Taxation Without Realization: A “Revolutionary” Approach to Ownership

NOËL B. CUNNINGHAM
DEBORAH H. SCHENK*

I. INTRODUCTION

An investigation into the concept of ownership in the Code quickly leads to two conclusions: The use of ownership to determine tax consequences is pervasive and the concept is at the core of a tremendous amount of litigation that has led to inconsistent and sometimes arbitrary results.

Under current law, the ownership of property raises several fundamental tax issues in a wide variety of specific contexts. There are four primary issues: (1) Usually the owner is taxed on the income produced by the property regardless of possession or enjoyment of the income interest. (2) The owner of property is entitled to account for the cost of acquisition through depreciation or amortization deductions. (3) Several tax incentives or benefits (notably, accelerated depreciation and formerly, the investment tax credit) are available only to the property’s owner. (4) A sale or disposition (that is, a transfer of ownership) triggers realization of gain or loss.

While Congress has determined that significant consequences flow from “ownership,” it has not defined the term. The Code and the regulations are silent as to its meaning; rather it has been left to the Service and the courts to define it in rulings and cases. Unfortunately, development of the concept of ownership has been characterized by unsophisticated analysis and a lack of uniformity.1

* The authors are Professors of Law at New York University School of Law. We would like to thank Brookes Billman, Glen Kohl, Lewis Kornhauser, Leo Schmolka and the participants at the Harvard Law School seminar on current research in taxation for their helpful comments. We profited from the research assistance of Michad Bumbaca, LL.M. 1988 New York University School of Law and conversations with Joseph Tsai, J.D. 1991 Yale Law School. We would also like to acknowledge with gratitude the support of the New York University Law Center Foundation and the Filomen D’Agostino and Max E. Greenberg Research Fund.

1 Initially, it appears that both Congress and the courts have agreed to ignore title and to attempt to isolate the true economic substance of ownership. In Corliss v. Bowers, 281 U.S. 376, 378 (1930), the Supreme Court observed that “taxation is not so much concerned with refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.” Although generally the owner is the taxpayer with the benefits and
In many circumstances, the tax law has insisted that there is a single "owner" of "the property" at any given time. Furthermore, the taxpayer designated as owner by the parties to a transaction may have only a small residual interest in the property and be an insignificant player in the transaction. This short-sighted approach is not used in other areas, where there is a recognition that there can be multiple owners of an asset, each having specific rights.

The pervasiveness of the concept of ownership, coupled with the current unsatisfactory state of analysis, leads us to propose alternatives. Although we would prefer a simple, administrable test, we agree with others who have noted that ownership questions are not likely to give rise to a simple solution. Once we rejected the possibility that there is a theoretically correct owner for a specific circumstance, we quickly concluded that the tax law is asking the wrong question. It is more appropriate to ask who owns what interests in the property rather than inquiring who is the owner. Whenever the issue of ownership arises, there is invariably more than one person with identifiable economic interests and rights in the property. It follows that an attempt to identify a single owner, from which tax consequences flow, is bound to be flawed.

Our exploration of the concept of ownership and our determination that the tax law should recognize various interests in property led us to conclude that the rules with respect to the concept of realization are needlessly flawed. Under current law, the owner of property generally reports no gain or loss until he sells or otherwise disposes of the property. Although this rule of administrative convenience may be necessary for many types of ownership interests, we find it impossible to justify when an asset predictably produces economic income without taxable income. For example, by its very nature, the value of a future interest in property increases solely due to the passage of time. Under current law, no portion of this appreciation is taxed until the interest in the property is sold. This treatment is inconsistent with the notion of taxing "income."

---

2 For a typical example of the courts' reluctance to do anything other than establish one owner of the property, see Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836, 844-45 (1972), aff'd, 500 F.2d 1222 (9th Cir. 1974) (lease vs. conditional sales contract).

3 For example, for property law purposes, the possessor of a life estate, the holder of a future interest and a tenant are all deemed "owners" in the sense of having certain legal rights.

4 See Walter C. Cliff & Philip J. Levine, Reflections on Ownership—Sales and Pledges of Installment Obligations, 39 Tax Law. 37, 42 (1985) ("Ownership issues ... are devoid of simple solutions"); Peter L. Faber, Determining the Owner of an Asset for Tax Purposes, 61 Taxes 795, 812 (1983) ("The search for precise solutions in an imprecise world will always be frustrating, but the effort should be made as long as the limitations of any approach are recognized.").
Therefore, we propose to modify the concept of realization to permit the taxation of such gains as they predictably accrue.

This article reconceptualizes ownership. It develops two interrelated proposals designed to eliminate many issues relating to ownership and realization:

1. In some, or in possibly all circumstances, ownership would be determined on the basis of a person's financial interest or investment in property. Wherever more than one person has a financial interest in property, each would be considered the owner of that interest.

2. Where the taxpayer acquires a commercial investment that predictably will yield low, or no current taxable income, a minimum rate of return would be imposed. The effect would be to narrow the scope of the realization requirement so that all income due solely to the passage of time would be taxed as it accrues.

The article begins by analyzing current law which is generally not satisfactory as to the question of who owns property. There is one major exception: § 1286 which prescribes the treatment of bonds with coupons attached. Where applicable, this provision treats a bond and each of its coupons as separate pieces of property; as a consequence, there can be numerous owners of a bond with coupons, each subject to tax. This approach is analytically superior to the unsophisticated analyses applied to other types of property and we propose to extend it.

In Section III we defend our proposals, including a temporal allocation of basis and the corollary imputation of a rate of return. We address the four significant issues critics are likely to raise. Those criticisms are that the proposals: (1) contravene the widely accepted realization requirement, (2) result in an erroneous measurement of income, (3) unfairly treat certain taxpayers and (4) add unacceptable complexity. While these issues are serious, we conclude that none raises insurmountable problems.

In Section IV we explore how the analysis could be used to alter the taxation of split interests in property. We first consider the utility of the analysis with regard to nondepreciable property. We then briefly examine whether the analysis is applicable where multiple interests are created in a single piece of depreciable property and determine that it is. We also conclude, however, that the utilization of tax incentives is only nominally dependent on ownership and that determining ownership for that

---

5 We use the term "financial interest" or "investment" to mean any interest in the benefits (income/gain) or burdens (deductions/losses) commonly associated with ownership.
purpose is a false issue. In Section V we apply the analysis to options (including the option element in nonrecourse financing), a more sophisticated example of a split interest with a time value element.

Although our analysis has its most direct application to split interests in property, it has significant implications when all of the interests in a piece of property are held by a single owner. If income were imputed to the holder of a future interest in an asset, it is difficult not to impute income to a single owner, who holds both the present and the future interest in a piece of property. Thus, in Section VI, we explore the extension of the analysis to a single owner of property.

Although we have described what we see as a systemic problem and have suggested a possible remedy, we do not recommend adopting our proposals for all interests in property. We do hope, however, that our analysis will illuminate the nature of what most scholars believe to be the most intractable problem in the income tax: the realization requirement. We also see our proposals as an additional powerful tool that can be used in conjunction with other mechanisms to work toward a closer approximation of a tax based upon a Haig-Simons accretion model.

II. The Generally Unsophisticated Approach of Current Law

A. Historical Analysis

Unlike other areas of the law, the tax law generally has insisted that there is a single owner of property that has been carved into split interests. As a result, only one taxpayer is taxed on the income produced by the property and only one taxpayer is entitled to depreciation. This position has spawned much needless litigation to determine the exclusive owner where more than one person has identifiable interests and rights in a single asset. Perhaps more importantly, mismeasurement of income often occurs as one taxpayer is overtaxed and one is undertaxed. This creates the opportunity for rate arbitrage. In many circumstances the current rules have led to deferral (and sometimes even permanent exclusion) of income.

This unsatisfactory analysis has deep and pervasive roots. In early important tax cases involving donative transfers, the Supreme Court refused to recognize multiple owners where a partial interest in property was gifted, finding that there had been no effective transfer of ownership.

---

6 See note 2.
7 Where both owners are in the same tax bracket, the undertaxation of one party is compensated by the overtaxation of the other. In almost all cases, however, the overtaxed person is in a lower tax bracket (or tax-exempt), resulting in a revenue loss.
and thus the donor should be taxed on the income. Where the taxpayer transferred an interest in property while retaining another, ownership usually was determined by inquiring whether the assignor retained such “sufficient power and control” that he should continue to be treated as the owner. Because the right to receive the income was not considered separate property, there was no exploration of the possibility that both the income and remainder interests in the property might produce income. Courts and Congress have continued to use this unsophisticated approach largely uninterrupted for almost fifty years, resulting in numerous tax avoidance devices in the estate planning area designed to take advantage of the mismeasurement of income. Current examples include a split-interest purchase and an intra-family transfer of a remainder for cash or a private annuity.

This simplistic and mistaken approach quickly spread to commercial transfers. Similar results were obtained where a seller retained either a term or reversionary interest in property. From elementary sales of leaseholds to complex commercial sale/leasebacks, taxpayers structured transactions to take advantage of statutory provisions and case law that ignored the time value of money and failed to tax unrealized appreciation. This has resulted in serious transactional complexity attributable to the fact that economically identical transactions produce disparate tax consequences.

These deficiencies stemmed largely from the failure to recognize multiple owners of such split interests. The necessity to find a single current owner of property leads to the unfortunate conclusion that, since the form of the transaction is often controlling and the risks and benefits can be shifted easily through contractual arrangements (such as a net lease), the taxpayer has the choice of tax results. As in the donative setting, the income is not taxed appropriately because only the “owner” is taxed. Specifically, the holder of a remainder interest is permitted to defer income, as he is not taxed on its increase in value over time. On the other

---

9 Helvering v. Horst, 311 U.S. 112 (1940). This issue and a proposed solution are discussed in text accompanying notes 125-44.

