

The Taxation of Advance Receipts

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Abstract

Under the present income tax, some advance receipts are neither taxable on receipt nor deductible on repayment, while others are subject to the opposite treatment: They are taxable when received and deductible when repaid or paid for. From a purely theoretical perspective, it remains unclear why different sets of rules apply in different cases. For example, if the fact of unrestricted control over the payment compels the conclusion that it is income, then most advance receipts, including loan proceeds, should be included in income immediately. Conversely, if the presence of an offsetting liability compels the conclusion that the payment is not (yet) income, then most advance receipts, including amounts received for future services, should not be taxed unless and until they are secured to the taxpayer without obligation.

This paper argues that confusion in this area stems from a misunderstanding of the role that the income concept plays and should play in guiding the proper rules for advance receipts, and from an inapposite application of consumption tax concepts in the income tax context. At bottom, an income tax taxes the creation of wealth, and a consumption tax reaches the opposite event – its preclusive withdrawal from the public store. If practical questions of tax administration were not salient, advance payments under the income tax would be included as and when secured to the taxpayer without offsetting obligation, without regard to the time of receipt of the funds themselves. Moreover, a similar result should obtain even if the realization-based character of our tax system is appropriately taken into account. The actual rules, however, often tax recipients either before the income arises, or not until after it is entirely “unrestricted.” In most cases, the divergences from the theoretically correct answer reflect an appropriate attempt to accommodate the effort to tax true income to the practicalities of tax administration. If it is unlikely the amounts will be true economic income, a general presumption of non-taxation on receipt and non-deduction on return is appropriate, subject to adjustment if the presumption turns out to be false. If it is likely the amounts will be true economic income, the opposite presumption is appropriate, again subject to adjustment if proved incorrect. Intermediate cases present problems of judgment that must be addressed from the perspective of effective administration of the tax law.

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The Taxation of Advance Receipts

I. Introduction

The treatment of advance receipts, which include prepaid services income, loans, deposits, and other items, remains a conceptually unsettled area of the tax law, despite the fact that most of the basic rules have been well established for decades.² One reason for the confusion is that the rules seem to lack a basic rationale. In a word, they appear to be inconsistent.³ Amounts termed “deposits” generally are not taxable to the recipient,⁴ whereas prepaid rent is.⁵ Loan proceeds are not taxable to the recipient,⁶ but prepaid services income almost always is.⁷ Moreover, it is not at all clear how the rules can be made consistent without violating deep-seated intuitions about proper outcomes in particular cases. For example, if loan proceeds were taxed on receipt and deducted on repayment, it would become unclear why rental property also should not be taxed on transfer to the renter and deductible to the renter on its return.

A second reason for the confusion is that the rules appear to be subject to manipulation. It is easy enough to convert a deposit into prepaid rent and vice-versa, without changing the underlying economics of the transaction.⁸ If the rules are formal, then tax electivity is easy. The question becomes how to draft the papers, not how to structure the economic transaction.

A final reason is that a lack of clarity on basic principles has led commentators to take diametrically opposed views about the income tax

² See Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245, ___ (2007) (discussing the history of the taxation of debt).

³ See, e.g., Deborah Geier; William A. Klein, *Tailor to the Emperor with No Clothes: The Supreme Court’s Tax Rules for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1687 (1994) (“[The premise] that there is a meaningful distinction for tax purposes between a deposit and an advance payment . . . is, according to sound principles of economic or financial analysis, demonstrably false.”); Martin McMahon [].

⁴ *Comm’r v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

⁵ Treas. Reg. § 1.68-1(b).

⁶ Klein notes that the exclusion of loan proceeds from gross income “has been regarded as so self-evidently correct that the only authority for it is case law on whether particular transactions are in fact loans or on the consequences of a loan transaction.” Klein, at 1691 (footnotes omitted).

⁷ *Compare* *Comm’r v. Schlude*, ___ U.S. ___ (prepayments for dance lessons includible), *with* *Artnell v. Comm’r*, ___ F.2d ___ (prepayments for parking at baseball games not includible). These cases are discussed below.

⁸ See Klein, at ___.

consequences of advance payments. Nowhere is this disagreement clearer than in the case of loan proceeds, which some have argued should be included on receipt and deducted as repaid, while others have insisted should be neither includible nor deductible.⁹ Similar disagreement prevails in the deposit and prepaid services contexts.

This article offers a resolution of the conundrums presented by advance payments. I distinguish on one hand the basic questions of when and whether someone in receipt of an advance payment has true economic income, from timing questions relevant for purposes of tax administration on the other. In essence, advance payments raise two timing questions. The first concerns the actual time at which a taxpayer can be said to have income. The second is the related administrative question of when is an appropriate time to tax the taxpayer. The latter has to do with the practicalities of collecting tax, whereas the former has to do with the income concept itself. The rules that courts and the IRS have developed for particular types of payments are, for the most part, answers to the second question and are largely correct. However, looking for analytical cogency from these rules, as many commentators have done, is bound to be fruitless if the rules are thought to embody a coherent income concept. The rules represent reasonable presumptions that are the product of the exigencies of tax administration; they do not hew to any well-defined income concept but make sense, to the extent they do, in light of the importance of collecting tax when it seems a tax will arise and a fund is available to pay it. Moreover, because commentators have improperly imported consumption tax concepts into the analysis, they have clouded the issues rather than clarified them.

Part II discusses current law for a variety of advance payments and identifies apparent inconsistencies in their tax treatments. Part III examines the underlying issue of when an individual can be said to have income under established income concepts. There are essentially two reasonable answers to the question, each of which would result in the same basic analysis of advance payments were the question of the timing of tax collection not salient. Part IV returns to the particular kinds of advance payments discussed in Part II, examining them in light of the established income concepts and with a focus on tax administration. Part V offers some observations on the consumption tax treatment of advance payments. Part VI is a conclusion.

⁹ Compare Dodge (generally arguing that advance payments, including loan proceeds, should be taxed on receipt), with Klein (generally arguing that the economically correct method for taxing advance payments would be to value them according to the probability that they will be retained as income in the future). Note that the question here concerns the treatment of loan principal, not interest.

II. Advance Payments

For purposes of the following discussion, I define advance payments broadly to include any payment received, in money or kind or even services, in exchange for the provision in some future period of money or some good or service.¹⁰ For example, a service recipient may pay a service provider for next year's work this year (prepaid services income),¹¹ or an owner of property may sell it to a purchaser, with payment therefor today and delivery next year (a prepaid forward contract).¹² Loans and deposits also are advance payments. In a loan, the lender transfers loan proceeds to the borrower, who incurs an offsetting obligation to repay the amount in the future as well as an on-going obligation to pay interest on outstanding principal. In a deposit, the recipient may hold the money for or on behalf of the depositor as a reserve against future fixed or contingent obligations; often the deposit is held as a fund to cover payment for the provision of future services to the depositor or against possible claims the holder may have against the depositor. At the limit, even a lessee may be said to have an advance payment on receipt of rental property, the offsetting obligation being to transfer the leased property back to the lessor.¹³

The rules applicable to many kinds of advance payments are settled (if seemingly contradictory), while in other instances they are less clear. For example, it is well established that loan proceeds are neither includible in income when received nor deductible from income when repaid,¹⁴ if a loan obligation is canceled, then the borrower typically has income to the extent of the canceled obligation.¹⁵ Similarly, it is undisputed that prepaid rent is includible in gross income.¹⁶ By contrast, advance payments received by accrual-method taxpayers in exchange for future services may or may not be includible on receipt, depending on how tightly the recipient can tie the sum received to the provision of

¹⁰ [CITE.]

¹¹ *See, e.g.,* Am. Auto. Ass'n v. Comm'r, ___ U.S. ___

¹² *See* David Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 FL. TAX REV. 471, [481-83] (1997).

¹³ As argued below, the obligation to pay rent during the rental period, like the obligation to pay interest on outstanding loan principal, is a separate obligation not characterized as incurred on a prepaid basis.

¹⁴ *See* Comm'r v. Tufts, 461 U.S. 300 (1983); *see also* note ___, *supra*.

¹⁵ IRC § 61(a)(12); *see also* Tufts, at ___ (holding that cancellation of nonrecourse debt in excess of fair market value of property secured thereby results in increased amount realized on disposition of property).

¹⁶ [CITE.]

specific services at a specific time. Where it is possible to associate the payments closely enough with the services, income recognition is deferred until the service is provided;¹⁷ in most instances, however, the service recipient will be unable to establish the required nexus and the payments will be taxed on receipt.¹⁸ The following discussion elaborates on these arrangements.

A. Deposits Versus Prepaid Rent

Courts' and the IRS's efforts to distinguish among types of advance receipts have been notably unpersuasive. Perhaps nowhere are the failings clearer than in attempts to distinguish between "deposits" paid to service providers (including lessors), and prepaid services income (including rent). As a general matter, an amount that may be termed a deposit is treated as neither includible by the payee nor deductible by the payor (assuming that a deduction would be available were the payment currently taxable¹⁹), while prepaid services income or rent is typically included on receipt. The Supreme Court attempted to bring some clarity to the area twenty years ago, in *Commissioner v. Indianapolis Power & Light Co.*²⁰ The question was whether amounts IPL, an electric utility, took in as "deposits" needed to be included in income when received. IPL collected the amounts from customers who had a history of delinquent payments as security for payment against future services. The amounts were twice the expected monthly utility bill. Initially, IPL paid three percent interest on the deposits. Later it paid 6%, but only to the extent deposits were held more than twelve months, with 0% paid prior thereto. Unclaimed deposits held for more than seven years escheated to the state. Customers could secure repayment by requesting it and demonstrating acceptable credit (or by terminating their service). IPL's non-inclusion of the amounts in income for accounting purposes was consistent with generally accepted accounting principles and applicable state law.

The Tax Court held the amounts were not income on receipt, and the Seventh Circuit affirmed on essentially the rationale adopted by the Tax Court.²¹

¹⁷ See, e.g. *See Artnell v. Comm'r*, 400 F.2d 981 (7th Cir. 1968); *Collegiate Cap and Gown Co. v. Comm'r*, T.C. Memo 1978-226; see also Rev. Proc. 71-21 (permitting up to one year of deferral for certain items of prepaid services income).

¹⁸ See, e.g., *Am. Auto. Ass'n v. Comm'r*, ___ U.S. ___ (automobile club dues); *Schlude v. Comm'r*, ___ U.S. ___ (dance lessons).

¹⁹ As a general matter rent paid in connection with the operation of a trade or business or for the production of income is deductible as an ordinary and necessary business expense, whereas rent for personal uses is not. IRC § 162(a).

²⁰ 493 U.S. 203 (1990).

²¹ *Indianapolis Power v. Comm'r*, 88 T.C. 964 (1980); 857 F.2d 1162 (7th Cir. 1988).

