ECONOMIC BENEFIT: FORMULATING A WORKABLE THEORY OF INCOME RECOGNITION

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I. Introduction

I.R.C. § 446[2] permits taxpayers to compute taxable income by using the accounting method regularly used to keep their business books.[3] The cash method of accounting is the simplest method because it permits taxpayers to use the deposit slips and check records from their checking account to keep track of taxable income and deductions.[4] For cash basis taxpayers, income is reported when payments are actually or constructively received and deductions are taken only when payment is actually made.[5]

Because taxpayers have the power to postpone the receipt of cash, three doctrines[6] have developed that require immediate income recognition even though actual receipt has not occurred. First, the constructive receipt doctrine requires a cash-method taxpayer to report income if the taxpayer has the power to obtain payment.[7] Second, the cash equivalence doctrine requires that a cash basis taxpayer report income if he receives an asset that he can readily convert into cash, such as a negotiable promissory note of the obligor.[8] Third, the economic benefit doctrine applies when the transaction is structured so that the taxpayer recognizes income when he is economically benefited even though he does not have power to obtain immediate payment.[9] In its simplest form, the economic benefit doctrine is applicable when the right to the future cash payment is nonforfeitable and the payment is funded

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2 *See* I.R.C. § 446 (a) (1986). References to "section" numbers refer to sections in the Internal Revenue Code of 1986, as amended.

3 The concept underlying the rule is that the taxpayer's business books are intended to give the taxpayer an accurate and realistic picture of the business' performance.

4 *See* Marvin A. Chirelstein, Federal Income Taxation, §11, at 233 (7th ed. 1994).

5 *See* Treas. Reg. § 1.461-1(a)(1) (as amended in 1993). There is no doctrine of constructive payment allowing deductions for expenses prior to payment.

6 *See* Ridgeley A. Scott, *Rabbis and Other Top Hats: The Great Escape*, 43 Cath. U.L. Rev. 1, 16 (1993) (describing the development of the doctrines beginning with the 1913 Revenue Act).

7 *See* Treas. Reg. § 1.451-1(a) (as amended in 1993).

8 *See* Scott, *supra* note 6, at 35. Scott stated the following:

> Cash equivalence is similar to constructive receipt in that both doctrines are premised on a reasonable opportunity to obtain payment. Income may be constructively received where there is a right to obtain actual possession of an item of income, while a promise may be the equivalent of cash if it can be converted into money by a disposition. One method of conversion is discounting to a financial institution.

Id.

9 *See* Scott, *supra* note 6, at 16-17. The economic benefit rule originated in an attempt by the treasury to tax benefits such as health and life insurance coverage. *See id.* at 17.

or set aside for future payment.[10] The economic benefit doctrine is often misunderstood, misapplied, and even ignored as a separate doctrine.[11]

If the economic benefit doctrine is applied broadly, any right to future payment could be taxed presently because the taxpayer is "better off," thereby eliminating the distinction between the cash and accrual methods of accounting. If applied narrowly, the economic benefit doctrine merges with the other two doctrines and allows the taxpayer overly broad discretion in selecting the year of taxation.

For example, in *Reed v. Commissioner*[12] a taxpayer deferred receipt of cash for seven days by placing the purchase price for the sale of stock into an escrow account to be paid out during the next tax year. *Childs v. Commissioner*[13] is another instance where the doctrine was narrowly applied.[14] In *Childs*, attorneys (taxpayers) representing tort claimants agreed to accept their fees over an extended period of time as part of a structured settlement.[15] The Tax Commissioner (the Commissioner) ruled that the taxpayers had to report the present value of future payments in income in the year of settlement.[16] The taxpayers argued that because they had no right to immediate payment, the fees should be reported when received.[17] The Tax Court agreed and allowed the attorneys wide latitude in structuring a deferred compensation arrangement without adhering to any of the complex rules normally governing such plans.[18]

The latitude afforded to the taxpayers in *Reed* and *Childs* constitutes an abuse of the cash method of accounting. Under I.R.C. § 446(b),[19] the Commissioner may challenge accounting methods

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10 For example, the future cash payment may be set aside in an escrow or trust account.

11 *See infra* note 84 and accompanying text.

12 723 F.2d 138 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982).

13 103 T.C. 634 (1994), *aff'd per curiam*, 89 F.3d 356 (11th Cir. 1996).

14 *See id.* at 653.

15 *See id.* at 642.

16 *See id.* at 647.

17 *See id.* at 652.

18 *See Childs*, 103 T.C. at 655.

19 *See* I.R.C. § 446(b) (1986) stating:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such methods as, in the opinion of the Secretary, does clearly reflect income.

The Internal Revenue Code does not define "clearly reflect income" and cases deal with this phrase on an individual basis.

that do not clearly reflect income. If properly applied, however, the "economic benefit" doctrine could prevent such abuses[20] and allow taxpayers flexibility to minimize their taxes and preserve the simplicity of the cash method of accounting. Because taxpayers construct complex transactions to take advantage of the cash method's simplicity, the economic benefit doctrine performs a valuable service in limiting such transactions.

This article will examine the "economic benefit" doctrine and discuss how its overly narrow application allows taxpayers to abuse the cash method of accounting. The author recognizes that rules applying to the cash method of accounting also impact scenarios covered by specific code sections.[21] This article, in turn, will only address those situations where such sections do not apply.

Part II A will layout for the general reader the concepts underlying the three major income recognition doctrines. Part II B will explain how decisions such as *Reed* and *Childs* have misapplied the economic benefit doctrine. Part II C will demonstrate how a consistent definition and application of the economic benefit doctrine is consistent with a number of long-standing tax rules. Part II C will also suggest how other tax rules may be used to limit the deferral abuses of the cash method of accounting.

II. TAX ACCOUNTING

I.R.C. § 446(c) acknowledges that taxpayers are permitted to compute taxable income under the cash and accrual methods of accounting.[22] For cash basis taxpayers, income is reported when

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20 *See* STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING § 3.03(1)(a), at 3-13 (2d ed. 1993). The author notes that the confusion and uncertainty in determining when an item of income should be taxed results from: "(1) a desire to achieve the benefits of the cash method and (2) the fact that certain provisions of the Code and Treasury Regulations attempt to delineate 'items' of income while other provisions attempt to regulate when those items should be recognized." *Id.*

21 *See* I.R.C. §§ 83, 453 (1986). Deferred payment sales of property are covered by the installment sale provisions of I.R.C. § 453 which does not consider purchaser obligations as payment unless readily marketable. *See* I.R.C. § 453(f)(4)(b) (1986); *see also* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, 106-7, 106-8 (2d ed. 1992) (noting that an obligation of a third person is payment regardless of its form or negotiability).

Transfers of "property" in payment of services (including services as an employee) are covered by I.R.C. § 83, which excludes unfunded and unsecured promises to pay from the definition of property and requires inclusion for property that is transferable or not subject to a substantial risk of forfeiture. *See* I.R.C. § 83(a) (1986); Treas. Reg. § 1.83-3(b) (as amended in 1985).

22 *See* I.R.C. § 446(c) (1986). The Internal Revenue Service (IRS) may challenge accounting methods if there are indications that income has not been clearly re-

payments are actually or constructively received and deductions are taken only when payment is made.[23] There is no doctrine of constructive payment allowing deductions for expenses prior to payment.

For the accrual-method taxpayer, income and deductions are reported when the "all-events" test is met.[24] On the income recognition side, the "all-events" test requires that income be reported before payment is received, if all events have occurred that fix the taxpayer's right to receive the income and if the amount of the income can be determined with reasonable accuracy.[25] On the deduction side, however, the additional requirement of economic performance prevents the accrual of deductions in advance of incurring the economic impact of the liability.[26]

The cash and accrual methods tend to converge on both the deduction and income side.[27] On the deduction side, the economic performance requirement tends to defer deductions until they are paid,[28] thereby forcing accrual-method taxpayers to reflect cash basis deductions. On the income side, a well-known trilogy of

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flected. *See* Ford Motor Co. v. Commissioner, 102 T.C. 87, 92 (1994), *aff'd*, 71 F.3d 209, 212 (6th Cir. 1995).

[23] *See* Treas. Reg. § 1.446-1(c)(i) (as amended in 1995). The regulation reads in part: "Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which [they are] *actually or constructively received.*"

Id. (emphasis added). The need for a constructive receipt regulation goes back to the beginning of the income taxation. *See* Scott, *supra* note 6, at 16.

[24] *See* Treas. Reg. § 1.446-1(c)(ii) (as amended in 1995). The "all-events" test was first announced in United States v. Anderson, 269 U.S. 422, 441 (1926).

[25] *See* Treas. Reg. § 1.451-51-1(a) (as amended in 1995).

[26] *See* Treas. Reg. §1.461-1(a)(2) (as amended in 1994). On the deduction side, a liability is taken into account "in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability." *Id.* I.R.C. § 461(h) was enacted in 1984. Prior to I.R.C. § 461(h), accrual-method taxpayers could take deductions for future liabilities when the fact of liability was established and the amount of the liability could be reasonably determined. Under this test, taxpayers could take a deduction long before the economic impact of the deduction was incurred. I.R.C. § 461(h) delays the deduction until the economic impact of the deduction is incurred. For a discussion of I.R.C. § 461(h) see Gordon Butler, *I.R.C. § 461(h): Tax Fairness and the Deduction of Future Liabilities*, 26 U. MEM. L. REV. 97 (1995).

[27] The *Knight-Ridder* court oversimplified the difference between the cash and accrual methods of accounting calling the cash method "simple, plodding, elemental" and the accrual method a "visionary prophet." Knight-Ridder Newspapers v. United States, 743 F.2d 781, 787 (11th Cir. 1984).

[28] *See* Treas. Reg. § 1.461-4 (as amended in 1995). The regulation sets out the requirements for economic performance with numerous examples where actual payment is required before economic performance occurs. *See id.*

cases[29] upheld the Commissioner's assertion that prepaid income must be included in gross income in the year of receipt even though the related services will be performed in a subsequent year.[30] The trilogy thereby dilutes the effect of the "all-events" test and treats accrual-method taxpayers like cash-method taxpayers for income recognition purposes. Administrative simplicity and a tax system that affords taxpayers the opportunity to have funds available for payment are policy considerations guiding court decisions.

For the cash-method taxpayer, the overlap of the two methods of accounting is encountered when the taxpayer receives a promise of future payment for services already rendered.[31] For example,[32] on December 15, 1995, the taxpayer performs services valued at $100 for a third party. An accrual-method taxpayer would recognize $100 of income in 1995 even though payment is deferred. A cash-method taxpayer would recognize $100 of income only at the time he "actually or constructively receives" the $100 payment. If the cash-method taxpayer receives cash in 1995, he will recognize income of $100 in 1995. Similarly, if the cash-method taxpayer actually receives an item of personal property or other services in exchange for the taxpayer's own services in 1995, the taxpayer must report income in 1995 equal to the fair market value of such property or services received.

If the $100 payment is deferred to a subsequent year, the cash-method taxpayer will not report any income in 1995. If the right to payment is evidenced by a negotiable promissory note or by the granting of a security interest in some property, however, the arrangement begins to resemble a "transfer" of property in satisfaction of the debt or a "setting aside" of property for the taxpayer that should be taxed as if cash or property had actually been received. By not taxing the transaction at present, an artificial defer-

29 *See* Schlude v. Commissioner, 372 U.S. 128, 137 (1963); American Auto. Ass'n v. United States, 367 U.S. 687, 697-98 (1961); Automobile Club of Mich. v. Commissioner, 353 U.S. 180, 189-90 (1957).

30 The possibility of deferring income is limited to extremely narrow situations. *See* Priv. Ltr. Rul. 91-43-083 (Aug. 1, 1991). For example, in Priv. Ltr. Rul. 91-43-083 (Aug. 1, 1991) the taxpayer sought to defer income recognition under a cooperative advertising arrangement until the taxpayer filed a claim for reimbursement. *Id.* The taxpayer unsuccessfully argued that the "all events" test had not been met because a claim for refund had not been filed and might never be filed. *See id.*

31 *See* Sproull v. Commissioner, 16 T.C. 244, 245 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952). The cash equivalence and economic benefit doctrines are generally not applied to deferred payment sales that are covered by other provisions. *See* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES 728 (3d. ed. 1995).

32 *See* GERTZMAN, *supra* note 20, at 3-13.

ral device is created whereby the taxpayer is assured of future payment without current taxation. The Commissioner will seek to include the secured amounts in gross income in the year in which such arrangements are established. In these situations the distinction between cash and accrual methods of accounting becomes blurred, if not totally eliminated.[33]

A. *Doctrines Affecting Timing of Cash-Method Income Recognition*

The constructive receipt, cash equivalence, and economic benefit doctrines address[34] when and under what circumstances a cash-method taxpayer must report income prior to actually receiving the cash payment.

1. Constructive Receipt

The constructive receipt doctrine expands the concept of "receipt" to include items generally made available to the taxpayer provided they are not subject "to substantial limitations or restrictions." The Treasury Regulation provides:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is *credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.* However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. . . .[35]

For income recognition purposes, constructive receipt focuses on whether the taxpayer has the power to obtain possession of the income.[36] If the power to receive payment exists and the taxpayer

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33 The blurring begins when the taxpayer receives something more than a mere promise by the third party, such as: a promise guaranteed by a solvent company, a secured position on property of the third party, or the third party is induced to delay payment for the purpose of shifting the income to a later year.

34 *See* Childs v. Commissioner, 103 T.C. 634, 642 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996); Reed v. Commissioner, 723 F.2d 138, 141 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982); *Sproull*, 16 T.C. at 245; United States v. Drescher, 179 F.2d 863, 864 (2d. Cir. 1950).

35 *See* Treas. Reg. § 1.451-2(a) (as amended in 1979) (emphasis added); Minor v. United States, 772 F.2d 1472, 1473 (9th Cir. 1985).

36 *See* Ross v. Commissioner, 169 F.2d 483, 490 (1st Cir. 1948). The elements of the constructive receipt doctrine have been summarized as follows:

> (1) An amount is immediately due and owing.
>
> (2) The obligor is ready, willing and able to pay that amount.
>
> (3) The amount due and owing is credited to the taxpayer on the books of the obligor or in a separate bank account.

chooses not to exercise it, the taxpayer will be treated as constructively receiving the income and taxed accordingly.[37] Thus, the constructive receipt doctrine prevents the taxpayer from deferring income[38] by merely turning his back on it and unilaterally selecting the year of reporting.[39]

Constructive receipt can be used by the Commissioner or the taxpayer[40] to include payments in income prior to the year in which payment is actually received. The standard for income recognition under the doctrine of constructive receipt is whether the taxpayer has unfettered discretion over the receipt of income or whether the receipt is subject to restrictions or limitations that are not self-imposed by the taxpayer.[41]

> (4) Either the taxpayer can freely withdraw the amount due and owing without restrictions or limitations, or has an unconditional vested right to receive that amount.
>
> (5) The taxpayer is aware of the foregoing facts.

Patricia Ann Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 N.Y.U. TAX L. REV. 525, 531 (1974) (footnotes omitted).

37 *See* GERTZMAN, *supra* note 20, at 3-22. Gertzman noted that the doctrine included in taxable income, money or other property:

> (1) that is subject to the taxpayer's unfettered will and control;
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> (2) that the taxpayer is free to enjoy at his own option;
>
> (3) that exists and is available to taxpayer; and
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> (4) that except for taxpayer's own volition, can immediately be reduced to his possession.

Id.

38 *See Ross*, 169 F.2d at 491. The *Ross* court stated:

> The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent taxpayers from choosing the year in which to return income merely by choosing the year in which to reduce it to possession. Thereby the Treasury may subject income to taxation when the only thing preventing its reduction to possession is the volition of the taxpayer.

Id.

39 *See* Hamilton Nat'l Bank v. Commissioner, 29 B.T.A. 63, 67 (1933).

40 *See* Carter v. Commissioner, 40 T.C.M. (CCH) 654, 654 (1980); Hornung v. Commissioner, 47 T.C. 428, 434 (1967). In *Carter*, the taxpayer did not receive wages for the last two months of 1974 until sometime in 1975. 40 T.C.M. (CCH) at 654. The taxpayer argued unsuccessfully that because his employer had budgeted the funds in 1974, he constructively received the wages in 1974. *See id.* Because the taxpayer did not have "free and unrestricted control of his wages prior to actual receipt" the court held he had not received the wages. *See id.* at 655. Likewise, in *Hornung*, a professional athlete was awarded a 1962 Corvette on December 31, 1961, for his performance in a game that day although possession did not occur until 1962. 47 T.C. at 430. Nevertheless, the taxpayer claimed the year of inclusion was 1961 (a year for which the statute of limitations had run). *See id.* at 433. Because the automobile, which was located in another city, could not physically be delivered in 1961, the court held that the constructive receipt doctrine did not apply. *See id.* at 435.

41 Specifically, check receipt cases have struggled with this concept. In *Davis v.*

Bittker and Lokken, two recognized tax scholars, identify seven categories in which the doctrine of constructive receipt becomes problematic.[42] Of particular relevance are situations where the constructive receipt and economic benefit doctrines interrelate: contracted due dates; amended due dates; substantial limitations on payment; escrows, security arrangements, and third-party promises.

Contracted due dates and amended due dates typically arise in the same context. Where the taxpayer contracts for a future payment date or modifies an existing contract to provide for a new payment date, the contracted (or amended) date will be honored for tax purposes provided the agreement is reached prior to the due date. Once the payment becomes due, however, the constructive receipt doctrine will prevent any modification for a delayed date. Thus, except in extreme cases,[43] if the taxpayer's agreement is made prior to the payment becoming due, the delay in income recognition should be upheld. This result reflects the principle that tax results "cannot be administered by speculating whether the payor would have been willing to agree to an earlier pay-

Commissioner, the taxpayer received notice after 5:00 P.M. on December 31, 1974, that a certified letter was waiting for her at the post office. 37 T.C.M. (CCH) 42, 42 (1978). The taxpayer claimed the letter on January 2, 1975 and discovered that it contained a severance paycheck. *See id.* The Commissioner sought to include the check in the taxpayer's 1974 income, but the Tax Court held that the essence of constructive receipt is the volition or knowledge of the taxpayer. *See id.* at 45. Therefore, the court explained that without such knowledge, the taxpayer was not in constructive receipt of the check. *See id.* Other cases have held that cash was constructively received when the taxpayer could actually have received the cash in hand. *See* Baxter v. Commissioner, 816 F.2d 493, 495 (9th Cir. 1987); Avery v. Commissioner, 292 U.S. 210, 215 (1934); Lavery v. Commissioner, 158 F.2d 859, 860 (7th Cir. 1946). For example, the *Kahler* court held that a check received after banking hours on December 31st was taxable in the year received because property having a fair market value had been received. Kahler v. Commissioner, 18 T.C. 31, 34-35 (1952). GRAETZ & SCHENK, *supra* note 31, at 725 suggest that *Kahler* is "more appropriate."

42 *See* BITTKER & LOKKEN, *supra* note 21, at 105-53 to 105-59. The authors discuss the following categories:

(1) when the due date is fixed by contract,
(2) when payment is deferred by amending the contract,
(3) where payment is subject to substantial limitations,
(4) interest on frozen bank accounts, (See I.R.C. § 451(g))
(5) escrows, security arrangements, and third-party promises,
(6) checks received at the end of the year, and
(7) losses.

Id.

43 *See id.* at 105-53 (suggesting that absent extreme situations, such as an employer and employee arranging the time and amount of payment of the next days wages on a daily basis, the agreement of the parties will govern).

ment."[44] Nevertheless, it is unwise to allow a taxpayer unlimited discretion in determining the year of payment without any consideration of the economic merits of the transaction; hence, some limits are necessary.[45]

Deferring income recognition by prior agreement is well established.[46] In *Veit v. Commissioner*,[47] Howard Veit was entitled to a bonus from his employer based on his employer's 1940 profits, which were to be determined and paid in 1941.[48] In November 1940, Veit and his employer agreed that the 1940 profit allocation would be paid in four installments during 1942.[49] After the 1940 profits were determined in 1941, but before the first installment became due, Veit and his employer entered a second agreement that provided that the installments to be paid in 1942 would instead be paid in five annual installments between 1942 and 1946.[50] The Commissioner sought to include the 1940 profit allocation in Veit's income in 1941 because the amount was determined in that year.[51] Finding that the 1940 deferral arrangement "was an arm's length business transaction that was mutually profitable to both"[52] parties, the court honored the contracted payment dates for tax purposes.[53]

The *Veit* case made a second trip to the court where the 1941

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44 *See* Rev. Rul. 60-31, 1960-1 C.B. 174, 178. Bittker and Lokken stated that "it would be virtually impossible to administer a rule requiring a case-by-case review of the precontract negotiations to determine whether the obligor would have agreed to an earlier date without any concessions by the taxpayer." BITTKER & LOKKEN *supra* note 21, at 105-53. Moreover, the *Gullett* court stated:

> [T]he doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipt basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive [money] was not restricted, and that his failure to receive [money] resulted from exercise of his own choice.