10 Commissioner v. Sunnen, 333 U.S. 591, 604 (1948); see also Helvering v. Clifford, 309 U.S. 331, 335 (1940) (“dominion and control”).

11 The one exception is the current treatment of stripped bonds under § 1286, which is discussed at text accompanying notes 19-29.

12 The sale of a remainder interest is discussed at text accompanying notes 161-64.

13 This transaction is discussed at text accompanying notes 146-63.

14 These transactions are evaluated at text accompanying notes 165-77.

15 Numerous commentators have noted that the remainderman’s interest increases in value with the passage of time. For suggestions that a remainderman is undertaxed, see Stephen B. Lund, Contingent Payments and the Time Value of Money, 40 Tax Law. 237, 280-81 (1987); Norman H. Lane, Intra-Family Sales: Toward a Uniform Tax Treatment, 41 Tax Law. 279, 284 (1988); John M. Maguire, Income Taxes on the Realization of Future Interests, 31 Yale L.J. 367 (1922); Raymond Rubin, Depreciation of Property Purchased Subject to a Lease, 65
side of the transaction, the taxation of the holder of the present interest under current law depends on how it was acquired. Where the interest was purchased, the holder is entitled to recover his cost ratably over the term;\(^{16}\) where it was created in a transaction in which the holder transferred the remainder interest, he may not be permitted any basis recovery whatsoever.\(^{17}\) These anomalous results are clearly unsatisfactory.\(^{18}\)

**B. Stripped Bonds**

The current statutory treatment of stripped bonds offers a markedly different and more realistic approach to the taxation of multiple interests in a single piece of property. Where the taxpayer disposes of either unmatured, detached coupons or the naked bond, the basis of the bond

---

\(^{16}\) An amount paid for a leasehold is recovered ratably over the term of the lease. Reg. § 1.162-11(a); see also Reg. § 1.162-11(b).

\(^{17}\) See United States v. Georgia R.R. & Banking Co., 348 F.2d 278 (5th Cir. 1965), cert. denied, 382 U.S. 973 (1966); Lomas Santa Fe, Inc. v. Commissioner, 74 T.C. 662 (1980), aff'd, 693 F.2d 71 (9th Cir. 1982), cert. denied, 460 U.S. 1083 (1983). The courts prohibited the creation of an amortizable term interest upon a disposition of the remainder. In both cases, however, the remainder interest was transferred to a related party for inadequate consideration. In *Lomas Santa Fe*, the corporation reserved a term of years upon a nontaxable transfer to a wholly-owned subsidiary; in *Georgia R.R.*, the remainder was distributed to shareholders. The logic of the cases does not extend to a sale to an unrelated party for consideration. See Walter J. Blum, Amortization of a Retained Terminable Interest After Transfer of a Remainder, 62 Taxes 211 (1984). Unlike donative cases where the uniform basis rule applies, the transferor's basis is not transferred to the remainderman who takes a cost basis. Unless the basis allocated to the term interest is to disappear, the holder of the term interest should either amortize the basis or take a loss upon expiration of the term interest. The former more accurately measures annual net income, since the latter approach would compensate for overstating annual income by offsetting it with a subsequent loss.

Denying amortization of the term interest might be supported on the assumption that the holder of the remainder was not taxed. If, as we propose below, the remainderman were to be taxed annually on the increase in value of his interest, this rationale for the treatment of the term interest would have no validity.

\(^{18}\) See Kenneth F. Joyce & Louis A. Del Cotto, The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests, 31 Tax L. Rev. 121, 128-29 (1976). The authors suggest that in some circumstances, courts effectively may have permitted the holder of the retained life interest to be taxed on the entire income as a proxy for taxing the increase in value of the remainder. Id. at 162-65. Surrogate taxation works well when both of the taxpayers are in the same tax bracket. It does not work as well in other circumstances. See Noël B. Cunningham, A Theoretical Analysis of the Tax Treatment of Future Costs, 40 Tax L. Rev. 577 (1985); Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506 (1986).
TAXATION WITHOUT REALIZATION

(with coupons attached) is allocated between the retained portion and the portion sold in proportion to their respective fair market values immediately before the disposition.\(^{19}\) Both the transferor and the transferee are then subject to the original issue discount rules because the issue price (the assigned basis in the case of the seller and the purchase price in the case of the buyer)\(^ {20}\) will be less than the redemption price (the amount payable on the coupon or the bond).\(^ {21}\) The OID on the detached coupon that accrues between the purchase date and the date of maturity is taxed to the transferee. The OID on the stripped bond is taxed to the transferor.\(^ {22}\) Because basis is allocated to the transferred interest, the seller is unable to create an artificial loss.\(^ {23}\) Requiring each taxpayer to report income on the separate property interests eliminates both the assignment of income and artificial loss issues with regard to a bond.

The following example illustrates the mechanics and reasoning of the treatment of stripped bonds:

**Example 1:** On January 1, 1990, Father buys a bond for $1,000 with a maturity date of January 1, 1995. The bond has a face value of $1,000 and has five annual interest coupons attached, each in the face amount of $100. On the date of acquisition, Father gives the coupon due on January 1, 1991, to Son. On January 1, 1991, Son redeems the coupon for $100.

The coupon and the bond are treated as separate properties, or separate interests in a single piece of property.\(^ {24}\) Viewed this way, Father acquired six zero interest coupon bonds, each of which currently is earning interest at the rate of 10% per year. In the aggregate, the bond and the coupons produce $100 a year. Father allocates his $1,000 basis among the six instruments. The following table\(^ {25}\) identifies the original

---

19 IRC § 1286(b)(3). This rule applies to both a donor/donee and a seller/purchaser. IRC § 1286(b).

20 Where a donor makes a gift of the coupons, the donee takes as his adjusted basis the portion of the donor's basis allocated to the coupons. IRC § 1015.

21 IRC § 1286(a), (b).

22 The OID rules do not apply to tax-exempt stripped bonds, IRC §§ 1286(d), 1272(a)(2)(A), 1275(a)(3), but the seller must allocate basis between the bond and the coupons and increase the basis in the retained portion by the accrued interest. IRC § 1286(d)(1)(C)(i).

23 Under Helvering v. Horst, 311 U.S. 112 (1940), no basis was allocated to the stripped coupons. The holder of the bond ordinarily could sell it for a price less than his basis, reflecting the fact that it had been stripped. This created an artificial loss. In income-shifting cases, there has never been a suggestion that the income would be taxed before it was realized. In Horst, the donee redeemed the coupon in the same taxable year as the gift. In Helvering v. Eubank, 311 U.S. 122 (1940), the assigned income was realized in a later year and the court implied that the donor would be taxed only upon payment to the donee.

24 Section 1286 is not limited to the traditional concept of coupon bonds, but applies as well to any right to interest, even though not evidenced by a separate coupon. IRC § 1286(c)(5).

25 Throughout most of our analysis, numbers are rounded to the nearest whole number.
basis and the amount of annual interest earned by each instrument for the five-year period.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupon #1</td>
<td>$91</td>
<td>$9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coupon #2</td>
<td>83</td>
<td>8</td>
<td>$9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coupon #3</td>
<td>75</td>
<td>8</td>
<td>8</td>
<td>$9</td>
<td></td>
</tr>
<tr>
<td>Coupon #4</td>
<td>68</td>
<td>7</td>
<td>8</td>
<td>8</td>
<td>$9</td>
</tr>
<tr>
<td>Coupon #5</td>
<td>62</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>8 $ 9</td>
</tr>
<tr>
<td>Bond</td>
<td>621</td>
<td>62</td>
<td>68</td>
<td>75</td>
<td>83</td>
</tr>
<tr>
<td>$1000</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
</tr>
</tbody>
</table>

As the bond and its coupons are viewed as six separate properties (or separate interests in a single piece of property), traditional assignment of income analysis has no application. When Father gives away (or sells) one or more of the coupons, he does not retain any interest in the transferred coupon(s). He should, of course, be taxed on any interest accruing on the transferred coupon(s) before the date of the transfer, but all interest accruing thereafter properly is taxable to Son. For example, Father gives away his entire interest in Coupon #1 before any interest accrues on it. Son has a transferred basis of $91 in the coupon and is taxable on the $9 of interest that accrues during 1990. Father reports the $91 that accrues on the remaining four coupons and the bond.

This analysis is far more in accord with the economic realities than the traditional treatment. Our first proposal flows directly from the approach taken in § 1286.

---

26 The value of any asset, including a bond, can be determined by discounting all cash flows to be received from the asset to their present values. This analysis requires treating the bond and each of its coupons as separate instruments. The original basis of each of these instruments is the present value of its cash flow, discounted at 10% compounded annually. In the aggregate, they must equal $1,000.

27 IRC § 1286(b)(1).

28 IRC § 1015(a).

29 We recognize that § 1286 is not perfect. It does not measure accurately the accrued interest income because it uses a constant yield to maturity, ignoring the term structure of interest. See Joseph Bankman & William A. Klein, Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest, 44 Tax L. Rev. 335 (1989); Theodore S. Sims, Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation, 47 Tax L. Rev. 313 (1992). Despite this shortcoming, we believe that the approach of § 1286 is far superior to current law.
III. Proposals: Temporal Allocation of Basis and Imputation of a Rate of Return

A. Summary of Proposals

We offer two proposals. First, in most circumstances, ownership would be determined on the basis of a taxpayer's financial interest in property. Where more than one person has a financial interest in property, each would be considered the owner of that interest and would report any income or depreciation attributable to that interest. Second, in a variety of circumstances, a minimum rate of return would be imposed on capital. This second proposal needs further explication.