The Tax Court relied on the facts that the deposits were required from only five percent of customers, the customers retained ultimate control over disposition of the deposits, and IPL paid customers interest. Moreover, IPL treated the deposits on its books as belonging to the customers. The Supreme Court affirmed, but its reasoning differed slightly. Accepting that a material difference exists between a deposit (no inclusion on receipt) and a prepayment (immediate inclusion), the Court looked to the circumstances under which repayment, if any, would likely to be forthcoming as a basis to distinguish between the two types of receipts. It concluded that legal entitlement to a repayment in cash more likely signals a deposit; where, however, cash is available to the payor merely as a remedy for the recipient's failure to perform, the amount is generally includible on receipt.²²

Commentators have rightly pointed to the incoherence of the Court's reasoning as a matter of economics or tax theory. In an extended discussion,²³ William Klein notes that the asserted distinction between a loan, to which the Court likens a deposit, and advance rent is essentially nil: The method by which the recipient of the amount finances the receipt is irrelevant to the economic consequences of the receipt. In both cases the recipient receives the right to use a payment for a period of time prior to the date she discharges her obligation. Either both should be included on receipt, or neither should.²⁴ Joseph Dodge, advocating a cash-flow approach to prepayments generally, reaches the same answer on the question of consistency but the opposite answer on the question of taxability: For Dodge, the treatment in both cases would be inclusion on receipt followed by a deduction if and when repayment occurs.²⁵

As to which of those rules is correct as an economic/income matter, disagreement prevails, as the previous discussion suggests. Klein takes the position that the offsetting liability rationale that precludes inclusion in income of loan proceeds on receipt (and, correspondingly, prevents deduction of principal as it is repaid) is the correct rule generally for advance receipts, and that the case for treating advance payments such as rent differently can be made out, if at all, only on the basis that the contingent nature of the repayment obligation (i.e., that it is due only to the extent the rental usage to be provided in fact is not provided) may require discounting of the future obligation.²⁶ Dodge takes an opposed position. On his view, the question is whether the taxpayer enjoys an accession to wealth

²² 493 U.S. at 207-08 [CHECK.]

²³ Klein, at 1713-23.

²⁴ *Id.*

²⁵ Dodge, at 256-65. Dodge would create an exception to the inclusion-deduction method for loan proceeds used to finance the acquisition of capitalizable assets. *Id.*, at 248.

²⁶ Klein, at 1730.

during the tax period. Recognizing that a pure accrual-based income tax would not necessarily support this approach, Dodge argues that under our realization-based tax system, rules parallel to those for built-in gain or loss on the asset side of the ledger ought to apply to liabilities. According to Dodge, as a general matter a realization-based approach would disregard future obligations to the extent they are “unrealized,” which is to say that payment is actually due. The approach would lead to something very close to a cash-flow consumption tax method of accounting for liabilities.²⁷

B. Prepaid Services Income

Similar disagreement obtains in the case of advance payment for services where no separate fund amounting to a deposit exists. The law in this area is somewhat more nuanced or, if one prefers, muddled. As a general matter, amounts received as payment during the year in exchange for services to be performed in a later year are included on receipt.²⁸ The application of this rule to cash-method taxpayers has always been relatively unproblematic, but the rules for accrual-method taxpayers remain somewhat unsettled. In a trilogy of cases decided by the Supreme Court in the 1950s and '60s, the general rule emerged that even accrual-method taxpayers must include in income on receipt amounts received for future services.²⁹ The rationale seems to be that while matching of income to the activity that earns it is a tax value,³⁰ in the absence of a corresponding future obligation sufficiently certain in both timing and extent, the matching principle must give way to the Commissioner's determination that deferral does not provide a “clear reflection of income,” as required by Section 451. Implicit in the analysis is that the question of whether the taxpayer has income on receipt has been answered in the affirmative, and the only issue is the timing question of when it should be included.³¹ Lower courts thus have held that where the future obligation is certain in timing and amount, deferral is appropriate for accrual method taxpayers,³² but in other cases it is not.

²⁷ Dodge, at __.

²⁸ See Reg. § 1.451-1 [CHECK.] (cash-method taxpayers); Schlude v. Comm'r, 372 U.S. 128 (1963) (accrual-method taxpayers).

²⁹ Comm'r v. Mich. Auto. Ass'n; Comm'r v. Am. Auto Ass'n; Schlude.

³⁰ See Geier, at 120 (stating that acceptance of the matching principle pervades the majorities' and dissents' opinions in both Mich. Auto Ass'n and Schlude).

³¹ See Geier, at 118.

³² See, e.g., Artnell v. Comm'r, 400 F.2d 981 (7th Cir. 1968) (prepaid parking for baseball games); Collegiate Cap and Gown Co. v. Comm'r, T.C. Memo 1978-226; [()] see also Rev. Proc. 71-21 (permitting up to one year of deferral for certain items of prepaid services income).

At least three positions have been staked out in the literature on the treatment of prepaid services income. Dodge and Klein each advance a rule consistent with the rules they propose in the case of prepaid rents versus deposits: For Klein the amounts generally should be deferred, whereas for Dodge they should be included on receipt. For Dodge the contingency of the repayment obligation is not relevant, inasmuch as he views the receipt of cash in the current period as an accession to wealth that is not properly offset by an obligation due in a future period, even if the obligation to repay is noncontingent, because the obligation is as yet unrealized.³³ Klein also views the contingency of a repayment obligation as not relevant where the alternative is the provision of services or goods at a market rate, because he considers the exchange of cash for future services to be a non-wealth-creating or -increasing transaction. Hence, whether the obligation is discharged with future services or a future cash payment, the present situation of the recipient taxpayer is the same: She has no income on receipt.

Deborah Geier offers a third position. She rejects the “matching principle” as a tax value, arguing instead that prepayment transactions necessarily contain both an untaxed interest element and some other transfer that generally goes either untaxed or overtaxed under an all-or-nothing rule.³⁴ Under the matching principle, the tax system endeavors to associate particular income items with the goods or services that produce them.³⁵ Geier argues that the matching principle, while appropriate for accounting purposes as a measure of the true financial well being of a taxpayer, is not a genuine income tax value and it should give way where it produces inequitable tax results.³⁶

Geier’s argument can be illustrated by reference to the customer deposits at issue in *Indianapolis Power and Light Co.*, discussed above.³⁷ As explained, on some deposits IPL paid 3% interest, a sub-market rate. On others it paid 6%, presumptively a market rate, but only after IPL had held the deposits for twelve months. In the case of all the loans, deposits either were applied dollar-for-dollar to utility bills at some point in the future, or were repaid in the future at the customer’s request. The effect was to provide IPL with a separate payment equal to the difference between the actual prepayment and the prepayment that would suffice to cover the utility bill or would be repaid, when either event occurred,

³³ Dodge, at ___.

³⁴ Geier, at ___.

³⁵ *Id.*, at ___.

³⁶ Geier, at ___; *see also* Dodge, at ___ (rejecting the matching principle on similar grounds).

³⁷ 493 U.S. 203 (1990).

assuming the latter payment earned 6%. Thus, in the case of the 3% deposits, only half of the actual interest earned was paid, while in the case of the delayed 6% deposits, a year went by when no interest was paid. Geier argues that as a consequence, “IPL succeeded in obtaining the one result that is clearly inappropriate when tax values are well understood: deferral of the inclusion by labeling the receipt as a ‘loan’ subject to an absolute obligation to repay . . . coupled with the failure to bifurcate the loan to account for the below-market rate of interest.”³⁸

Geier’s point, while accurate, addresses an issue distinct from that of the tax treatment of the non-compensatory portion of the transfer (i.e., the genuine deposit): what to do about the acknowledged presence of an interest component to a prepayment arrangement. This problem is real, but comparatively minor. Consider an IPL customer who paid \$100 in Year One in exchange for either a \$100 credit against her bill in Year 2 or the right to receive the \$100 back plus the interest, if any, that would accrue at 6% once IPL held the deposit for 12 months. Assume the customer elected to receive the \$100 back after exactly 12 months. At the time of the initial transfer, \$94.34 would suffice to fund the \$100 repayment,³⁹ and \$5.66 would represent a separate payment of some kind to IPL.⁴⁰ Geier’s point is that the \$5.66 is an amount that should be currently taxed to IPL. Moreover, the customer should, it seems, be taxed on the \$5.66 deemed interest earned on the \$94.34 during the year. Thus the question that arises is what is at stake in terms of tax revenue given that neither of these items goes explicitly taxed under the actual holding in *IPL*. With regard to IPL’s side of the transaction, the revenue loss for the Treasury is minor. It is equal to the present value of the deferral on the tax owed on \$5.66 for one year.⁴¹ At a 40% tax rate, IPL would owe \$2.26 tax on the initial payment. If IPL can defer the tax for a year, it needs only \$2.14 to fund the future tax liability, or \$0.12 less than it would have to pay if the liability were current. Twelve cents represents approximately

³⁸ Geier, at 132.

³⁹ Assuming a market rate of interest of 6%, \$94.34 would yield \$100 assuming annual compounding.

⁴⁰ George Yin characterizes the payment as a charge IPL made to high-risk customers for bearing the risk that they would not pay their bills, but, as argued below, this characterization seems incorrect in light of the fact that IPL obtains the security from the receipt of the deposit. George K. Yin, *Of Indianapolis Power and Light and the Definition of Debt: Another View*, 11 VA. TAX REV. 467, 483 (1991).

⁴¹ That is, under the Court’s ruling, the \$5.66 payment to IPL takes the form of interest earned during the one-year period IPL holds the \$100. The additional \$0.34 of interest on the \$5.66 payment would accrue over that year under both the Court’s and Geier’s treatment.

5% of the tax liability, 2% of IPL's income from the transaction, and 0.12% of the total amount transferred.

On the customer's side, more may be at stake. On one hand, there appears to be \$5.66 of untaxed interest, representing the difference between what is "loaned" to IPL as a genuine deposit and the \$100 that is either returned to the customer, as in the example here, or applied to the customer's bill. On the other hand, there is a separate payment of \$5.66 to IPL. In the case of business customers, it would seem that little rides on the treatment of this \$5.66 since, if broken out separately, it likely would be deductible as a business expense in Year 1 or Year 2.⁴² If the interest on the deposit were also taxed, the net effect would be, at most, a deduction to the customer of \$0.12 – the value of the current deduction of \$5.66 less the present value of the tax due in one year on the identical amount.

For non-business customers, however, there remains the question of the proper characterization of the payment. Geier, following George Yin, suggests it should be treated as a nondeductible personal expense incurred as a payment for the greater risk of non-payment that IPL absorbs from these customers.⁴³ If this characterization is correct, it appears that the customer is under-taxed, because the \$5.66 of interest on the deposit portion (\$94.34) escapes tax and no offsetting deduction on the fee paid to IPL is available that would at least reduce the problem to one purely of timing.⁴⁴ In short, Treasury is out the tax on \$5.66 of interest.

Yin's characterization, however, seems implausible given the facts of the arrangement. IPL's risk is covered by the fact that it retains the deposit to apply against the customer's utility bill in the event of non-payment. No separate payment is needed to safeguard IPL for this eventuality. Rather the \$5.66 "fee" seems to be more akin to an option premium that high-risk customers are charged for the right to purchase the electricity. Thus, when the deposit ultimately is applied against the customer's bill, IPL is simply charging more for the electricity. When the deposit is returned, the customer sustains a loss of the fee: She gets nothing in exchange for it.

⁴² See IRC § 162. It could be argued that the payment represents a capital expenditure to the extent it supplies a benefit to the customer beyond the current taxable year. See IRC § 263. Even so it would be amortizable under Section 167. Moreover, the recurring expense exception could bring the payment under Section 162 even if it otherwise would be capitalizable under Section 162. See *id.*, § __.

⁴³ See Geier at __ (citing Yin, at 483).

⁴⁴ IRC §262.

