time value of money. That definition, however, was derived from an earlier effort to identify an element of interest that was assumed to exist. As a result, an interest-free receipt was converted into an interest-bearing receipt that was exempt from tax. The effect of this exemption has been to permit the investment of a pre-tax receipt — clearly an improper result.

While the congressional approach represents a substantial improvement over the judicial approach to the definition of debt, it also fails to produce a correct result. The artificial creation of interest does not properly implement time value of money principles. Unless interest is actually paid on a receipt, the receipt should not be treated as debt, and the entire amount of the receipt should be subject to immediate taxation in full. In that respect, the all-or-nothing feature of the traditional judicial approach to debt emerges as entirely correct.

It would not be difficult for Congress and the judiciary to imple-
ment the reforms advocated in this article. Indeed, the proposals presented here would greatly simplify and rationalize both the taxation of low-interest loans and a wide range of classification issues that have recurred with frequency. As a result, a more correct and consistent allocation of the tax burden could be achieved, along with a reduction in the frequency of many income tax controversies.
APPENDIX — CASE ILLUSTRATIONS

CASE ONE
Abbie, a key employee of Distributor, Inc., has obtained a $10,000 loan from Distributor, giving in exchange her personal note. The note matures in six years and bears interest at a market rate of 10%, payable annually. However, at Abbie's option, the note can at any time be applied to reduce outstanding accounts receivable due Abbie for the Distributor's purchase of goods from her. Both Abbie and Distributor are subject to a marginal rate of tax of 30%, and both can earn a 10% pre-tax return on their investments.

CASE TWO
Like Abbie, Bob is employed by Distributor and obtains a $10,000 loan from his employer. The note given by Bob in exchange for the loan also matures in six years but does not bear any stated interest. Bob is also subject to a marginal tax rate of 30% and can earn a 10% pre-tax return on his investments.

CASE TWO (DEDUCTION)
Distributor allows Bob to use its real property as a site for a World's Fair, but on the condition that at the conclusion of the Fair, Bob will restore the site to its original condition. Restoration will occur in six years and can be predicted to cost $10,000. Bob remains subject to a 30% rate of tax and can earn a pre-tax return of 10% on his investments.

CASE THREE
Carrie has borrowed $10,000 on a note that matures in six years and bears a market rate of interest of 10%. The proceeds of the note have been reinvested by Carrie, also at a 10% return. Carrie is subject to a marginal tax rate of 30%.

CASE FOUR
Pursuant to its established bonus compensation plan, at the end of the year Employer pays Don $10,000. A later review of Don's performance for that year discloses that he was not entitled to any bonus at all. Six years after the initial receipt, Don returns the $10,000 to Employer. Both Don and Employer are subject to a 30% rate of tax. Don paid a tax of $3,000 on the bonus and invested the balance, obtaining a 10% pre-tax return.