Our current income tax system is based loosely on a comprehensive income tax base and that is the model we use for our proposals. Tax theorists generally have accepted the so-called Haig-Simons definition of income: consumption plus the change in the taxpayer's net worth during the relevant accounting period. There is little disagreement that an increase in a taxpayer's net worth constitutes economic income regardless of the form of the taxpayer's ownership. The issue is when to take this income into account for tax purposes.

The Haig-Simons approach incorporates ex post valuation; that is, income is determined by measuring asset value at the end of the tax period and comparing it to the value at the beginning of the period. Realization of the income within the period is not necessary; thus, a pure Haig-Simons system would use a mark-to-market approach. Most commentators believe that this would be administratively unworkable on a universal basis, although feasible in limited application. For that reason,
current law uses a variant of ex post valuation, delaying the valuation and realization of the income until the taxpayer disposes of the asset. Although this wait-and-see approach uses ex post valuation as Haig and Simons envisioned, it often seriously understates economic income.

The alternative, ex ante valuation, which would require a prediction of the income is, in theory, inconsistent with the Haig-Simons ideal and has been subject to criticism on equity grounds. Furthermore, an ex ante approach is seriously flawed where accurate prediction of the income is impossible. Thus, for example, measuring income by predicting market appreciation or depreciation almost always would understate or overstate income.

Although we agree with these general criticisms, we do not, however, believe that ex ante valuation must be rejected in all cases. We conclude, that ex ante valuation should be considered where it is extremely likely to correspond to ex post valuation, avoids the administrative complexity of ex post valuation and mitigates the mismeasurement of income caused by the realization requirement. As an example where those three limitations hold, we propose to include in income annually the expected increase in the value of property to the extent it reflects the passage of time.

---


37 See, e.g., Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1600-01 (1979) (“But an ex ante approach to taxation requires a major restructuring of the classic conceptions of tax equity. Horizontal equity, the most widely accepted notion of fairness in taxation, requires that persons in similar circumstances pay similar amounts of tax. Although the tax literature is replete with disputes over whether ‘similar’ or ‘different’ circumstances are being compared, the notion that similar circumstances should be evaluated ex ante in present value terms seems quite a radical departure. Regardless of the precise contours of the definition of income or consumption, it seem clear that horizontal equity must be an ex post concept.”); Warren, note 34, at 1098 (“fairness in taxation should depend on outcomes, not expectations.” (citation omitted)).

38 See Mark Kelman, Time Preference and Tax Equity, 35 Stan. L. Rev. 649, 654 (1983) (a focus on ex post outcomes “may not negate the general significance of ex ante capacity as a relevant measure of taxability”).

39 Others have proposed something similar in specific contexts. Professor Popkin proposes a similar solution as a substitute for the sale-of-a-carved-out-interest doctrine. Popkin, note 15, at 188-95. Ronald Morris and Peter Glicklich have noted that when rent provided in a lease is less than the market rent, the fee, which will be purchased at a discount, is an appreciating asset. Although they suggest that the fee purchaser might include the increasing value of the reversion in income each year, they speculate that realization concepts might prevent taxing that accrual. They argue, however, that any deductions arising from the purchase of a fee encumbered by a below-market lease should be disallowed, at least to the extent of the untaxed appreciation in the reversion. Ronald A. Morris & Peter A. Glicklich, Some Incongruities in the Taxation of Leased Real Property, 40 Tax Law. 85, 115-16 (1986).

Professor Norman Lane, in a proposal to provide uniform treatment for intra-family sales, suggests that the appropriate way to treat a sale of a remainder with the retention of a life
All assets have an expected value. Our sense is that only in limited circumstances does that expected value correspond very closely to the actual post-value. Because our tax system uses income as the determinant of ability to pay, we agree it is generally unwise to use expected value as the measure of income. On the other hand, to the extent an increase in value is due solely to the passage of time, an a priori estimate of that amount is likely to be quite accurate and to reflect fairly the holder's ability to pay. Moreover, the failure to include this income as it economically accrues itself raises equity concerns. Deferring the income until realization creates distortions and encourages extremely complex game playing.

Mechanically, we propose to measure this income by applying a guideline rate of return to the taxpayer's basis in the property interest. The resulting amount, presumed to be the expected increase in value, would be taxed as income and added to the taxpayer's basis each year. For purposes of determining the amount of income in a subsequent year, the guideline rate of return would be applied to the taxpayer's basis as increased by the previously imputed income.

We propose to use the risk-free rate of return, that is, the rate on Treasury securities, as the guideline rate of return. In a functioning market, the expected yield from an asset is at least equal to the rate of return on a risk-free asset. It is implausible that an investor would hold an asset with an expected yield lower than that on a Treasury bill, which guarantees a risk-free rate. Thus, we presume that a taxpayer's change in net worth for a given period, attributable to the passage of time, would be at least equal to the risk-free return.

One further question is when to take this income into account. The Haig-Simons formulation does not specify the appropriate taxing period.
Although the issue of periodicity is important, we do not need to be concerned with it here. We presume that the change in net worth would be included in the base at some point and do not address when that should occur. For ease of illustration, we have used a year as the taxable period because that is what is used currently. The issue raised and our proposed solution would be valid so long as there was not continuous taxation or a one-time deathbed accounting, neither of which we believe is likely to come to pass.

This proposal can be viewed as a narrowing of the realization requirement. A change in net worth attributable to the passage of time would not wait until realization to be recognized. As explained below, this is not a radical concept; the tax system already has singled out this type of appreciation and, in some cases, has required the taxpayer to account for it on an annual basis. Our proposal builds on this approach.

As a corollary to these proposals, we suggest one other amendment to current law. Ex ante valuation requires an ex post reconciliation. Because the income reflects the expected increase in value rather than the actual increase, an adjustment must be made on realization, the event triggering the ex post reconciliation. Where the actual increase in value exceeds that which has been taxed previously, no one is likely to be offended; the additional gain would be reported on realization. Where the actual increase in value is less than the expected increase, the basis, which has been adjusted by the latter amount, will exceed the fair market value, creating a loss.

---

48 See, e.g., IRC § 1272 (inclusion of expected income on OID obligation), § 1256 (requirement that commodity be marked to market). In fact, one might even consider the accrual method of accounting as a narrowing of the realization requirement. An accrual basis taxpayer accounts for income on an ex ante basis and subsequently adjusts when ex post the amount of income reported turns out to be more or less.

Professor Kahn does not see an identity between OID and the appreciation of the remaining life of an asset. He notes that in the latter case, the appreciation arises from “the proximity of the earning of estimated income.” His emphasis on estimated income apparently is designed to call attention to the fact that the appreciation is uncertain. He also points out that unlike the OID rules, which were adopted in part to prevent mismatching between debtor and creditor, there is no debtor in the unrealized appreciation case. Douglas A. Kahn, Kahn Defends Stance on Accelerated Depreciation, 53 Tax Notes 1079, 1081 (Dec. 2, 1991) [hereinafter Depreciation].

49 Taxing the increase in value of a future interest, for example, makes possible several other minor changes in the taxation of split interests and we discuss those below in our examples. See text accompanying note 64.

Currently, this loss might be characterized as a capital loss\textsuperscript{51} even though it is due solely to the ordinary income inclusions required by the proposal. This would be an unacceptable mismatch.\textsuperscript{52} We propose that, to the extent the taxpayer was required to include the imputed income on an annual basis, she would be entitled to an ordinary, rather than a capital loss.\textsuperscript{53} Others may find that such limited relief offends their sense of equity. While we are not convinced there is a significant problem, political considerations may mandate additional relief. In Appendix I, we discuss what form that relief might take.

**B. Example**

The paradigm example of the application of our proposal is a split purchase.\textsuperscript{54} Consider the following:

*Example 2:* \(A\) owns *Blackacre* with a value and basis of $1,000. *Blackacre* produces annual net rentals of $100. On January 1, 1993, \(A\) sell the right to the property for three years to \(B\) for $249. \(A\) also sells the remainder to \(C\) for $751, the present value of the remainder.\textsuperscript{55} The property is expected to hold its value so that it is anticipated to be worth $1,000 in three years.

\textsuperscript{51} Under § 1211(b), the amount of capital loss that can be deducted in any taxable year is limited to the amount of capital gain plus $3,000.

\textsuperscript{52} An apt analogy is the recapture of depreciation deductions on a sale as ordinary income rather than capital gain. IRC §§ 1245, 1250. There are, however, current examples of mismatching. The OID on a debt instrument is reported as ordinary income as it accrues, IRC § 1272, but if interest rates rise and the holder sells the bond at a loss, the loss is usually capital. IRC § 1221. The shareholder of an S corporation can take an ordinary deduction for pass-through losses, IRC § 1366, that reduce basis, IRC § 1367(a)(2), producing a capital gain on a sale of the stock.

\textsuperscript{53} See Popkin, note 15, at 184.