45 Gullet v. Commissioner, 31 B.T.A. 1067, 1069 (1935). *See infra* notes 274 and accompanying text.

46 *See* Commissioner v. Oates, 18 T.C. 570, 571 (1952), *aff'd*, 207 F.2d 711, 712 (7th Cir. 1953); Willits v. Commissioner, 50 T.C. 602, 619 (1968); Veit v. Commissioner, 8 T.C.M. (CCH) 919, 922 (1949) [hereinafter *Veit II*]; Veit v. Commissioner, 8 T.C. 809, 816 (1947) [hereinafter *Veit I*]. For a discussion of *Veit* I and II, see Scott, *supra* note 6, at 23-24.

47 8 T.C. 809 (1947).

48 *See id.* at 811.

49 *See id.* at 812.

50 *See id.* at 813.

51 *See id.* at 816.

52 *See* Veit v. Commissioner, 8 T.C. at *id.*

53 *See id.* at 818.

agreement modifying the 1942 payment schedule was examined. The court concluded that because Veit was never able to demand immediate payment, the second agreement would likewise be effective in deferring income recognition.[54] The key to the *Veit* cases was that the agreement was a bona fide arm's-length agreement.[55] Such an agreement prevents the application of the doctrine of constructive receipt unless it is shown to be "a mere subterfuge and sham for the purpose of enabling petitioner to postpone his income tax to another year."[56]

Bittker and Lokken's third category applies where payment is subject to substantial limitations. The authors note that, under the treasury regulations, modest penalties for early withdrawal from a segregated account (i.e. three months interest) would be considered substantial restrictions on the receipt of payment.[57] Other cases have held that modest restrictions on the receipt of funds prevents the inclusion of income under the doctrine of constructive receipt. Examples include life insurance policies that restrict cash value withdrawals and policies or annuities that can only be cashed out at less than the replacement value.[58] Accordingly, absolute prohibitions on early withdrawal would be a substantial limitation.[59]

The final category—escrows, security arrangements, and third-party promises—creates a conflict for the taxpayer. The "holy grail"[60] of total security without taxation is defined as: assurance

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54 *See Veit II*, 8 T.C.M. (CCH) at 922.

55 *See id; Veit I*, 8 T.C. at 816. Deferred compensation rulings will only be issued if the agreements for deferred compensation are entered into prior to the calendar year in which the services are to be performed. *See* Rev. Proc. 92-65, 1992-2 C.B. 428.

56 *Veit I*, 8 T.C. at 816. The IRS has taken the position that a deferral election must be made prior to the year the services were to be performed. *See* Rev. Rul. 69-650, 1969-2 C.B. 106. The Tax Court reaffirmed its holding in *Veit II* while setting forth a five-point test for determining when an employee had constructively received income. *See* Martin v. Commissioner, 96 T.C. 814, 814 (1991); PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION-CASES AND MATERIALS 1077-78 (3d ed. 1994); BITTKER & LOKKEN, *supra* note 21, at 105-54.

57 *See* Treas. Reg. §§ 1.446-1(c)(1)(i) (as amended in 1995), 1.451-2(a) (as amended in 1979). In *Miele*, a lawyer was only taxed on client advances placed in a segregated account when the lawyer became entitled to withdraw from the account. Miele v. Commissioner, 72 T.C. 284, 291 (1979). Moreover, Bittker and Lokken note that restrictions on interest accruals for more than one year will recharacterize the interest as original issue discount and require it to be reported according to the original issue discount provisions of I.R.C. § 1274. *See* BITTKER & LOKKEN, *supra* note 21, at 105-54, n.31; 105-55.

58 *See* BITTKER & LOKKEN, *supra* note 21, at 105-55 n.33.

59 *See infra* note 173 and accompanying text.

60 *See* A. Thomas Brisendine, Chief of Branch 1 of the IRS Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations), reported 69 Tax

that the payment will be made without establishing sufficient power over the assets securing payment to trigger the doctrines of constructive receipt, cash equivalence, or economic benefit.[61]

Common arrangements to avoid triggering the doctrines involve finding a guarantor for the payment or setting aside assets in a trust. While the presence of a guarantor is generally not deemed to trigger income recognition, a financially strong guarantor could result in the promise being viewed as a cash equivalent.[62] Nevertheless, these common arrangements avoid income recognition because courts narrowly apply the constructive receipt doctrine.

The Commissioner's definitive statement regarding the application of the constructive receipt doctrine to deferred compensation arrangements is Revenue Ruling 60-31.[63] In a series of examples, the Commissioner establishes several guidelines for the compensation area. First, unfunded employer promises of future payment are not currently taxed to the employee.[64] Second, if the employer and employee agree to the arrangement prior to performance of the services, the agreement will be effective to defer income recognition.[65] Third, it is irrelevant that the employer is

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Notes 1509 (Dec. 18, 1995). Pvt. Ltr. Rul. 96-09-010 (Mar. 1, 1996) held such terms preclude deferral of income to the beneficiaries. *See also* J. Martin Burke & Michael K. Friel, *Escrow Agreement Effectively Delays Income for a Cash-Basis Taxpayer*, 8 Rev. of Tax'n of Individuals 251 (1984).

61 *See* BITTKER & LOKKEN, *supra* note 21, at 105-56 to 105-57. Taxpayers, desiring to defer income but concerned with the solvency of the obligor, seek greater security than the mere promise to pay. *See id.* at 105-56. As the security becomes more substantial, the likelihood of the arrangement being "viewed as the equivalent of cash or as constructive receipt of an amount entrusted to the obligor . . . becomes greater." *Id.* An employer's promise of future payments funded by an annuity that remains the property of the employer and subject to the employer's creditors is deemed to be constructively received. *See* Goldsmith v. United States, 586 F.2d 810, 817 (Ct. Cl. 1978); United States v. Drescher, 179 F.2d 863, 865 (2d Cir. 1950);

62 *See* BITTKER & LOKKEN, *supra* note 21, at 105-57; *see also* Watson v. Commissioner, 613 F.2d 594, 599 (5th Cir. 1980) (discussing that payment was secured by a letter of credit).

63 *See* Rev. Rul. 60-31, 1960-1 C.B. 174. Bittker and Lokken refer to the ruling as the "fountainhead of learning on the subject of nonqualified deferred compensation." BITTKER & LOKKEN, *supra* note 21, at 60-3.

64 *See* Rev. Rul. 60-31, 1960-1 C.B., at 177. Treas. Reg. § 1.83-3(e) (as amended in 1985) excludes an "unfunded and unsecured promise to pay money or property in the future" from the definition of "property" thereby excluding such promises from coverage under I.R.C. § 83, which applies to transfers of "property."

65 The Commissioner will only issue rulings if the agreement is reached prior to the period for which the services will be performed. *See* Rev. Rul. 71-19, 1971-1 C.B. 184. Rulings will not be issued where the agreement is modified prior to the payment becoming due unless the plan requires a substantial forfeiture provision that is effective throughout the deferral period. *See id.; see also* Rev. Proc. 92-65, 1992-2 C.B. 428; Rev. Rul. 71-419, 1971-2 C.B. 220 (indicating that the period for which the services

willing to pay the compensation currently.[66] Finally, Revenue Ruling 60-31 extends the analysis beyond constructive receipt and applies the economic benefit doctrine to deferred compensation arrangements.[67]

2. Cash Equivalence

Under the cash equivalence doctrine, a taxpayer who receives a promise that is the equivalent of cash must report the income as if cash had been received.[68] The focus[69] is whether the taxpayer received something that he can readily convert into cash.[70] The form of property[71] that creates most of the difficulty is the receipt of a promise of future payment, such as: an account receivable, a contract right, a promissory note, or similar form.

Including the fair market value of a promise of future pay-

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rendered is the taxpayer's taxable year); Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 68-86, 1968-1 C.B. 184.

66 *See* Rev. Rul. 60-31, 1960-1 C.B., at 178.

67 *See id.*

68 The cash method is considered "easily understood by laymen, requires only rudimentary books and records, minimizes or eliminates the need for the allocation of income and expenses between two or more taxable years, and ordinarily assigns tax liabilities to the period when cash is available . . . ." BITTKER & LOKKEN, *supra* note 21, at 105-48.

69 In describing the cash equivalence doctrine, Gertzman focuses on whether "income is in such a form (or is of such a character) that its receipt should trigger its recognition for tax purposes." GERTZMAN, *supra* note 20, at 3-13.

70 Gertzman alleges that read literally, I.R.C. §§ 61, 446, and 451 suggest that when something is received, the only question is whether the item has a readily ascertainable fair market value, and if it does, taxation would be immediate and appropriate. *See* GERTZMAN, *supra* note 20, at 3-14 (citing I.R.C. §§ 61, 446, 451 (1986)). Gertzman suggests that I.R.C. § 1001(b) is consistent with this interpretation, because the amount realized is defined solely in terms of cash and the fair market value of property received in a property transaction. *See id.* (citing I.R.C. § 1001(b) (1986)). Where the amount realized does not have a readily ascertainable fair market value, the transaction could be considered open until the amount is eventually determined. *See* Burnet v. Logan, 283 U. S. 404, 412-13 (1931) (holding that value of mineral royalties received in exchange for stock in mineral company were indeterminable at the time the transaction was closed and taxation was deferred until determination).

71 The basis for the cash equivalence doctrine finds its genesis in Treas. Reg. § 1.446-1(c)(i) which provides:

> [G]enerally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (*whether in the form of cash, property, or services*) are to be included for the taxable year in which actually or constructively received.

Treas. Reg. §1.446-1(c)(i) (as amended in 1993) (emphasis added).

Although this statement is broad enough to include any promise to pay, courts have narrowed its scope considerably. *See* John F. Cooper, *The Economic Benefit Doctrine: How an Unconstitutional Right to a Future Benefit Can Cause a Current Tax Detriment*, 71 MARQ. L. REV. 217, 230 (1988).

ment in income when received creates two obvious problems. First, the taxpayer may not have funds to pay the tax. The cash equivalence doctrine should consider whether the taxpayer is sufficiently liquid to pay the taxes.[72] Second, including mere promises to pay in the gross income of cash-method taxpayers will blur the distinction between cash and accrual methods of accounting.

The most frequently cited case defining cash equivalence is *Cowden v. Commissioner.*[73] In *Cowden*, the taxpayer entered into a mineral lease where an oil company agreed to make bonus payments to the taxpayer over a three-year period. The Tax Court held that the right to the bonus payments was readily and immediately convertible to cash and, therefore, was the equivalent of cash. The Fifth Circuit reversed the Tax Court because the fair market value of the actual contract received by the taxpayers was not properly calculated. The Fifth Circuit identified the following criteria for determining whether a promise is a cash equivalent: the promise is (1) made by a solvent obligor; (2) unconditional; (3) assignable; (4) not subject to set-offs; and (5) of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money.[74]

Other cases have added the requirement that the note be intended as payment rather than as mere evidence of the debt.[75] One commentator summarized the cash equivalence doctrine as

72 There are numerous instances in which the taxpayer must report income despite the unavailability of cash. *See* I.R.C. §§ 83, 1242 (1986).

73 289 F.2d 20 (5th Cir. 1961). Gertzman refers to *Cowden* as "traditional cash equivalence." GERTZMAN, *supra* note 20, at 3-16.

74 *See Cowden*, 289 F.2d at 24. The *Cowden* court stated:

> A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. . . . [I]f a promise to pay off a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash. . . . The principle that negotiability is not the test of taxability in an equivalent of cash case such as is before us . . . points up the doctrine that substance and not form should control in the application of the income tax laws.

Id.; see also Rev. Rul. 68-606, 1968-2 C.B. 42.

75 *See* Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938) (holding that the taxpayer was not required to include a note received as salary in income where the note was not intended as payment but merely as evidence of the obligation and could not be treated as cash).

an inquiry into the likelihood of eventual payment.[76]

Gertzman, a well-known tax scholar, would require that all the *Cowden* requirements be met before any amount would be included in gross income. He suggests that to do otherwise "would impose unnecessary complexity and undue hardship on the taxpayer or otherwise would be inconsistent with the use of the cash method."[77] Gertzman acknowledges two alternative approaches to determine the cash equivalence of the obligor's promise that are less restrictive than *Cowden.*[78] First, if the promise has a fair market value and a ready market, the amount should be included in income. Second, if the promise merely has a fair market value, the amount should be included in income.

Under his first alternative, Gertzman would include the fair market value of the promise in the taxpayer's income regardless of whether it is considered equivalent to cash. One ruling suggests that a ready market is essential for inclusion.[79] Whenever the taxpayer has the power to obtain cash, he should not be permitted to ignore the economic realities of the transaction.[80]

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76 *See* Scott, *supra* note 6, at 6-7, 18, 35-36. Scott states:

> Receipt of a promise is income if it is considered to be the equivalent of cash. A promise is equivalent to cash if it is likely that the recipient eventually will receive cash or property. On the other hand, if substantial doubt exists concerning eventual collection, the promise is not the equivalent of cash.

Id. at 18.

77 GERTZMAN, *supra* note 20, at 3-17; *see also* Bright v. United states, 926 F.2d 383, 387 (5th Cir. 1991) (holding that the amount of gross income of a check when received should be included in income because the funds were available).

78 Gertzman's first approach to resolve the issue of when intangible property is taxed is as follows:

> [A] mere right to receive cash (as evidenced by a contract, note, or other written instrument) should not be taxed until such right is converted into cash or into property rights that are essentially equivalent to cash, without regard to whether the initial right to receive cash has an ascertainable FMV [fair market value] or is in any particular form.

GERTZMAN, *supra* note 20, at 3-16.

79 *See* Rev. Rul. 73-173, 1973-1 C.B. 40 (suggesting that the inquiry centers on whether the taxpayer receives a present economic benefit such as a right that can be transferred). The Revenue Ruling explains that the inquiry is whether the rights are "freely transferable," "readily marketable," and "immediately convertible to cash." *Id.* The ruling involved a taxpayer who received breeding rights to a thoroughbred stallion, which could be valued and had a ready market. *See id.* at 41. Accordingly, the value of the rights were included in the taxpayer's income because they were considered the equivalent of cash. *See id.*

80 *Cowden* recognized that the rigidities of the rules must yield to practical realities. The court stated:

> [T]he taxpayers urge that there can be no 'equivalent of cash' obligation unless it is a negotiable instrument. Such a test, to be determined by the form of the obligation, is as unrealistic as it is formalistic. The

Gertzman's second alternative is that the cash equivalence doctrine would apply if the promise of future payment had a readily ascertainable fair market value.[81] The problem with such an approach is that amounts would be included in income even though the taxpayer is required to accept a significant discount to obtain the cash to pay the tax. This approach is taken in the installment sales regulations where automatic inclusion is the "penalty" for opting out of the installment sales provisions.[82] If liquidity is a goal, then this approach should be taken sparingly.

> income tax law deals in economic realities, not legal abstractions, and the reach of the income tax law is not to be delimited by technical refinements or mere formalism.

Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961) (citations omitted).

[81] *See* Warren Jones Co. v. Commissioner, 524 F.2d 788, 794 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973) (holding that if the contract had an ascertainable fair market value, that amount must be included in the amount realized to determine gain or loss and the character of such gain or loss under I.R.C. § 1001 even though the taxpayer must take a 50% discount to negotiate the note).

The concern that taxpayers would be required to recognize income regardless of the discount has been alleviated by the Installment Sales Revision Act of 1980, which revised the installment sales provisions under I.R.C. § 453 (1986). *See* BITTKER & LOKKEN, *supra* note 21, at 105-50; GERTZMAN, *supra* note 20, at 3-18 to 3-19; GRAETZ & SCHENK, *supra* note 31, at 728-29; MCDANIEL, *supra* note 56, at 981-2.

Moreover, McDaniel notes that Prop. Regs. § 1.1001-1(g) (1993) provides that the amount realized on any sale of property is the adjusted issue price of the debt obligation under the original issue discount rules without regard to whether § 453 applies. MCDANIEL, *supra* note 56, at 982. McDaniel concludes that the effect of the proposed regulations is to eliminate the cash equivalency doctrine as applied to sale of property. *See id. But see* Bright v. United States, 926 F.2d 383, 387 (5th Cir. 1991) (suggesting that the cash equivalence doctrine may still be applicable to sales of property).

[82] A taxpayer who elects not to have the gain on a sale reported on the installment basis must include the amount of the sale in gross income if it has a fair market value. *See* I.R.C. § 483 (1986). Specifically, the regulation provides:

> A taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting. The fair market value of an installment obligation shall be determined in accordance with . . . this section. In making such determination, any provision of contract or local law restricting the transferability of the installment obligation shall be disregarded. Receipt of an installment obligation shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, *whether or not such obligation is the equivalent of cash.* An installment obligation is considered to be property and is subject to valuation . . . without regard to whether the obligation is embodied in note, an executory contract, or any other instrument, or is an oral promise enforceable under local law.

Treas. Reg. § 15A.453-1(d)(2)(i) (as amended in 1994) (emphasis added). Further, the fair market value of the obligation will never be less than the fair market value of the property sold, minus any other consideration received by the taxpayer. *See* Treas. Reg. § 15A.453-1(d)(2)(ii) (as amended in 1994).

The *Cowden* requirements set forth a fairly clear basis for resolving the issues: if the taxpayer can get cash without a discount, taxation should occur.

3. Economic Benefit

The economic benefit doctrine[83] includes amounts in the gross income of cash basis taxpayers when the right to the future payment is nonforfeitable and a fund is set aside for the future payment. While the constructive receipt and cash equivalence doctrines are well-defined and provide a sound basis for analysis, the economic benefit doctrine is not as clear.[84]

The economic benefit doctrine is, however, clearly applicable to deferred compensation arrangements. For example, Revenue Rule 60-31 (example 4) involved a professional athlete who directed the football club to deposit a signing bonus into an escrow fund to be paid over a five-year period. The ruling held that the bonus constituted income to the athlete when deposited in the escrow account, not because there was constructive receipt, but because the taxpayer received an economic benefit. The Commissioner's reliance on *Sproull v. Commissioner* reaffirmed the economic benefit doctrine's application in the compensation area,

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83 Metzer notes the history of the economic benefit doctrine:

> The formal concept of economic benefit emerged as late as 1945, in *Commissioner v. Smith* where the Supreme Court indicated that the income tax laws were 'broad enough to include in taxable income any economic or financial benefit conferred on [an] employee as compensation, whatever the form or mode by which it is effected.' Unlike the concept of constructive receipt, the concept of economic benefit emerged in the area of employee compensation, where it continues to be more relevant than in other areas of federal income taxation.

See Metzer, *supra* note 36, at 550 (footnotes omitted). Cooper suggests that the elements of the doctrine were established with *Sproull v. Commissioner* and that subsequent decisions were refinements or applications of the *Sproull* standards. *See* Cooper, *supra* note 71, at 238; *see also* Lawrence A. Frolik, *The Convergence of I.R.C. § 104(A)(2),* Norfolk & Western Railway Co. v. Liepelt and Structured Tort Settlements*: Tax Policy Derailed,* 51 FORDHAM L. REV. 565, 577 (1983) (asserting that the genesis of the doctrine was found in *Old Colony Trust Co. v. Commissioner*, which held that taxes paid on behalf of an employee constituted additional income to the employer).

84 According to Friedhoff, "[t]he correct focus of the constructive receipt doctrine is when the escrow was imposed, rather than the nature of its imposition. . . . [T]he distinction between the economic benefit and constructive receipt doctrines is somewhat artificial. . . ." *See* Gary Friedhoff, Reed v. Commissioner*: A Case for the Economic Benefit Doctrine,* 46 OHIO ST. L.J. 1001, 1008 (1985). Metzer states: "constructive receipt deals with 'when' property should be included in a taxpayer's gross income (when actually received or at some point prior to actual receipt), while economic benefit deals with 'what' property or rights actually received by the taxpayer should be subject to immediate taxation." Metzer, *supra* note 36, at 551. In this regard, cash equivalence is akin to an economic benefit.

although its application outside the area has been questioned.[85]

The lines between economic benefit and both constructive receipt and cash equivalence are unclear.[86] One court[87] equated economic benefit with the cash equivalence by requiring that the benefit not only have an ascertainable fair market value but also that it was the equivalent of cash.[88] Some commentators[89] do not acknowledge the economic benefit doctrine as a distinct doctrine[90] and address all situations under the constructive receipt doctrine if

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85 *See* Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982); GRAETZ & SCHENK, *supra* note 31, at 726 (acknowledging that the economic benefit doctrine originated in compensation cases).