As a general matter, the cost of an option for the right to purchase a non-business asset is a personal expenditure, and lapse of the option would be a nondeductible personal expense.⁴⁵ Here, however, the better result would view the payment as a simple economic loss. In the usual case, an option purchaser obtains something of value in exchange for the option, but it is hard to see what the purchaser of the “option” to pay the going rate for electric service receives in exchange for the option premium. If the payment in fact were made in exchange for the greater risk IPL bears to provide service to the customer, then the customer would obtain something of value. But, as stated, IPL, by securing payment for its charges up front through the deposit, has already covered this risk. In fact IPL is simply exercising what is likely monopoly or oligopoly power under the guise of a security arrangement applicable to high-risk customers. If the market for utility services were competitive, one might well continue to see the deposit arrangement for high-risk customers, but one would not continue to see inadequate interest paid on the deposits.

If this characterization is accurate, then the payment is an economic loss and technically should be deductible. The relevant provision would be Section 165, which, however, would almost certainly deny the loss on technical grounds for any IPL customer.⁴⁶ By the same token, the Supreme Court’s ruling in *IPL* does not identify the hidden interest element in the transaction, thereby effectively overriding the technical limitations of Section 165 in a case in which it would seem appropriate to do so. Hence it would seem that rough justice is preserved under *IPL*.⁴⁷

⁴⁵ As an example, consumers who are parties to “rent-to-own” contracts for consumer durables often obtain an option to purchase the rented property. Lapse of the option does not entitle the consumer to a deduction. Similarly, payment for the right to purchase season tickets (sometimes referred to as “personal seat licenses”) is a non-deductible expense even if the license purchaser never actually buys the tickets. [CITES.]

⁴⁶ Under Section 165(c)(3), deductions for personal losses generally are limited to “losses aris[ing] from fire, storm, shipwreck, or other casualty, or from theft.” It is doubtful that the option premium would qualify, but even if it did, it would be subject to the \$100 and 10% of AGI limitations of Sections 165(h)(1) and (h)(2).

⁴⁷ Justice is “rough” because, even setting aside the technical limitations of Section 165, as an economic matter the loss exceeds the interest income because the loss occurs earlier, as previously discussed in the text. Yin and Geier both observe that under Section 7872, enacted for tax years after those at issue in *IPL*, the transaction would be recharacterized as they advocate. Whether that is true, however, depends on whether the arrangement would escape recharacterization under the general rule of Section 7872 because it does not “have a significant effect on any Federal tax liability of the lender or the borrower.” IRC § 7872(c)(1)(E). *See also* Treas. Reg. §§ 1.7872-5(b)(14) & (c)(3) (explaining the lack-of-significant-effect rule).

This argument, however, does not expressly address the more fundamental question of how to characterize the much larger portion of the payment that is not a separate fee (or gift or something else, as the case may be). With regard to that issue, Geier's answer appears to be something of a hybrid between Dodge's and Klein's. With Dodge, Geier believes that an item received in Year 1 that in a later period is determined to be income should have been taxable in Year 1. With Klein, however, she would not tax the item at all if it never turned out to be income, which is to say a corrective deduction is appropriate where the initial presumption is incorrect. This view would preserve existing treatment for loans but tax prepaid services and other income, to the extent it did not bear adequate stated interest, when received.

C. Loans

1. The Offsetting Obligation Theory

The tax treatment of loan proceeds has been well established for decades.⁴⁸ As a general matter, under the rules applicable to loans, no income arises for the borrower on receipt of loan proceeds, and no deduction is available on repayment of principal.⁴⁹ (Hereinafter, I refer to this treatment as the “accrual model.”) Similarly, the lender has no deduction or inclusion on the transfer or the later return, respectively, of principal. Interest generally is taxable⁵⁰ on receipt or when paid and, if it is paid in connection with the conduct of a trade or business or, more generally, the production of income, deductible by the payor.⁵¹ When amounts originally disregarded under this regime are subsequently determined by the lender to be uncollectible, the borrower usually will have income from the discharge of indebtedness,⁵² subject to possible limitation if the debtor is insolvent,⁵³ while the lender typically will have a bad debt deduction.⁵⁴

Although the accrual model is well established and widely accepted among tax scholars as legally correct (at least for true market-rate loans), Dodge has recently argued that the accrual model is incorrect under a realization-based income tax such as ours. The traditional justification for the accrual model has

⁴⁸ See Dodge, at __ (2007) (discussing the history of the taxation of debt).

⁴⁹ See Glen Arlen Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623, 634 (1985) (“Borrowing money at a market rate of interest does not constitute receipt of gross income.”).

⁵⁰ IRC § 61(a)(4).

⁵¹ IRC § 163(a).

⁵² IRC § 61(a)(12).

⁵³ IRC § 108(a)

⁵⁴ IRC § 166.

been the offsetting obligation theory. Under this theory, no tax arises on receipt of loan proceeds because the borrower is considered to be no wealthier by reason of the receipt of the proceeds than she was before she entered into the loan transaction. Because the burden of the obligation to repay precisely offsets the value of the outstanding principal amount, the loan transaction is viewed as an economic wash.⁵⁵ Moreover, as principal is repaid, a *pro tanto* reduction in the size of the benefit of the previous inclusion occurs, so that at all times the net value of the loan proceeds plus the obligation is zero. Similarly, the lender has no deduction on payout of the loan proceeds because the borrower's note is an asset of equal value exchanged therefor. It is a straightforward exchange of value for value.⁵⁶

A simple fixed-rate loan that is amortized over a fixed period illustrates the idea. The borrower receives \$X in cash in exchange for a note providing for repayment thereof, plus a market rate of interest. For the reasons stated, there neither is income on receipt nor are there deductions on repayment. Under the loan, periodic payments consist of both interest and principal. As the borrower makes payments allocable to principal, her obligation with respect to the outstanding principal is reduced, but the amount of the reduction is precisely equal to the reduction in the benefit the borrower enjoyed on receipt of the loan proceeds. Similarly, the lender's asset – the note from the borrower – diminishes in value in the same amount as the principal repaid. Interest is accounted for separately as either deductible or not to the borrower, depending on whether the loan is for a personal use,⁵⁷ and includible by the lender.⁵⁸

The accrual model has many virtues, not least of which is its simplicity: The acts of borrowing and repayment can be disregarded for income tax purposes. It also is not necessary to account for loans depending on whether the interest or principal amount is contingent for some portion of the life of the loan. Moreover, the accrual model is compatible with the principal purpose of most loan transactions, which is to acquire liquidity. Viewing borrowing as a liquidity

⁵⁵ See Dodge, at ___, Johnson, at 384; Kohl, at 634.

⁵⁶ See IRC § 1001, Treas. Reg. § 1.1001-3.

In some cases, the rationale has been extended so far as to attribute basis to the borrower in her own debt obligation. See, e.g., *Peracchi v. Comm'r*, 143 F.3d 487 (9th Cir. 1998). Under this theory the taxpayer may use the obligation created by a promise to pay another person, even if not made in exchange for value received, to create basis in property available to offset liabilities transferred or offloaded to that person.

⁵⁷ See IRC § 163(h). Other limitations may apply to the deductibility of interest as well. See, e.g., § 163(d) (limitation on investment interest); § 163(j) (denial of deduction to certain highly-leveraged corporations).

⁵⁸ See *id.*, § 61(a)(4).

device, the accrual model keeps the income tax from working at cross purposes to the loan because the act of borrowing does not itself create liquidity-destroying tax liabilities. Hence liquidity is more readily available than it would be under the cash-flow method. Finally, there appears to be a reasonable logical basis for treating the proceeds of borrowing differently from unrestricted receipts. It seems correct to say that a taxpayer in receipt of an item that comes with a corresponding liability does not enjoy the same accession to wealth that someone does who receives the item free and clear.

2. Dodge's Criticisms of the Offsetting Obligation Theory

Dodge disagrees with each of these arguments. He argues that most forms of borrowing should be taxable on receipt and deductible on repayment, because the receipt of loan proceeds represents a real accession to wealth that is not matched by an offsetting liability under a realization-based income tax. Dodge acknowledges that the liability is real, but argues that the liability should not be accounted for until the period in which it actually becomes due. Prior to that period, it is appropriate to leave the tax liability out of the tax base, just as unrealized gains and losses on the asset side of the ledger are omitted from the tax base.⁵⁹

Dodge observes that the standard justification for the accrual model is far less compelling than are the virtues of its application. In the first place, the theory is inconsistent with the tax treatment of the other kinds of receipts also associated with offsetting future obligations already discussed, such as prepaid services income. Similarly, future liabilities, though fixed in amount, generally are not deductible at least until the taxpayer bears the real economic burden of the liability – even where the obligor accounts for income on the accrual method.⁶⁰ These rules are not generally thought to be inappropriate, and a contrary rule would tend to invite arrangements that most would regard as abusive. For example, if taxpayers could defer inclusion of prepaid services income until economic performance occurred, then through the expedient of prepaid employment contracts they could reduce the real burden of their tax liabilities while enjoying the economic benefit of the associated receipts. Similarly, the

⁵⁹ See IRC § 1001 (tax is applied to gain or loss realized on sale or other disposition of property). There are some exceptions to the realization rule, but these are relatively narrow. See §§ 475 (dealers in securities); 1256 (certain forward, futures and option contracts).

⁶⁰ Section 461(h) requires “economic performance” associated with an otherwise accrued liability to have taken place before the liability is deductible by an accrual-method taxpayer. Congress adopted the provision in order to preclude accrual method taxpayers from currently deducting otherwise accrued liabilities that would not be payable until far into the future. See H.R. REP. NO. 98-432, pt. 2, at 1254-55 (1984). [CHECK.]

ability of accrual-method taxpayers to deduct accrued but unpaid liabilities before payment led Congress to enact Section 461(h), which precludes any deduction for such liabilities until the economic performance associated with the liability takes place.⁶¹

It has been suggested that a decisive difference between loan receipts and prepaid service income lies in the fact that prepaid services income and loan proceeds have different presumptive sources of repayment.⁶² Income from prepaid services, though it is not owned free and clear in an economic sense, is expected to be repaid with services having zero basis to the service provider. Thus there is no tax “cost” associated with the repayment. From a tax perspective, it is free. Loan proceeds, by contrast, presumptively will be repaid with after-tax amounts. For example, if *Borrower* repays *Lender* with salary income received from *Employer*, *Borrower* will pay tax on the salary income as earned, and only after-tax proceeds will be remitted to *Lender*. Hence the offsetting liability attaches to an amount in which *Borrower* will have basis.

Unfortunately, this rationale amounts to little more than a formalism, a point made by both Dodge and Klein (arguing for the opposite general rule). It relies on the irrelevant circumstance that the lender is not the same person as the service recipient.⁶³ In the typical case, *Borrower* can effect nearly the same arrangement by borrowing an amount equal to otherwise prepaid salary from *Lender* and using salary income taxed as received from *Employer* to repay the loan. If *Lender* is the same person as *Employer*, it seems the same treatment should result. More to the point, the fact that a loan is expected to be repaid with after-tax amounts is essentially meaningless in terms of real economic effect. In both the prepaid salary and loan proceeds cases, the taxpayer receives an amount now for which repayment will be required later. The only difference is the time at which taxes are withheld.

An additional and perhaps more telling difficulty afflicts the offsetting obligation theory: It remains unclear why loan proceeds are not income to the borrower on receipt to the extent they are not repayable in the year received, given the realization-based nature of the income tax.⁶⁴ Under the “Haig-Simons” conception of income that is widely accepted as the normative benchmark for the actual income tax,⁶⁵ income is defined as the net increase in wealth (including

⁶¹ See McMahon, at 1090.

⁶² Calvin H. Johnson, *The Illegitimate “Earned” Requirement in Tax and Nontax Accounting*, 50 TAX L. REV. 373, 385 (1995).

⁶³ See Klein, at ___, for a persuasive refutation of the source-of-payment rationale.