\textsuperscript{55} Throughout our analysis, except as otherwise noted, we make the following assumptions: (1) the riskless rate of interest is 10% a year, compounded annually; (2) all taxpayers pay tax at the rate of 30%; and (3) there is no inflation. For a more extensive discussion of the choice of interest rate, see Appendix II. Assuming away inflation may ignore a significant issue. Inflation is a much more serious problem for short-term assets (such as those marked-to-market) than for those producing appreciation that is deferred because the advantage of deferral is likely to offset the taxation of the inflation component. A proposal, such as the one offered here, which taxes gains as they accrue, may significantly increase the effective tax rate if not coupled with indexing. We ignore inflation solely for ease of explication; the appropriate approach would be to apply the discount rate to an indexed basis.
Under current law, B would be entitled to amortize his initial $249 basis ratably over the three-year leasehold; therefore, B would have annual income of $17 [$100 — $83]. C would not report any income during this period. Notice that under the current rules, this joint purchase has reduced the aggregate taxable income from $100 to $17 or by $83 per year during the term of the lease.56

Under the proposed rules, C, would be treated as the "owner" of a discrete property interest and would report as income annually the expected increase in value. This expected increase in value would be determined by applying a guideline rate of return to the taxpayer's basis.57 Thus, in 1993 C would include $75 in income and add this amount to his basis. The adjustment made to basis is presumed to reflect the change in value for purposes of imputation in 1994 and 1995. In 1994 and 1995,

56 In an effort to curb the abuses associated with split interests, Congress included a provision in 1989 that disallows the amortization of a term interest where the remainder interest is held by a related party. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7645, 103 Stat. 2381 (codified at IRC § 167(e)(1)). Related parties are defined in IRC § 267(b), (e). The holder of the term interest reduces his basis by the disallowed deduction, but the holder of the remainder interest increases his basis by a like amount. IRC § 167(e)(3). This is another form of substitute taxation. Compare IRC §§ 273 and 1001(e).

The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388-497, further decreased the utility of the split interest purchase. Where two members of a family purchase multiple interests in property, the person acquiring the term interest is treated as if he purchased the entire property and then transferred the remainder for consideration to the purchaser of that interest. IRC § 2702(c)(2). Neither of these rules has any application to split purchases by unrelated parties.

57 Although the income is not taxed currently, it is reported upon a disposition because C's basis is only $751. If upon taking possession, C sold Blackacre, he would report $249, the amount of the deferred income. Deferral, however, is highly beneficial: Assuming a 10% discount rate and a 40% tax rate, the present value of the taxes due on $249 in three years is $74.83. If, however, C were required to report the $249 of income ratably ($83/year), the present value of these taxes would be $82.56. Note that the longer C postpones payment of these taxes, the lower their present value. If C holds the property until death, the $249 will be excluded permanently from the base. IRC § 1014.

58 That is, the risk-free rate of return, here presumed to be 10% compounded annually.

59 If income were to be calculated as a percentage of basis, additional pressure would be put on the definition of basis. For example, whether or not contingent payments were included in basis would become more significant. See Associated Patentees v. Commissioner, 4 T.C. 979 (1945). In general, we would adopt the rules used for depreciation purposes, in part on simplicity grounds and in part because, as we observe elsewhere, depreciation is the reverse of income imputation. See text accompanying notes 72-75. But there may be circumstances where following the depreciation rules would be inappropriate. For example, income probably should be imputed to the original rather than the reduced basis where § 1017 applies. The problems of defining basis are similar to those that would arise under a system of asset indexation. For a discussion of those issues, see N.Y. St. Bar Ass'n, Tax Sec. Ad Hoc Committee on Indexation of Basis, Report on Inflation Adjustments to the Basis of Capital Assets, 48 Tax Notes 759 (Aug. 6, 1990).

60 This would be true even where the holder has a carryover basis from a transferor (for example, IRC § 1015) or a substituted basis from another asset (for example, IRC § 1031(d))
would include $83 and $91 respectively.\textsuperscript{61} This income should be treated as the equivalent of interest.\textsuperscript{62} C, in effect, would be compensated for the use of the $751 he transferred to A. The effect of treating C's income as interest would be to recharacterize a portion of what would have been rental income to A as interest income to C. When C takes possession on January 1, 1993, his basis in \emph{Blackacre} would be $1,000, its expected value.\textsuperscript{63}

We also advocate that the treatment of the holder of a leasehold be consistent, whether he acquired the leasehold by purchase or by retention. In either case, the holder should recover his cost in the leasehold under a system of economic depreciation.\textsuperscript{65} To illustrate, B who

---

as the basis in the hands of the transferor (or the substituted basis) would have been adjusted to reflect income imputation and thus presumptively would be the fair market value.

A similar assumption is made in Reg. § 1.704-1(b). In determining whether a partnership distribution has substantial economic effect, there is a presumption that the amount of depreciation taken for purposes of capital accounts is the actual decline in value of the property. Reg. § 1.704-1(b)(2)(vii)(c)(2). As in the partnership context, there is a problem, at least a transitional one, when there is reason to know that the property has a basis lower (or higher) than its fair market value.

\textsuperscript{61} An imputation system that uses historical cost (rather than the actual fair market value) obviously will overstate or understate income in some cases. Suppose in \textit{Example 2}, \emph{Blackacre} has increased in value to $2000 by the end of Year 1. If historical cost is used, C would have $75 of income in Year 1 and $83 in Year 2 (($751 + 75) \times 10\%). If the actual fair market value were used, C would have $200 of income in Year 2 ($2000 \times 10\%). See Thomas L. Evans, The Taxation of Multi-Period Projects: An Analysis of Competing Models, 69 Tex. L. Rev. 1109, 1157 (1991) (criticizing the historical cost approach). While a fair market value approach would be more accurate, we reject it because it is too complex. Annual valuation would be required and if the system is to require appraisals, it might as well use a mark-to-market system for all assets.

\textsuperscript{62} The Service has on one occasion convinced a court that income realized on a sale by the holder of a remainder interest was interest analogous to OID. Jones v. Commissioner, 330 F.2d 302 (3rd Cir. 1964). On remand, the Tax Court, in fact, characterized a portion of the amount received as interest. 25 T.C.M. (CCH) 701, 706-07 (1966).

Under current law, the characterization of an item of income or expense as interest has numerous consequences. There are at least 22 categories of interest. Some interest is fully deductible, some is partially deductible and some is not deductible at all. See, e.g., IRC §§ 163(a), (d), (h), 265(a)(2), 469, 861. The characterization of a payment as interest is also important for a variety of other reasons such as source rules, treaties and status of entities (for example, whether or not a corporation is a personal holding company, a foreign personal holding company or a REIT).

\textsuperscript{63} The actual value of the property may be more or less than the expected value, but C must have \textit{expected} the remainder to increase in value (or alternatively, \emph{Blackacre} to hold value) or presumably he would not have purchased it.

\textsuperscript{64} Although this might appear to require an amortization deduction for the term interest portion of any piece of property held by a single owner, as demonstrated in text accompanying notes 278-89, this is not necessary if the property has a currently taxable market yield.

purchases the three-year leasehold, would recover his $249 basis according to the following schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Decline in Value (Depreciation)</th>
<th>Remaining Value at Year End</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Basis</td>
<td>$249</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>$75</td>
<td>$74</td>
</tr>
<tr>
<td>1994</td>
<td>83</td>
<td>91</td>
</tr>
<tr>
<td>1995</td>
<td>91</td>
<td>0</td>
</tr>
</tbody>
</table>

If, at the time C’s interest in Blackacre vests, it is worth more than $1,000, C would report no additional income until a realization event occurs. When it does, C generally would report capital gain. In the unusual case where the property did not hold its value, C would report an ordinary loss to the extent of ordinary income inclusions and any remaining loss would be capital. For example, if subsequent to vesting, C sold Blackacre for $600, C would report a loss of $400 of which $251 would be ordinary and $149 would be capital.66

C. Issues for Discussion

As with any proposal calling for ex ante valuation, critics undoubtedly will raise four objections to the proposed rule requiring imputation of income. The first is that it contravenes ingrained and widely accepted notions of the realization requirement. The second is that our proposal almost certainly will result in an erroneous measurement of income. The third and related argument is that this rule is inequitable, resulting in patently unfair treatment of certain taxpayers. The fourth is that the proposal adds unacceptable complexity. We deal with these arguments seriatim.

1. The Realization Requirement

The proposal calls for the annual accrual of appreciation due solely to the passage of time. Gain or loss attributable to other factors would continue to be recognized only on the disposition of the property. Thus, the proposal abandons the realization requirement in some, but not all circumstances.67 Expected increases in value would be reported as they ac-

66 For another alternative, see Appendix I.
67 The realization requirement has been referred to as the Achilles heel of an accretion tax. See William D. Andrews, The Achilles’ Heel of the Comprehensive Income Tax, in New Directions in Federal Tax Policy for the 1980s 278 (Charles E. Walker & Mark A. Bloomfield eds., 1983). Although many scholars deplore the distortion caused by the benefits of tax deferral, no one has seriously proposed complete elimination of the realization requirement. A number of scholars have, however, proposed imposing an interest charge for the period the tax
TAXATION WITHOUT REALIZATION

1992]

741

crue regardless of whether they are realized. Unexpected changes in value would continue to be protected by the realization requirement.

The realization requirement is not constitutionally mandated, and the notion that it is violable is not new. It already has been abandoned in a number of circumstances, particularly those where the income reflects an increase in value due to the passage of time, such as interest. The proposal is an extension of that approach to other similar forms of income.