86 *See id.* at 728. In *Pulsifer v. Commissioner* a minor was held taxable on lottery winnings deposited in a bank account to be held until the child reached majority or a guardian applied for them. 64 T.C. 245, 246 (1975). The court relied on the economic benefit doctrine because a fund had been irrevocably set aside beyond the reach of the payor's creditors. *See id.* at 247. The presence of a cash fund suggests cash equivalence and the ability of a guardian to obtain the funds suggests constructive receipt. *See id.* at 247-48. Similarly, in *Anastasio,* lottery winnings were taxed when paid to the child's parents because the child "received sufficient economic and financial benefits" to be taxable at that point. Anastasio v. Commissioner, 67 T.C. 814 (1977), *aff'd in unpublished opinion,* 573 F.2d 1287 (2d Cir. 1977). The court explained that payment to the parents suggested constructive receipt. *See id.* at 818. Interestingly, both cases relied solely on the economic benefit doctrine set forth in Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd,* 194 F.2d 541 (6th Cir. 1952).

87 *See* Reed v. Commissioner, 723 F.2d 138, 147 (1983), *rev'g* 45 T.C.M. (CCH) 398 (1982). The *Minor* court described the economic benefit doctrine as an alternative method to constructive receipt for determining when a taxpayer receives taxable benefits. *See* Minor v. United States, 772 F.2d 1472, 1474 (1985).

88 Scott divides the economic benefit doctrine into two categories: 1) funded promises in which property is set aside and not subject to the claims of creditors of the obligor, and 2) unfunded promises to pay that are subject to the claims of the obligor's creditors and are only income if "adequately marketable," which are promises that can be used to obtain cash. *See* Scott, *supra* note 6, at 29; Treas. Reg. § 1.83-1 (a)(1) (1978).

89 *See* Cooper, *supra* note 71, at 250, applying the economic benefit doctrine to prizes and awards in which contest winnings were deposited into an account to be paid out over a period of time. The specific ruling applied the economic benefit doctrine and required the reporting of the discounted value of future payments in the year the winnings were set aside. *See* Gen. Couns. Mem. 33,373 (Nov. 21, 1966). Moreover, the ruling provided the basis for addressing a situation in which a minor won the Irish Sweepstakes and the receipts were deposited in court until he reached the age of majority. The ruling discounted value of the funds taxable under the economic benefit doctrine. The fact that the minor had no right to assign the funds was irrelevant. See *infra* note 84 for a discussion of two cases addressing the issue of prizes and awards.

90 Bittker and Lokken do not discuss the economic benefit doctrine and consider *Sproull* a cash equivalence case, stating:

> For the difference between the constructive receipt doctrine and the requirement that cash basis taxpayers report 'cash equivalents' when received *see* Sproull v. Commissioner . . . (in taxing bonus to taxpayer in year it was paid by employer to trustee to hold, invest, and pay over in later years, court rejected IRS' constructive receipt argument but con-

assets are set aside[91] or under the cash equivalence doctrine if nonforfeitable, marketable rights are involved.[92]

The economic benefit doctrine includes amounts in income even though the taxpayer does not have the power to obtain payment directly from the obligor or indirectly by transfer to a third party.[93] Further, benefits do not need to be assignable, which is a key to the cash equivalence doctrine.[94] It is sufficient that the taxpayer obtain a right in some asset or fund[95] which, although not subject to the taxpayer's immediate control, is valuable, unconditional, and nonforfeitable.

The economic benefit doctrine deals with nonforfeitable rights and, thus, embraces situations not covered by I.R.C. § 83.[96]

> cluded that employee's rights under trust were equivalent of cash)[. *B*]*ut see* Rev. Rul. 60-31, 1960-1 CB 174.

BITTKER & LOKKEN *supra* note 21, at 105-51 n.22. The authors also describe *Sproull* in their discussion of the constructive receipt category "escrows, security arrangements, third party promises, etc." pointing out that the greater security the taxpayer has, the greater likelihood the amount will be considered as constructively received or the equivalent of cash. *See id.* at 105-56 to 105-57. Gertzman neither discusses the economic benefit doctrine nor cites to *Sproull* or *Drescher*. *See* GERTZMAN, *supra* note 20, at 3-17, 3-18.

91 *See* BITTKER & LOKKEN *supra* note 21, at 105-56, 105-57.

92 One commentator states:

> The terms *cash equivalent* and *economic benefit* are assumed here to be interchangeable. Some people draw a distinction in which cash equivalence refers only to certain promises to pay received from the other party to an exchange. All other noncash benefits (including promises to pay of third parties) are referred to as economic benefits. The distinction is little used. In fact, the courts and commentators often seem unable to recognize the obvious distinction between constructive receipt, on the one hand, and cash equivalence or economic benefit, on the other hand.

WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 55 & n.113 (10th ed. 1994).

93 *See* United States v. Drescher, 179 F.2d 863, 869 (2d Cir. 1950) (stating that such control or power was not necessary). Scott notes the similarity, stating: "Cash equivalence is similar to constructive receipt in that both doctrines are premised on a reasonable opportunity to obtain payment." Scott, *supra* note 6, at 35; Treas. Reg. 1.446-1(a)(3) (1992); Treas Reg. 1.61-2(d)(4) (1989); Treas. Reg. 1.451-2(a) (1979).

94 *See* Anastasio v. Commissioner, 67 T.C. 814 (1977), *aff'd in unpublished opinion*, 573 F.2d 1287 (2d Cir. 1977).

95 A "fund" is created when an amount is irrevocably deposited with a third party, and a service provider's interest in such a fund is "vested" if it is nonforfeitable. *See* Pvt. Ltr. Rul. 93-36-001. (Sept. 10, 1996)

96 According to Pvt. Ltr. Rul. 93-36-001 (Sept. 10, 1996), I.R.C. § 83 (1986) is a codification of the economic benefit doctrine. The Commissioner states:

> Section 83 of the Code is generally believed to be a codification of the economic benefit doctrine as it applies to transfers of property as remuneration for services. Therefore, in analyzing the definition of 'property,' it is helpful to briefly review the economic benefit doctrine.

Under I.R.C. § 83, rights to property "transferred" are automatically included in income if they are nonforfeitable.[97] Unsecured promises are not subject to I.R.C. § 83 because they do not fit that section's definition of "property"[98] and are not considered capable of valuation.[99] The presence of a fund creates a situation that is not covered by the fundamental rule that unfunded and unsecured promises to pay in the future such as notes, accounts receivable, and similar rights,[100] do not create taxable income for the cash ba-

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> Under that doctrine, a service recipient's creation of a fund in which a service provider has vested rights will result in immediate inclusion of the amount funded in the service provider's gross income.

Priv. Ltr. Rul. 93-36-001 (Sept. 10, 1996). For legislative history of I.R.C. § 83, see H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 86-89 (1969); H.R. Rep. No. 91-413 (Part 2), 91st Cong., 1st Sess. 61-65 (1969); S Rep. No. 91-552, 91st Cong., 1st Sess. 119-24 (1969); Cong. Rep. No. 91-782, 91st Cong., 1st Sess. 303-04 (1969).

97 I.R.C. § 83 (1986) determines when property transferred in exchange for services is included in income. I.R.C. § 83 builds on the concept of constructive receipt and asks whether the property is "transferable" or is "not subject to substantial risk of forfeiture." *See* I.R.C. § 83 (1986). Transferability and risk of forfeiture are substantive terms and their definitions should not be constrained by artificial (i.e. formal limitations) or general rules. Such formalities should be disregarded and the economic realities used to determine the tax result. The theory of I.R.C. § 83 is that "the taxpayer does not receive a valuable economic benefit until the property is transferable or no longer subject to a substantial risk of forfeiture." *See* Metzer, *supra* note 36, at 544-45. The regulation provides that a substantial risk of forfeiture exists:

> [W]here rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Treas. Reg. § 1.83-3(c)(1) (as amended in 1985).

98 *See* Treas. Reg. § 1.83-3(e) (as amended in 1985).

99 *See* Perry v. Commissioner 152 F.2d 183, 187 (1945); *see also* Minor v. United States, 772 F.2d 1472, 1476 (9th Cir. 1985) (holding that because the fund (i.e., the trust assets) were subject to claims from the employer's creditors, the value of the taxpayer's interest was "incapable of valuation" and could therefore not be considered property under I.R.C. § 83).

100 For example, a novation is an agreement between two parties that a new obligation will be substituted for an existing one. In *Shuster v. Helvering*, the Commissioner argued that the new obligation constituted "property" that was taxable upon receipt (i.e. upon novation of the existing agreement). Shuster v. Helvering, 121 F.2d 643, 644-45 (2d Cir. 1941). The *Shuster* court stated:

> No word is more loosely used and it is easy enough to find authorities speaking of contracts as "property," but the consequences of so treating them for purposes of the income tax are absurd. . . . To argue that all these [promises] are income as soon as the obligor becomes bound, especially when the taxpayer, as here, keeps his books on the cash basis, is so fantastic as to deserve no discussion . . . .

Id. at 645; *see also* Commissioner v. Olmsted, 304 F.2d 16, 22-23 (8th Cir. 1962) (holding that a promise of periodic payments from the other party to the contract was not taxable because the other party continued to be the promisor and nothing was paid out to secure a third-party promise).

sis taxpayer, even if such promise is non-forfeitable.[101] To include such items in gross income without a fund would obliterate the distinction between cash and accrual accounting.[102]

The economic benefit doctrine requires that income be reported when the other two doctrines do not. If the parties agree to delay the payment before it is due, the taxpayer cannot demand immediate payment and cannot be in constructive receipt of the income. Because the economic benefit doctrine focuses on the nature of the rights and not the power to demand immediate payment, the prior deferral agreement is irrelevant. Where the taxpayer took no action to defer the payment, the economic benefit doctrine was held to include an escrow fund in income upon deposit.[103]

The economic benefit doctrine should overcome the court's reluctance to consider the motivation behind bona fide, arm's length bargains. Such bargains should not immunize every deferral arrangement. Instead, funded agreements deferring payment should be scrutinized for evidence of a risk of forfeiture or loss to the taxpayer during the deferral period. The taxpayer could be required to demonstrate a substantial non-tax reason for the deferred payment or prove that tax implications were not the primary reason for the deferral. If such evidence is not found, the taxpayer's interest should be taxed at that time.

a. *United States v. Drescher*

In 1939, Drescher's employer purchased a non-forfeitable, single premium annuity contract at a cost of $5000, naming Drescher as the annuitant and providing for payments commencing when Drescher became 65-years-old.[104] Because the employer maintained possession of the annuity, Drescher could neither accelerate nor assign the payments.[105]

The Commissioner asserted that the cost of the annuity should

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[101] *See* Rev. Rul. 60-31, 1960 C.B. 174, 177. The cash equivalence and the economic benefit doctrines provide limited exceptions or limitations on this rule. *See Minor*, 772 F.2d at 1474, 1476; Treas. Reg. § 1.83-3(c)(1) (as amended in 1985).

[102] *See* BITTKER & LOKKEN, *supra* note 21, at 105-49; GRAETZ & SCHENK, *supra* note 31, at 715; *see also* MCDANIEL *supra* note 56, at 974-75 (noting that if all claims against another party such as notes, checks, or open account indebtedness were included in gross income, the distinction between cash and accrual methods would be eliminated).

[103] *See* Sproull v. Commissioner, 16 T.C. 244, 248 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

[104] United States v. Drescher, 179 F.2d 863 (2d Cir. 1950).

[105] *See id.* at 864.

be included in Drescher's 1939 income.[106] The court held that in 1939 Drescher received, as compensation for prior services, "something" of economic benefit that Drescher did not have previously.[107] That "something" was the obligation of the issuer of the annuity to pay money in the future to Drescher on the terms stated in the annuity.[108]

The annuity was neither assignable nor accelerable. This was not, however, sufficient to avoid inclusion under existing case law.[109] Moreover, nonassignability did not render the annuity void of any present value. While the annuity was less valuable to the employee than the amount paid by the employer, it was certainly worth "something"[110] and should be taxed.[111]

Dissenting in part, Judge Clark argued that the entire cost of purchasing the annuity should be included in Drescher's income in the year of purchase since the normal human desire to be se-

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106 *See id.* at 863.

107 *See id.* at 865-66.

108 *See id.* at 866.

109 *See Drescher*, 179 F.2d at 867. The court noted that in *Ward v. Commissioner*, an annuity was taxable to the employee when it was delivered to the taxpayer and assignable by him. *See id.* at 865 (citing Ward v. Commissioner, 159 F.2d 502 (2d Cir. 1947)).

110 The dissent felt that the two features may not affect the value as they stated:

> The two features stressed in the opinion, namely, the nonassignability and the present non-accelerability of the annuities, may add to their usability for the particular purpose, but would seem not to change the basis of value. Perhaps, indeed, they render the contracts more desirable not only to the employer, but also to the annuitant's wife, as making the security provisions less easily impaired, and thus have a special appeal to a husband solicitous of his wife's future.

Id. at 868. (Clark, J., dissenting).

111 The *Drescher* court recognized a value in the death benefit that was payable immediately upon the death of the taxpayer:

> Likewise, the assurance that any beneficiary named by him at the time the contract was executed, or substituted by him at a later date, would in the event of his death receive the cost of each contract, plus interest after a few years, conferred a present economic benefit on him. Whatever present value the life insurance feature had to him is clearly taxable.

Id. at 866. This statement was used by the court in *Goldsmith*, to support its finding that the death and disability benefit portion of a deferred income arrangement with a physician was currently taxable even though the retirement benefit was not. Goldsmith v. United States, 586 F.2d 810, 821 (Ct. Cl. 1978). In *Goldsmith*, the employee agreed that a percentage of his salary would be used to fund a deferred compensation arrangement. *Id.* at 814. The employee designated which insurance company would be used to provide the benefits and could discontinue the arrangement on 30 days notice. *See id.* The court held that the current life insurance benefit constituted an economic benefit that was taxable currently; but, the court did not include the retirement annuity as a current benefit. *See id.* at 822.

cure during retirement was satisfied to the full value of the annuity. Recognizing that economic realities should govern tax law, the judge stated:

> [I]n the light of modern conditions of life, the satisfying of the highly natural and indeed burning desire of most men of middle age to obtain security for their old age and for their widows at death seems so clearly an economic benefit that I wonder it has been questioned as much as it has. Nor do I see the need to support this conclusion by looking for some highly theoretical possibility of turning this benefit into immediate dollars and cents any more than in the case where an employee is furnished living quarters or meals. Just as the latter are valued as additional compensation, though not assigned or assignable, so I think this highly valuable security is a purchased benefit for these company executives. . . .[112]

It is this economic reality that subsequent decisions such as *Reed* and *Childs* ignore in favor of artificial distinctions. Judge Clark rejected such distinctions stating:

> [C]onsequently the making of nice distinctions in either taxability or the amount thereof between assignable or accelerable annuities or their delivery or retention by the company— after careful forethought and advice of its attorneys with naturally an eye on both pension and tax possibilities—seems to me improper, when the general purpose to make adequate retirement provisions for these employees was made so clear.[113]

b. *Sproull v. Commissioner*

Following *Drescher* is *Sproull v. Commissioner*,[114] which established the economic benefit doctrine as a separate doctrine. In *Sproull*, the employer awarded him a $10,500 bonus for services performed over a number of prior years.[115] The employer depos-

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112 *See Drescher*, 179 F.2d at 867. (Clark, J., dissenting).

113 *Id.* (citations omitted). The *Oden* court made a similar point in discussing whether promissory notes were true obligations when secured by certificates of deposit:

> Petitioners and respondent agree that [purchaser] in fact issued promissory notes payable to their order. The notes were in acceptable legal form. However, for tax purposes, conformity to legal forms is not necessarily determinative, for the incidence of taxation depends upon the substance of a transaction. We may look at actualities and upon determination that the form employed for carrying out the challenged tax event is unreal or a sham [we] may sustain or disregard the effect of the fiction as best serves the purposes of the tax structure.

Oden v. Commissioner, 56 T.C. 569, 575 (1971) (citations omitted).

114 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

115 Sproull was a large stockholder and president of Brainard Steel Corp. in 1929.

ited the bonus with a local bank as trustee on December 31, 1945, with directions to pay Sproull $5250 on December 26, 1946, and the balance a year later. Sproull did not initiate or direct the establishment of the trust. His employer deducted $10,500 from its tax return for 1945, the year of deposit into escrow,[116] but Sproull did not report income until 1946 and 1947, when the trust payments were received.

The Commissioner sought to include the entire amount in Sproull's income in 1945. Sproull argued that he neither received nor constructively received income for 1945 because (1) he could not reduce the money to possession in 1945, and (2) "he had no control of the establishment of the trust."[117] The court noted that even if constructive receipt had not occurred, the real issue was whether any economic or financial benefit had been "conferred on the employee as compensation in the taxable year[.]"[118] Relying on *McEwen v. Commissioner*,[119] the court concluded that the benefit was taxable to Sproull. In *McEwen*, the taxpayer's employment agreement provided that a portion of his compensation be paid into a trust to fund an annuity.[120] Citing assignment of income cases,[121] *McEwen* held that it was irrelevant whether the annuity was

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See id. at 245. His salary had been set at $12,000 per year, but when Brainard Steel ran into financial difficulties, Sproull voluntarily decreased his compensation for a number of years. *See id.* In 1945, when Brainard Steel had once again become successful, the board of directors authorized a $10,500 cash bonus for Sproull in consideration of his prior services, which the board felt had not been adequately compensated. *See id.*

116 The deduction predates the enactment of I.R.C. § 404(d)(5), which would have denied the deduction until included in Sproull's income.

117 *See Sproull*, 16 T.C. at 246; *see also* Fetzer Refrigerator Co. v. United States, 437 F.2d 577, 580 (6th Cir. 1971) (holding that a taxpayer who controlled a corporation had constructively received rents that were recorded on the books of the corporation because the taxpayer had authority to draw checks); Newmark v. Commissioner, 311 F.2d 913, 918 (2d Cir. 1962) (finding income includible where the taxpayer who received corporate notes in lieu of a salary had sufficient control over the corporation to convert the notes into cash at will). *But see* Hyland v. Commissioner, 175 F.2d 422, 424 (2d Cir. 1949) (explaining that shareholders did not have authority to issue checks, and therefore, income was not includible). *See generally* GRAETZ & SCHENK, *supra* note 31, at 718.

118 *See Sproull*, 16 T.C. at 247. The language of the *Sproull* opinion is confusing. Although the court acknowledged that the cash equivalence doctrine would apply to the case, it proceeds to discuss the *Brodie* and *McEwen* cases without indicating whether it is merely expanding the cash equivalence doctrine or identifying a separate doctrine.

119 6 T.C. 1018 (1947).

120 *Id.*

121 The *McEwen* court stated:

> The petitioner herein was the recipient in 1941 of an economic benefit just as much as was the taxpayer in *Old Colony Trust Co. v. Commissioner*,

delivered either to the taxpayer or the trustee if an economic benefit was unconditionally conferred upon the employee.[122] The key to the economic benefit doctrine is that the interest is non-forfeitable and funded. When these elements are established, the only question is one of valuation.[123]

The court's reasoning in *Sproull* could be viewed as expanding then existing doctrines or as creating a new doctrine. It could be viewed as an expansion of the cash equivalence doctrine because the factors influencing the court's decision,[124] particularly an ascertainable value and assignability, are factors creating a cash equivalence.[125] On the other hand, it could be viewed as an expansion of

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> wherein, as additional compensation, the employer paid income taxes assessed against his employee; and as the taxpayer in *Helvering v. Horst*, who detached interest coupons from bonds and delivered them to his son, who later in the year at their maturity was paid the amount thereof. . . .

Id. at 1026 (citations omitted). A recent case involved assignment of income principles in which an attorney agreed to waive a forwarding fee of $408,318 in favor of his sister in a medical malpractice action involving the sister's daughter. *See* Sutherland v. Commissioner, T.Ct. Mem. § 96,001 No. 5780-92 (Jan. 2, 1996). The court held that the attorney could not "avoid tax by an anticipatory arrangement that assigns income earned by the taxpayer to another." *Id.*

122 *See McEwen*, 6 T.C. at 1026.