⁶⁴ See Dodge, at 256; Geier, at

⁶⁵ See Dodge, at ___.

values spent on consumption) during the relevant tax period.⁶⁶ The concept is thus intrinsically periodic. It is meaningless to speak of an individual's income without specifying a period to which it applies, even though there may be no "natural" period to which an ideal income tax need apply. When the repayment obligation arises in a period later than the period in which receipt occurs, it would seem that the obligor on the loan has income to the full extent of the receipt, because her wealth during the period is not reduced by the future obligation.⁶⁷ If *Borrower* receives \$100,000 in Year 1 in exchange for her note to *Lender*, payable in full in Year 10 with adequate stated interest prior thereto, then *Borrower* appears to have \$100,000 income in Year 1 because of the loan. The obligation to repay, while real, does not have any impact on *Borrower* in Year 1. Rather the impact occurs in the period or periods in which the loan becomes due, just as the recipient of prepaid income for services typically has income on receipt even though she has an obligation to provide the services in a future period.

Thus, Dodge argues that the borrower has income equal to the loan proceeds on receipt because

the earliest time that a decrease in wealth can be said to occur is the date payment is due, that being the earliest time that the creditor has the right (and possibly the power) to cause the debtor's existing stock of wealth (if any) to be reduced, as well as being the earliest date on which interest can commence to run.⁶⁸

Moreover, Dodge denies that the fact that a lender has no deduction on extension of the loan requires non-inclusion by the borrower. On his view, repayment obligations, because they relate to future periods, are generally irrelevant to the measurement of income in the current period. However, repayment rights, because they are typically salable, represent an asset the value of which is approximately equal to the cash the lender surrenders on the loan.⁶⁹

III. When Income Arises

The preceding approaches all seek to formulate a rule for the taxation of advance receipts on the basis of an effort to tax real income, or to approximate the taxation of real income, under the income tax. This part explains why those

⁶⁶ HENRY SIMONS, THE CONCEPT OF INCOME __ (1938).

⁶⁷ Although in practice the measurement of taxable income always has deviated from the Haig-Simons ideal in that, among other things, it has usually been deemed necessary that income be "realized" before it is taxed, that criterion clearly is satisfied in the case of loan proceeds, as their receipt is a realization event under any definition thereof. See Dodge, at 250-54.

⁶⁸ Dodge, at 256-57.

⁶⁹ *Id.*, at 258-59.

approaches are generally misguided. From a theoretical perspective, there are two competing concepts of income that may be said to form the foundation of our actual income tax. Under both of them, advance receipts generally would become taxable only as and when they are secured to the taxpayer an offsetting liability. The concept that has come to dominate academic circles is the Haig-Simons definition of income previously described,⁷⁰ which defines an individual's income as equal to the individual's change in wealth, including amounts spent on consumption, during a given period. An alternative definition, which also has a rich intellectual pedigree,⁷¹ would understand income as the conversion of human or natural capital into wealth.⁷² Here the conceptual starting point is not so much the individual as the collective system of production and exchange from which wealth arises. Under this definition, what we call income is already latent in various forms of capital; it becomes income when it is converted from latent value into real economic value. Other kinds of transfers, such as gifts or certain payments made in connection with the division of property, do not constitute income events, though they may signal a shift in previously-taxed income from one party to another that should be taken account of for tax purposes. As argued below, both definitions should result in essentially the same understanding of the income tax consequences of the receipt of an advance payment. Subparts A and B analyze advance receipts under the income tax under these two understandings, but without regard to time-value of money issues that frequently arise in the advance receipts setting. Subpart C focuses on the effects that implicit interest in certain advance receipt cases has on the analysis.

A. Timing of Income Under the “Haig-Simons” Definition

The Haig-Simons income definition can be expressed algebraically as:

$$I = \Delta W + C,$$

where I represents income, ΔW change in wealth, and C amounts spent on consumption, all during the relevant tax period.⁷³ Thus, an individual who earns \$40,000 in wages, receives \$9,000 in interest income and spends \$15,000 on consumed items has \$49,000 of income during the tax period. It consists of

⁷⁰ See Dodge, at ___.

⁷¹ The origins of the concept extend at least as far back as John Locke's labor theory of value. See JOHN LOCKE, TWO TREATISES OF GOVERNMENT, 2nd Treatise, Ch. V.

⁷² See Klein, at ___.

⁷³ SIMONS, at 50 (“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.”) [TAKEN FROM DODGE ARTICLE; CHECK QUOTE.]

\$34,00 net change in wealth (= \$40,000 + \$9,000 - \$15,000) and \$15,000 spent on consumption. Under this definition, all accessions to wealth, regardless of whether they result from earnings, gifts, capital gains, windfalls or other sources, constitute income.

What of an individual who receives a payment subject to an offsetting obligation of some sort? In the case of loans, it is generally believed that no income arises for the borrower on receipt of loan proceeds, and no deduction is available on repayment of principal, assuming that the obligation carries a market rate of interest.⁷⁴ Similarly, the lender has no deduction or inclusion, respectively, on the transfer or the later return of principal. Interest generally is taxable⁷⁵ on receipt or when paid, and, if it is paid in connection with the conduct of a trade or business or, more generally, for the production of income, it is deductible by the payor.⁷⁶ When amounts originally disregarded under this regime are subsequently determined by the lender to be uncollectible, the borrower usually will have income from the discharge of indebtedness,⁷⁷ subject to possible limitation if the borrower is insolvent,⁷⁸ while the lender typically will have a bad debt deduction.⁷⁹

Less clear are the cases of other kinds of offsetting obligations, discussed in the preceding Part. As indicated, commentators have variously viewed the facts that the offsetting obligation can be satisfied by an exchange, that the obligation is contingent, that the obligation is incurred at a discount, or that the obligation may be satisfied with “pre-tax” amounts, as reasons for distinguishing between loan treatment and current taxation. Moreover, Dodge suggests that the Haig-Simons theory itself supports current inclusion of loan proceeds in the case of a realization-based income tax.⁸⁰

As a general matter, these criticisms are misplaced. They reflect two sorts of confusion. First, they may rely on the exigencies of tax administration rather than on any coherent concept of income as a basis to determine whether current payments should or should not be included in gross income. Second, their

⁷⁴ See Glen Arlen Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623, 634 (1985) (“Borrowing money at a market rate of interest does not constitute receipt of gross income.”).

⁷⁵ IRC § 61(a)(4).

⁷⁶ IRC § 163(a).

⁷⁷ IRC § 61(a)(12).

⁷⁸ IRC § 108(a).

⁷⁹ IRC § 166.

⁸⁰ Dodge.

analyses are informed by concepts such as control over or dissipation of the receipt rather than that of accession to wealth. Control and dissipation, however, are relevant to a consumption tax analysis of prepayments, not to their income tax analysis. Focusing on the crux of the Haig-Simons concept, the question is whether the receipt of the advance payment represents an accession to wealth. Where the advance payment is subject to an offsetting obligation of equal value (taking into account time-value-of-money principles), the answer to this question must be “no.”

1. Basic analysis

There are at least two ways to illustrate the point that advance receipts made between parties dealing at arm’s length do not result in income under the Haig-Simons concept. First, on an intuitive level one can say that two individuals, *A* and *B*, each in receipt of \$X on Day 1, but only one of whom, *A*, must return \$X in two years and pay adequate interest in the interim, do not have equal incomes. Each has disposition over cash, but surely the person who receives the \$X free and clear enjoys an accession to wealth that the obligated person does not. Put bluntly, it matters whether you are *A* or *B*. Secondly, and more concretely, the fact that the obligor must pay adequate interest, in one way or another, while the \$X is in her possession indicates that she has exchanged value for value. Her purchase of liquidity is no different from a person’s purchase of any other commodity. Inasmuch as the exchange occurs at arm’s length, the value she receives is by definition its cost. To the extent the obligor prefers the loan proceeds plus the obligation to no loan at all, she enjoys nothing more than consumer surplus in that the liquidity she purchases with her interest payments is worth more to her than the amount it costs. But consumer surplus has never been subject to tax under the income tax, and it would seem strange to tax it here alone. The liquidity value is no different from the value that a patron in a restaurant gets from an exceptionally good meal or a factory owner gets from the purchase of machinery to use in a profitable business. Further, there is no reason to assume that the amount of consumer surplus equals the loan amount. And, lastly, there is no reason to provide a deduction for consumer surplus on repayment of the loan.

2. Counterarguments

As indicated in the previous part, Dodge and others have suggested that factors such as the payee’s complete dominion over the receipt or her ability to use the receipt to finance personal consumption indicate that, at least as far as a realization-based income tax is concerned, advance receipts, even loan proceeds, should be included on receipt.⁸¹ Each of these claims fails.

⁸¹ Dodge, at 256-58; Geier, at _____. See also Mich. Auto. Ass’n; Schlude; [discussing dominion as a factor in deciding whether taxpayer has income].

(i) Dominion

Consider first the idea that the recipient's control over the proceeds would be relevant to the income tax treatment of them. If the normative criterion of income taxation is that it reflects ability to pay, then inclusion on the basis that control provides such an ability is surely misguided. The notion of ability to pay is a normative one, not a practical one.⁸² Income taxability is not a matter of possession or control, but of identifying true accessions to wealth. If possession and control over the receipt are determinative of ability to pay, then woe betide the bailee who receives cash on December 30 that she must return on January 2. Her control is no less than that of the borrower or the recipient of advance services payments. Perhaps the point will be made that the borrower or recipient of prepaid services income, unlike the bailee, "owns" the proceeds. But to assert that ownership exists, when the receipt is linked to a future obligation to make good (either by return or by providing services), is simply to draw a legal conclusion predicated on the view that the borrower/service provider but not the bailee has income on receipt. In short, it is question-begging. One might equally ask what relevance ownership has.

Further, it cannot be correct to say that whether a genuine accession to wealth occurs depends on the arbitrary period in which it is accounted for. If the income tax were calculated on the basis of a calendar decade rather than a calendar year, the tax consequences to a borrower of a nine-year term loan would dramatically depend on the date of borrowing. If late in the calendar decade, a huge tax liability would arise from the borrowing, if early enough, none at all. Ideally an income tax would be assessed on the basis of lifetime income, not income during a period. The periodic nature of the income tax results largely from the administrative need to collect tax on an on-going basis, coupled with the fact that it is not possible to know lifetime income prior to the end of the life.⁸³ There is, however, nothing substantive about the period itself. How much wealth a person has right now does not depend on whether the period in which "right now" occurs extends far enough out to embrace an obligation that we also know about, "right now."

Lastly, the control argument proves too much. Lessees of property obtain control over the leased property, at least to some extent, but as far as I am aware no one has suggested inclusion of leaseholds in income in a manner consistent with the control theory. Although there are limits on the extent of that control,

⁸² Note that Simons himself seems to have recognized this point, as he did not view the receipt of loan proceeds as income. *See* Dodge, at 253 n.33 ("Even Henry Simons ignored the tax treatment of borrowing. . . ."). [CITE SIMONS DIRECTLY IF POSSIBLE.]