The realization requirement only informs when income generally should be reported; it does not define what is income. Congress can, and often does, choose to tax previously accrued income only when it is realized, but it need not do so. In fact, it should only do so when serious administrative considerations warrant deferral. In each of our examples, there is clearly income that could be taxed as it accrues. The issue is

on appreciation is deferred. See, e.g., Cynthia J. Blum, New Role for the Treasury: Charging Interest on Tax Deferral Loans, 25 Harv. J. on Legis. 1 (1988); Roger Brinner, Inflation, Deferral and the Neutral Taxation of Capital Gains, 26 Nat'l Tax J. 565 (1973); Fellows, note 47, at 737; Pamela B. Gann, Neutral Taxation of Capital Income: An Achievable Goal?, Law & Contemp. Probs., Autumn 1985, at 77; Shakow, note 36. To some limited extent, Congress has moved in this direction. See text accompanying notes 86-91. Others have favored a consumption-based tax in part because it eliminates the issues raised by the realization requirement. See, e.g., William D. Andrews, A Consumption-Type or Cash Flow Income Tax, 87 Harv. L. Rev. 1113, 1131 (1974). Although, as we explain in this section, we prefer current accrual assuming an accretion tax is the model, our proposal is in tune with this ongoing attack on the realization requirement.

This is, admittedly, a poor choice of terms because these gains and losses are clearly possible outcomes. We use "unexpected" simply to mean the difference between the actual and expected outcomes.


Neither the erroneous taxation of expected increases in value where the property demonstrably declines in value or the erroneous allowance of depreciation where the property demonstrably increases in value poses a challenge to Congress' constitutional power to tax income.


71 See Evans, Evolution, note 70, at 827-28. The author points out that the interest capitalization rules of § 263A(f) are a surrogate for imputing and capitalizing the return on equity and as such are close to a mark-to-market system where income is recognized without regard to realization.
whether these are cases where it is appropriate to use the realization requirement to defer reporting the accrued income.

Interestingly, taxing the expected increase in value prior to realization is no different than accounting for the expected decrease in value through depreciation. Under current law, taxpayers are permitted to account for the anticipated loss in value of certain assets resulting from depreciation before a disposition. The deduction is permitted even though the decrease in value is not realized. In fact, a deduction for expected loss in value (determined on an ex ante basis) is allowed even where the asset actually increases in value during a taxable year (determined on an ex post basis). It is reasonable to inquire why an anticipated decline in value should be taken into account for tax purposes, but not an equally (possibly even more) likely increase in value. Obviously, Congress believed that it was not necessary to wait until realization to take into account an expected decrease in value. Our focus is whether the factors that motivate Congress to use the realization rule for any particular kind of income are different for expected increases than for expected decreases.

The realization requirement is essentially a rule of administrative convenience premised on not inconsequential problems. It is founded on three concerns that, according to Treasury, "taken together, appear to be insurmountable." They are: "(1) the administrative burden of annual reporting; (2) the difficulty and cost of determining asset values annually; and (3) the potential hardship of obtaining the funds to pay taxes on accrued but unrealized gains." Any proposal that would tax income as

---

72 There is ample legislative history indicating that Congress believed depreciation deductions approximated the decline in value of an asset. See, e.g., S. Rep. No. 1622, 83d Cong., 2d Sess. 25-29 (1954). The Supreme Court has stated that the deduction in any one year is supposed to approximate the actual decline in value of the asset. United States v. Ludey, 274 U.S. 295, 300-01 (1927). See also Reg. § 1.471-2(c) (lower of cost or market inventory rule which in effect permits a deduction for a loss before it is realized).

73 George Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179, 1222 (1987) ("Depreciation is based on expected, not actual, value losses.").

74 See, e.g., Michael J. McIntyre, More Give and Take on Accelerated Depreciation, 53 Tax Notes 1319, 1319 (Dec. 16, 1991) ("deduction for depreciation is itself a departure from the realization rule"); Mundstock, note 73, at 1226 ("The most significant exception to the principle that changes in value are taken into account only when realized in a measurable transaction is depreciation."). Contra Douglas A. Kahn, Kahn Responds, 53 Tax Notes 1319, 1319-20 (Dec. 16, 1991) (purpose of depreciation is not to account for loss in value but an allocation of cost expended and the cost was realized in year expended); Davenport, note 40, at 1404 ("the year's use of the asset triggers a realization event with respect to the portion that is no longer of economic utility").

75 There are three concerns (discussed in the immediately following text) that are thought to support realization. Congress is apparently willing to overlook these problems in permitting depreciation.

76 Treasury Dep't, Blueprints for Basic Tax Reform 81 (1977) [hereinafter Blueprints].

77 Id.
it accrues rather than when realized should satisfy the burden of proof with respect to administrative inconvenience, annual valuation and liquidity.

As to the first concern, our proposal, standing by itself, would not impose a significant administrative burden on either taxpayers or the Service. The administrative difficulties prompting the realization rule are directly linked to the complications occasioned by determining asset values through annual appraisals. We agree that appraisals are a costly and burdensome solution and it is for this reason that we propose to utilize a guideline rate of return applied to basis. While this device may sacrifice some accuracy, it eliminates the need to determine asset values annually. Similar rules for measuring depreciation and OID do not appear to have imposed a significant administrative hardship. Whether the mere fact of annual reporting is an extensive burden depends in large part on the number and type of assets subject to the imputation of income as well as the sophistication of the owners. Any burden may be more than offset by elimination of various tax planning devices and attendant controversies.

The second concern, liquidity, is more problematic. In a limited number of cases, the taxpayer may be forced to sell the asset to raise funds to pay tax on the imputed income. In other situations in which accrual taxation theoretically may be preferred, but liquidity prevents implementation, an alternative is to impose the tax upon realization with

---

78 Any system requiring appraisals is likely to be a loss for the government because it does not have the resources to win.

79 Accuracy is sacrificed only in the sense that the actual increase in value is not measured. However, since we propose to accrue annually only the expected increase in value, that is, only the increase attributable solely to the passage of time, use of a guideline rate (for example, the T-bill rate) fairly accurately should measure the portion to be taxed—the risk-free return.

80 IRC § 168(b).

81 IRC § 1272(a).

82 The choice of a method of imputation (a schedular rate applied to basis) and the types of assets subject to the proposal reflects a preference that the proposed rules should be limited to both sophisticated taxpayers as well as those who are likely to take advantage of income shifting or deferral.

83 See text following note 124. The net costs of applying the tax law would decrease both for the Service and for taxpayers if the realization requirement were narrowed. See Boris I. Bittker, Tax Reform and Tax Simplification, 29 U. Miami L. Rev. 1, 3 (1974); Shakow, note 36, at 1167.


Liquidity is more accurately a question of imposing taxes before possession or receipt of cash than a question of imposing taxes before realization. For example, taxpayers can elect to pay taxes currently on income that will not be received until a subsequent taxable year. Although the income reported by a shareholder of a S corporation may have been realized by the corporation, there has been no realization event with respect to the shareholder. Absent a subchapter S election, the shareholder realizes the income upon a distribution. See IRC §§ 1362, 1366(a).
an added interest charge reflecting deferral of the tax. Such an approach usually is considered the economic equivalent of current taxation and is presently used in three situations.

The best analogy is found in the rules governing passive foreign investment companies where interest is charged on accrued gain on PFIC stock that is not recognized until a disposition of the stock. These rather complex rules, which were designed to relieve perceived liquidity problems were mandated because Congress believed if current taxation were not required, the economic equivalent of current taxation should be approached. Other examples of interest-bearing deferred tax liabilities are found in the rules applicable to the use of the installment method by a nondealer seller of property, the throwback rules for foreign trusts and the taxable year rules for partnerships and S corporations.

Interest-bearing tax liability proposals generally are defended on the ground that deferring payment until a realization event increases the likelihood that the taxpayer will have cash to pay the taxes. Thus, liquidity problems raised by annual accrual are eliminated. But deferring the tax liability can create liquidity problems of its own. The amount received on the disposition will, absent a 100% tax rate, always be sufficient to fund the taxes, but it does not follow that it will be sufficient to

---

85 For a discussion of the issues that arise in an interest-bearing tax liability proposal, see Blum, note 67. For a critical evaluation of interest-bearing tax liability proposals, see Shakow, note 36, at 1169, and the authorities cited therein.

86 Gain realized on the disposition of stock in a PFIC is allocated on a daily basis to the entire period in which the stock is held and tax is calculated for each year's gain. IRC § 1291(a)(1), (2). The tax is not levied until disposition. IRC § 1291(a)(1)(C). The tax is computed at the highest rate under §§ 1 or 11 for the year in question, IRC § 1291(c)(2), but interest is calculated on the deferred tax. Interest accrues from the due date of the return for each year to which the gain is allocated until the due date of the return for the year of sale. IRC § 1291(c)(3). Interest is calculated at the rate for underpayment of tax. Id.

87 Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 1023 (Comm. Print 1987) ("Although Congress believed current taxation was more appropriate than continuation of deferral of tax on income derived from passive assets, Congress recognized that current taxation of U.S. investors in passive foreign investment companies could create difficulties for certain investors in cases where the U.S. investors . . . did not have sufficient liquidity to meet a current tax liability before actual income was realized from their investment.").

88 Id.

89 IRC § 453A(a)(1). See also § 453(l)(3) which has similar rules for installment obligations received on the sale of a timeshare or residential lot. Compare IRC § 461(h) (economic performance rules under which a taxpayer is not given a deduction when a liability accrues, but is compensated by a larger deduction at a later time.)

90 Ordinarily a beneficiary receiving a trust distribution is given a credit for taxes paid by the trust when the income accumulated and no interest is charged on the deferred tax liability even if the tax imposed on the beneficiary exceeds that imposed on the trust. IRC § 667. If the trust is a foreign trust, however, nondeductible interest is imposed on this deferred tax liability. IRC § 668(a), (c).

91 IRC § 7519.
fund the interest. Presumably, if the taxpayer invested an amount equal to the current tax on an annual accrual at an after-tax return at least equal to the interest to be charged on the tax liability, he would have sufficient funds to pay the tax and the interest upon disposition. If, however, he has such an amount to invest, there is no liquidity problem with current accrual. If he does not have such an amount to invest, he could have an even larger liquidity problem upon disposition under an interest-bearing deferral rule than under an accrual rule.