123 Sproull argued that he received only an equitable interest in the trust and not a vested, possessory interest in an annuity contract as was true in earlier cases. Nevertheless, the court believed that the facts of *Sproull* presented a stronger case for taxability than other cases. The court emphasized that Sproull had to do nothing further to earn or establish his rights to the money, no one else had any right to the money, and he could assign his right in the interest created. The court held that the trust conferred an "economic or financial benefit" on Sproull in 1945 equal to the amount transferred. *See Sproull*, 16 T.C. at 248-49.

124 The *Sproull* court stated:

> [I]t must be held that the expenditure of the $10,500 in setting up the trust conferred an economic or financial benefit on petitioner properly taxable to him in 1945. The fund was ascertained and paid over by petitioner's employer for his benefit in that year. Petitioner had to do nothing further to earn it or establish his rights therein. The only duties of the trustee were to hold, invest, accumulate, and . . . pay over the fund . . . to petitioner or his estate . . . . No one else had any interest in or control over the monies. The trust agreement contained no restriction whatever on petitioner's right to assign or otherwise dispose of the interest thus created in him. On the facts here there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit . . . .

Id. at 247-48.

125 *See id.* at 248. The *Sproull* court stated: "[I]t is . . . true that the amount which the Commissioner has included in petitioner's income for 1945 was used in that year for his benefit . . . in setting up the trust of which petitioner . . . was the sole beneficiary . . . ." *Id.* at 247.

Moreover, the court explained that the issue became whether there was any ben-

the doctrine of constructive receipt because a fund was "set apart for the taxpayer" although the taxpayer did not have the power to draw upon it. *Sproull* suggests an independent doctrine. By recognizing that something was irrevocably paid out for the taxpayer's benefit, the court distinguished *Sproull* from cases where the amount of compensation was subject to a future contingency or to the possibility of return to the employer.[126]

Perhaps the most important and distinct feature of *Sproull* is that unlike other taxpayers, Sproull had taken no part in negotiating the transaction under which the trust was established. The fact that taxation can occur without any involvement on the part of the taxpayer strongly suggests that it is the nature of the right received and not the arm's-length nature of the agreement that is determinative. It is unfortunate that Sproull's employer provided him with taxable income[127] but did not provide him with the funds to pay the tax. Such action may force an employee to assign his interest in the trust in order to pay the current tax.[128] In this regard,

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efits conferred on the employee as compensation, either economic or financial. *See id.*

The IRS adopted the principle of *Sproull*. *See* Example 4 of Rev. Rul. 60-31, 1960-1 C.B. 174, 180. In the example, the taxpayer signed a football-player contract that provided that his signing bonus be placed in an escrow with a bank and be paid to the player over a five-year period. Citing *Sproull*, the IRS ruling held the entire amount taxable upon payment to the bank.

126 *Sproull*, 16 T.C. at 247.

127 An interesting case in the estate and gift area is *Estate of DiMarco*, in which the Commissioner alleged that the decedent had made a taxable gift of an annuity established by the decedent's employer. Estate of DiMarco v. Commissioner, 87 T.C. 653, 659 (1986). The court held that no gift had been made because the decedent had no power over the selection of beneficiary under the annuity. *See id.* at 665. In discussing whether a taxable event could occur without a volitional act by the donor, the court stated:

> While we agree with respondent that a taxable event may occur without a volitional act by the donor, as in a case where an incomplete transfer of property becomes complete because of the occurrence of an event outside the donor's control, we do not believe that a taxable event can occur for gift tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so.

Id. at 663.

128 The *Warren Jones* court rejected the hardship argument stating:

> The Tax Court observed that requiring the taxpayer to realize the fair market value of the contract in the year of the sale could subject the taxpayer to substantial hardships. The taxpayer would be taxed in the initial year on a substantial portion of its gain from the sale of the property, even though it had received, in cash, only a small fraction of the purchase price. To raise funds to pay its taxes, the taxpayer might be forced to sell the contract at the contract's fair market value, even

Sproull is closely aligned with the cash equivalence doctrine.

Nevertheless, *Sproull* and *Drescher* stand for the proposition that the economic value of nonforfeitable rights benefiting the taxpayer give rise to inclusion under the economic benefit doctrine without regard to whether the taxpayer exercised any control, before or after the rights are created. The flagrant violation of this principle will be demonstrated by two cases.

B. *Cases Misapplying the Three Doctrines*

Having described the three doctrines and explained how the economic benefit doctrine expands the other two, it is clear that two cases have grossly misapplied the doctrines. In both cases, the court relied on the taxpayer's "bona fide arm's length" agreement to justify unlimited deferral opportunities.

The first case, *Reed v. Commissioner*, misapplied all three doctrines. *Reed* is rarely cited but remains as implicit support for other decisions such as *Childs v. Commissioner*. *Reed* has all the characteristics of *Sproull;* yet it arrived at a different result. In *Reed*, the constructive receipt and cash equivalence doctrines are narrowed to near non-existence and the economic benefit doctrine is virtually ignored. Although *Reed* is a 1983 case, it cites neither *Sproull* nor *Drescher* decided in 1952 and 1950, respectively.

In *Childs*, the court's overly technical application of the doctrines missed the critical issue of identifying the employer or principal obligor, thereby allowing the taxpayers to freely decide the year of taxability. *Childs* did not cite *Reed*, which allowed the taxpayer broad discretion in determining the year of taxability.

1. *Reed v. Commissioner*

In *Reed v. Commissioner*,[129] Reed, a cash-method taxpayer, agreed to sell common stock in a corporation to Cvengros in No-

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> though such a sale might not otherwise be necessary or advantageous. Most importantly in the Tax Court's view, if the taxpayer were required to realize the fair market value of the contract in the year of the sale, the sale transaction would be closed for tax purposes in that year; hence, the taxpayer's capital gain on the transaction would be permanently limited to the difference between its adjusted basis and the contract's fair market value plus the cash payments received in the year of sale. If the taxpayer did retain the contract, so as to collect its face value, the amounts received in excess of the contract's fair market value would constitute ordinary income.

Warren Jones v. Commissioner, 524 F.2d 788, 790-91 (9th Cir. 1978).

129 723 F.2d 138 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982).

vember, 1973.[130] The sale was to be closed before the end of 1973.[131] Reed wanted to sell certain other assets and realize losses that would offset the gain from the sale to Cvengros.[132] The offsetting loss transactions, however, could not be completed by the end of 1973.[133] Reed then negotiated an amendment to the sale agreement that provided that the purchase price would be deposited into the escrow account on December 27, 1973, and disbursed by the escrow holder to Reed on January 3, 1974.[134] Accordingly, Reed had no right to receive the sale proceeds until 1974.[135] The deferred payment provision was negotiated as part of the purchase agreement and was legally binding.[136] No condition, other than the passage of time, was placed on Reed's right to receive the escrow funds.

Reed claimed he was not required to report the gain on the sale until 1974, when he received the sale proceeds from the escrow holder. [137] The Commissioner asserted[138] that Reed should report the income in 1973, when the escrow holder received the proceeds from the purchaser.[139] Reed urged that the escrow account was a valid income-deferral device because: (1) the account was set up under a bona fide agreement between Reed and Cvengros deferring payment of the sales proceeds; (2) Reed was not entitled to receive any incidental benefits from the escrow account; and (3) the escrow holder was not Reed's agent. The Tax Court agreed with the Commissioner reasoning that, because Reed could dispose of his interest in the escrow fund (e.g. assign it to a third person), Reed had constructively received the equivalent of the full sales price.[140]

After considering the application of the constructive receipt doctrine as well as the economic benefit doctrine, the court of ap-

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130 *See id.* at 140.

131 *See id.*

132 *See id.* at 141.

133 *See id.*

134 *See Reed,* 723 F.2d at 141.

135 *See id.*

136 *See id.* The court noted that "Cvengros, at his financial backer's insistence, was initially unwilling to make the deferred payment but agreed to the escrow device after Reed promised to remain on the Electromech Board of Directors following the sale to insure a smooth ownership transition." *Id.* at 144.

137 *See id.* at 141.

138 The cash equivalence doctrine applied to sales of property prior to the extensive amendments to I.R.C. § 453, which occurred in the 1980 Installment Sales Revision Act.

139 *See Reed,* 723 F.2d at 149.

140 *See id.*

peals reversed.[141] According to the court, the constructive receipt doctrine requires that income be recognized "when the taxpayer has an unqualified, vested right to receive immediate payment."[142] The court explained, however, that because taxpayers have the right to provide for deferred payment, such agreements and amendments will be honored for tax purposes if made before payment is due.[143] The court articulated that the agreement and the amendment are effective even if (1) the buyer is willing and able to make immediate payment and (2) the taxpayer's primary objective is to minimize taxes.[144] According to the *Reed* court, all that is required is that the parties intended "to be bound by the agreement and were, in fact, legally bound."[145] Finding the escrow arrangement resulted from a "bona fide arm's length" agreement,[146] the court concluded that Reed never had an unconditional right to receive payment in 1973, and thus, constructive receipt had not occurred.[147]

The *Reed* court relied on two decisions that allowed the deferral of income through the use of escrow arrangements. In the first case, *United States v. Busby*,[148] a cotton farmer delivered cotton to a gin for processing and sale. The proceeds of the sale were delivered to an escrow agent to be delivered to the taxpayer in the year following the sale. The district court held for the Commissioner but the Fifth Circuit reversed. The question on appeal involved a jury finding that the gin owner was the agent of the purchaser and not the taxpayer. The court of appeals upheld the jury finding and

141 *See id.*

142 *See id.* at 142; Metzer, *supra* note 36, at 531.

143 *See Reed*, 723 F.2d at 142; *see also* Schniers v. Commissioner, 69 T.C. 511, 520 (1977) (upholding a farmer's claim that income was taxable in 1974 because the taxpayer was not required to contract for immediate payment and may contract for payment in a subsequent year); Amend v. Commissioner, 13 T.C. 178,186 (1949) (holding that the taxpayer/farmer could contract for payment in a subsequent year even though the buyer was willing to make an immediate payment).

144 *See id.* at 143.

145 *Id.*

146 *See id.*

147 *See id.* at 149. If the payment had became due before the escrow arrangement was agreed upon, the payment would have been constructively received. The court distinguished an earlier case that involved the sale of timber, *Williams v. United States*, 219 F.2d 523, 527 (5th Cir. 1955), on the basis that the escrow was unilaterally imposed after the timber purchaser's bid had been accepted and the purchaser had offered to pay in full. Under such circumstances, the court found the timber seller had constructively received the purchase price. Accordingly, the *Reed* court found the escrow resulted from "a bona fide modification to the purchase-sale agreement." *Reed*, 723 F.2d at 144.

148 679 F.2d 48 (5th Cir. 1982).

held that the taxpayer had not received the purchase price in the year of sale.

The *Busby* decision is often dismissed as a case addressing the issue concerning standard of review.[149] Nevertheless, the facts demonstrate that the agreement with Busby required the escrow deposit and that Busby did not receive any incidental benefit (e.g. interest or issuance of a letter of credit) from the escrow.[150] Such facts were not determinative.

In the second case, *Commissioner v. Tyler*,[151] the taxpayer tendered common stock into an escrow account in 1927 with the understanding that the securities would be purchased and the purchase price paid in 1928 if eighty percent of the outstanding stock in the corporation were tendered. The purchase price was deposited in the escrow in 1927.[152] Although the eighty percent requirement was met and the securities delivered in 1927, the purchase price was not paid until 1928. The *Tyler* court found that the escrow was a "substantial limitation or restriction as to the time or manner of payment,"[153] which prevented receipt by the

149 *See* Charles E. Falk, *Constructive Receipt and Economic Benefit: Putting* Reed *In the Proper Perspective*, THE TAX MAGAZINE, June 1984, at 425, 428. The *Busby* court concluded that the taxpayer did not reach the merits of the constructive receipt doctrine. Falk explained:

> The standard for reviewing a grant of a judgment n.o.v., however, is not a finding of fact, but rather a finding that reasonable men could have reached different conclusions. If so, the jury verdict should not be disturbed. Thus, the Fifth Circuit did not conclude that *Busby* was not in constructive receipt, but rather that such a finding was reasonable.

Id.

150 The *Busby* court allowed a cotton grower to use an escrow to hold the proceeds of sales in 1973 into the 1974 tax year. *See Busby*, 679 F.2d at 49. A concurring opinion by Judge Thornberry suggests that the question of constructive receipt was much closer than the majority acknowledged. *See id.* at 50. Judge Thornberry, however, joined the majority on the basis that the escrow arrangement provided no incidental benefits to the seller in 1973. *See id.* The Judge compared the case with *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955), where the taxpayers had received a letter of credit based on the escrow. *See id.*

151 72 F.2d 950 (3d Cir. 1934).

152 The court discussed whether the escrow agent was the agent of the buyer or the seller, and concluded that it was not the agent of the seller because the seller had no control over the escrow agent.

153 *See* Tyler, 72 F.2d at 951-52, noting that Treas. Reg. § 74 reads:

> Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer *without any substantial limitation or restriction as to the time* or manner of payment or condition upon which payment is to be made, and must be made available to him

taxpayer.[154]

The *Reed* court followed *Busby* and *Tyler* and found that Reed's deferred payment agreement prevented Reed from drawing upon the proceeds so that the constructive receipt doctrine was inapplicable. Addressing the economic benefit doctrine, the *Reed* court noted two conditions that were not present in *Reed*. First, the taxpayer received some present beneficial interest or "economic benefit" in the escrow account such as investment income or a letter of credit.[155] Reed received no such income. Second, the escrows resulted from a "self-imposed limitation on funds that the taxpayer had an unqualified, vested right to control."[156]

In *Reed*, the Commissioner argued that whenever a taxpayer has an "unconditional right to future payment from an irrevocable escrow account" income must be recognized.[157] The Commissioner relied on *Kuehner v. Commissioner*[158] in which the taxpayer placed fifty shares of stock in escrow in 1947 and the purchaser deposited the full amount of the purchase price, $65,000. The escrow trustee in *Kuehner* agreed to distribute $13,000 annually to the seller for five years. Interest earned on the funds went to the seller and dividends on the stock reduced the purchase price. On these facts the *Kuehner* court held that a single sale had taken place in 1947, rather than five separate sales over five years as argued by the taxpayer.

To value the escrow rights, the court had to determine the fair

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> so that it may be drawn at any time, and its receipt brought within his own control and disposition.

Id. (emphasis added).

154 *See* Robert J. McDonald, *Deferred Compensation: Conceptual Astigmatism*, 24 N.Y.U. TAX L. REV. 201, 204 (1969) (explaining that "the central consideration is whether the taxpayer's control of the time of its payment is subject to restrictions or limitations").

155 In *Goldsmith*, the court limited the economic benefit doctrine to benefits that are capable of current valuation. Goldsmith v. Commissioner, 586 F.2d 810, 821-22 (Ct. Cl. 1978). The *Goldsmith* court stated:

> The economic benefit doctrine does not depend for its applicability on whether the employee could have received cash by stretching out his hand. It is based on the theory that the promise to pay deferred compensation in the future in and of itself under certain circumstances may constitute an economic benefit or the equivalent of cash to be taxed currently at present value, if it can be valued currently with some exactness.

Id. at 820. *Goldsmith* held that certain insurance features or the deferred compensation plan could be valued, but that the retirement feature could not. *See id.* at 821-22.

156 Reed v. Commissioner, 723 F.2d 138, 142 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982).

157 *See id.* at 146.

158 214 F.2d 437 (1st Cir.), *aff'g* 20 T.C. 875 (1953).

market value of the property Kuehner received.[159] Because there was a "high degree of certainty" that Kuehner would receive the entire $65,000 within four and one-half years, the court determined he had realized the entire amount in 1947.[160]

It is not clear whether the *Kuehner* court applied the economic benefit doctrine or cash equivalence principles[161] because the court acknowledged that the deposit could be considered the "equivalent of cash."[162] This was not a mere promise to pay, but a deposit irrevocably set aside for taxpayer's sole benefit. No condition attached to the payment other than the passage of time, and no further performance was required by the buyer or seller.

Nevertheless, the *Reed* court rejected the Commissioner's interpretation of *Kuehner.*[163] First, according to the *Reed* court, *Kuehner* held that an escrow deposit would only be "equivalent to cash" if the taxpayer had a present interest in the deposit such as the right to receive interest. Second, the court stated that to read *Kuehner* broadly would undermine deferred payment arrangements as effective methods of deferring income.[164] Finally, the court concluded that a broad reading would erode the distinction between cash and accrual methods of accounting.

In its application to compensation cases, the *Reed* court saw the "economic benefit" doctrine as primarily an inquiry into whether the benefit has an ascertainable fair market value.[165] The

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159 For example, see I.R.C. § 1001(a)-(b) (1986). Gain on the sale is the amount realized over the adjusted basis. The amount realized is the sum of money received plus the fair market value of property.

160 Presumably the interest on the escrowed funds, which was paid to the seller, reflected a market rate. Thus, time-value-of-money considerations would not be relevant and the only question was whether there was any significant risk that the principle would not be paid. If interest were not paid on the deposit, the promise would be equivalent to an original issue discount and the present value of the five $13,000 payments (using a six percent discount rate for payments in arrears) would be $54,761.

161 *See Kuehner*, 214 F.2d at 440. The *Kuehner* court referenced both the cash equivalence and economic benefit doctrines. *See id.* Moreover, Falk concluded, "The First Circuit [in *Kuehner*] affirmed the Tax Court's holding by emphasizing the fair market value of the trust account, not its cash equivalence." *Falk, supra* note 149, at 449.

162 *See id.*

163 The *Reed* court cited the following language from *Kuehner* as suggestive of a broad interpretation of the doctrine of economic benefit: "Under the terms of the 1947 agreement the interest from the invested [escrow fund] was payable to the petitioner. The Trustee's duties were ministerial and the economic benefits of the [escrow] fund held by it belonged to the [taxpayer]."
723 F.2d at 146 (quoting *Kuehner*, 214 F.2d at 440).

164 *See* Rev. Rul. 60-31, 1960-1 C.B. 174.

165 *Reed*, 723 F.2d at 147; Goldsmith v. Commissioner, 586 F.2d 810, 820 (Ct. Cl. 1978). *See generally* Metzer, *supra* note 36, at 500-51.

court felt that such a narrow inquiry would be inappropriate in areas other than compensation and held that the inquiry must go "beyond" the question of fair market value to the question of whether the contract right was the equivalent of cash. To determine whether the agreement in *Reed* met the cash equivalence test, the court invoked the test of *Cowden v. Commissioner*.[166] Recall that *Cowden* required that the promise of payment be readily transferable in commerce and intended as payment. Because Reed's escrow rights did not meet these tests, the court found that the escrow was not a cash equivalent. Interestingly, the court characterized the rights as "added assurance that payment would be made next year."[167]

The court responded to the argument that Reed's interest should be taxed because it was assignable by asserting that assignability was not determinative.[168] Allowing the question to turn on assignability would undermine deferred payment arrangements as effective methods of deferring income.[169] Because Reed made no attempt to assign the escrow funds, the court felt he "did nothing to charge himself with any economic benefit derived from the funds."[170]

The court responded to the Commissioner's argument that the escrow agent was Reed's agent and thus the escrow was self-imposed, by stating that the escrow was the result of a bona fide modification to the purchase agreement, which required both the seller's and Reed's approval.[171] The court also rejected the Commissioner's argument that an agency resulted because the funds would eventually benefit Reed. According to the court, such a rule would invalidate any escrow that deferred payment. [172]

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166 289 F.2d 20 (1961).

167 *Reed*, 723 F.2d at 148; *see also* Freidhoff, *supra* note 84, at 1013 (arguing that the escrow in *Reed* meets the *Cowden* standards and because the deferral period is only seven days, the escrow would not require a significant discount).

168 The opposite result was reached in *United States v. Drescher*, where the court found that an economic benefit occurred. 179 F.2d 863, 867 (2d Cir. 1950). Although the court spoke in terms of non-assignability, it alluded to a clause in the policy allowing for any beneficiary named by the taxpayer at the time the contract was executed to receive the cost of each contract, plus interest at the death of the taxpayer. *See id.* at 866. This clause scratches the surface of "assignability."

169 *Reed*, 723 F.2d at 148.

170 *See id.*

171 Burke and Friel state: "A definition of the substantive difference between the ineffective 'self-imposed limitation' and effective bona fide arm's-length substantial limitation may be elusive, particularly when one recalls that deferral may be the objective of the seller alone."