⁸³ [CITE TO FENNELL & STARK?].

under the control theory it is these limits, and not the fact that the lessee pays rent (tantamount to interest) for the use of the property, that should determine the extent of the lessee's income. For example, consider a lessee that leases a factory from its owner for one-half its useful life, or 15 years. The lease customarily requires monthly rent at a fair market rate. Under the control theory, on the date the lease is signed, the lessee has income to the tune of the portion of the factory over which it has control, which is to say the value of the factory's useful life that will be available to the lessee during the term of the lease.⁸⁴ Separately, the lessee has deductions for rent and, presumably, a deduction on termination of the lease equal to the original inclusion.⁸⁵ At the same time, under Dodge's theory the lessor, it seems, will disregard both the "loss" on disposition and the "gain" on reacquisition, just as, on his view, the lender in a loan transaction realizes no loss on transfer of loan proceeds and no income as they are repaid.⁸⁶

(ii) Source of Payment or Repayment

As previously discussed, a number of commentators have suggested that the source or presumptive source of repayment is relevant to the question whether the advance receipt should trigger an immediate inclusion. Calvin Johnson uses the example of an attorney, *F*, who is prepaid \$1 million for 5 years of personal services, as an example.⁸⁷ As contrasted with a recipient of loan proceeds, *F* will discharge the obligation with personal services, and "[w]hether the services are future services, past services or services performed simultaneously with payment, they cannot offset reported compensation,"⁸⁸ because the service provider has no basis in those services. Thus, the failure to include the receipt currently is not

⁸⁴ Assuming economic rather than statutory depreciation, the sinking fund method would apply to determine what percentage of the factory's value the lease term consumed. See MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS __ (10th ed. 2005) (describing the sinking fund theory as applied to depreciable capital assets).

⁸⁵ Strictly speaking, the lessee should be permitted to amortize the leasehold under the sinking fund method. [CITE.] Generally, however, the tax law will not permit amortization as long as the lessor remains the "tax owner" of the property. [CITE.] Assuming the lessor does remain the tax owner, on return the lessee instead would simply deduct the original payment, as described in the text.

⁸⁶ Dodge, at __. In other words, on Dodge's view loans, leases and other advance payment transactions create income out of nothing on inception, and then cancel that income on termination. This problem is explored in more detail immediately below.

⁸⁷ Johnson, at 385-86.

⁸⁸ Johnson, at 385.

merely a timing error, “but a graver error of giving respect to items that cannot be treated as a cost at any time.”⁸⁹

Johnson’s analysis, like Dodge’s in the case of loan proceeds, confuses two distinct issues that must be kept separate in order to arrive at a proper understanding of the income tax consequences of an advance receipt. The fact that an obligation will or is highly likely to be discharged with services income, or indeed with anything having a basis in the advance payee’s hands different from the value of what is received, does not answer the question whether the recipient has income *now*. The basis of the property or services that the recipient will use to discharge the liability tells us only how much income (or loss) she will have if and as the obligation is discharged. Prior to that time (and setting aside the very real issue of the time-value of the \$1 million payment, discussed below), the economic position of *F* is no different from that of the obligor on a \$1 million loan. *F* is on the hook for \$1 million, either of services, or of cash (or property) if he fails to provide the services. Since *F*’s services are worth \$1 million, he is in a net zero position: no income and no loss on the transaction. The reason it is a net zero position has nothing to do with basis. It has to do with the fact that he has not been enriched. To be sure, the enrichment, or some of it, is likely to occur, and we might well (indeed we often do) impose a tax on likely income. But the reason for taxing likely income is that other considerations, such as the difficulty or uncertainty of taxing the actual income when it arises, make doing so appropriate.⁹⁰ Focusing only on the conceptual question of when income arises, there is no basis for attributing \$1 million to *F* on receipt of the proceeds. Likely income, while often a good substitute for actual income, is not the same as actual income.

Consider the case in which the services *F* is to provide are personal to the payor, whom I will call *G*. Assume *G* is a cash-method taxpayer. *G* has no deduction on payment because she has received a long-lived asset worth what she paid,⁹¹ and she would have no amortization over the five-year term because the expenditure is personal in nature.⁹² If we believe that *F* has income on receipt, prior to his providing any services at all, we therefore must explain how income

⁸⁹ *Id.*

⁹⁰ See Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 20-21 (1984) (noting and questioning arguments for immediate taxation of prepayments on the grounds of administrative convenience and protecting the fisc).

⁹¹ See IRC § 263. Dodge himself notes that the lender in a loan transaction does not have a deduction on transfer of the loan proceeds because the lender retains an alienable asset worth the amount of the proceeds. Dodge, at ___.

⁹² *Id.*, § 262.

has been created out of nothing. After all, *G* still has an asset worth \$1 million, and there is no reason to view *G*'s payment as creating a loss to *G* at any time: If *F* in the following year cancels the arrangement, never providing the services, he would have to return the full \$1 million to *G*, who would be out nothing in income terms. Hence we must posit the creation of income out of nothing on the date of the advance payment, as well as its subsequent disappearance back into the void should the arrangement be cancelled. The only way to avoid this ultimately non-sensical result is to recognize that treating the prepayment as income represents a decision to tax "likely income," not income itself.

Nor is the situation any different where the cost is deductible or amortizable to the payor; it is just more nuanced. In the above example, if *G*'s expenditure is business rather than personal in nature, she still may not deduct the expense, though she may amortize it over the five-year term.⁹³ Thus we are still left with the difficulty of creating income out of thin air on initial transfer, but at least over time there is some recognition that *G* bears a cost that is associated with *F*'s income. Moreover, in some instances a prepayment for services might be deductible to a cash-method taxpayer even though the services were not to be provided until sometime in the future. In that case, the advance payee's putative income would be matched by a deduction on the payor side.

Even if all business-based advance payments were immediately deductible, however, the analysis would not change. The deduction for business expenses, set forth in Section 162(a), is predicated on the idea that the value the payor receives in exchange for the expense is properly accounted for when its goods or services are sold, not that the payor has suffered a loss as a result of the advance payment.⁹⁴ The deduction does not represent a loss, but a recognition either that the connection between the expenditure and the associated income item is too attenuated to be identified with a particular item (in the case of long-lived benefits associated with expensed items) or (in the case of short-lived assets or services) that there is no functional difference between providing an expense and

⁹³ Section 263 continues to apply to deny the immediate deduction, but the general rules permitting amortization of long-lived business assets apply under Section 167. If *G* were an accrual-method taxpayer, she would also have to negotiate the economic performance rules of Section 461(h), which generally would require her to deduct the payments over the five-year term. *See* Treas. Reg. § 1.461-4(d)(2). These rules would not change the argument here.

⁹⁴ Losses are separately accounted for under Section 165. *See generally* BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, ¶ 25.8.5; Rev. Rul. 79-80, 1979-1 C.B. 86 (distinguishing between expenses for acquiring securities deductible under § 162(a) and losses on purchase or sale of wrong securities deductible under § 165(a)); *Holt v. Comm'r*, 69 T.C. 75 (1977) ("The distinction between losses and expenses has generally been regarded as self-evident.")

requiring immediate capitalization followed by reduced income on sale of the good or service.⁹⁵ In short, the deduction under Section 162 is a kind of realization rule, not an acknowledgment of a loss to the payor.⁹⁶ It remains the case, then, that wealth is deemed created out of nothing under the inclusion/no deduction approach Dodge advocates.

(iii) Personal use

Essentially the same criticism may be made of the idea that the personal benefit associated with consumption or potential consumption of advance receipts justifies treating them as income on receipt. The income concept is different from the consumption concept. One can be perfectly capable of consumption of property that does not represent an accession to wealth. Or to put the point another way, legal ownership is not determinative of economic wealth. If it were, then the taxpayer in receipt of loan proceeds would be as wealthy as the taxpayer who receives the same dollar amount free and clear. Conversely, the ability of the recipient to consume the proceeds indicates nothing more than that a consumption tax is fundamentally different from an income tax. A tax on consumption is just that; it has nothing necessarily to do with whether the consumed item represents an accession to wealth but only with the availability of resources that the taxpayer may use to consume.⁹⁷

(iv) Realization

An intriguing argument that Dodge advances for current inclusion of advance receipts, including loan proceeds, is that consistent application of the realization rule precludes accounting for obligations prior to the period in which they are payable.⁹⁸ The argument runs by analogy. In the case of assets held by the taxpayer, built-in gain or loss is excluded from the tax base until the period in

⁹⁵ See *Encyclopaedia Britannica v. Comm'r*, 685 F.2d 212 (7th Cir. 1982) (discussing theory of capitalization and expensing). Thus it is not surprising that Congress, the courts and the IRS all generally have endeavored to force capitalization whenever the prospect that an expenditure creates a long-lived asset is real. See, e.g., IRC §§ 263 (requiring capitalization for long-lived assets) & 263A (extending same principles to self-created assets); *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992) (capitalization required even if expenditure does not create a separate, distinct asset but merely enhances life of existing asset); Rev. Rul. 2000-4, 2000-1 C.B. 331 (explaining capitalization and expensing principles). See generally BITTKER & LOKKEN, at ¶ 105A.1.

⁹⁶ See Charlotte Crane, *Liabilities and the Need to Keep the Income Tax Base Closed*, 25 VA. TAX REV. 31, 55 (2005) (noting that costs of production are generally accounted for either by immediate deduction or additions to basis in costs of goods sold).

⁹⁷ *Andrews*, ___.

⁹⁸ Dodge, at 260-65.

which it is “realized,” typically in a disposition. Prior to realization, taxpayers do not pay tax on appreciation, nor are they permitted a deduction on built-in losses.⁹⁹ Analogous treatment of liabilities would seem to require their exclusion from the tax base as well. A currently realized advance receipt should not be offset by a future liability if the liability will not be payable until a future period. Hence, under a realization-based income tax the recipient of an advance payment should be considered as having a clear accession to wealth that is unfettered by any recognizable offsetting obligation. While a thoroughgoing application of accretion concepts might permit deferral of gain on various sorts of advance receipts, under the actual tax system, in which nearly all gains and losses are accounted for under the realization rule, “accretion taxation occupies a small island in a realization ocean.”¹⁰⁰ If accretion taxation is not applicable to advance receipts, then cash-flow consideration is.

There are several difficulties with this view. In the first place, the notion that no offsetting liability currently exists in the case of an advance payment is generally incorrect. Consider an on-market loan arrangement. Failure to make interest payments generally results in acceleration of the loan,¹⁰¹ which indicates that the non-payment of loan principal until term is only optically different from a current obligation to repay the loan proceeds with each interest payment. Moreover, the analysis remains essentially the same even if failure to make (some) interest payments simply triggers a larger interest payment obligation. Ultimately the borrower pays for the loan proceeds on an on-going basis. Hence the realization event is payment of interest. To say, as Dodge does, that the interest is paid for the use, but not the receipt of the loans, is simply incorrect.¹⁰² If the borrower does not pay the interest, the loan must be returned. Consider that as an economic matter, and apart from market fluctuations, a lease, rental, or advance payment of any kind in which the recipient makes ongoing payments for the use of the transferred item is equivalent to a series of such arrangements, each separately negotiated, for the term during which payment for the use is due. Thus, if we disregard the fact that market conditions change over time, there is no economic difference between a one-year loan of \$X that provides for monthly interest payments of \$Y and a return of the \$X principal at term, and twelve successive one-month loans of \$X each, each having \$Y of total interest due. To be sure, there is generally no reason to assume that market conditions will remain constant, but it is in fact this assumption, and not the deferred obligation to return the \$X, that reflects the operation of the realization rule in the case of advance

⁹⁹ See IRC § 1001(a).

¹⁰⁰ Dodge, at 265.

¹⁰¹ [CITE].

