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And the Rebuttal

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In the past decade the sophistication of the analysis of the relationship between income taxation and the passage of time by both scholars[1] and Congress has increased enormously. Little of that sophistication, however, has rubbed off on the courts. In this increasingly critical area, the Supreme Court remains 20 to 50 years out of date; the opinion in *Indianapolis Power* could have been written by Justice Jackson.

That failure on the part of the Court provoked the commentaries of myself[2] and Professor Yin.[3] While the areas in which we disagree may be of greater academic interest, the areas in which we do agree are of greater practical importance and should be underscored. Importantly, we agree that the tests employed by the courts in general and the Supreme Court in particular for distinguishing between the proceeds of a loan and a taxable receipt are fundamentally defective and require urgent revision. Secondly (although Professor Yin might not put it just this way), we appear to agree that debt for income tax purposes ought to mean a receipt that is offset by a repayment obligation that bears a market rate of interest—and nothing more or less. The difference between Professor Yin and myself is that for this purpose I would only recognize interest that was actually structured into the transaction by the parties while Professor Yin would recast their transaction along the lines of section 7872 to create interest (at a market rate) that would protect the remaining portion of the receipt from tax.

To explore this point of disagreement, we might examine four more taxpayers who otherwise are in identical income tax positions. Each receives a receipt of $10,000 at time 0, invests the receipt at a 10 percent return, and disburses an amount equal to the

[1] For recent examples, see Thomas L. Evans, The Taxation of Multi-Period Projects: An Analysis of Competing Models, 69 Texas L. Rev. 1109 (1991); Jeff Strnad, Periodicity and Accretion Taxation: Norms and Implementation, 99 Yale L.J. 1817 (1990).

[2] Glenn E. Coven, Redefining Debt: Of *Indianapolis Power* and Fictitious Interest, 10 Va. Tax Rev. 587 (1991).

[3] George K. Yin, Of *Indianapolis Power and Light* and the Definition of Debt: Another View, 11 Va. Tax Rev. 467 (1991).

receipt exactly six years later, at time 6. In the absence of taxation, each would have gained an identical accession to wealth. Now introduce income taxation—our system of income taxation. Will the taxpayers be left in identical after-tax positions? Of course not.

A's receipt was salary. It will be taxed immediately as will the return on her investment. Her disbursement was for fully deductible educational expenses related to her employment. At time 6, after her disbursement, she will be left with $3,500. D's receipt consisted of compensation of $4,360 and the proceeds of a discounted loan obtained from a Bank in the amount of $5,640. The loan transaction is effectively exempt from income taxation;[4] at time 6 he will be left with $4,578 attributable to the investment of the compensation. On facts that are identical in the absence of taxation, under our income tax system D would be taxed far more lightly than A and that result is appropriate.[5]

B's transaction is essentially identical to A's. The difference is that B returned his receipt to his employer because it had been paid to him in error. Under our system, B will be subject to the same pattern of tax as A; thus B will be left in the same after-tax economic position as A.

C is the one who holds our attention. C received an interest free loan[6] from her employer and the issue is whether C should be taxed like A and B, or like D, since she cannot be taxed like both. That is, should C's unitary $10,000 receipt be fully taxed (and deducted upon repayment) or treated as salary of $4,360 and the proceeds of a loan of $5,640 and thus only partially taxed? To put the

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[4] The taxable return on the investment of the loan proceeds will be offset by the accrued deduction for the interest payable.

[5] Of course, D could be taxed like A. The proceeds of his loan could be made taxable and his repayment deductible. In that event, however, the investment of the loan proceeds would not generate sufficient income to pay the interest on his loan and thus the loan transaction, viewed in isolation, would result in an after-tax economic loss. D therefore would be required to use the return on the investment of his salary to pay the interest on his loan.

If the loan and the salary were viewed together as a unitary receipt, current taxation of the total proceeds would not result in an economic loss and thus might not be seen as improper. Nevertheless, we do regard the compensation and the loan as entirely separate transactions and, accordingly, would regard taxing D like A to be wrong.

[6] Following convention, I refer to such transfers as loans. The issue here, however, is not the label attached to the transaction but the treatment of the transaction for income tax purposes. On that issue, there is nothing magic about the existence of the repayment obligation. As I sought to demonstrate in my article, if the repayment obligation is not interest bearing, there is no reason to exclude the receipt from income.

question in context, consider some real world C's:

—A public utility demands a deposit from certain customers which is commingled with its general funds. Deposits are continually received and returned; the utility is effectively in permanent possession of an unrestricted, non-interest bearing pool of capital of several million dollars.

—A custom manufacturer demands a payment before commencing the construction of the goods ordered, and payment is immediately spent by the manufacturer on components.