172 One commentator has asserted:

> [T]he cases cited in *Reed* do not really support this conclusion. Further-

2. Critical Analysis of *Reed*

The First Circuit's analysis in *Reed* is flawed in a number of respects. First, its interpretation of the constructive receipt doctrine is incorrect because it expanded the concept of a "substantial limitation and restriction" to include any limitation on the time of payment so long as the parties intended to and, in fact, did agree to such limitation.[173] Second, the court virtually eliminated application of the economic benefit doctrine outside the deferred compensation area by requiring a showing of cash equivalence.[174] The key to the economic benefit doctrine is to apply the principles of

> more, the opinion is absurd in principle because the taxpayer's nonentitlement to earnings on the escrow fund affected only the amount of the funds' present value to the taxpayer; nonentitlement to earnings did not prevent the value of the taxpayer's unconditional interest in the fund from being a current economic benefit to him. Clearly, when the taxpayer received a nonforfeitable right to the escrow fund . . . he obtained something of value that he had not owned previously and that was materially different from a mere promise to pay. . . . The *Reed* court's folly created a wonderful windfall for the taxpayer and a corresponding cost to the Treasury . . . . *Reed* can appropriately be held up as an example of the dumb things that courts are capable of doing when they mechanically apply precedent while ignoring the statute and the structure of tax law.

JOSEPH M. DODGE ET AL., TEACHER'S MANUAL, FEDERAL INCOME TAX DOCTRINE, STRUCTURE AND POLICY 256-57 (1995).

173 Falk concludes that *Reed* reached the correct result on constructive receipt but for the wrong reason. Falk states, "The First Circuit missed the issue . . . [i]t was not that the limitation was self-imposed, but rather that it was imposed after the taxpayer was in constructive receipt." Falk, *supra* note 149, at 428. It would seem Falk's reasoning is circular because by definition any restriction imposed after constructive receipt is self-imposed.

174 *See* Burke & Friel *supra* note 60, at 262-63. Falk purports that the *Reed* court failed to "distinguish between the taxability of a cash basis taxpayer who receives income without the sale of property and the taxability of one who receives income from the sale of property." Falk, *supra* note 149, at 430. Falk explains that the point of taxation is different. *See id.* Falk suggests that in sales of property the only question is the fair market value of the consideration received, whereas in deferred payment service transactions the question is whether what is received is a cash equivalent. *See* Gertzman, *supra* note 20, at 68. Suggesting that the fair market value is the sole consideration in property transactions, Falk states:

> [I]t has long been held that a taxpayer who receives fully vested funds in a trust or escrow account where the availability of such funds is only a function of time is regarded as receiving gross income. This is not because the taxpayer received a cash equivalent, but because he has received property that can be assigned, factored or hypothecated. . . . This is the essence of the economic benefit doctrine. If the taxpayer received property it is included in the amount realized. . . . It is difficult to imagine that Reed did not receive a valuable economic benefit, and hence property. . . .

Id.

Revenue Ruling 60-31 beyond deferred compensation arrangements to sales and other situations.

The first flaw is that by interpreting the regulation that income be set apart "so that the taxpayer could have drawn upon it" as requiring an "unqualified, vested right to immediate payment," the court requires that the income be virtually in the taxpayer's hand before it is constructively received.[175] Further, it practically eliminates the regulation that income is "not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[176] *Reed's* analysis seems to be that any limitation is substantial so long as it is imposed by agreement before constructive receipt occurs.

Reed involved a seven-day limitation. It represented a loss of seven days of interest on $266,000, but in return Reed delayed paying his $71,412 tax for one year. If Reed could invest the deferred taxes at six percent after taxes, he would have lost $306 in interest for the seven days while making $4285 interest on the delayed tax payment. Economically, Reed's limitation created a lucrative investment opportunity.

Even if the escrow were a limitation on Reed's ability to obtain the funds, the question remains whether it was "substantial." The regulations contemplate that only substantial limitations on a taxpayer's control prevent constructive receipt. Should a seven-day delay be considered substantial when there is little or no chance that Reed will not receive the funds? The *Reed* court seems to think any time limitation is "substantial." But "substantial" refers to the substance, not merely the form of the limitation. In other words, is the limitation "real?"[177] Perhaps the question should be whether the limitation involves some "risk" that the funds will not be paid to the beneficiary.[178]

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175 Burke and Friel note "that Reed, without objection from anyone, could have prevailed upon the escrowee to deliver the escrowed funds to him or to his assignee prior to January 3, 1974." Burke & Friel, *supra* note 60, at 260.

176 *See* Treas. Reg. § 1.451-2 (a) (as amended in 1979).

177 Substantial is defined as:

> [o]f real worth and importance; of considerable value; valuable. Belonging to substance; actually existing; real; not seeming or imaginary; not illusive; solid; true; veritable. Something worthwhile as distinguished from something without value or merely nominal. Synonymous with material.

BLACK'S LAW DICTIONARY 996 (6th ed. 1991) (citations omitted).

178 *See* Yosha v. Commissioner, 861 F.2d 494, 499-500 (7th Cir. 1988) (suggesting that where market risks are eliminated from transactions, the transactions lack economic substance and become "artifices created by accomplices in tax evasion, the brokers."); Kuehner v. Commissioner, 214 F.2d 437, 441 (1954), *aff'g* 20 T.C. 875

The two clauses of the regulation should be read together so that a "substantial limitation or restriction" must be found before an escrow can be used to defeat the constructive receipt of the income.[179] In the context of a sale of a business, escrows are commonly used to secure warranty provisions thereby insuring the purchaser of the business of a fund to charge if the warranties are breached.[180] Whether a limitation is substantial may focus on whether someone other than the seller has an interest in the escrow that limits the seller's control of the funds.[181] An affirmative answer indicates that constructive receipt may not have occurred whereas a negative answer suggests the opposite result.

The Commissioner in *Reed* relied on *Williams v. United States*,[182] in which the seller imposed an escrow arrangement after the contract to sell timber was executed and the buyer had agreed to pay cash.[183] The *Reed* court viewed *Williams* as involving a self-imposed escrow,[184] whereas in *Reed* there was a modification to the contract

(1953) (holding that because there was a degree of certainty that the entire escrow amount would be paid, the court did not discount the amount for the purposes of income recognition).

179 The existence of a substantial restriction is a question of fact. *See* Treas. Reg. §§ 1.83-3(c) (as amended in 1985), 1.451-2(a) (as amended in 1979). Scott indicates that under I.R.C. § 83:

> A substantial risk may exist where ownership depends on the performance of future services, noncompetition, or the occurrence of a condition related to the purpose of the transfer. Since the employer's state of mind is relevant, an otherwise adequate condition does not constitute a substantial risk if it seems unlikely that the employer would insist on enforcement.

Scott, *supra* note 6, at 31-32.

180 *See* Oden v. Commissioner, 56 T.C. 569, 577 (1971) (distinguishing cases where the escrow was used to secure warranties).

181 Scott posits that under I.R.C. § 83(c)(1) (1988) and Treas. Reg. § 1.83-3(c)(1)-(c)(2) (1985) "[a] substantial risk may exist where ownership depends on . . . the occurrence of a condition related to the purpose of the transfer." Scott, *supra* note 6, at 31-32.

182 219 F.2d 523 (5th Cir. 1955).

183 The *Williams* court stated:

> We cannot agree . . . that the means adopted here had the legal effect claimed. . . . This is so for two reasons. The first is . . . that when the lumber company's bid was accepted, and it desired and offered to comply with it by paying the full purchase price, the taxpayers were then in constructive receipt of it, and that the self imposed limitation of the escrow device did not in fact and in law change the situation so as to make the funds any less available to, and constructively received by them.

184 *Id.* at 526.

See Reed v. Commissioner, 723 F.2d 138, 146 (1st Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982). *Reed* likewise dismissed *Oden v. Commissioner* on the basis that it was self-imposed. A more accurate reflection of *Oden*, however, is that the court

imposing the escrow prior to payment becoming due, which prevented constructive receipt.

The court's reasoning does not explain why the *Williams* court did not find a similar modification since the timber buyer in *Williams* had an agreement to pay cash. The answer is that the *Reed* court accepted the form without looking at the substance. In both *Williams* and *Reed*, the escrow was solely for the benefit of seller, had a clear unilateral flavor, was imposed without consideration, and terminated the buyer's entire interest in the funds deposited in the escrow.[185]

The second flaw in *Reed* is its analysis of the economic benefit doctrine. *Reed* suggests that a distinguishing feature[186] of economic benefit is the receipt of some present beneficial interest such as investment income,[187] a letter of credit,[188] or interest income,[189] none of which was present in *Reed*. The receipt of interest or other current benefit was not considered crucial in economic benefit cases such as *Drescher*, *Sproull*, or *Kuehner*, notwithstanding the *Reed* court's assertion that it determined the outcome in *Kuehner*. While the *Kuehner* court recognized that interest accrual and assignability supported a finding that the cash equivalence doctrine applied, the thrust of the opinion was the irrevocable setting aside of funds and the binding precedent of the *Sproull* decision that forced the court to include the funds in Kuehner's

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found that the escrow had no economic substance. For this reason, the court held that the funds had been received upon the closing of the sale. In this regard, *Reed* is indistinguishable from *Oden* and should have followed that decision.

A better formulation is that the escrow was imposed after the taxpayer was in constructive receipt of the funds. Falk states:

> [t]his is a crucial distinction since receipt—actual or constructive—is the point of taxation for a cash basis taxpayer, and, after the right to receive ripens to receipt, no arrangement can alter the taxability. Although arriving at the correct result, the First Circuit missed the issue. In Williams it was not that the limitation was self-imposed, but rather that it was imposed after the taxpayer was in constructive receipt.

185 Falk, *supra* note 149, at 428.

The *Reed* court's finding of consideration for the deferral in Reed's agreement to stay on the board for a period of time is not convincing because the buyer severed all ties to the funds upon deposit in the escrow. *Reed*, 723 F.2d at 141.

186 A second distinguishing feature noted in *Reed* is that many economic benefit cases included self-imposed restrictions. Such restrictions are more pertinent under the constrictive receipt doctrine and are analyzed above. *See* Williams v. United States, 219 F.2d 523, 527 (1955); Oden v. Commissioner, 56 T.C. 569, 575 (1971).

187 *See* Kuehner v. United States, 214 F.2d 437, 440-41 (1954), *aff'g* 20 T.C. 875 (1953).

188 *See* Watson v. United States, 613 F.2d 591, 597 (1980).

189 *See* Pozzi v. Commissioner, 49 T.C. 119, 120 (1967).

income.[190]

The *Reed* court's requirement that the taxpayer receive some present, beneficial interest in the fund is specious.[191] The court suggests that had Reed received investment interest on the funds deposited in the escrow (estimated at $306), he would have realized the $266,000 gain in 1973. Determining whether receipt has occurred by asking whether the taxpayer is entitled to the investment interest is not sustainable. Binding the Commissioner to such mechanical rules elevates form over substance.[192] Taxability should be determined by the economic substance of the arrangement and not merely the form.[193] The economic reality is that Reed's escrowed purchase price is more secure than the letter of credit,[194] which caused income recognition in the *Watson* case also cited by *Reed*.[195]

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190 The Commissioner argued that even if a present beneficial interest was required, Reed had received such an interest by virtue of his right to assign his right to receive payment under the agreement. The court rejected this argument stating: "[t]o base the economic benefit rule on whether a taxpayer could have assigned his contractual right to future payment would eviscerate the well recognized rule that a taxpayer can defer income recognition pursuant to a bona fide deferred payment agreement." *Reed*, 723 F.2d at 148. Moreover, Falk states:

> [i]t has long been held that a taxpayer who receives fully vested funds in a trust or escrow account where the availability of such funds is only a function of time is regarded as receiving gross income. This is not because the taxpayer has received a cash equivalent, but because he has received property that can be assigned, factored or hypothecated. He is taxable just as if he had received insurance coverage, an automobile, a boat or other valuable remuneration. This is the essence of the economic benefit doctrine. . . . It is difficult to imagine that Reed did not receive a valuable economic benefit, and hence property, where funds were irrevocably deposited for him in 1973 in an escrow account to be disbursed a week later. This was the implication of the Tax Court's opinion in *Reed*, and should have been affirmed by the First Circuit.

191 Falk, *supra* note 149, at 430.

Oden involved an escrow in which the buyer received interest from certificates of deposit in the escrow and did not pay interest on the note given to the seller as evidence of debt. The *Oden* court recognized that the purchase price could easily be adjusted to reflect unstated interest and that it was the substance and not the form that determined taxation. Oden v. Commissioner, 56 T.C. 569, 575 (1971).

192 *See* Burke & Friel, *supra* note 60, at 262.

193 *See* Treas. Reg. § 1.701-2 (as amended in 1995).

194 *See* Burke & Friel, *supra* note 60, at 261.

195 The *Watson* court rejected formalistic arguments that a letter of credit securing the future payment of the purchase price of cotton did not meet the *Cowden* standards of cash equivalence. Watson v. Commissioner, 613 F.2d 594, 599 (5th Cir. 1980). The taxpayer argued that he did not have control over the income because the letter of credit was not unconditional, assignable, or readily marketable. *See id.* at 597-98. The court rejected these arguments as elevating form over substance and included the value of the letter of credit in income when issued. *See id.* at 599. It stated that "a

Reed's other two arguments against *Kuehner* are not convincing. First, reading *Kuehner* broadly would not undermine deferred payment arrangements because such arrangements are based on the proposition that unsecured promises to pay in the future are not current income. Such promises are general obligations of the promisor. In *Kuehner*, as in other economic benefit cases, there is a setting aside of assets away from the claims of creditors. That funds cease to be subject to the seller's creditors is a critical feature of *Drescher* and *Sproull* and the primary justification for deferral in compensation situations.[196]

Second, *Reed*'s rejection of *Kuehner* because the distinction between cash and accrual-method accounting would be eroded is unfounded. The reason for preserving the cash method is to maintain its simplicity. The simplicity is lost if taxpayers are permitted to use escrow accounts lacking economic substance to successfully defer income.

Although *Reed* is frequently cited by commentators, none of the cases citing *Reed* has followed its holding with regard to the escrow. Looking at situations in terms of economic realities as demanded by the economic benefit doctrine and as suggested by Judge Clark in his dissent in *Drescher*, is a far better approach to analyzing these situations.[197] In fact, such an approach is "necessary to maintain the integrity of [S]ection 61 as well as the annual accounting system."[198]

3. *Childs v. Commissioner*

In *Childs v. Commissioner*,[199] a law firm, which consisted of at-

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commercial instrument is 'unconditional' when, under local law, the obligation cannot be avoided or modified without the consent of the obligee." *Id.* at 597.

Applying "objective economic realities" the court concluded the letter of credit was assignable and that a ready market existed because it could be used for collateral on a loan. *See id.* at 598. Although the taxpayer did not know letters of credit could be used for collateral, the court stated: "[e]conomic realities, not tax motives, must govern in determining whether income is properly taxable in a given year." *Id.* at 599.

196 *See generally* Robinson v. Commissioner, 44 T. C. 20 (1965); Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980).

197 *See Watson*, 613 F.2d at 520.

198 Burke & Friel, *supra* note 60, at 263.

199 The tort claims arose out of a 1984 explosion which resulted in the death of Willie James Jones and serious injuries to Jermeral C. Garrett (Garrett), the minor son of Annette Jones (Jones). Garrett and Jones retained the law firm Swearingen, Childs & Philips under the following fee arrangement: "33 1/3 percent of the gross amount recovered in the litigation if the case was settled before the suit was tried, and 40 percent of any gross amount recovered if the case was settled after the suit was tried. . . ." *See* Childs v. Commissioner, 103 T.C. 634, 654 (1994), *aff'd*, 89 F.3d 356 (11th Cir. 1996). Actions were brought against Columbus Propane Gas Service, Inc.

torneys Childs, Phillips and Swearingen, settled two personal injury cases. The settlements provided for an initial payment to the plaintiffs as well as periodic payments over a number of years in the future, commonly called a "structured settlement." The tort defendants' insurance company gave each of three lawyers options for the payment of their respective portions of the legal fees. Each attorney selected a different payment arrangement with one attorney collecting his entire fee within six months while another received lifetime payments. The attorneys reported the fees as the payments were received.

In March 1986, a tentative settlement was reached providing for a $240,000 initial payment to the plaintiff, Garrett, a minor, plus structured payments.[200] The structured payment obligation was assigned by the defendant's insurance carrier (the Primary Insurer) to a second insurer (the Payment Obligor)[201] although the Primary Insurer would remain primarily liable for the amounts owed. The Primary Insurer paid the Payment Obligor an amount sufficient to purchase annuities to fund the payments.

Because Garrett was a minor, the attorneys consulted with the State Bar of Georgia regarding the appropriate amount and method of payment of attorneys' fees. The State Bar advised that the attorneys could receive a fee at the time of settlement equal to a percentage of the present value of the Garrett settlement.[202] Attorney Phillips expressed a desire to receive his fee immediately but Mr. Bradford objected to immediate payment as did Mrs. Jones who stated "that she did not want the attorneys to receive their fee immediately, if she and Garrett were to take a structured settlement."[203] Before the settlement was finalized the parties agreed

(Columbus Propane) for negligence. The cases were referred to Columbus Propane's insurance carrier (the Primary Insurer), which retained Charles S. Bradford of Structured Annuity Settlements, Inc. to negotiate a settlement.

200 The decision does not indicate whether the payments will continue for a specified period or for Garrett's life.

201 The company responsible for making payments to the attorneys under the Garrett settlement was First Executive Corporation, which funded the attorneys' fees under the Garrett settlement, by purchasing an annuity from its subsidiary Executive Life Insurance Company. The company responsible for making payments to the attorneys under the Jones settlement was Manulife Service Corporation, which funded the attorneys' fees under the Jones settlement by purchasing an annuity from Manufacturers Life Insurance Company. For purposes of this article, the persons responsible for the payment to the attorneys will be referred to as "Payment Obligor."

202 A percentage of the present value of the Garrett settlement was then used to purchase the annuity for the attorneys.

203 The logic of Mrs. Jones's assertion is not convincing because there is a clear tax reason for Garrett and Jones to accept structured settlements; a reason that is not applicable to the attorneys. The entire amount of the payments are excluded from

that legal fees would be paid in a structured format and each attorney selected a different payment schedule that was made a part of the settlement agreement. Attorney Phillips requested annual payments in 1987 and 1988; Childs requested a combination of monthly and annual payments terminating in 1999; and Swearingen requested annual payments through 2001. The present value of all payments, calculated at a six percent annual rate of interest, was $336,329.[204]

The settlement agreement was approved by the district court and by an Alabama state court on behalf of the Alabama minor. The Payment Obligor purchased annuities to fund the obligations, naming the attorneys as annuitants. Under the Garrett's settlement agreement, the annuitants could not accelerate, defer, increase, or reduce the payments to their present value.[205] The Payment Obligor was the owner of the annuities and had the right to change the beneficiary.[206]

The attorneys brought suit on behalf of Garrett's mother, Mrs. Jones, in 1986, and the case proceeded in the same manner as the Garrett case. In the fall of 1987, a settlement was reached whereby Mrs. Jones received an immediate lump sum payment[207] together with structured payments.[208] Again, the attorneys were allowed to select the method in which their fees were paid,[209] and again the selections were made a part of the final agreement with Mrs. Jones. Attorney Phillips requested monthly payments commencing in

gross income under I.R.C. § 104(a)(2) thereby exempting any investment income resulting from the deferred payment. This benefit is not afforded to the attorneys representing the injured person.

204 See the table of payments in Exhibit A of the Appendix.

205 The parties to the settlement each signed an assignment and assumption agreement assigning the Primary Insurer's payment obligation to the Payment Obligor. Paragraph five of the assignment, which qualified under I.R.C. § 130, provided in part:

> The parties to this Agreement agree (1) that any periodic payments hereunder shall not be capable of being accelerated, deferred, increased, or decreased by Jones, Hood, Garrett or any other recipient hereunder and (2) that said persons, or any other recipient hereunder, shall not have, by reason of this Agreement, any right against [the Payment Obligor] other than the rights of a general creditor.

Childs v. Commissioner, 103 T.C. 634, 643 (1994), *aff'd*, 89 F.3d 356 (11th Cir. 1996).

206 *See id.* at 643-44.

207 Mrs. Jones was paid an immediate lump sum of $464,431, from which she paid certain claims against Mr. Jones's estate and legal fees. The portion paid to the attorneys under the lump sum was not in dispute.