There are also a number of serious implementation questions with a deferral alternative. One is the appropriate interest rate. Most commentators agree that in order to eliminate the inequity and inefficiency resulting from deferral, the individual taxpayer's after-tax rate of return on investments should be used. They also agree, however, that for administrative reasons, a uniform interest rate must be specified. This might result in overpayment of interest by taxpayers who actually earned a lower rate of interest than that specified, and underpayment by those who earned higher rates. Although mismeasurement would occur if a uniform rate was used to calculate the after-tax rate of return, use of the taxpayer's own individual tax rate would be too complex. Assuming overpayment is more objectionable than underpayment, a low risk-free rate coupled with the highest possible marginal tax rate could be used. Alternatively, the taxpayer's borrowing rate could be used, on the assumption that he might have borrowed to pay the taxes, but if tax deferral is mandatory, the taxpayer may be worse off than if he had paid taxes currently on the accrued income.

To illustrate, assume that at all times the relevant tax rate is 70% and that the rate of return is 20%. holds property with a basis of zero for six years. At that time, she sells the property for a $600 gain. If this gain is allocated ratably over the six-year period, she will owe the following amounts in taxes and interest:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax</th>
<th>Years of Deferral</th>
<th>Interest Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$70</td>
<td>5</td>
<td>$70.80</td>
</tr>
<tr>
<td>2</td>
<td>70</td>
<td>4</td>
<td>52.43</td>
</tr>
<tr>
<td>3</td>
<td>70</td>
<td>3</td>
<td>36.46</td>
</tr>
<tr>
<td>4</td>
<td>70</td>
<td>2</td>
<td>22.58</td>
</tr>
<tr>
<td>5</td>
<td>70</td>
<td>1</td>
<td>10.80</td>
</tr>
<tr>
<td>6</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

The total liability is $420 plus $193.07 or $613.07, which exceeds the amount received.

This assumes that the interest paid is not deductible. If it were, the appropriate investment rate would be the before-tax rate. If the interest is not deductible (as it is not under current law, IRC § 163(h)), an interest-bearing deferral rule creates a tremendous lock-in effect.

Blum, note 67, at 26; Blueprints, note 76, at 81-82.

Blum, note 67, at 15; Blueprints, note 76, at 81-82.

Blum, note 67, at 19-20; see also Note, Fairness and Tax Avoidance in the Taxation of Installment Sales, 100 Harv. L. Rev. 403, 411-14 (1986).

Blum, note 67, at 21. This would occur where his borrowing rate was greater than the rate he could earn on his assets.
A much more serious problem in implementing a tax deferral loan alternative is what to do with loan balances outstanding at death. If § 1014 is allowed to cancel the loan, the expected increase in value not only would avoid current accrual, but would escape tax entirely. This would of course exacerbate the lock-in effect of § 1014 by creating an additional incentive to retain assets until death. Thus, death would have to be treated as a disposition or as an item of income with respect to a decedent.98

Use of an interest-bearing deferred tax alternative would appear to be preferred only if a full accrual system were contemplated, which might actually raise liquidity concerns. We are not advocating full accrual; rather we propose a modification of the realization requirement that falls far short of an accretion tax. While a tax deferral version of our proposal could be devised which would be the economic equivalent of income imputation, we believe it should be considered only if it would eliminate severe liquidity problems associated with current taxation and would not create implementation problems. On balance, we find that neither threshold has been met and thus we believe that annual accrual is preferable, at least to the limited extent of our proposal.

2. Erroneous Measurement of Income

The second likely criticism of the proposed ex ante rule is that we know, with some certainty, that although it is both "simple and elegant," it is also "wrong."99 Putting aside a bond with a stated redemption price at maturity, the value of any given property at some future point in time cannot be known. It almost surely will be worth more or less than its expected value. Only in a rare and extraordinary case will it be worth exactly its expected value. Given that it is known with some assurance that a property interest will not be worth its expected value, in what way is the proposed rule better than current law?

Current law generally operates on a "null hypothesis,"100 that is, it presumes that nothing at all happens until realization. Critics may argue that it is preferable to wait and see what the property will be worth on disposition rather than presuming some rate of return that is surely

98 See IRC § 691. Alternatively, a carryover basis rule could be implemented with an interest charge and a tacked holding period. This is less desirable than a disposition-at-death rule because it adds complexity and could extend the term of the "loan" for decades.

99 This locution is often attributed to H.L. Mencken. See e.g., William A. Klein, Tax Effects of Nonpayment of Child Support, 45 Tax L. Rev. 259, 277 n.76 (1990). The authors have been unable to find a citation attributable to Mencken, but would be happy to be proven wrong.

100 See Land, note 15, at 263.
TAXATION WITHOUT REALIZATION

wrong. While the proposed rule may not perfectly measure income,\textsuperscript{101} it would measure income far more accurately than current law does.\textsuperscript{102} This is attributable to current law's disregard for the predictable increase in value due to the passage of time. For example, in Example 2, all parties and the market apparently believe that in three years when the remainderman's interest vests, Blackacre will be worth approximately $1,000. It is clearly possible that Blackacre will be worth more than $1,000; conversely, it is also possible that Blackacre will be worth less than $1,000. It is far more realistic, however, to assume that Blackacre will be worth its expected value of $1,000 rather than $751.\textsuperscript{103} Current law's assumption that the remainderman's interest in Blackacre will be worth only $751 upon vesting strikes us as far more erroneous than assuming it will increase in value.

We are not troubled by the possibility that the income that is reported before it is realized may be different than the amount actually realized, any more than those who favor the realization requirement appear to be troubled when realized income fails to accurately account for previously accrued income.\textsuperscript{104} The tax system already takes into account accrued income that may prove to be different than that realized. For example, original issue discount,\textsuperscript{105} unrecognized gain on straddles,\textsuperscript{106} gain on regulated futures contracts\textsuperscript{107} and certain call premiums\textsuperscript{108} are reported before they are realized. Deductions on depreciable property are permitted before they are realized where a decline in value in the property is

\textsuperscript{101} The first-best rule, taking a Haig-Simons approach as normative, would account for the actual increase in value annually, whether or not realized.

\textsuperscript{102} That is to say the proposed rule is a better second-best approach than current law.

\textsuperscript{103} Put another way, it is much more likely that the future interest will increase in value with the passage of time than not.

\textsuperscript{104} For example, suppose the taxpayer purchases a painting for $1,000. At the end of Year 1, the painting is worth $1,400. At the end of Year 2, the taxpayer sells the painting for $1,300. The realization requirement permits the taxpayer to report only $300 of income although her wealth had increased by $400 in Year 1, a change in wealth she will never be required to account for.

\textsuperscript{105} IRC § 1272(a).

\textsuperscript{106} IRC § 1092(a)(3).

\textsuperscript{107} IRC § 1256(a). This section also covers foreign currency contracts, nonequity options and dealer equity options. IRC § 1256(b).

\textsuperscript{108} Where preferred stock is issued with an issuer's call (that is the issuer has an optional right to redeem the stock after a period of time at an "unreasonable" premium), the holder must include the premium in income on an economic accrual basis over the period of time the call is outstanding, even though the premium may not be paid if the stock is not called. IRC §§ 305(b)(4), (c). This rule has been criticized. Corporations Committee, N.Y. St. Bar Ass'n Tax Sec., Report on Regulations to be Issued Implementing the Changes to Section 305(c) Made by the Revenue Reconciliation Act of 1990, 52 Tax Notes 1199, 1205-06 (Sept. 2, 1991); see also Teryl L. Minasian & Elzbieta K. Welz, Guidelines for Determining when Discount on Preferred Stock Will Create Taxable Income, 53 J. Tax'n 2, 4 (1980); Note, Discounted Preferred Stock Under the New Section 305 Treasury Regulations: On Confusing Debt and Equity, 84 Yale L.J. 324, 340 (1974).
expected. In each case, a subsequent event (usually realization) reconciles the discrepancies. For example, where OID accrues, but the taxpayer sells before redemption for an amount that does not reflect the entire OID reported, a loss is permitted. Where depreciable property declines in value at a rate less than the schedular rate, recapture is required. We also would use the ultimate realization event as a corrective device. In summary, we do not believe that the likelihood that the accrued income may be different than the amount ultimately realized is a radical departure from current law. In any event, we believe it is preferable to the erroneous mismeasurement under current law.

3. Unfair Treatment

Although we are persuaded that the proposed rule is superior to current law, we suspect that others may be troubled that in almost all cases, the rule would result in overtaxation of some taxpayers and undertaxation of others. This result may be seen by some as unfair, especially to those who would be overtaxed under this regime.

Equity concerns relating to the fairness of the proposed rule stem from the fact that the current system generally taxes a person after the fact (ex post) on his actual income, rather than on the basis of his expectations (ex ante). As noted above, we agree that taxation of all income on an ex ante basis would be a poor idea. Where, however, as here, the expected income is reasonably certain and can be measured fairly, we believe the failure to tax would be even worse. Essentially, we argue that, once the Haig-Simons approach is abandoned, taxing the expected income moves the system closer to that ideal than does current law (which ignores expected income) and thus is more equitable.

Since the proposed rule is based upon expectations, not outcomes, an argument also could be made that a system that would result in the overtaxation of many individuals has political, even if not theoretical flaws. Thus, although we are not convinced of the equity argument, we have included a discussion of possible adjustments in Appendix I.