—A closely held corporation transfers $2 million to a principal shareholder, a key employee. The funds are spent on the individual's consumption and are not repaid until the death of the payee. Upon the payee's death, the loan is repaid and the funds withdrawn through the redemption of stock, the basis of which has been stepped up to market value.

While in every instance it would indeed be possible to recast these receipts as loans in part under a section 7872-type bifurcation approach, thereby taxing each "C" far more lightly than would occur if the receipt were immediately taxable, it is not at all clear why we would wish to do that. In each instance the payee will derive an economic benefit indistinguishable from the benefit of the receipt of income over the period of time in which the receipt is retained. Indeed, in general, an interest free advance is a tax motivated transaction designed to permit an immediate economic receipt but defer the attendant tax liability. Moreover, a deduction for the repayment, if and when it occurs, will adequately compensate for C's year 6 disbursement just as it adequately compensates for A's and B's. In fact, C's single transaction is not meaningfully different from B's or A's but bears little resemblance to D's two separate transactions. Should not, therefore, C be taxed like A and not like D?

Professor Yin's response to all of this is that the more favorable treatment of C is in fact required by the internal logic of the taxing system. I disagree.

Professor Yin begins with the premise that any reciprocal exchange of value in which the performance of the parties is separated by time creates a loan, either expressly or impliedly. Moreover, Professor Yin evidently accepts what I conceive to be the consensus view that the existence of a loan necessarily requires the existence of interest.[7] Since interest *is* present by definition and *is* borne by the borrower, it *must* also be taxed to the lender. Professor Yin thus asserts that any system of taxation, such as the one I propose, that does not tax the lender on the interest earned improperly undertaxes the lender and overtaxes the borrower.[8] From that beginning, Professor Yin concludes that the correct approach to interest free transfers is bifurcation along the lines of section 7872.

The assertion that non-simultaneous exchanges of value *do* bear interest is quite misleading. As a matter of economic fact, interest is either paid with respect to a receipt or it is not. If it is paid, then neither my proposal nor section 7872 have any application to the transaction.[9] If it is not, it only confuses the analysis to assert that an interest burden is borne in a transaction in which it concededly is not borne. Rather, the issue involves identifying the most appropriate income tax burden for one who obtains a non-interest bearing receipt.

The section 7872 bifurcation approach, which Professor Yin seems to prefer, proceeds from the assumption that the recipient does not bear the economic burden of interest payments with respect to the amount transferred. Given that factual assumption, the section then imposes a burden of taxation on the recipient that approximates the tax that would have been paid if the transaction had assumed a radically different form: the loan of a lesser amount, at a market rate of interest, plus the making of a functionally unrelated payment. The question reexamined in my article was whether it made any sense for income tax purposes to construct so elaborately interest free transfers. Presumably, such a reconstruction should be undertaken only if the resulting tax burden were superior to any alternative treatment of the transaction. That, however, is not the case.

The tax burden imposed by section 7872 on the "borrower" is substantially lower than the burden that would have been imposed if the receipt had been treated as immediately taxable income. That reduced tax burden is presumably justified by the fact that

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[7] See Yin, supra note 3, at 474.

[8] See id. at 479.

[9] For analytical purposes, I am following Professor Yin in ignoring the intermediate case of low interest loans.

the recipient is now viewed as paying interest and the principle that taxing the proceeds of an interest bearing loan is improper. But, the bifurcation of the transaction for tax purposes does not, and cannot, alter its economic substance: the "borrower" in fact does not repay more than was received and thus does not in fact pay interest. Accordingly, as I sought to demonstrate in my article, there is no justification for the reduced burden of taxation that section 7872 extends. Since the "borrower" will retain the entire investment return attributable to the receipt, the "borrower" should be taxed in the same manner as any other recipient of a non-interest bearing receipt[10], notwithstanding the theoretical obligation to repay the principal amount of the receipt at some future date.

Moreover, the logic of the argument that interest must be present in non-simultaneous exchanges does not lead to the bifurcation conclusion. That discrepancy appears quite clearly in Professor Yin's argument that lenders are undertaxed under my proposal. Starting with the premise that the transaction is a loan, he observes that the capital invested by the borrower is that of the lender and that the lender is entitled to a return on that capital. He then asserts that the lender should be taxed as if that return had been received (although it was not).[11] If this analysis were adopted, however, it would seem to follow that the entire amount

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[10] The argument set forth in my article was not that the recipient should be taxed on the investment return because he or she retained all of it but rather was that, because of the recipient's entitlement to that return, the initial receipt should be taxed as income rather than excluded as the proceeds of a loan. See Coven, supra note 2, at 611-12.

Nevertheless, Professor Yin's ultimate criticism of my proposal is that it would fail to tax the lender on the investment return to which it is "entitled" but does not receive while it would tax the borrower on the investment return to which it is not entitled but does in fact receive. In a commercial transaction between unrelated parties, it is not clear why that is a fault.