208 The decision does not indicate whether the payments are for Mrs. Jones's life.

209 See Appendix B for description of payments to be made to Attorneys Childs, Phillips, and Swearingen.

1992 and continuing for the remainder of his life; Childs requested payments in January and April 1988; and Swearingen requested monthly payments commencing in 1988 and continuing for the remainder of his life. The present value of all payments, calculated at a six percent annual rate of interest, was $418,729.[210]

The obligation of the Primary Insurer for the structured payments was assigned to the Payment Obligor, although the Primary Insurer remained secondarily liable for the payments. In October 1987, the Primary Insurer paid $536,069 to the Payment Obligor to purchase three annuities to "fund" the structured payments to the attorneys. The Primary Insurer was named as owner of these annuities and had authority to change the beneficiary of the policies.[211]

Attorneys Childs, Phillips, and Swearingen reported only amounts actually received from the settlements. The Commissioner determined under I.R.C. § 83, the attorneys should have included the fair market value of the Garrett annuities in 1986 and the Jones annuities in 1987. As the basis for his argument, the Commissioner asserted that the attorneys had constructively received the value of the annuities in the year of settlement.[212]

The court first addressed the Commissioner's argument that the attorneys' fees constituted property transferred in connection with the performance of services to be included under § 83. [213] To

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210 See the table of payments in Exhibit B of the Appendix.

211 The beneficiary of the Childs's annuity could only be changed during Childs's lifetime.

212 In a 1993 private letter ruling, Pvt. Ltr. Rul. 93-36-001 (May 12, 1993), the Commissioner addressed a similar situation and concluded that I.R.C. § 83 applied because the tort plaintiff had set aside a portion of the recovery for the attorneys. The ruling found that this action constituted a funding of the obligation, which thereby fell into the definition of property. Supporting this conclusion, the ruling cites Rev. Rul. 77-420, 1977-2 C.B. 172; Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 60-31, 1960-1 C.B. 174; and Rev. Rul. 55-691, 1955-2 C.B. 21, all of which relied on *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

The Commissioner concluded the debt for attorneys' fees was "secured" because state regulatory law requires that insurance companies maintain reserves and have a priority over general creditors of the insurance carriers. He also concluded that because substantially all of the services owed to the client were performed before the deferred payment arrangement was determined and because the insurers were "ready, willing, and able to pay the taxpayer his fees in cash" that the attorneys had constructively received the fees when the annuities were purchased.

213 I.R.C. § 83 (1986) provides:

> (a).General Rule.—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial

decide whether the promise to pay attorneys' fees under the Garrett and Jones settlements and the corresponding annuities constituted I.R.C. § 83 "property," the Tax Court focused on the definition of property that excluded unfunded and unsecured promises to pay in the future.[214]

Because the term "funded" is not defined in the Code or the regulations,[215] the court sought assistance from the holdings in three Tax Court cases. First, *Sproull v. Commissioner*[216] included the taxpayer's interest in a trust fund in the year the employer transferred moneys to the trust, since the taxpayer was the owner of the economic and financial benefit conferred when the trust was created. Next, in *Centre v. Commissioner*[217] an insurance policy purchased by an employer to fund a deferred compensation obligation was not taxable to the employee at the time the premiums were paid by the employer because the employer remained both the owner and the beneficiary of the policy. Finally, in *Minor v.*

> interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. . . .

See McDaniel, *supra* note 56, at 1079-99. I.R.C. § 83 was enacted to deal with situations previously addressed by the economic benefit doctrine.

214 Treas. Reg. § 1.83-3(e) (as amended in 1985) provides:

> [T]he term 'property' includes real and personal property *other than either money or an unfunded and unsecured promise to pay money* or property *in the future*. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account. . . .

Id. (emphasis added).

215 Under the Employee Retirement Income Security Act (ERISA), an exemption for so-called "top hat plans" requires that such plans be "unfunded," which generally means that the plan assets are subject to the employer's creditors. Moreover, Scott notes:

> The plan must be unfunded. Legislative materials do not suggest an approach to the funding issue, and courts have dealt with the question simply by examining the details of each particular plan. Labor takes the position that decisions are to be based on an examination of the facts and circumstances including the status of the plan under non-ERISA law. . . . Labor apparently will continue to follow the IRS approach that treats a plan as unfunded so long as the assets remain subject to claims of the employer's creditors.

Scott, *supra* note 6, at 9 (footnotes omitted).

216 *See* Sproull v. Commissioner, 16 T.C. 244, 245 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952); *see also* United States v. Drescher, 179 F.2d 863, 866 (2d Cir. 1950) (holding that an economic benefit was conferred upon the purchase of an annuity).

217 55 T.C. 16, 20 (1970)

United States[218] a physician designated that a percentage of his fees be placed in a trust fund for future distribution. Because the employer was the settlor and beneficiary of the trust and because the funds were not secured from the employer's creditors,[219] the court held that "no amount of ascertainable value had been conferred" on the physician that could be taxed.[220]

Taking the cases together, the *Childs* court held that funding does not occur as long as the obligor remains the owner of the trust funds and it remains subject to the general creditors of the obligor.[221] Accordingly, because the owner of the Garrett and Jones annuities had power to change the beneficiary[222] and the payments could not be "accelerated, deferred, increased, or decreased," the court concluded that the promises to the attorneys were not funded.[223]

The Court then addressed the Commissioner's argument that the guarantees by the insurance companies caused the promises to be secured. As a result, the Commissioner asserted that the lien for attorneys' fees, and the Georgia requirement that insurance companies maintain reserves, constituted secured interests.[224] The Tax Court responded by stating that a simple guarantee alone does not render a promise secured, because a guarantee is by definition a promise to pay.[225] The Tax Court concluded that the agreements by the insurance companies were unfunded and unsecured promises for future payment and did not constitute property under I.R.C. § 83.[226] Accordingly, the future payments were not includible in the taxpayer's income under I.R.C. § 83.[227]

The Tax Court next addressed the Commissioner's argument

218 772 F.2d 1472-73 (9th Cir. 1985).

219 *See* Scott, *supra* note 6, at 10 n.93 (explaining that the key question in so-called "rabbi" trusts is whether the assets in the trust are subject to the claims of the general creditors of the obligor).

220 *See Minor*, 772 F.2d at 1476. Cooper, *supra* note 69, at 247, sharply criticizes *Minor*, noting that the "slavish acceptance of the trust instrument's designation of the corporation as the beneficiary of the arrangement appears to exalt form at the expense of substance."

221 Childs v. Commissioner, 103 T.C. 634, 651 (1994), *aff'd*, 89 F.3d 356 (11th Cir. 1996).

222 *See id.* at 644. The right to change beneficiaries terminated upon the death of the applicable attorney.

223 *See id.* at 651.

224 *See id.* at 652.

225 *See id.* at 652 (citing Berry v. United States, 760 F.2d 85 (4th Cir. 1985), *aff'g per curiam*, 593 F. Supp. 80, 85 (M.D.N.C. 1984); Brand v. Commissioner, 81 T.C. 821, 828 (1983)).

226 *See Childs*, 103 T.C. at 653.

227 *See id.*

that the taxpayers had constructively received the amount paid for the annuities in the year of purchase. The court noted that a taxpayer constructively receives income when he has an "unqualified, vested right to receive immediate payment."[228] Because the attorneys did not become entitled to their fees until the settlement agreements were binding and judgment was entered,[229] they never had the right to receive immediate payment[230] and, thus, had not constructively received the proceeds.[231]

The result of the *Childs* decision is that the rights and benefits received by the attorneys under the settlement agreements were not sufficiently established to be included in gross income.

4. Critical Analysis of *Childs*

The *Childs* court rejected the application of the constructive receipt doctrine as well as the economic benefit doctrine[232] be-

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228 *See id.* at 654 (quoting Martin v. Commissioner, 96 T.C. 814, 823 (1991)); Reed v. Commissioner, 723 F.2d 138, 142 (1st. Cir. 1983), *rev'g* 45 T.C.M. (CCH) 398 (1982).

229 *See Childs*, 103 T.C. at 637-38. The court also noted that under the attorney's fee arrangement, the attorneys were to receive a percentage of the amount "recovered" for the client. *See id.* at 637. The term "recovered" suggested that the fee was only earned when an amount was actually received by the client. Again, since the structured fee arrangement was agreed upon before the clients "recovered" any amount, no money or property was made available to the taxpayer attorneys, and accordingly, constructive receipt did not occur upon settlement of the cases.

230 *See* Rev. Rul. 60-31, 1960-1 C.B. 174, 179 (acknowledging that deferral arrangements for unearned royalties made prior to the time the royalties are earned will be taxed only upon payment to the cash basis taxpayer).

231 *See Childs*, 103 T.C. at 655. The court cited *Oates v. Commissioner*, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953). In *Oates*, the taxpayer had modified the schedule for payment of insurance commissions after retirement to spread the payments over a longer period than originally provided. *See* 18 T.C. at 572. The Commissioner argued that modification could not delay the taxability of the commissions. *See id.* at 585. The Commissioner's initial nonacquiescence in *Oates* (*nonacq.*, 1952-2 C.B. 5) was later withdrawn (*nonacq. withdrawn and acq. substituted*, 1960-2 C.B. 6).

In a case not cited, *Commissioner v. Olmsted Inc. Life Agency*, 304 F.2d 16 (8th Cir. 1962), *aff'g* 35 T.C. 429 (1960), an insurance agency terminated its agency contract and assigned its right to renewal commissions to the insurer in exchange for a 15-year annuity issued by the insurer. *Olmsted*, 304 F.2d at 18. Relying on *Oates*, the court held that the exchange was not a "sale or other disposition" of the agency contract under I.R.C. § 1001, but was a novation that deferred the income. *See id.* at 20. The Commissioner argued that *Oates* did not apply because, in *Olmsted*, the taxpayer's contract rights were assignable and the insurer would have paid cash immediately. *See id.* at 19. In Pvt. Ltr. Rul. 85-25-003 (Mar. 4, 1985), the IRS suggested that *Olmsted* stood for the proposition that a taxable disposition depends on whether the new contract differs materially in kind from the old contract. The IRS filed a nonacquiescence in *Olmsted*, 1961-2 C.B. 6. *See* GRAETZ & SCHENK, *supra* note 31, at 720.

232 *Childs*, 103 T.C. at 655. The *Childs* court acknowledged the economic benefit doctrine. *See id.* at 649. The doctrine is often considered an exception or an alterna-

cause the structured settlement had been agreed to prior to the settlement becoming final.[233] Accordingly, the attorneys never had the right to demand immediate payment. The doctrine of cash equivalence did not apply either, since the attorneys could not assign the right to future payments and obtain an immediate cash payment. Because the payments were unsecured promises of the insurance company and the insurance company's assets remained subject to the rights of its creditors, no vested rights accrued and the doctrine of economic benefit did not apply. The principal flaw in *Childs* is that the court lost sight of who engaged the attorneys and who was the principal obligor. Such an error affected the courts analysis of the constructive receipt doctrine, the economic benefit doctrine, and I.R.C. § 83.

In *Childs*, Garrett and Jones were principals and the attorneys were agents. It is to the principals that the attorneys must look to secure payment of their fees. Garrett's and Jones's only asset was their claim against Columbus Gas. When the claims were settled, Garrett and Jones released their claims in exchange for cash plus promises of future payment by the Primary Insurer. They set aside a portion of their rights to future payment for payment of attorneys' fees. Having set such funds aside, Garrett and Jones were discharged from their obligation for attorneys' fees.[234] Under these circumstances, the economic benefit doctrine would require

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tive to the requirement that the taxpayer is taxed only if he receives or constructively receives income. *See* Minor v. United States, 772 F.2d 1472, 1473 (9th Cir. 1985).

[233] It is interesting that *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983), *rev'g* 45 T.C.M.(CCH) 398 (1982), a case allowing a taxpayer to defer receipt of sale proceeds for seven days from one tax year to the next by use of an escrow arrangement determined before the final contract was signed, was not cited.

[234] Pvt. Ltr. Rul. 93-36-001 (May 12, 1993) (recognizing that the relevant inquiry is whether the assets set apart are subject to the creditors of the attorneys' clients). The letter ruling states:

> Thus, Revenue Ruling 77-420 illustrates that not all substantial forfeiture provisions will delay taxation; only those resulting in forfeiture to the service recipient or its creditors. . . . Applying the above principles to the facts of the instant case, it is clear that Taxpayer's . . . rights to payments under the annuity policies emanate from the legal services that he performed for his clients, and that his clients have fully compensated him for his services by sharing their recoveries with him in accordance with their contingency fee, [sic] agreements. In effect, by irrevocably directing the liability insurers to pay Taxpayer his portion of their recoveries, Taxpayer's clients have funded their promises to share those recoveries with him, and, in doing so, have conferred economic benefits on him.

Id.

the taxpayer to include the amount in income.[235]

Childs is a simple application of *Drescher*.[236] In *Drescher*, an employer purchased an annuity for an employee and the court required the cost of the annuity to be included immediately in the employee's income.[237] In *Childs*, Garrett and Jones, like the employer in *Drescher*, merely purchased an annuity to compensate their "employees," i.e. the attorneys. Unlike the *Drescher* court, which did not mention the creditors of the company issuing the annuity in its analysis, the *Childs* court found the existence of creditors with claims against the annuity a bar to inclusion of the annuity in the taxpayer's income. For purposes of determining whether the cost of the annuity should be included in income, however, the important creditors are those of the primary obligor.[238] In *Childs*, the primary obligors are Garrett and Jones. In *Childs*, Garrett and Jones set aside assets for the benefit of the attorneys, which was the hallmark of current taxability under the economic benefit doctrine.

To avoid current taxation, the attorneys in *Childs* could merely have agreed to look to Garrett and Jones to make the future payments. Since Garrett and Jones were not sophisticated in finance,

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235 Scott notes that promises by third parties are included in income. *See* Scott, *supra* note 6, at 29. He states:

> An obligation of a third person to satisfy an employer's promise to pay is a common form of a funded promise. The third person promise rule usually involves insurance policies. An employee does not have income if the policy is owned by the employer who promises a benefit to the employee, because the asset is still subject to claims of creditors of the employer. Claims cease to be a factor when the employer transfers the policy to the employee. The employee will be deemed to receive income from the insurance policy at the time of transfer.

Id. at 29-30 (footnotes omitted).

236 Citing *Sproull*, Scott asserts that "[a]n obligation of a third person to satisfy an employer's promise to pay is a common form of a funded promise." Scott, *supra* note 6, at 30 (footnotes omitted).

237 In discussing the application of the economic benefit doctrine to salary reduction plans in which the employer makes contributions to an insurance company for an annuity, Metzer, *supra* note 36, at 572 states the following:

> Without . . . special statutory provisions . . . all annuity and life insurance premiums transferred to an insurer on behalf of a particular employee would generally be includible in his gross income on a current basis. By analogy, all salary reduction payments transferred to a third party trustee on behalf of a particular employee should be includible in his gross income on a current basis, unless there is a specific statutory exception.

238 The settlement agreements removed assets from the creditors of Garrett and Jones. Their present or future creditors had no access to the funds used to pay the attorneys' fees. As such, the promise cannot be considered an unfunded, unsecured promise to pay in the future.

however, they would have created too much risk for the attorneys. In addition, providing a third-party promise as Garrett and Jones did constitutes setting aside property,[239] which is equivalent to purchasing an annuity under *Drescher*. As a result, the Tax Court in *Childs* never considered *Drescher* and reached the wrong result.

Setting assets aside where the obligor (Garrett and Jones) has relinquished all further claims also implicates the constructive receipt doctrine because the power to demand immediate payment may be inferred.[240] During the negotiations in *Childs*, the attorneys exercised considerable power to structure the settlement to meet their needs. The attorneys separated their future payments from those of their clients and split the law firm's claim for attorneys' fees by allowing each partner to structure an individualized deferred compensation plan.

The inference that the attorneys had the power to demand immediate payment is strengthened by the weakness of the reasons given for the structured settlements. The objections to immediate payment by Jones and the Primary Insurer seem contrived. The Primary Insurer paid a significant sum to the Payment Obligor to purchase the required annuities, which strongly suggests a willingness to make a current payment to the attorneys.[241] Jones's insistence that the attorneys not be paid earlier than she or Garrett did not prevent the attorneys from exercising broad discretion to determine their fees independent of the schedule of payments for their clients. Further, Jones's structured settlement was necessitated by tax considerations unrelated to the attorneys' fees.[242]

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239 *See* Rev. Rul. 77-420, 1977-2 C.B. 172; Rev. Rul. 69-50, 1969-1 C.B. 140.

240 Pvt. Ltr. Rul. 93-36-001 (May 12, 1993) (determining that the attorneys' fees were included in the attorneys' income under the constructive receipt doctrine since the fee arrangement was made after the taxpayers had performed substantially all of the services and since the insurer was ready, willing, and able to pay cash immediately). In *Childs*, the court concluded that because the attorneys' fees were structured and determined before the final settlement was reached, there was never a time when the attorneys could demand payment. Accordingly, there was never a time when the attorneys had constructive receipt of the fees. *Childs*, 103 T.C. at 654-55.

241 The Commissioner in Pvt. Ltr. Rul. 93-36-001 (May 12, 1993), found that constructive receipt occurred when an insurer agreed to settle the personal injury case and pay a portion of the settlement proceeds to the attorneys on a structured basis.

242 *See* I.R.C. § 104(a)(2) (as amended in 1996). The section was amended in 1983 to make clear that the exclusion applied regardless of whether the damages are received in "lump sums or as periodic payments." The amendment was intended to codify prior law so that amounts are excluded only if the taxpayer is "not in constructive receipt of, or does not have the current economic benefit of, the funds required to produce the periodic payments." H.R. Rep. No. 832, 97th cong., 2d sess. 4 (1982) (citing Rev. Rul. 79-220, 1979-2 C.B. 74; Rev. Rul 77-230, 1977-2 C.B. 214).

Frolik, *supra* note 83, at 574-83, argues that excluding periodic payments fosters

Without a substantial non-tax purpose for the deferral, the deferral should not be considered as resulting from a bona fide arm's length agreement. It should be considered self-imposed and taxable under the constructive receipt doctrine.[243]

In *Childs*, the tax court answers all arguments by asserting, first, that the parties reached the agreement prior to any amount becoming payable to the attorneys and, second, that a mere guarantee does not constitute a securing of the obligation.[244] As already noted, the parties' prior agreement is irrelevant to the economic benefit doctrine; the only other issues are whether the rights are non-forfeitable and whether the assets are set apart from the claims of the obligor's creditors. Both occurred in *Childs*.

Responding to the second assertion, it is noted that the Primary Insurer is not a guarantor of Garrett's and Jones's obligations to pay attorneys' fees. Rather, the Primary Insurer has become the primary obligor and is holding the assets of Garrett and Jones to pay the attorneys. Of course the Primary Insurer could have paid the full amount of the settlement funds to Garrett and Jones. In such case, Garrett and Jones would then have been personally obli-

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horizontal inequity. Frolik would repeal the amendment and allow the economic benefit doctrine to determine when to report income. Under that approach, the present value of the settlement would be reported in the year of settlement and the interest component taxed separately either under I.R.C. § 72 (governing annuities), I.R.C. § 1272 (governing original issue discount debt obligations), or under the open transaction doctrine. *See also* Cooper, *supra* note 71, at 258 (discussing whether the interest component of structured settlements must be reported under the economic benefit doctrine).

243 The court in *Oates v. Commissioner*, in allowing a renegotiation of a commission schedule, stated:

> Here the parties were confronted by a situation where inconvenience and resulting dissatisfaction came to the retired agents by reason of the constantly decreasing payments made by the company under the original contract. To relieve the situation, the company and the taxpayer, after full and complete negotiations, before retirement of the agent, agreed to abrogate and annul the old contract, to substitute a new one and thus to improve the unsatisfactory posture of affairs. The taxpayer . . . took no dominion over the accrued commissions other than to agree to receive them in cash installments as they matured under the contract.

207 F.2d 711, 713-14 (7th Cir. 1953).

244 As stated in *Childs*:

> It is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay. Therefore, the mere fact that several insurance companies guaranteed the payments to petitioners is irrelevant to our determination of whether petitioners' right to receive the future payments was secured.

Commissioner v. Childs, 103 T.C. 634, 652 (1994), *aff'd per curiam*, 89 F.3d 356 (11th Cir. 1996) (citations omitted).

gated to pay the attorneys' fees. If the Primary Insurer actually guaranteed such payment by Garrett and Jones, the Primary Insurer would have been a true guarantor and the Tax Court's holding would have been technically sound. In *Childs*, this is not the case, and it would be unusual for tort settlements to provide that the Primary Insurer would guarantee future payments to the injured party's attorney after discharging its obligation through disbursement of the entire recovery to the injured party.