109 See, e.g., IRC § 168.
110 IRC §§ 1245, 1250.
111 See, e.g., Adams et al, note 54, at 36 (taxing the increase in value is unfair because the remainderman is forced to recognize "phantom income").
112 The group that is undertaxed is much easier to deal with. To the extent that the property is worth more than its expected value at the time the reversionary interest ripens, there are no serious problems. From the taxpayer's point of view, he has been undertaxed and has little to complain about. From Treasury's point of view, the government would be far better off than it is under the current system.
Closely related to the fairness issue is that of economic distortion and the possibility of tax arbitrage. Since taxpayers generally will select investments with favored tax treatment, if annual accrual of income were required of some assets, but not others, the latter would become tax-preferred, resulting in a possibly inefficient reallocation of capital to those assets. Because, however, our proposal reduces the available opportunities for tax arbitrage by decreasing the number of assets where annual accrual is not required, it may reduce the inefficiency created by the current preference for deferral. For example, taxpayers currently are able to engage in rate arbitrage (by shifting income to a low-bracket taxpayer through a split interest) and to defer or sometimes permanently exclude a tax liability (by eliminating income through a split purchase). If income were imputed to the interest that predictably increases in value over time, there would be no tax incentive to structure a transaction with multiple interests.

Finally, one might question whether equity is increased by a piecemeal approach that would tax this type of expected appreciation on an accrual basis whether or not it actually occurs, while at the same time exempting other increases in value that actually occur. As noted previously, our proposal for ex ante valuation, in this limited circumstance, is a good substitute for the ex post valuation called for in the Haig-Simons approach and moves the system closer to the ideal. This type of appreciation is distinguishable from market gain. The latter is subject to market risk and therefore its realization is uncertain. Appreciation due to the passage of time, however, is certain to accrue economically. This is a distinction already recognized in the tax law. The tax system taxes interest and other items theoretically similar to interest on an accrual

---

114 For example, corporate growth stock that increases in value annually, but is not subject to annual taxation, may be a more attractive investment than a bond with OID subject to annual accrual. This tax benefit may be capitalized into the share price and thus the market may remove the horizontal inequity. See Boris I. Bittker, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, in The Economics of Taxation 19 (Henry J. Aaron & Michael J. Boskin eds., 1980).

115 Where A transfers a remainder interest to B, retaining an income interest, A is taxed on all of the current income even though B has economic income attributable to the increase in value of his interest over time. If A is in a lower tax bracket than B is, rate arbitrage occurs.

116 See text accompanying note 57.

117 The more accurate alternative of taxing all accrued appreciation often would require appraisals. See Shakow, note 36 (discussion of the implementation of a general accrual tax). We reject such an approach. Appraisals are costly and subject to abuse and the added accuracy does not outweigh the economic and political costs.

basis. The type of expected appreciation that we focus on is analytically similar.

4. Complexity

Critics also may assert that proposals to allocate basis temporally and to impute income to an asset predictably increasing in value should be rejected due to their complexity. While we agree that a proposal which increases overall complexity is highly suspect, we do not believe that our two proposals are subject to such a charge.

There are basically three kinds of complexity and an increase in one form may be offset by a decrease in another. Our two proposals would marginally increase “rule complexity”—that arising from the interpretation of the written rules. In all likelihood, the statutory language implementing the two rules would be extensive and complex. Thus, rule complexity, in the sense of additional verbiage, would be increased. In addition, there might be interpretative problems to the extent income imputation were selective. If income were imputed to one class of assets but not another, describing the asset classes would become difficult and much pressure would be placed on line drawing.

“Compliance complexity”—recordkeeping, calculations and filling out forms—is also a potential result, but we have crafted our proposal to keep such complications to a minimum. Although taxpayers who engage in transactions or acquire assets subject to basis allocation or income imputation would be required to report income on an annual basis, this procedure need not be highly complex. Use of a guideline rate of return

---

119 Actually, there is at least one circumstance, § 1256, where the Code even taxes market gain before it is realized.

120 This concept may be understood by recharacterizing the transaction in Example 2 as a loan of $751 from the remainderman to the seller, combined with a future sale of Blackacre by the seller to the remainderman, the sales price of which is set at $751 plus 10% interest payable in three years. Viewed this way, the remainderman has annual interest income that accrues and is added to his basis in the loan. The remainderman is really the beneficiary of the income from the $751 purchase price and should be taxed on this income. See Cunningham, note 18; Halperin, note 18. At maturity, the remainderman will have reported $249 of interest income, IRC § 1272, and will have a basis in the loan of $1,000. This analysis generates almost identical tax consequences to the remainderman as those under a sale/purchase analysis. Under a loan analysis, the remainderman could have gain or loss when the loan was satisfied if the land was not worth precisely $1,000. On the other side of the transaction, A would accrue interest totaling $249 over the three-year term of the “loan” and usually would be entitled to deductions equal to the cost recovery deductions provided under the sale analysis. One significant difference in characterizing this transaction as a loan rather than a sale/purchase is the possible characterization of this income as interest. See note 62. Another difference is the timing of the sale to the remainderman. Under the loan characterization, the sale does not occur until the loan is paid off, and therefore A would not report any gain or loss until that time.

121 This discussion draws on David F. Bradford, Untangling the Income Tax 266-76 (1986).

122 This is easily confirmed by a perusal of § 1286, the model for our proposal.
would eliminate the need for appraisals, and depending on the frequency with which the rate was changed, the necessary information could be tabularized. In terms of compliance complexity, our proposal is certainly no more complex than the rules for depreciation (which apply a guideline rate to determine the annual decrease in value) and probably less so.

Any additional rule and compliance complexity would be dwarfed, however, by the probable elimination of “transactional complexity”—arranging affairs to minimize taxes. Much of the complexity of the tax law can be traced to efforts to structure transactions in economically equivalent forms to take advantage of favored tax results. To the extent economically equivalent transactions are treated identically for tax purposes, transactional complexity is decreased (and not coincidentally equity is increased). Annual accrual, at least to the extent proposed here, would promote economic consistency and would eliminate much complex planning. The next section describes several common transactions that either no longer would be undertaken or would be freed from tax considerations if our proposed rules were adopted. As these examples demonstrate, our proposal would reduce transactional complexity significantly. Thus, overall complexity would be decreased rather than increased.

IV. APPLICATION TO COMMON SPLIT INTERESTS IN PROPERTY

A. Split Interests in Nondepreciable Property

This section applies the two proposals to a variety of common transactions that split property into multiple interests. In this section, we examine transactions in which the property is not depreciable. In the succeeding section, we explore the ramifications of split interests in depreciable property.

1. Gratuitous Transfers of Income and Remainder Interests

The current tax treatment of gratuitous transfers of income and remainder interests is deficient in that the transferor is taxed on all current income, resulting in a mismeasurement of income and the possibility of

---

123 The simplest approach is to apply a constant rate to the basis over the life of the asset. Whether a constant rate is appropriate is discussed in Appendix II.

124 Unlike the OID or coupon-stripping rules, there would be no middle man who could supply information to the taxpayer. Therefore, in order to satisfy compliance concerns, the taxpayer must be able to calculate the income easily. The ease with which taxpayers could comply with these rules also depends in part on how the system deals with the effects of inflation, an issue beyond the scope of this article. See note 55.
rate arbitrage. Under our proposed rules, "ownership" issues would be eliminated, resulting in a more accurate allocation of income.

Except in the case of a bond subject to § 1286, current law ignores the possibility that when an income interest is transferred, both the transferor and the transferee could be simultaneous owners. The right to future income is not considered property. Unless the donor transfers the underlying property as well as the right to its income, the donor remains the owner for tax purposes and is taxed on the income. Although the theory appears to be that the assignor effectively can revoke the assignment by exercising control over the underlying property, the rule applies even where the retention of the property leaves the donor with absolutely no control over the transferred income and no way to revoke the gift. The principle also applies where the donor has only a wasting interest, unless a vertical portion is conveyed.

The grantor trust rules basically follow the general common law principles, which is to choose either the beneficiary, the trust or the grantor as the owner of the property, subject to tax. In general, the grantor continues to be treated as the owner of the trust if he has a reversionary interest, a power that can affect beneficial enjoyment of the corpus or income, or certain managerial powers of a broad or unusual nature.

Where the donor (or decedent) gives an income interest to one person and the underlying property to another, the uniform basis rules apply.