¹⁰² Dodge, at __.

receipts. Thus, a twelve-month lease will lock in the rental rate for the entire term, whereas successive one-month leases lock in the terms for only one month. As market rates fluctuate during the year, the value of the lease will tip in one or the other party's favor, but the tax system does not pick up this value shift in the absence of a disposition.¹⁰³

Does the argument change if the obligation to pay interest is deferred? In the case of deferral until the term of the loan, it would seem that the entire use of the proceeds is unfettered by any repayment obligation, suggesting that, at least for cash-method taxpayers, the realization rule should defer taking account of the liability entirely. Here the second difficulty with the realization argument arises. The inclusion of the full amount of the loan proceeds on the ground that interest payments are deferred is unwarranted even if one applies a cash method of accounting to the obligor. The application of the realization rule is not the same as the adoption of a consumption tax, and cash-method accounting under an income tax is not the same as cash-flow taxation under a consumption tax, because the two tax bases differ in their object: accession to wealth versus consumption (or deemed consumption). Thus it is possible for the realization rule to operate under both an income tax and a consumption tax, in each case distorting actual tax values somewhat; it is not as though a consumption tax is the same as a realization-based income tax taken to its logical extreme.¹⁰⁴

Applying realization principles to the income taxation of loans, one can say that the accession to wealth the obligor enjoys is (artificially) created by the reprieve granted in the obligation to pay interest. The question is how much income the reprieve is treated as creating. For this purpose, we disregard the interest accrual during the term because we are applying realization principles, and it is not accrual but payment that matters. On this analysis, however, the borrower is still not enriched by the full fair market value of the proceeds, but only by the value of the time-slice of the loan proceeds she receives. In other words, it does not follow that a switch to a realization-based income tax means that the measure of her income is the consumption power to which she accedes as a result of the receipt of the loan. Consumption power is the basis for assessing a consumption tax, not an income tax. Under an income tax, the question is the size

¹⁰³ One might also argue that value is created *ex ante* in the parties' agreement to lock in the rate for the term of the arrangement. Except to the extent both parties are risk-averse, one party will pay the other for assuming the risk she does not wish to bear. As an example, nonrecourse debt generally bears a higher rate of interest than recourse debt. [CITE.]

¹⁰⁴ Examples of deemed consumption include the lack of a deduction for unspent cash on hand under a cash-flow consumption tax and, unless specifically provided for to the contrary, the absence of a deduction for the portion of consumer goods purchased during the taxable year that have a use beyond the taxable year. [CITE.]

of the accession to wealth, and under a realization-based income tax, the question is how the deferral of the equal and offsetting obligation affects that size.

To see the point, consider the case of Cinderella's coach. In the fairy tale, Cinderella's fairy godmother provides her with the coach during the day, but she must be finished with it by the final stroke of midnight because at that time it will turn back into a pumpkin.¹⁰⁵ Let us assume for purposes of the discussion that Cinderella's use of the coach is unfettered. She may ride in it, burn it for a fire, or throw it off a cliff for the enjoyment of seeing it crash below. In all cases the coach reappears in the godmother's hands at midnight, identical to what she provided Cinderella, save only normal wear-and-tear.

One might consider Cinderella's use of the coach a particularly fanciful kind of time-slice transfer of property. Cinderella has been enriched by the receipt, but she has not received an amount equal to the fair market value of the coach in fee. Rather she has received a wasting asset the value of which equals the value of the time-slice. Unlike our borrower, of course, Cinderella has received value because she need never pay for the use of the coach. But if we stipulate that all interest is due after the term of the loan and that because of that deferral realization principles preclude us from considering the interest as an obligation during the period of receipt, then we would treat the borrower just as we treat Cinderella for all periods prior to which any payment of interest is due. In that case, the most we can say that our borrower has received is the fair market value of the time-slice of the loan. Put more concisely, one can say that the advance payee has income under a realization-based tax to the extent she can defer payment for the value she received. But the value she received is not the property in fee, but a time-slice of it.¹⁰⁶

Finally, the notion that the exchange itself of the promise to pay for the loan proceeds should generate income because the obligor has no basis in the promise represents a mistaken view of the nature of basis.¹⁰⁷ Fundamentally, basis is a tax accounting concept that measures the extent to which the taxpayer has accounted for assets on an after-tax basis.¹⁰⁸ The question in all cases,

¹⁰⁵ The Cinderella fairy tale is discussed in JACK ZIPES, *THE GREAT FAIRY TALE TRADITION: FROM STRAPAROLA AND BASILE TO THE BROTHERS GRIMM* (2000) [CHECK.].

¹⁰⁶ Again, the analysis would differ under a consumption tax. Since the question is not the extent to which the payee is enriched but the extent to which she can consume in the period, the full value of the coach would be includible to Cinderella, as a result of the fact that, as stipulated, she may do anything she wants to the coach while it is in her possession.

¹⁰⁷ Dodge, at 259-60.

¹⁰⁸ See Kohl, at ____.

however, is what the taxpayer has received as a result of the advance receipt. In this sense, the liability question is logically prior to the basis question. Before one can ascertain how much gain or loss arises on an exchange of a future obligation for a current receipt, one must determine the value of what one has currently received. That quantum of value has only an attenuated relationship to the fair market value of the fee interest received. As the preceding discussion has shown, in most cases the value is essentially nothing (other than non-taxed consumer surplus). In the unusual case in which interest or the obligation to provide services or property is deferred until the future, the realization rule could trigger a gain to the extent of the value of the time-slice received prior to the obligation to pay for it, but that is all. In short, the fact that the offsetting cash or other property (or service) flows may occur in a future period does not mean that the taxpayer has acceded to wealth. The notion that she does is predicated on a conflation of control over the receipt with income.

B. Income as Realized Capital

A slightly different theory of the income concept would conceive of it as a way of measuring the transformation of wealth from one form to another. On this view, all income is already latent in the world as natural or human capital, and the measurement of income is simply the keeping track of the time at which latent wealth becomes manifest.¹⁰⁹ This theory finds expression in both the earliest case law interpreting the income concept¹¹⁰ and philosophical literature locating the sources of human wealth in natural resources and human labor.¹¹¹ If income is realized capital, it becomes important to distinguish the income event from the transfer of resources or money that may occur on or in connection with that event. For example, consider two individuals who exchange their services for the services of the other. On the realized capital conception of income, the decisive income event is not the receipt of the other's services, but the performance of one's own. The performance generates the income, and the exchange is one of value for value; it generates no tax liability at all. The exchange is simply a good time to tax the two parties. The same is true in the more conventional setting in which a service provider receives money for her services. Technically it is not the receipt of the money but the provision of the services (whether for her own benefit or for exchange to another) that generates the income. The exchange merely attends the production of income. Further, some transfers may not be associated with any wealth creation whatever. Alimony payments are one example; gifts are another. In these settings a tax may or may not arise, but where it does, an offsetting deduction should be available. In effect any tax that is

¹⁰⁹ See Klein, for a discussion of this concept.

¹¹⁰ See, e.g., *Eisner v. Macomber* and cases cited therein.

¹¹¹ See, e.g., JOHN LOCKE, *TWO TREATISES OF GOVERNMENT*, at __ ().

imposed in the absence of an income event reflects a judgment that the person to whom the genuine income was originally attributed is not the proper person to bear the tax, because the income has been reassigned as well.¹¹² Thus, the income event still is not the receipt of wealth; rather the tax consequences reflect, or are understood to reflect, the correction of a prior income assignment.

In the ordinary case, the difference between the more standard understanding of income as the receipt of value (an “accession to wealth”) and the realized capital understanding of it as the realization of wealth will not differ. As a general matter, income is produced for exchange, which is to say that the producer of income typically receives a like amount of income from a counterparty in exchange for the income she produces, and she does so at that time. The production and exchange of income are simultaneous and equal, with the result that both concepts of income yield a single measure.

In some instances, however, income is not produced for exchange, but it is taxed to the producer nonetheless. The tax law’s treatment of these cases arguably provides telling support for the income as realized capital conception, because no tax should result to a transferor in such a case under the accession to wealth theory. For example, when a corporation distributes appreciated property, the built-in gain on the property is taxed to the corporation.¹¹³ Other examples are contributions of appreciated property to political campaigns, which trigger gain to the donor equal to the amount of the appreciation,¹¹⁴ and appreciated gifts, which would trigger gain to the transferor but for the special rules providing for different treatment under Section 1015.¹¹⁵ If income were limited to the receipt of value, no tax to the transferor would arise in these cases.

Under the realized capital theory, advance payments are relatively easily classified: They ought not be net taxable events to the extent they involve mere shifting of wealth, as opposed to creating it (or paying for wealth already created), unless the tax law deems the reassignment of a prior income amount appropriate (i.e., provides a corresponding deduction or loss to another party to the transaction). Thus, where income shifting is at issue, any tax that arises to the

¹¹² Thus, genuine alimony is included in the recipient’s income and deductible from the payor’s gross income to arrive at adjusted gross income. *See* IRC §§ 71(a) (alimony received is included in gross income); 215(a) (payor of alimony is entitled to a deduction therefor); 62(a)(10) (the deduction is applied to arrive at the payor’s adjusted gross income). By contrast, gifts are not taxable to the recipient but also are not deductible to the payor. *See id.* § 102(a).

¹¹³ IRC § 311(b). Loss is not recognized, but this asymmetry is widely recognized as necessitated in order to avoid strategic loss recognition. [CITE.]

¹¹⁴ IRC § 84(a).

¹¹⁵ *See* U.S. v. Davis, __ U.S. __ (19__).

recipient on the shift should be offset by a corresponding deduction to the payor. The theoretical basis for the shift would be that it corrects the identity of the income recipient, not that it is itself an income event. Thus, a transfer of loan proceeds, a prepayment for services or the transfer of rental of property, are not income events. Each is a transfer made in anticipation of some kind of income event – be it the use of the money lent or the property rented, or the provision of services. Critically, the actual income event has nothing to do with the prior transfer. The shifting of funds is wholly distinct from their production or, if one prefers, their realization in the form of explicit wealth. Thus, a loan arrangement (as distinct from the payment of interest) generates no income to the borrower (and no loss to the lender). The income that arises for the lender results from sale of the value of the use of the money, and she is paid for that with interest. The same occurs in the rental context and in the prepaid services context.

To be sure, in some instances amounts will be taxed to one party (and deducted by the other), even when there is no income in the sense defined here. The most salient example is cancellation of debt income. But taxation of the borrower in this case simply corrects a presumption about the owner of income that turns out to have been mistaken. It is a reassignment of income to the borrower (subject to the limitations of Section 108) from the lender on the basis that the party that turns out to have the benefit of the prior income is different from the party initially assumed to benefit from it. In effect it acknowledges that amounts previously treated as income to the lender were in fact transferred to the borrower. Accordingly, the lender enjoys a concomitant deduction.¹¹⁶

C. Time-Value of Money Principles

The preceding discussion disregarded the fact that in the case of any advance receipt for which an on-going obligation to pay (whether currently or not) is not express, a disguised interest component is present, as illustrated in the discussion of *Indianapolis Power and Light*, above. The presence of interest in actual cases makes the analysis of prepayments more complex, because a true income tax will pick up interest as it accrues (and generally provide a deduction therefor to the payor).¹¹⁷ Contrary to the conclusions of some commentators,

¹¹⁶ IRC § 166.