Childs also implicates the cash equivalence doctrine and the application of the *Cowden* standards to the annuities. While offered generally by insurance companies in commerce, annuities are specific to the individual annuitant and even if salable, are not liquid.[245] Under a strict interpretation of either *Cowden* or Professor Gertzman's first alternative, the annuities in *Childs* do not raise to the level of cash equivalence. On the other hand, Gertzman's second alternative to *Cowden*, (i.e. whether the promise has a fair market value), is too broad to be an effective test.[246] A court might look, however, to the substance of the transaction and conclude that the attorneys could have realized sufficient value to require reporting under a cash equivalence analysis.[247]

The *Childs* court's I.R.C. § 83 analysis is likewise flawed because it did not ask the question of who was the transferor. Therefore, the *Childs* court treated the Primary Insurer as if it had an obligation to the attorneys for the services performed. That was not the case. In fact, I.R.C. § 83 would apply because the annuity is property under I.R.C. § 83 when used to fund the obligation of the transferor.[248] The transferor under I.R.C. § 83 should have been Garrett and Jones because they transferred their tort claims in ex-

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245 According to Scott, *supra* note 6, at 34:

> One type of unfunded promise is included in an employment contract. Because no market exists for employment contracts, the IRS has announced that receipt of this type of promise is not income. The IRS position presumably will change should a market develop.

(footnotes omitted).

246 *Id.* at 35-36, notes the connection between fair market value and marketability as follows:

> Since a controlling factor is the practical ability to obtain payment, a promise cannot be marketable unless it has a fair market value. Even if the promise has substantial value, if that value is sufficiently uncertain to make it inappropriately speculative, then the promise has no fair market value.

247 *See* Watson v. Commissioner, 613 F.2d 594, 599 (5th Cir. 1980).

248 *See* Treas. Reg. § 1.83-3(e) (as amended 1985) providing: "The term [property] also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account."

change for annuities, payable in part to their attorneys.[249]

Taken to its logical conclusion, *Childs* would permit an employee to say to his employer, "take my salary next year and buy me an annuity to fund my private pension." Having pushed general tax rules to their logical conclusion, either Congress, the Commissioner, or the courts need to restrain the excess. For example, a judicial limitation on *Childs* could be a recognition of the economic benefit doctrine as a separate doctrine. Such a limitation is consistent with and even demanded by general tax principles.

C. *The Economic Benefit Doctrine and General Tax Rules*

Childs presses the limits of the constructive receipt and cash equivalence doctrines and, in effect, eliminates the economic benefit doctrine. The taxpayers in *Childs* narrowly avoided application of each of the doctrines thereby deferring income for periods as short as a single tax year and as long as the lifetime of the taxpayer.

The economic benefit doctrine as applied in Example 4 of Revenue Ruling 60-31 focuses on non-forfeitability and the setting aside of assets. The economic benefit doctrine should recognize that negotiations and agreements (or modifications thereof) deferring payment beyond the taxpayer's completion of performance are irrelevant unless tied to substantial risks arising out of the transaction. If the promises are general, unfunded, or unsecured obligations of the obligor, the economic benefit doctrine would not include such amounts in the taxpayer's income. These rules are consistent with general tax principles.

1. The Parties' Motivation

Taxpayers are permitted considerable latitude in structuring transactions through arm's-length bargaining[250] and third-party ar-

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[249] In *Commissioner v. Olmsted*, the court recognized that taxable income would be recognized by the beneficiary of an annuity where the employer transferred money to an insurance company for the annuity. 304 F.2d 16, 22 (8th Cir. 1962). The court accepted the argument that such an annuity was the equivalent of cash for tax purposes. *See id.*

[250] As Judge Learned Hand stated in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935): "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." The Supreme Court agreed, stating: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid them, by means which the law permits, cannot be doubted." *Helvering*, 293 U.S. at 465, 469; *see also* Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961) (noting a taxpayer's ability to minimize taxes). *But see* Schlemmer v. United States, 94 F.2d 77 (2d Cir. 1938).

rangements to defer payments to a cash-method taxpayer. Courts are generally reluctant to examine the motivation of the parties to such transactions. A limitation should be imposed, however, on situations in which the third party has no interest in the timing of payments and the risk of loss is minimized or where the taxpayer's sole motivation is tax deferral.[251]

Agreements arrived at through arm's length negotiations are generally respected for tax purposes and the motivation of the parties in reaching the agreements are not found to be relevant. Arguments that the obligor was ready, willing, and able to pay cash currently, have not been persuasive in the light of preexisting agreements.[252] In the compensation area, long-standing principles recognize that employees can defer compensation over a long period of time for pension purposes. Indeed, postponing taxation is often the sole motive for deferred compensation agreements. Does the parties' motivation have any relevance to the application of the three doctrines? Are the taxpayers free to structure their transactions for deferral purposes?

When the obligor has no interest in the outcome, the arm's length character of the transaction is eliminated and the deferral agreement should be viewed as "self-imposed." Unlike contract law where the sufficiency of the consideration is unimportant, in tax law sufficiency should be considered in economic terms. Unless there is a "nexus" between the interest of the third party and the deferral of payment, the deferral should be deemed "self-imposed" by the taxpayer and ignored. A sufficient nexus exists for deferral if the obligor's promise is unfunded and unsecured or leaves the obligor free to use the funds.

Reed is an example where a purchaser of stock had no interest in the escrow account to which the purchase price was deposited. Applying a prior agreement to prevent constructive receipt resulted in an absurd result.[253] Where the obligor has completely

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[251] The *Williams* court stated:

> We agree with the taxpayers' general proposition and have often declared, as other courts have, that the taxpayers may conduct their business so as to minimize their taxes, provided only that the arrangements are real, not sham arrangements, and are legally effective to accomplish the desired result, and that, in determining whether the means used are, or are not, effective, the fact that tax reduction is a moving cause in the choice is not a material factor.

Williams v. United States, 219 F.2d 523, 527 (5th Cir. 1955) (footnotes omitted).

[252] *See* Rev. Rul. 60-31, 1960-1 C.B. at 178; Pvt. Ltr. Rul. 93-36-001 (Sept. 10, 1993).

[253] A technique used in the deferred compensation area is to transfer assets to a trust outside the control of the transferor, but subject to the creditors of the trans-

relinquished control over assets and has no further interest in their disposition, a presumption should arise that the other party to the transaction has, in fact, exercised the power to control the disposition of assets thus triggering the constructive receipt doctrine.

Taxpayer motivation also impacts the economic benefit doctrine. Under the economic benefit doctrine, negotiations leading to a deferral arrangement are irrelevant because the focus is on the economic benefit to the taxpayer. However, when assets are set aside, the absence of a non-tax motive bolsters the conclusion that the promised future payment is nonforfeitable and that funding has occurred. In such situations, the taxpayer should have the burden to show a substantial non-tax purpose for the escrow (in *Reed*), the establishment of insurance annuities (in *Childs*), or other genuine deferred arrangements.

Without a non-tax purpose, a deferred payment transaction structured solely to minimize taxes does not defer income.[254] The "sham transaction" doctrine asks whether there is economic sub-

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feror. The Commissioner has conceded that the value of such assets would not be included in income upon transfer to the trust. *See* Rev. Proc. 92-65, 1992-2 C.B. 428; Rev. Proc. 92-64, 1992-2 C.B. 422. Employees benefit from the transfer because it eliminates the possibility that the employer will later refuse to pay the amount. *See* Scott, *supra* note 6, at 4-5, 10. Indeed, employees can often designate the investments in which the trust will invest. *See id.* at 10-11.

254 *See* Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (denying interest deductions to Irish Sweepstakes winner who structured borrowing and lending transaction to spread winnings over several years). Although the notes were not a sham, the transaction's only purpose was securing a deduction and allowing a deduction would "encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress." *Id.* at 742. The court stated:

> [T]he interest deduction should be permitted whenever . . . the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or . . . the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. . . .[A] taxpayer has the right to decrease . . . his taxes . . . by any means the law permits. . . . On the other hand . . . this provision should not . . . permit an interest deduction when it appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain . . . an interest deduction.

Id. at 741-42. (citation omitted); *see also* Knetsch v. United States, 364 U.S. 361, 365 (1960) (denying interest deductions in sham transactions).

In *Estate of Franklin*, depreciation and interest deductions were denied where the secured liability on property was significantly greater than the fair market value of the property. Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976). The court reasoned that depreciation is based on investment in property and interest is based on the use or forbearance of money. *See id.* Neither condition existed under the circumstances. *See id.*

stance to the transaction other than the tax benefits.[255] For example, in *Reed* there was no purpose other than tax deferral and thus the arrangement bordered on a sham transaction. At a minimum, *Reed* demonstrates the absurd results of escrow arrangements that have no purpose other than tax results.

In *Childs*, the primary if not the only purpose of the deferral arrangement was to establish a private pension plan for the attorneys.[256] The tax deferral had significant and substantial economic consequences. The tax benefits were: 1) the exclusion of the initial value of the structured settlement and 2) the deferral of taxation on the interest build-up over the years on the annuity. The taxpayers/attorneys established a pre-tax pension contribution without complying with the provisions governing such investments (e.g. U.S.C. § 401(k)).

2. Step Transactions

The form chosen by the taxpayer for a transaction will generally govern the transaction. However, when the deferral is over an extended period of time, the transaction in reality constitutes two transactions. First, the immediate performance by the taxpayer for a fee, and second, an investment decision by the taxpayer to take an extended payment.

In *Childs*, not only was the primary obligor changed from the tort victim to an insurance company, but the beneficiary of the obligation was changed from the law firm to the individual members of the firm. The attorneys undoubtedly recognized that the Garrett and Jones settlement involved a sophisticated tax and investment decision under I.R.C. § 104(a)(2)[257] and so advised their clients. Indeed a guardian was appointed for the minor Garrett and in making the settlement decision the guardian was charged with a high standard of care applicable to trustees.[258] To fulfill such duty, the guardian analyzed the settlement offer and deter-

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255 In *Zeltzerman v. Commissioner*, 34 T.C. 73, 84, *aff'd per curiam*, 283 F.2d 514 (1st Cir. 1960), the taxpayer sought deferral of income through an arrangement whereby the hospital at which he performed services purchased annuities in lieu of paying current compensation. Because the taxpayer had the option to receive either the annuity certificates or cash, the arrangement lacked economic substance. Similarly, *Goldsmith v. United States*, 586 F.2d 810, 817 (Ct. Cl. 1978) found it bordered on a sham.

256 The court's suggestion that such a structured result was demanded by the clients and Primary Insurer has already been shown to be contrived.

257 *See* I.R.C. § 104(a)(2) (1986); Frolik, *supra* note 83, at 573-74, 581-82.

258 Historically, the trustee was required to invest in conservative investments. With the recent revisions of the trustee standard by the adoption of the new prudent inves-

mined that it met the required standard of care.[259]

The attorneys made a similar two-step decision. First, they sought counsel from the State Bar of Georgia to help them calculate their fees from Garrett and used present-value analysis to determine the fee. Second, all three attorneys made individual investment decisions that left nothing to do but wait for the checks to arrive. Clearly, if the attorneys agreed to payment of their fees over an extended period, they undoubtedly would have considered the investment quality of the obligation and concluded that the payments were generally secure with a lifetime payout.

An insurance annuity is merely a conservative investment. Presumably the tax result in Childs would have been the same if the settlement agreement provided that the periodic payments be determined by the return on a speculative mutual fund maintained by the Primary Insurer. The fair market value of the Primary Insurer's obligation to the attorneys should be included in the taxpayer's income because this situation can be equated with one in which the taxpayer first obtained cash and then invested the amount in the particular investment.[260] Where the taxpayer accepts a deferred payment obligation for currently completed services and assets are set aside, the taxpayer has made a long-term investment decision and the step-transaction approach should recognize that the taxpayer has received an economic or financial benefit that should be currently reported.

3. Guarantees

Having a transaction guaranteed by a third party generally does not constitute security that will cause the obligor's promise to be included in income. The principle should not apply where the obligor's assets are in any way segregated to support the guarantee. Further, when the obligor is a highly solvent organization or a regulated financial institution unrelated to the transaction, the

tor rule, trustees are required to follow current investment principles such as the efficient market hypothesis elimination of unsystematic risk.

259 From the standpoint of investments, a regulated insurance company would be considered a conservative investment; perhaps it would be the equivalent of cash in economic terms. The important point is that the client's decision is really two decisions. First the decision to settle the tort case and second, the decision to invest the proceeds over an extended period.

260 *See* GERTZMAN, *supra* note 20, at 3-17. Gertzman notes that if the instrument could not be converted, inclusion would "impose unnecessary complexity and undue hardship on the taxpayer or would be inconsistent with the use of the cash method." *Id.*

amount so guaranteed should be included in the taxpayer's income.

Where the obligation to the taxpayer is guaranteed by a third party, courts have held that such guarantees do not transform an unfunded or unsecured obligation into a funded or secured obligation.[261] Such a rule relieves the court of the obligation to evaluate the economic realities of the guarantee.[262] However, the rule should not apply when, as in *Childs*, the guarantor is substituted for the obligor.

Likewise, when the deferral is over a long term, additional limitations are necessary. While short-term obligations by solvent taxpayers (e.g., General Motors Corporation) are in reality often equivalent to cash, they are not included in income to protect the simplicity of the cash method of accounting. When the obligation is long-term and the guarantor is solvent, however, tax law must address the economic reality of the situation. Because the risk of non-payment is eliminated by the third-party guarantees, the underlying policy of the economic benefit doctrine should include the guaranteed amount in income. When long-term guarantees are economically equivalent to the setting aside of assets and the taxpayer's interest is no longer subject to the obligor's creditors,[263] the value of the obligation should be currently included in the taxpayer's income, unless some non-tax purpose is shown.

It may be noted that tax deferral is often the sole purpose of many commonly recognized transactions such as deferred compensation plans.[264] Further, the Commissioner has agreed with the proposition that guarantees, even by third parties unrelated to the

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261 *See* Berry v. United States, 593 F. Supp. 80 (N.D.N.C. 1984); *see also* Robinson v. Commissioner, 420 T.C. 20, 37 (1965), acq. 1970-2 C.B. xxi (indicating that a guarantee by the obligor's parent did not constitute funding). *But see* Priv. Ltr. Rul. 84-06-012 (Nov. 3, 1983) where the Internal Revenue Service ruled that:

> under the economic benefit doctrine as it applies to surety arrangement, the current value of the protection provided . . . constitutes an economic benefit the cost of which is taxable to an employee if paid by the employer, and thus held the employee taxable on the premiums paid the surety, but not the amount secured.

262 *See* Temp. Reg. § 15A.453-1(b)(3) (explaining that the term payment does not include evidences of indebtedness regardless of whether it is guaranteed by a third party (including a government agency)).

263 Bittker and Lokken, recognizing the benefits of simplicity in short-term obligations, state: "At the very least, cash basis employees with ordinary unsecured claims against their employers for services rendered should not be taxed until the claim is paid, even if it is an assignable chose in action and is virtually certain to be paid in due course." BITTKER & LOKKEN, *supra* note 21, at 105-50.

264 *See* Scott, *supra* note 6, at 13.

transaction, do not constitute funding.[265] These practices do not undermine the proposal because the overriding principle is that the economic benefit doctrine only includes amounts in income when assets are set aside and are no longer subject to the obligor's creditors. The long-term guarantee merely becomes the equivalent of assets set aside. *Childs*, citing *Minor*, recognized this principle and stated:

> only at the time when the beneficiary obtains nonforfeitable economic or financial benefits in the trust or insurance policy is the provision for future payments secured or funded. However, if the trust or policy is subject to the rights of general creditors of the obligor, funding has not occurred.[266]

4. Method of Accounting

Taxpayers are generally allowed to use their normal method of accounting for tax purposes. I.R.C. § 446(b) sets out limits, however, on the use of any method of accounting by giving the Secretary the authority to challenge the method on the grounds that it does not clearly reflect income. Under the clear reflection of income doctrine, use of the cash method, which is often considered "less accurate than accrual accounting,"[267] is subject to the Commissioner's right to require a different method.[268] The application of the clear reflection of income doctrine to the deduction side of cash-method taxpayers is well-established.

In *Sandor v. Commissioner*,[269] the Commissioner disallowed a current interest deduction for five years of prepaid interest for a cash-method taxpayer.[270] The Commissioner argued that the taxpayer's accounting did not "clearly reflect income." The Tax Court had found that "the only reason the interest for the full five-year period was prepaid in 1968 was to give the taxpayer the benefit of a large deduction for interest in a year in which his income was quite

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265 *See id.*

266 *See* Childs v. Commissioner, 106 T.C. 634, 651 (1994), *aff'd per curiam*, 89 F.3d 356 (11th Cir. 1996) (citing Minor v. United States, 772 F.2d 1472 (9th Cir. 1985)).

267 *See* BITTKER & LOKKEN, *supra* note 21, at 105-47.

268 I.R.C. § 446(b) states: "If no method of accounting has been regularly used by the taxpayer or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." I.R.C. § 446 (b) (1986). *See* BITTKER & LOKKEN, *supra* note 21, at 105-47 to -48.

269 536 F.2d 874 (9th Cir. 1976).

270 *See id.* at 875. The taxpayer relied on I.R.C. § 163, which provides in part: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

high."[271] The court stated, "[w]hile we recognize that a taxpayer may decrease his taxes by means which the law permits . . . we believe this right is subject to the right of the Commissioner under [S]ection 446 to change the taxpayer's method of accounting with respect to a material item in order to clearly reflect income."[272] The Court of Appeals for the Ninth Circuit affirmed, concluding that a deduction of the prepayment would materially distort income for 1968.

An exception to *Sandor*, known as the "one-year rule," allows a taxpayer to deduct prepaid expenses where the period covered by the prepayment is less than one year from the time of payment.[273] A similar exception could be developed on the income side where the deferral results in the ordinary course of the taxpayer's business.[274]

In *Childs* a clear distortion occurs on the income side. The law firm undoubtedly deducted all general office expenses incurred in operating the law office in the year, including the expenses of effectuating the Garrett and Jones settlements against income received during the year. Nevertheless, much of the income generated during that year from the Garrett and Jones tort litigation was deferred over an extended period.

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[271] Sandor v. Commissioner, 62 T.C. 469, 474 (1974), *aff'd*, 536 F.2d 874, 875 (9th Cir. 1976).

[272] *Id.* at 481.

[273] Applying Treas. Reg. 1.461-1(a)(1) to prepaid rent, *Zaninovich* held that a taxpayer who paid rent on December 20, 1973, for the period from December 1, 1973 through November 30, 1974 was entitled to deduct the entire rental payment on his 1973 tax return. *See* Zaninovich v. Commissioner, 616 F.2d 429, 433 (9th Cir. 1980). The "one-year rule" distinguishes between currently deductible expenses and capital expenditures having a useful life "substantially beyond" the close of the taxable year. *See id.* at 432.

Compare *Sandor* with *Commissioner v. Van Raden*, in which the Commissioner determined that a deduction of prepaid cattle feed expense constituted a material distortion of income. *See* Commissioner v. Van Raden, 650 F.2d 1046, 1050 (9th Cir. 1981). The Van Radens invested in a limited partnership engaged in cattle feeding December, 1972. *See id.* at 1047. The partnership purchased a one-year supply of feed, none of which was consumed in 1972, and claimed a deduction for the purchase on its 1972 return resulting in a net operating loss. *See id.* The Commissioner argued that a 1972 deduction for feed consumed in 1973 and 1974 constituted a substantial distortion of income. *See id.* The Tax Court used a similar analysis as *Sandor*, but used the "one-year rule" to hold that the deduction did not result in a distortion of income. *See id.* at 1050.

[274] Under Rev. Rul. 82-208, 1982-2 C.B. 58, the Commissioner allowed a deduction to cash basis taxpayers for prepaid state income taxes provided the amounts are reasonably determined in good faith. *See also* Rev. Proc. 71-21, 1971-2 C.B. 549 (allowing accrual basis taxpayers to defer prepaid income for services to be performed in the succeeding year until the next tax year).

Long-term deferrals distort income, and thus should not be permitted as deferral devices.[275] The argument that such a rule would blur the difference between cash and accrual methods is not persuasive. Earlier in this article, it was demonstrated that the difference is already blurred for income and expenses in accrual-method accounting and for deductions in cash-method accounting.[276] Further, the reason for applying the cash method (i.e. simplicity) is lost when the cash-method taxpayer enters complex transactions that meticulously defer specific amounts over the taxpayer's lifetime. Ignoring such clear distortion of income solely to maintain cash-method simplicity pushes the cash method of accounting beyond its natural limits.[277]

5. Time-Value-of-Money Principles

Time-value-of-money principles have generally not been applied to income recognition by cash-basis taxpayers. In *Ford Motor*

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[275] In *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 409-10 (5th Cir. 1969), the court specifically noted the time between the receipt of payment for an aircraft and the bond issued at the time of sale. The *Mooney* court stated:

> In virtually all . . . cases . . . there was still some relationship between those funds and related expenses which, more or less proximately, had to be borne. If there were no actual strings there were at least invisible strings attached to the money. Taxpayers could not use the money without at least an eye to the upcoming expenses or services to be performed . . . . For all practical purposes the revenue . . . is his to use as he pleases . . . . In what sense, then, is it an accurate reflection of income to regard it as an expense of doing business in the current year? To so regard it is to let an accounting fiction obscure the business and fiscal realities that are the heart of this case.