[11] This argument may be recognized as essentially an assignment of income analysis. Historically certain types of interest free transfers were employed to accomplish a temporary shifting of income from capital that should have been attacked under the traditional assignment of income rules. See Helvering v. Horst, 311 U.S. 112 (1940). The failure of the Internal Revenue Service to invoke those rules was in part responsible for the need for section 7872.

When (1) the transferee is not subject to tax upon obtaining the initial receipt and (2) the transferee is in a lower income tax bracket than is the transferor, my proposal would resurrect the pre-section 7872 potential for using interest free transfers to assign income improperly. Accordingly, such gratuitous transfers would require scrutiny under the normal assignment of income rules as do all other temporary transfers of capital among related taxpayers.

of the receipt, all of which must be repaid, constituted the lender's capital upon which a return should be paid. Professor Yin, however, consistently with the section 7872 approach, treats as the lender's capital only that portion of the loan that under bifurcation would be treated as the principal amount lent.[12] That definition of the "lender's capital" is purely arbitrary.[13] As I argued in my article, bifurcation simply does not reflect the economic substance of an interest free transfer and produces an improper income tax result.

While bifurcation is not appropriate, Professor Yin's argument that interest must be present in non-simultaneous transfers does suggest another approach to the "interest free" receipt problem. The taxing system might require that we look much harder for the existence of interest in fact. In many cases, that closer scrutiny will be to no avail. Contrary to Professor Yin's assumption, some transfers are simply not interest bearing. When, for example, an interest free advance is made to a dominant shareholder in a closely held corporation, no value flows back from the shareholder to the corporation in substitution for interest that is worth identifying. In other cases, careful case-by-case examination may disclose the existence of interest. In fact, such an argument could be made on the facts of *Indianapolis Power*.

The implication of the argument that interest must be present is that the borrower is compensating the lender for the use of the receipt outside of their formal transaction through a transfer of goods or services. In *Indianapolis Power* it might be argued that the utility-borrower was transferring to its customers value in the form of making sales on credit to the otherwise non-creditworthy customer. The receipt of that service, in the nature of interest, should thus be currently taxed to the customer. Reconstructing the transaction to make it understandable (?), it is as if the utility paid interest on the deposit and the customer returned that amount as an increased cost of electrical service. The utility would have an interest deduction offset by an increased income from sales while the customer would have interest income not offset by the increased consumption expense.

Whether it would be very sensible to search that hard for the

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[12] See Yin, supra note 3, at 479.

[13] Professor Yin may not wholly disagree with this conclusion. See id. at 483, note 54.

existence of interest, and thus avoid the pattern of taxation that I propose, is questionable. Firstly, and in sharp contrast to the taxation of Abbie in my article (who obtained a conventional interest bearing loan), taxing the receipt does not prevent the recipient from funding the obligation to pay interest. The constructive interest payment and offsetting receipt are entirely fictitious; they have no economic significance. Secondly, such a recharacterization is wholly unadministerable, as Professor Yin appears to recognize.[14] Imposing an actual tax on the customers of Indianapolis Power is, to put it mildly, not feasible and suitable proxies for such a tax are not apparent. Therefore, if such an approach to interest free receipts were accepted in principle, the approach would not be applied in practice and the transaction would remain undertaxed. Nevertheless, if a receipt is offset by a repayment obligation that is in fact interest bearing, albeit in disguise, the receipt constitutes the proceeds of a loan and in principle ought not be subject to current taxation, nor should it be bifurcated.[15]

The bifurcation of an interest free transfer is an example of economic analysis going astray. The creation of an interest substitute through a present value computation is intellectually satisfying and widely appealing. Unfortunately, it does not produce an income tax result that is as consistent with the balance of the taxing system as does the simple taxation of the receipt. Accordingly, receipts that are only offset by non-interest bearing repayment obligations should not be treated as loans for income tax purposes.

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[14] See id. at 487.

[15] Professor Yin also observes that the pattern of taxation that I propose is not consistent with the requirements of a full current accrual approach to income taxation. That may be so. Under full accrual, many transactions would be taxed differently. However, under the existing tax system, unrealized gains and losses in assets or liabilities are not reflected for income tax purposes on a current basis. The annual increase in the burden of repayment of a discounted obligation would only be reflected for income tax purposes if that increase represented a built-in interest factor. However, if the transaction is an interest free loan (or other advance), the transaction will not contain interest unless the transaction has already been bifurcated along the lines of section 7872. Professor Yin's criticism, therefore, either assumes the very point in dispute, that C's receipt should be bifurcated, or is derived from a concept of taxation that is not currently a part of our taxing system.