¹¹⁷ The concern to identify and tax interest that economically accrues under a multitude of arrangements pervades the Code. See IRC §§ 61(a)(3) (general interest inclusion), 163 (interest deduction), 453 (imputing interest to certain installment obligations); 483 (inclusion of disguised interest in deferred payment property transactions); 1272 (inclusion for accrued but not currently payable interest on original issue discount obligations), 7872 (identifying and taxing as such interest implicit in certain below-market-loan arrangements).

however, it does not change the fundamental analysis of whether the prepayment constitutes income.¹¹⁸

Consider again Johnson’s example of the lawyer, *F*, who receives \$1 million at the close of Year 0 in exchange for the obligation to provide personal services to a client during Years 1 through 5. If *F* and the client, *G*, deal with each other at arm’s length, then the present value of *G*’s payment should equal the expected cost of the services if paid for on an as-rendered basis. Suppose interest rates are 10% compounded annually, and payments for *G*’s services ordinarily would be due in full at the close of the calendar year in which they are provided. Suppose further that *F*’s fees are expected to keep pace with interest rates, and that the discount to which *F* and *G* agree simply reflects this expectation. In that case, *F*’s current fee for a year’s worth of services is \$200,000. Assuming annual compounding, the obligation to pay \$1 million at the close of Year 0 is equivalent in present value terms to payments totaling \$1.343 million over the five-year term.¹¹⁹ In effect, *G* is paying for future services in part by earning interest on a loan to *F*, who in turn applies the interest earned to offset a portion of *G*’s obligation to pay for the services, the balance coming from remaining “principal” on the deposit. If we suppose the arrangement lasts for the full five years, then at the end of each of Years 1 through 5, *G* would have interest income and, depending upon the nature of the expenditure (business or personal), potentially an offsetting deduction. *F* would have a deduction for interest paid and an inclusion equal to the interest and a portion of the principal together totaling the amount of his service income. Table 1 illustrates these outcomes.

Table 1: Interest and Principal Paid on \$1 Million Drawn over Five Years

Year	Interest Earned	Payment	Post-Payment Principal
1.	\$100,000	\$220,000	\$880,000
2.	88,000	242,000	726,000
3.	72,600	266,200	532,400
4.	53,240	292,820	292,820
5.	29,282	322,102	0
Total	\$343,122.00	\$1,343,122.00	--

The interest that is earned represents a true accession to wealth, ultimately for *G*, and the tax system should pick it up as well as provide a deduction for *F*.

¹¹⁸ See discussion in text and notes at nn. ___ - ___, *supra*. Johnson, at 386-90.

¹¹⁹ That is, at the close of Year 1, *G* would pay \$220,000, at the close of Year 2, \$242,000, and so on.

As discussed previously, under current law this would not be the result for cash-method taxpayers. Instead, *F* would have to include the \$1 million on receipt.¹²⁰ If *F* is an accrual-method taxpayer, however, it appears he would be able to defer inclusion until the amounts were earned, because he charges on a per-year basis and therefore can associate the portions allocable to future years with identifiable services closely enough to avoid current inclusion.¹²¹

For the reasons previously discussed, full inclusion is incorrect because it overtaxes *F* and undertaxes *G*. Conversely, as the discussion above demonstrates, deferral that does not include a deemed interest portion also would be incorrect. Further, if the agreement provides that *G* is entitled to return of a ratable portion of the fee in the event of cancellation, and the agreement is cancelled after Year 1 with *F* returning \$800,000 to *G*, an additional amount needs to be accounted for. *G* still should include the interest earned on the full \$1 million during the year, or \$100,000. *G* also should be treated as having paid \$220,000 in attorney's fees, since that is *F*'s going rate. Lastly, *G* has made an additional \$80,000 payment to *F* at that time, representing an additional fee for services, includible in Year 1.¹²² Assuming that no limitations on interest deductions apply to *F*, he should simply include \$300,000 of income at the end of the year, since the deemed deduction for interest paid to *G* will exactly offset the interest *F* is deemed to earn on the deposit. If the agreement is not cancelled, *G* will have annual interest inclusions equal to the amounts listed in Table 1, and may or may not have a deduction for some or all of the annual fee paid to *F*, depending on the nature of the services provided.¹²³

¹²⁰ See Treas. Reg. § 1.451-1(a).

¹²¹ Artnell v. Comm'r, *supra*.

¹²² The analysis is similar to that applicable to IPL and its customers, discussed at length above. The \$80,000 payment is a separate income item paid to the service provider that should be included in income. The difference from the *Indianapolis Power* facts is that because payment of the item is contingent on *F*'s not providing the services, it cannot be included before the contingency is resolved unless the likelihood that the services will be provided is so low as to be negligible. [CITE]. Where that likelihood is not negligible, the item is best viewed as a cancellation penalty.

¹²³ As stated, if the services are personal in nature, then *G* will be entitled to no deduction. IRC § 262. If they are business-related she may be entitled to a deduction under Section 162(a), though the expenditure would need to be capitalized if it produces or enhances the value of an asset, tangible or intangible. See IRC § 263; *INDOPCO Corp. v. Comm'r, supra*. In addition, if *G* is an accrual-method taxpayer she will need to negotiate the economic performance limitations of Section 461(h). If the expenditure is incurred in an income-producing activity that is not a trade or business, she may be entitled to a deduction under Section 212 (again subject to §§ 263 and 461(h)), but it will

As previously discussed, current law does not provide for the preceding treatment.¹²⁴ It will tax the full \$1 million on receipt, unless the amount qualifies under the exception for expenditures that are closely tied to a particular service of fixed size occurring on a date certain, in which case the receipt will qualify as a deposit and will be included in the recipient's income on the date the service is provided.¹²⁵ As contrasted with prior law, however, current law generally does attempt to tax the hidden interest element present in such arrangements. Under Section 7872, if a deposit qualifies as a loan and the deposit provides for a "below-market" rate of interest, one of two treatments applies. In the case of term loans, the initial payment is bifurcated into an OID-like debt instrument and a separate payment that is characterized according to the nature of the relationship between the parties (as, for example, rent, compensation, a gift, etc.).¹²⁶ In the case of demand or gift loans, the lender is deemed to supplement on an annual basis the outstanding loan amount with a payment equal to the interest forgone by the lender on that amount; the borrower is then deemed to repay this amount to the lender as interest.¹²⁷ This supplement is likewise characterized according to the nature of the relationship in connection with which the loan is made.

It would appear that the \$1 million payment to *F* does qualify as a deposit, because the arrangement specifies that *F*'s fee is for whatever services he provides each year during the term. Thus it is possible to allocate \$200,000 annually to each year.¹²⁸ It further appears that the deposit qualifies as a below-market loan, given the broad interpretation of the term "loan" that applies under Section 7872.¹²⁹ Under proposed regulations, the \$1 million would be treated as a demand loan, assuming that the arrangement can be cancelled at any time with a ratable portion of the \$1 million returnable to *G*.¹³⁰ At the end of each year during which a portion of the deposit was outstanding, *G* would be deemed to

be subject to the 2% floor on miscellaneous itemized deductions and potentially to phase-out under Section 68. See IRC §§ 67 & 68.

¹²⁴ See generally Part II, *supra*.

¹²⁵ See *Artnell v. Comm'r*; *Boise Cascade v. Comm'r*.

¹²⁶ IRC § 7872(b).

¹²⁷ *Id.*, § 7872(a).

¹²⁸ See *Boise Cascade v. Comm'r*.

¹²⁹ See Prop. Reg. § 1.7872-2(a)(1), (3). See also Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 529 (Comm. Print 1984) ("[A]ny transfer of money that provides the transferor with a right to repayment is a loan.").

¹³⁰ See Prop. Reg. § 1.7872-10(a)(5) (treating all compensation-related loans in which the benefit of the below-market discount is not transferable as demand loans).

make a payment to *F* equal in amount to the interest forgone on the loan arrangement, and *F* in turn would be deemed to pay *G* the interest.¹³¹ Thus, at the end of Year 1, *G* would be deemed to pay *F* \$100,000, which would be characterized according to its substance as compensation. *F* would be deemed to pay *G* \$100,000 in interest. Lastly, *G* would be deemed to transfer \$200,000 of principal to *F*, also as compensation for services. Similarly, at the end of Year 2, *G* would be deemed to pay *F* \$80,000, equal to the interest forgone on \$800,000. *G* also would have an \$80,000 interest inclusion and a deemed payment of \$200,000 principal to *F*.

Although the preceding treatment does not precisely track the real economics of the arrangement, it is tolerably close. If we assume that \$200,000 of the deposit is “paid” to *F* annually, then the total imputed interest turns out to be \$300,000.¹³² The result differs from the preceding analysis because it unrealistically assumes that the services account for \$200,000 annually. Nonetheless, the \$43,000 discrepancy is relatively minor given the total values involved. At all events, neither the fact of imputed interest nor the fact that current law fails to reach the precisely correct result bolsters the case for immediate inclusion on the ground that it is analytically correct. Johnson argues to the contrary, stating that the extra services that *G* impliedly receives for interest “supports the argument that *F* has a \$1 million improvement in value immediately when the unearned payments are received.”¹³³ As a basis for this conclusion he notes that the presence of implicit interest indicates that the future services have a present value of \$1 million, and that the provision of interest and principal in the form of zero-basis services means *F* must be taxed immediately. As contrasted with a genuine loan (which Johnson would treat as a non-taxable event with respect to the transfer of the loan proceeds, just as under current law), the interest on the loan is retained by *F*.¹³⁴

Johnson’s analysis amounts to little more than the application of conclusory labels and the assertion of non-sequiturs. The fact that *F* receives a payment of \$1 million does not mean it is income, even if the payment earns (or is deemed to earn) interest at a market rate. If *F* has a \$1 million “improvement in value,” while *G* has suffered no loss in value (*G* has an asset worth \$1 million), then “value” has been created out of thin air, only to disappear back if or to the

¹³¹ See Prop. Reg. § 1.7872-6.

¹³² This amount equals the sum of deemed interest payments resulting from a deemed annual allocation of \$200,000 to *F* = \$100,000 + \$80,000 + \$60,000 + \$40,000 + \$20,000.

¹³³ Johnson, at 386.

¹³⁴ *Id.*, at 386-87.

extent that *F* never provides the services and refunds the balance.¹³⁵ If retention of the money is contingent on *F*'s provision of future services, and they are of equal value to the \$1 million, then he has received nothing: He has an obligation to turn over to *G* an amount equal to what he has received from her. His basis or not in the services is not relevant to what he has received. Similarly, the fact that in a genuine loan arrangement interest would be paid over to the lender, whereas *F* pays no express interest to *G*, is of no significance. *F* economically turns over the interest by providing services worth \$1 million plus the interest that \$1 million generates in an arm's-length transaction, as Johnson himself stipulates.

IV. Practical Considerations

The preceding discussion has argued that, from an economic perspective, no income can be said to arise on an advance receipt. What, then, of the various rules providing for taxation of advance receipts in some settings, and deferral of tax in others? Should not all advance receipts be treated as taxable as and when they are associated with either a genuine accession to wealth or the transformation of latent capital into actual wealth, and not before?

The tax administrator does not have the luxury of imposing tax only as and when true income arises. The accrual method is an effort to approximate that ideal, but even the accrual method is subject to practical considerations that may result in deferral or acceleration of income for tax purposes as compared to the time at which real economic income arises. The cash method, of course, is a still coarser approximation, designed to reflect the fact that liquidity may not always attend income. What these departures generally have in common is a need to accommodate tax collection to these realities. Perhaps the most significant departure is the taxation on receipt of prepaid services income, except in the limited circumstance in which the taxpayer can pin down the timing of the associated service and the amount of income associated with it with sufficient specificity to provide a "clear reflection of income."¹³⁶ Presumably the general rule of taxation reflects the expectation that prepaid services receipts generally will turn out to be received in exchange for actual services. If so, a good time to tax them is when they are received. The tax administrator has no interest in permitting the taxpayer to dissipate the fund and thereby become insolvent before the tax that is likely to be due can be collected. Therefore the better presumption is taxation subject to a later deduction if it turns out the item will never be earned and the payment is returned.