Id.

[276] *See supra* note 26 and accompanying text.

[277] According to Gertzman, if the existence of an ascertainable fair market value were the test for inclusion under the cash method, the distinction between cash and accrual methods of accounting would be virtually eliminated. Such a result would cause cash-flow problems; burden the record-keeping capacity of individuals; eliminate the simplicity of the cash method; and lose the certainty of knowing when the item is reported. Gertzman posits that intangible property "whose receipt is to be excluded is that property whose character is such that it should not be deemed the 'equivalent of cash' and whose recognition should therefore be delayed until cash or an equivalent of cash is . . . received." GERTZMAN, *supra* note 20, at 3-14 to -15.

Under I.R.C. § 1001, gain is determined by the difference between the amount realized and the taxpayer's basis in the property. The amount realized is the sum of money realized plus the fair market value of any property received. For this purpose, fair market value is the readily realizable market value. Therefore, the time for recognition is dependent on whether market value can be determined, not on the character or form of income received. *See* GERTZMAN, *supra* note 20, at 3-14. For a discussion of this legislative development, see Report of Committee on Sales, Exchanges and Basis, 31 TAX LAW 1481 (1978).

Co. v. Commissioner,[278] the Tax Court found that the taxpayer's deduction of the full value of future liabilities did not clearly reflect income and instead applied time-value-of-money principles and limited the deduction to the discounted present value of the future liability.

Generally, courts have not generally applied time-value-of-money principles to determine the amount of income to include or the amount of a deduction to allow for either cash- or accrual-method taxpayers. Under the accrual method of tax accounting, the timing of deductions is dependent on the "all-events" test, supplemented by the economic performance requirement. When a deduction is allowed, however, the full amount of the liability is deducted without discount. The continued validity of this rule became questionable when the Tax Court decided *Ford Motor Co.*[279]

In *Ford Motor Co.*, for the first time, the Tax Court denied a deduction for the full amount of a future obligation, but allowed a current deduction for what was the practical equivalent of the discounted present value of such future obligation. The result rested on the Commissioner's authority, under I.R.C. § 446(b), to designate an accounting method that "clearly reflects income."

In 1980, Ford reached settlements in a number of personal injury and wrongful death claims that required Ford to pay the claimants fixed amounts periodically for up to fifty-eight years. In total, Ford agreed to pay approximately $24.5 million to the claimants.[280] Ford then purchased annuities to cover the payments at a premium cost of $4.5 million. Ford maintained ownership of the annuities and continued to be liable to the claimants for the full amount of the payments.[281] Claiming the requirements of the "all-events" test had been met, Ford sought to deduct the entire $24.5 million obligation in the year of settlement.[282]

The Commissioner challenged the deduction, arguing that Ford's accrual method of accounting did not clearly reflect income[283] and limited Ford to a deduction equal to the cost of the annuities (i.e. $4.5 million). Finding that the Commissioner had not abused his discretion under I.R.C. § 446(b),[284] the Tax Court

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278 102 T.C. 87 (1994), *aff'd*, 71 F.3d 209 (6th Cir. 1995).

279 *See id.* For an in-depth analysis of the opinion in *Ford Motor Co. v. Commissioner*, see Gordon Butler, *supra* note 26.

280 *See Ford Motor Co.*, 102 T.C. at 89.

281 *See id.*

282 *See id.* at 90.

283 *See* I.R.C. § 446(b) (1988).

284 *See Ford Motor Co.*, 102 T.C. at 91. As noted by Raby:

held that the Commissioner's determination was supported by the facts.[285] The Sixth Circuit affirmed, stating that Ford's result would extend "the accrual method of accounting beyond its inherent limitations."[286]

By limiting *Ford Motor Co's.* deduction to the cost of the annuity that represented the discounted present value of the payments to be made to the tort claimants, the court accepted the method used by *Ford Motor Co.* to calculate the expense under financial accounting standards.[287] Affirming this remedy the Sixth Circuit stated:

> While we recognize that to require Ford to account for its tort obligations on the cash method might have been a more logical alternative, we cannot find that the Commissioner's exercise of her discretion was arbitrary because it resulted in an accounting treatment more favorable to Ford than a straight cash method

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> The IRS determination is not merely presumptively correct; rather, it will only be set aside if it is an abuse of discretion. But what is the standard to be used in deciding whether the IRS has abused its discretion in holding that a method does not clearly reflect income. Ah, there's the rub. If Congress had known what clearly reflected income, it probably would have said so.

William L. Raby, *Tax Practice and Accounting News: Raby says that Tax Court's Decision in Ford May Destabilize Tax Accounting*, 62 TAX NOTES 1169, 1169 (1994). *See* Lucas v. American Code, 280 U.S. 445, 449 (1930).

285 *See Ford Motor Co*, 102 T.C. at 96. The *Hallmark* court stated:

> Respondent's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis.

Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 31 (1988). *Hallmark* was distinguished in *Ford Motor Co.* on the basis that the statement should not be interpreted broadly because the *Hallmark* court only addressed the question of whether the all events test had been met for the accrual of income by the taxpayer that had not been met.

286 71 F.3d at 215.

287 The Court essentially adopted the Generally Accepted Accounting Principles (GAAP) treatment used by Ford for financial accounting purposes. In the past, tax law followed GAAP more closely than it does today. On the relationship between tax accounting rules (i.e. that accounting clearly reflect income) and GAAP, the classic statement is found in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), which states:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc [sic].

Id. at 542-43 (citations omitted).

would be.[288]

Ford Motor Co. demonstrates that deferrals over significant periods may distort income and press an accounting method beyond its "inherent limits." The appropriate remedy seems to apply the time-value-of-money principles. These principles should be applied to *Childs* and the discounted present value of the payments to be received by the attorneys should be reported in the year of settlement.

6. Tax Symmetry

To prevent abuse of tax deferral devices, tax law often defers deductions by one party to a transaction until income is recognized by the other party. The attorneys in *Childs* wanted to establish a pension-like benefit in which the contribution was immediately deductible (or not included in income) and the investment appreciation was not taxed until distribution. When dealing with nonqualified pension plans and I.R.C. § 83 transfers, the transferor is denied a deduction until the funds are included in the income of the recipient taxpayer.[289] This balance[290] is self-policing because the tax loss caused by virtue of not taxing the recipient currently is offset by denying a current deduction. Such symmetry enters the negotiation process because one party wants to defer income while the other desires a current deduction.

No such rules limit the use of the cash method of tax account-

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288 71 F.3d at 217.

289 *See* I.R.C. § 83 (h) (1986) providing: "In the case of a transfer of property to which this section applies . . . there shall be allowed as a deduction under section 162, to the person for whom were performed services . . . an amount equal to the amount included . . . in gross income of the person who performed such services. . . ." Moreover, McDaniel, *supra* note 56, at 980, notes that Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, accepts the principle that there is no constructive receipt when an employee receives unfunded, nonforfeitable rights to deferred compensation even though the employer would have been willing to pay cash immediately and the deferral arrangement had no independent business purpose beyond the deferral of the payments.

Unfunded, deferred-compensation plans are governed by the constructive receipt doctrine. *See* Rev. Proc. 92-65, 1992-2 C.B. 428 (describing the conditions when the IRS will issue advance rulings regarding the application of the constructive receipt doctrine to unfunded deferred compensation plans). Funded, nonqualified plans (unfunded plans are nonqualified), historically governed by the economic benefit doctrine, are covered by I.R.C. § 402(b)(1), which provides that payments to employee trusts are covered by I.R.C. § 83, thereby achieving substantially the same results as under the economic benefit doctrine. See Scott, *supra* note 6, at 2-3 for a general discussion of the tax attributes of non-qualified plans.

290 *See, e.g.*, I.R.C. § 267 (as amended in 1988) (delaying deductions between related parties); I.R.C. §§ 1274, 163(e) (1986) (providing income recognition and deduction of interest on debt instruments having original issue discount).

ing and where they do, the effect is erratic.[291] I.R.C. § 404(a), which imposes an income/deduction balance on non-qualified deferred payment plans,[292] applies to employer contributions that amount to a plan,[293] including payments to independent contractors.[294] Such a balance does not apply to personal injury settlements because under I.R.C. § 104(a)(2) tort plaintiffs do not include the recovery in income, and thus are not concerned about the deduction for attorneys' fees.[295]

In some cases, however, tort plaintiffs could experience some unexpected and diverse tax results from long-term deferrals. In the case of non-physical injuries, the portion of the recovery for punitive damages is not excludable to the plaintiff.[296] For example, if a taxpayer/plaintiff obtains a $1 million settlement representing $100,000 (10% of $1 million) in compensatory damages and $900,000 (90% of $1 million) in punitive damages, the $900,000 is taxable. If, of the $1 million received by the taxpayer, he pays his attorney a fee of $400,000 (40% of $1 million), what are the tax consequences? The taxpayer includes $900,000 in income and under I.R.C. § 212 the taxpayer would take a deduction of

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291 *See* GRAETZ & SCHENK, *supra* note 31, at 813.

292 *See* I.R.C. § 404(d)(1) (1986). Rev. Rul. 88-68, 1988-2 C.B. 117, held that a service recipient who agrees to pay an independent contractor a fee for certain services performed by the independent contractor over a four-year period could only deduct the fees as the independent contractor included them in income. The ruling held that

> [service recipient's] agreement with [the independent contractor] is a method or arrangement of compensation that has the effect of a plan deferring the receipt of compensation, because under the agreement [the independent contractor] is to receive some of the compensation more than a brief period of time after the end of [service provider's] taxable year in which the services creating the right to the compensation were performed.

Id.

293 *See* I.R.C. § 404(a)(5) (as amended in 1987), which provides:

> If contributions are paid by an employer to or under . . . a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year: . . .
>
> (5) [I]f the plan is not [a qualified plan], in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan . . . .

294 *See* I.R.C. § 404(d) (1986).

295 *See* I.R.C. § 265 (1986).

296 I.R.C. § 104(a)(2) (1996) was amended in 1996 to limit the exclusion to physical personal injuries and deny the exclusion for any punitive damages. *See* The Small Business Job Protection Act, P.L. 104-188 § 1605.

$360,000 (90% of $400,000) representing the expenses of producing "taxable" income. The deduction is below the line[297] and subject to the 2% floor for miscellaneous deductions,[298] phaseouts on itemized deductions and personal exemptions,[299] and the limitation of the standard deduction. [300] The result is an itemized deduction for attorney fees of approximately $318,000[301] and phaseout of the personal exemption.

Modifying the example, assume the attorneys take their fee up front and the taxpayer accepts a twenty year structured settlement beginning the following year. In the year of settlement the taxpayer receives $400,000, which he pays his attorneys. Of this $400,000, the taxpayer includes $360,000 in income representing the punitive damage portion. The taxpayer would take a $360,000 deduction subject to the below-the-line limitations unless he is forced to capitalize the deduction and amortize it over twenty years in proportion to the recovery.[302] In the latter case, the taxpayer could, subject to limitations, deduct $144,000 (40% of $360,000) in the year of settlement and $21,600 (1/20th of 60% of $360,000) in each of the twenty years. In the year of settlement, the taxpayer would have taxable income of $229,000 and a tax of $72,212[303] without any apparent means of paying the tax currently.

Finally, if the taxpayer accepts a $600,000 lump sum settlement and the attorney defers his $400,000 fee for twenty-five years until his sixty-fifth birthday, the taxpayer would have gross income of $540,000 (90% of $600,000) in the year of settlement but no deduction for attorneys' fees. Investing the attorneys' fees at 8%, the insurance company would pay the attorney approximately $2.7 million in twenty-five years. The taxpayer/plaintiff would include $2.43 million (90%) in his income and take an itemized deduction

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297 *See* I.R.C. § 62 (1993).

298 *See* I.R.C. § 67 (1993).

299 *See* I.R.C. §§ 68, 151(d)(3) (1993).

300 *See* I.R.C. § 63 (1993).

301 The $360,000 deduction is reduced by $18,000 (2% of Adjusted Gross Income (AGI) of $900,000 under I.R.C. § 67) by $24,000 (3% of AGI less threshold of $100,000 for phaseout of itemized deduction under I.R.C. § 68).

302 *See* INDOPCO v. Commissioner, 503 U.S. 79, 90 (1992) (holding that investment banking, legal, and other costs incurred in connection with the acquisition of another company were not deductible currently under I.R.C. § 162 and must be capitalized because the expenditures resulted in future benefits).

303 Gross income (and adjusted gross income) of $360,000 with an itemized deduction of $144,000 less $7200 (2% of $360,000 under I.R.C. § 67) and less $7800 (3% of $360,000 less $100,000 under I.R.C. § 68) and loss of the personal exemption (I.R.C. § 151). The taxpayer's taxable income would be $231,000. Under 1995 rates, the tax on this amount would be $72,212. Inflation adjustment on phaseouts is ignored.

under I.R.C. § 212 of approximately $2.31 million. The result would be taxable income of $119,000 to the taxpayer that he may not want to recognize.[304]

The issues raised by the foregoing hypothetical would not affect Garrett or Jones in *Childs* because the entire settlement amount was excluded under I.R.C. § 104(a)(2). The example does demonstrate the problem of allowing extended deferral arrangements under the cash method of tax accounting. Applying the economic benefit doctrine would force the parties to address the attorneys' tax issue as part of the structured settlement negotiations.[305] It would recognize that taxation of the attorneys' fees is appropriate upon the completion of services.

7. Illiquidity of Taxpayer

In determining the appropriate time to tax a transaction, the availability of funds to pay the tax is often a consideration. Such consideration is only applicable to transactions through specific Code sections. In numerous situations the unavailability of funds makes current taxation of income inappropriate. The whole gamut of non-recognition rules provide a background for when taxability is not administratively desirable. Such situations generally reflect important policy reasons and not that current taxation of such transactions is prohibited. For example, income from abandoned leasehold improvements could be taxed currently even though the taxpayer does not have funds available to discharge the tax. Congress enacted I.R.C. §§ 109 and 1019, however, to defer income recognition on the value of abandoned leasehold improvements until the underlying assets are sold.[306]

Deferral is a tax-policy consideration. There is no reason attorneys handling personal injury settlements should be allowed extended deferrals of income. The motivating force behind structured settlements in the tort area is the exclusion of personal injury recoveries from gross income under I.R.C. § 104(a)(2). Congress has seen fit to make this exclusion broadly available, but has not extended its benefit to the attorneys assisting in the structuring of settlements. Moreover, exclusions should be narrowly ap-

304 Gross income (and adjusted gross income of $2.43 million) with an itemized deduction of $2.43 million less $48, 600 (2% of $2.43 million under I.R.C. § 68) and less $69,900 (3% of 2.43 million less $100,000 under I.R.C. § 68) and loss of personal exemption (I.R.C. § 151). The taxpayer's taxable income would be $119,000.

305 By virtue of I.R.C. § 104(a)(2), tax consequences should be a topic of discussion in any tort claim involving personal injury. *See* Frolik, *supra* note 83, at 582.

306 *See* I.R.C. §§ 453, 1031, 1033, 1034 (1986).

plied. Therefore, even if the amount and timing of the attorney's fees were determined solely by amounts to be received by the tort plaintiff, the attorneys should be taxed currently, particularly if their interest is set apart from that of the tort plaintiff. The settlement reflects the realities of I.R.C. § 104(a)(2), and should also take into account the realities of cash-method accounting and the recognition of current income. If attorneys or other cash-method taxpayers desire further methods of long-term deferral, it should be accomplished through legislation and not the courts.

III. Conclusion

This article has explored the three doctrines used to restrain abuse of the cash method of accounting for income. It has shown how two traditional doctrines, constructive receipt and cash equivalence, are relatively well-defined when confined to their natural limits. Because they are relatively narrow and technical, however, they cannot apply to certain areas. When courts attempt to expand these doctrines beyond their natural limits to prevent abuses, considerable confusion results and it becomes unclear which doctrine is being applied. This article has shown that the economic benefit doctrine is often ignored as a separate and distinct doctrine with the result that unwarranted deferral is frequently obtained, as demonstrated in *Reed* and *Childs*.

To prevent abuse and confusion, this article has advocated the recognition of the economic benefit doctrine as a separate doctrine. As set forth in Example 4 of Revenue Rule 60-31,[307] the salient features of the doctrine are that the rights to payment must be nonforfeitable and that something of value must be set aside to fund or secure the nonforfeitable rights. In determining whether something of value is set aside, the question focuses on whether the assets that will be used to pay the obligation are fully subject to the creditors of the obligor. Further, agreements to defer between the taxpayer and the obligor are irrelevant if the conditions of the economic benefit doctrine are satisfied.

The recent case of *Childs* involved taxpayers who took extreme liberty in structuring the receipt of fees in personal injury litigation. The economic benefit doctrine, rightly defined, forces the attorneys to recognize their fees in income at the time the personal injury claim is settled and the fees are earned. The amount of the income should be based on the present value of the future pay-

307 *See supra* note 83 and accompanying text.

ments. Any amount received in future years by the taxpayer in excess of the amount included in income should be considered the result of the taxpayer's individual investment decision.

Support for this approach has been found in the case of *Ford Motor Co.* which for the first time applied time-value-of-money principles to situations in which the Commissioner argued that the taxpayer's accounting method did not clearly reflect income. By pursuing the analysis suggested herein, some of the pitfalls of the three doctrines applicable to receipt of income by cash-method taxpayers will be eliminated.

Finally, this article has demonstrated that applying the economic benefit doctrine as a separate doctrine is consistent with the economic reality of the situation. Such approach accurately reflects the motivation of the parties and is consistent with longstanding tax rules such as the step-transaction doctrine, the use of guarantees, taxpayer freedom in determining accounting method, principles of tax symmetry, and consideration of taxpayer illiquidity.

IV. APPENDIX

Exhibit A

Attorney and Payment Schedule	Attorney Fees Under the Garrett Release Agreement[308]	Present Value at 6% (Jan. 1, 1987)
Mr. Philips:		
1987 (Jan)	52,155	52,155
1988 (Jan)	52,155	49,201
Mr. Childs:		
1987-1996	1,324/ mo.	119,257
1996-1999 (Aug)	6,000/ yr.	11,609
Mr. Swearingen:		
1987-1992 (Jan)	11,734/ yr.	37,694
1992-1993-1994 (Aug)	10,000/ yr.	19,974
1995 (Aug)	20,000	11,168
1996-1997 (Aug)	10,000/ yr.	10,237
1998 (Aug)	22,000	10,933
1999-2000-2001 (Aug)	12,000/ yr.	14,101
Present value of attorneys' fees:		336,329

308 The payments to be made to Attorneys Childs, Phillips, and Swearingen under the Garrett Settlement are described in *Childs v. Commissioner*, 103 T.C. 634, 642 (1994), *aff'd per curiam*, 89 F.3d 356 (11th Cir. 1996).

Exhibit B

Attorney and payment schedule	Attorneys' fees under the Jones Release Agreement[309]	Present Value at 6% (Jan. 1, 1988)
Mr. Philips (b. 1949):		
(life expect: 43.5 yrs)		
1992-life (Jan)	$1,000/mo.*	$132,233
*(3% compounded annually)		
Mr. Childs (b. 1946):		
(life expect: 40.26 yrs)		
1988 (Jan)	49,000	48,877
1988 (Apr)	49,050	48,315
Mr. Swearingen (b. 1943)		
(life expect: 37.7 yrs)		
1988-92	1,000/mo.	51,725
1997-2001	1,200/mo.	34,624
2002-06	1,400/mo.	30,216
2007-11	1,600/mo.	25,805
2112-life	1,800/mo.	46,934
Present value of attorneys' fees:		418,729[310]

309 For a description of the payments to be made to Attorneys Childs, Phillips, and Swearingen under the Jones Settlement, see *Childs*, 103 T.C. at 645-46.

310 The case suggests that the insurance carrier paid a total of $536,069 for the "Jones annuities." It is unclear whether this amount represents payment solely for the annuities for the attorneys or includes the cost of the annuity for Mrs. Jones. *See id.* at 647.