By the same token, the availability of the accrual method suggests that concern over payment of tax liabilities is not as over-arching as might appear, at

¹³⁵ Under Johnson's and Dodge's approaches, income could be multiplied without limit by the simple expedient of having taxpayers make obligations to each other.

¹³⁶ See IRC § 451.

least for those taxpayers permitted or required to use the method.¹³⁷ Further, it is difficult to see why that worry, if it is real, should be able to be overborne by the taxpayer's showing in the *Artnell* type of situation, in which it is possible to identify particular services with particular dates and costs and thereby to avoid immediate inclusion. The tax administrator's concern with making sure it gets paid is not ameliorated by the taxpayer's showing of exactly how much of a prepayment is economically attributable to each particular future service the taxpayer provides. The taxpayer still can dissipate the funds before tax is due.

A possible way to frame the argument would be to say that the matching principle remains a tax value, along with others such as ensuring payment of tax that is likely to become due. If one concedes that the two types of concerns may be weighed against each other, then the current regime would seem to make sense. The government's interest in ensuring that tax due is collected entitles it to tax amounts that are likely to turn out to be income when they are received, as long as provision is made for amelioration of hardship when expected income items do not materialize. In other words, where the likelihood of income is a close substitute for income, and the availability of a fund to pay tax on that income, should it arise, is a closer complement to the likely income than to the actual income, the government is justified in taxing the likely income rather than the income itself. Nonetheless, the government's interest in ensuring that tax due is collected has to be weighed against the value of taxing true income, and when taxpayers such as the baseball team in *Artnell* can demonstrate that their method of accounting is quite accurate, the collection value should give way.

The treatment of loan proceeds under the current income tax is fully consistent with this approach. Loan proceeds are not a close substitute for income. Therefore the appropriate presumption is that no tax will arise in connection with their receipt, and the corrective is inclusion when it turns out that the presumption is false.¹³⁸

V. Implications for Cash-Flow Consumption Taxation

The preceding discussion has relied on the distinction between consumption taxation and income taxation as a basis for clarifying the proper taxation of advance receipts under the income tax, and also to indicate how commentators have gone astray in considering certain forms of advance receipts to constitute genuine income despite the absence of either a true accession to

¹³⁷ The latter group comprises principally C corporations. [CHECK.]

¹³⁸ Typical situations include cancellation of debt, which generally is included in gross income subject to limitation for insolvent debtors, *see* IRC §§ 61(a)(12), 108, and compensation, as long as the parties initially believed the amount was genuine debt or the property was subject to a substantial risk of forfeiture when it was transferred. *See id.*, § 83.

wealth or an associated transformation of human or natural capital into explicit wealth. A question arises, however, about how the considerations developed above bear on the consumption tax treatment of advance payments. If, for example, cash-flow treatment under a consumption tax disregards future obligations to return advance receipts, must taxpayers include the full fair market value of items received during the period of receipt even if the return of such items is imminent?

Consider an ordinary property rental under a cash-flow consumption tax. In general, a cash-flow consumption tax taxes inflows and outflows without regard to offsetting obligations.¹³⁹ Thus, when an individual receives wages, she must include them in her consumption base, and when she invests amounts, she may deduct them. The basic idea is that uninvested amounts received are presumptively used for consumption items (even if the recipient simply puts the money in the mattress).¹⁴⁰ The same treatment applies to loan proceeds. Because it is possible to consume the full value of loan proceeds, no exclusion is available to the borrower for them. When they are repaid, however, the borrower receives a deduction. Further, there is no “unfairness” resulting from the fact that a borrower is worse-off economically than a non-borrower who receives the same proceeds. Because the object of the tax is to treat individuals who are equal in consumption power equally, the fact that the same individuals may be unequal in wealth terms is not relevant.

The rental case, however, seems to present a difficulty. It is one thing to say that *E* and *B*, an earner and a borrower, respectively, of \$X, enjoy the same consumption power even though *B* must repay the loan later on. But are we to extend the same treatment to renters of property as well? Consider the unfortunate soul, *R*, who rents an opulent vacation home for the Christmas holidays, straddling January 1. Must *R* include the full fair market value of the home in Year 0 and defer her deduction until the end of Year 1? If a consumption tax tracks the flow of value rather than the economic income or loss of the taxpayer, it would seem so.

The better view is that she should not. Let us suppose that we take seriously the idea that the question under a consumption tax is how much

¹³⁹ See generally Andrews, at ___, for a discussion of the basic features of a cash-flow consumption tax.

¹⁴⁰ Under some versions of a cash-flow consumption tax a deduction is offered in the case of the purchase of consumer durables having an expected useful life beyond the taxable year, on the ground that the purchaser presumptively will consume the item over the useful life. [CITES.] Failure to provide such a deduction is analogous to the realization rule under the income tax (i.e., treating full value as consumed on purchase, or realization).

consumption power the taxpayer has during the period. This definition might appear stipulative (we could define the consumption tax base as unfettered consumption power, which is closer to an income concept), but it seems to be what consumption tax advocates generally have in mind.¹⁴¹ More to the point it is the meaning of a tax on true consumption, which is a tax on the private, preclusive use of resources.¹⁴² Even so, *R* has not acquired the legal power to consume the full value of the property. At most she has acquired the power to consume the proportion of its total value that the value during the consumption period bears to the total value of the property. Unlike *E* or *B*, who may do with the \$X they receive as they see fit, *R* may not sell the rented property, wreck it, or modify it. She has to return it to its owner in the same condition as before, save normal wear and tear.¹⁴³ In the meantime, she may make use of it, but only to the extent that her use does not exceed the value of what she got. Contrast her situation with that of *B*, our borrower of \$X. *B* may have to return the \$X on the same date that *R* must surrender her leasehold, but in the simple loan case, no limit operates on *B* in her use of the loan. She may in fact use the entire proceeds for whatever purpose she wishes. The only condition on her is that she must repay the full dollar amount at the loan term.

These considerations make clear why it is in the consumption tax context, and not the income tax context, that the concept of control over the receipt has its proper application. Control is inapposite in determining income because the question under an income tax is whether the taxpayer has an accession to wealth, and control may be, indeed it typically is intended to be, provided with no accession to wealth. That, indeed, is why people borrow: They need control over resources they don't have. By contrast, in the consumption tax context, where the question is not whether you have acceded to wealth but whether you have drawn it down, control is the critical question. One cannot consume resources over

¹⁴¹ [CITES.]

¹⁴² See Thomas Hobbes, *Leviathan*, Ch. ___, for the most well known early articulation of the idea of a consumption tax. Hobbes describes a consumption tax as a tax on withdrawal of resources from common use.

¹⁴³ The argument suggests that even normal borrowers may have less consumption value on cash than its face amount when the lender places restrictions on the use of the proceeds. There should be no inequity here, however, inasmuch as such a restriction either is immaterial (in the case of business borrowers) or has the effect of overcoming the inequity of the realization rule in the consumption tax context. Consider borrowing to finance the purchase of a personal residence, where the loan proceeds must be used for this purpose. The borrower arguably lacks control over the loan, but at the same time, the consumption of the item purchased is not going to occur exclusively in the period of purchase anyway.

which one lacks control, or more precisely one can consume resources only to the extent of one's control over them.

VI. Conclusion

Ultimately the proper treatment of advance receipts under either an income or a consumption tax depends on keeping three conceptual questions distinct: What is income?, What is consumption?, and To what extent should the tax on income or consumption be modified for purposes of tax administration, political legitimacy, or other purposes external to the tax itself?

With regard to the first two questions, on a macroeconomic level one may say that in general an income tax is a tax on producing or creating resources – on putting resources into the public store – and a consumption tax is a tax on taking them out of the public store. To the extent each tax is a personal tax, the tax system will attempt to associate the taxed activity with the person who engages in it. Under an income tax, this means taxing accessions to wealth. An agreement to create wealth, such as a prepaid service arrangement, is not an accession to wealth but only a contract to create it. Only once the wealth is really created may we say that there is genuine income. In this regard prepaid service income is the same as a loan in economic terms, the only difference being the presumptive result of the transaction. Under a loan arrangement, it is not contemplated that wealth will be created (except from the use of the money, which is paid for and properly charged as income to the lender), and the fund the borrower receives is not made available to satisfy a future claim on income by the borrower; under a prepaid service arrangement, it is contemplated that wealth will be created and transferred to the payor. The cash is made available to the service payor in anticipation of payment for the wealth created. In neither case, however, is the transfer itself an accession to wealth.

To be sure, the tax system sometimes accounts a transaction as an accession to wealth when no wealth creation has occurred. The typical situation is where the production of wealth preceded the ultimate accession, and the tax system must make a correction because the initial accession was taxed to the wrong party. In these instances, what is called an accession is really a reassignment of wealth already created (and taxed), and there generally will be an associated deduction with the reassignment. Thus cancellation of debt is income to the borrower not because there is an accession to wealth on a macroeconomic level, but because the identity of the person acceding to the wealth is different from the assumption the tax law made in assigning that value to the lender. Typically the lender will have an offsetting deduction.¹⁴⁴

¹⁴⁴ IRC § 166.

A consumption tax, by contrast, is a tax on the withdrawal of resources from the public store. Therefore, whether there has been an accession to wealth in connection with the withdrawal is immaterial. The criterion is in fact control, or at least that is the presumptive criterion: Uninvested cash is treated as consumption to the full extent of the cash because of the total control the taxpayer has over the cash. Needless to say, it is possible to consume without wealth because it is possible legitimately to take property out of the public store that one does not own. That is, control does not imply wealth. In the usual case, withdrawal from the public store requires an implicit promise to put the equivalent back at some point down the road, but that, of course, is not a taxable event under a consumption tax. It is only taxed under an income tax.

As regards the third question – What departures from a pure income or consumption base are appropriate in light of administrative and other concerns? – the answer is obviously context-dependent. The very existence of the cash method of accounting, which applies to the vast majority of taxpayers under the actual income tax,¹⁴⁵ attests to the significance of administrative concerns in operating an actual tax system. Similarly, the realization rule under both an income and a consumption tax plays a significant role in tax administration, even though in both cases it authorizes substantial departures from a pure tax base. Whether it is appropriate to tolerate these kinds of rules for any particular tax system depends on such factors as the availability of liquidity, political acceptability, valuation, and others such as whether the tax system ought to promote or retard certain activities. It does not depend, however, on whether the advance receipt is “income.”

As previously discussed, the income tax rules for advance receipts reflect an effort to accommodate a tax on income to practical realities. The most significant departure from a true income base in this area is the general rule of taxing advance services income on receipt. As discussed previously, one may conceptualize this rule as a tax on likely income instead of on actual income, because likely income is a good substitute for actual income, and because the timing of actual income is unlikely enough to coincide with the actual ability to pay tax to make a true income tax rule administratively workable. A less generous theory for the rule is that the government would prefer to get paid sooner. In the opposite direction, the rule that genuine deposits are not taxable may lead to under-taxation where the deposit or a portion of it is *de facto* applied to satisfy the customer’s bill, without an appropriate adjustment to the deposit itself.

Other rules, which generally defer tax on advance receipts, are for the most part correct from a pure income tax standpoint. Far from representing an

¹⁴⁵ [CITE].

inapt importation of the matching value into the income tax, they recognize that the matching value is a core value of the income tax, and they endeavor to respect by delaying taxation until income occurs.