---

125 See, e.g., Helvering v. Horst, 311 U.S. 112 (1940).
127 In the case of the coupons transferred in Horst, 311 U.S. 112, the donor, who retained the bond, retained no control over the income interest, but nevertheless was treated as the owner of both property interests. See also Helvering v. Eubank, 311 U.S. 122 (1940) (assignment of renewal commissions).
128 E.g., Harrison v. Schaffner, 312 U.S. 579 (1941) (life beneficiary of trust assigned specified dollar amount of income from trust to children).
130 IRC §§ 671-679 (grantor treated as the owner of all or a portion of a trust over which he retains substantial control).
131 IRC §§ 671-675. In addition, certain powers held by a third person are treated as if retained by the grantor unless the third person has a beneficial interest in the trust that could be affected adversely by an exercise or nonexercise of the power. If the grantor is taxed on the income under the statutory scheme, the beneficiary is untaxed even though he is entitled to the income, and the remainderman may be untaxed even though his interest increases in value. The grantor trust rules go beyond the common law assignment of income cases in that the grantor not only is taxed on the income, but also is treated as the owner of the property so that deductions and credits, for example, are reportable by the grantor. IRC § 671; Reg. § 1.671-3; see also Reg. § 1.1001-2(c) Ex. 5; Rev. Rul. 85-13, 1985-1 C.B. 184; Rev. Rul. 87-61, 1987-2 C.B. 219. But see Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).
132 The uniform basis rules provide that the basis of property acquired by bequest or gift remains constant regardless of how the property is held. The basis, which is determined with regard to the property as a whole, is allocated among the various property interests, for example, a life estate and a remainder. Reg. § 1.1014-4(a), (b). Allocation is based on relative fair market values so that the life tenant's basis diminishes with time and the remainderman's
under which the owners of the income interest and remainder interest share basis.133

The rules governing a gratuitous transfer of a remainder interest give similar erroneous results. The transferor is taxed on all income received and the remainderman receives his interest tax-free.134 A similar issue arises in the case of gift-leasebacks where the donor transfers an asset to a lower-bracket family member and leases back the property. The new "owner" reports the rental income that the transferor attempts to deduct.135

Under our proposed rules, both the donor and the donee would be treated as owners of their respective interests in the property. The only complicating factor is that the present value of the term interest is not revealed by a market transaction; it therefore must be estimated by applying the appropriate discount rate136 to the income stream. As a general rule, the donee would take as his basis the donor's basis in the transferred interest.137 Where the donor had recently purchased the property, the present value would give the donee his adjusted basis.138 If increases. Reg. § 1.1014-5. The remainderman, however, reports no income when his interest vests regardless of whether the value at that time exceeds his basis. Upon a disposition, he would report only gain reflecting a change in market value, not the change in value caused by the mere passage of time. The consequence is that the remainderman is allocated the entire basis if he holds his interest until the term interest expires.

Although the life tenant is assigned a basis upon a donative transfer, it is generally not needed since he is entitled neither to offset this basis against the income received nor to a deduction for the decline in value. IRC § 273. Depreciation is permitted in the case of a wasting asset. The life tenant is treated as the absolute owner for purposes of depreciation. Reg. § 1.1014-4(b). Generally such an allocation is necessary only where one of the divided interests is sold. That rule could be avoided, however, if the life tenant sold his life estate and could use the basis to offset the purchase price, which would represent the present value of the remaining income stream. To counteract such a possibility, the Code provides that no basis offset is permitted where the seller's basis represents a portion of the entire adjusted basis of the property, IRC § 1001(e), unless both the term and remainder interests are sold in the same transaction. These rules can be seen as a surrogate for taxing the remainderman on the increase in value of her interest.

134 E.g., Rosenfeld v. Commissioner, 705 F.2d 1277 (2d Cir. 1983); Perry v. United States, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965). The courts have struggled to determine whether the transaction was a sham or whether it was motivated by a business purpose. A sale-leaseback also can arise in a family setting. E.g., Hudspeth v. Commissioner, 509 F.2d 1224 (9th Cir. 1975). Under current law, bracket compression has all but eliminated these transactions. Rate differences no longer justify the transactional complexity of the ploys. Split purchases and sales of remainders, by contrast, continue to be driven by wealth transfer taxation where rates reach 55%. See New Rules for Valuing Partial Interests Substantially Complicate Transactions, 16 Est. Plan. 330, 334 (1989).
135 See Appendix II for a discussion of how the discount rate is to be determined.
136 IRC § 1015.
137 For a method of calculating the present value of a term interest and a remainder, see Reg. § 25.2512-5. The present value (PV(\(u\))) of a remainder interest in \(X\) that will vest in \(n\) years is calculated by the formula

---

Imaged with the Permission of N.Y.U. Tax Law Review
the donor previously purchased the property, the present value would determine the relative portion of the donor's basis to which the donee would be entitled.139

To illustrate the model's application:

Example 3: On January 1, 1993, A gives to B a three-year income interest in Blackacre in which he has a $1,000 basis, retaining the remainder. Blackacre has a current value of $1,000 and produces $100 in annual net rents.

In contrast with current law, the proposed model would treat both donor and donee as having interests in the property. Their respective bases would be determined by allocating the donor's $1,000 basis between the transferred and retained interests in the property in accordance with their relative fair market values.140 On these facts, B would take a basis of $249 in the income interest and A would retain a $751 basis in the remainder interest.141 A would have OID-type income of $75, $83 and $91 respectively for the years 1993, 1994 and 1995, and these amounts would be added to his basis.142 When he retakes possession on January

\[
\text{PV}(X) = X \left[ \frac{1}{(1 + \delta)^n} \right].
\]

The present value of the income stream from \( X \) (PV\text{(X)} for \( n \) years) is calculated as

\[
\text{PV}(X) = X \left[ 1 \times \left( 1 + \delta \right)^n \right].
\]


139 The basis should be based on the proportionate fair market values of the interest transferred and the interest retained. See Hunter v. Commissioner, 44 T.C. 109, 115-16 (1965); Rev. Rul. 77-413, 1977-2 C.B. 298. Compare Estate of Camden v. Commissioner, 47 B.T.A. 926, 933 (1942), aff'd per curiam, 139 F.2d 697 (6th Cir. 1943), which used an actuarial method. A similar allocation of any adjustment for gift tax paid, IRC § 1015(d), could be made.

140 See note 138.

141 In the case of gifted appreciated property, the basis of the property would be allocated between the gifted and retained portion on the basis of the relative fair market values. For example, if A had previously purchased Blackacre for $500, that would be the aggregate basis for A and B. B would have a basis of approximately $125 since the present value of his interest represents approximately one-fourth of the total value. Notice that both B's depreciation and A's income would be calculated from basis, not value. This is due to the inherent unrealized gain in the property.

In the case of gifted property that has declined in value, we would propose to use a lower of basis or value rule, similar to that of § 1015(a). This would prevent the amortization deductions from creating a deductible loss for the holder of the term interest and from overstating the income of the holder of the remainder interest. For example, if A had previously purchased Blackacre for $2000, but its value at the time of the gift was $1,000, A's basis would be $249 and B's basis would be $751.

142 This proposal raises several technical issues when the identity of the owner of a split interest is not known. Consider, for example, a testamentary trust that is created at death with income to the spouse and remainder to the children. The basis of the trust property would be the fair market value at death, IRC § 1014, and would be allocated between the spouse and the remaindermen as a class on an actuarial basis. Reg. § 1.1014-5(a)(3). Unlike the income imputed to a remainderman of gifted property, the OID-type income reported by the heir would be calculated on a fair market value, rather than cost basis and thus, usually
1, 1996, his basis in Blackacre would be $1,000. B would depreciate his $249 basis over three years and would have net income of $25, $17 and $9 respectively for the years 1993, 1994 and 1995.

In the alternative, if A had given away the remainder, retaining the leasehold, the model would give parallel results, except that the donor and donee will have swapped economic positions. In either scenario, there no longer would be an income tax incentive to gift a partial interest in property and thus the issue of whether the donor retained ownership of the "property" would not arise.

2. Commercial Transactions Involving Income and Remainder Interests

Because current law does not always treat transactions in accord with their economics, taxpayers often attempt to take advantage of this distortion. We discuss below several commercial examples of this phenomenon which involve multiple interests in a single piece of property. Application of the two proposed rules would eliminate the abuse potent
tial in these arrangements and would substantially curtail transactional complexity.

a. Sale of Income Interest

Early cases involving the transfer of carve-outs of future income presumed the transactions were sales; the only issue was whether the income therefrom was ordinary or capital.\textsuperscript{146} This had the effect of taxing the "seller" immediately on the amount received, a result generally less advantageous than deferral.\textsuperscript{147} In some circumstances, however, this characterization is quite favorable, for example, where the taxpayer wants to accelerate income to absorb an expiring net operating loss carryforward.\textsuperscript{148} In these cases, the Service attempted to recharacterize the transaction as a loan.\textsuperscript{149} In that posture, the seller/borrower has no income on receipt of the loan "proceeds," but is taxed on the income produced by the property used to make principal and interest payments.

Under current law, characterization of a transaction depends on the attendant facts and circumstances. In several cases, courts have found that the transaction more closely resembled a loan since the purported seller of future income was obligated to produce such income by his own underlying property. The transferor's basis would be allocated between the rights transferred and the rights retained.

Similar questions about ownership have arisen in connection with the acquisition of property. See, e.g., Dettmers v. Commissioner, 430 F.2d 1019 (6th Cir. 1970) (ownership determines whether replacement property acquired within time limit for § 1033 nonrecognition); Merrill v. Commissioner, 40 T.C. 66 (1963), aff'd per curiam, 336 F.2d 771 (9th Cir. 1964) (holding period starts with first day of ownership).

\textsuperscript{146} E.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). The taxpayer, the Commissioner and the Supreme Court all treated the amount received for the carve-out of the income interest as an amount received on a sale.

\textsuperscript{147} The current treatment could be justified because of the impossibility under current law of taxing the remainder interest over time.

\textsuperscript{148} In most cases, no part of the taxpayer's basis is allocated to the sale, on the theory that it was a sale of anticipated future income. See, e.g., Hort v. Commissioner, 313 U.S. 28 (1941) (consideration received for cancellation of lease is not a return of capital).

\textsuperscript{149} A transaction in which the taxpayer sells the right to future income for its present value may be functionally equivalent to a nonrecourse loan made by the "purchaser" to be paid back by the seller with interest in the form of the future income.

The Service took a similar position in connection with "repos." Where a taxpayer transfers a security to a third party with an option or agreement to repurchase, the transaction is subject to recharacterization as a secured financing. See, e.g., Comtel v. Commissioner, 376 F.2d 791 (2d Cir.), cert. denied, 389 U.S. 929 (1967). In a typical transaction, a bank agreed to purchase tax-exempt securities from a customer and either acquired a put on the securities or the seller had a call. If respected as a sale, the bank, as the owner of the securities, had tax-exempt income; if treated as a financing, the "seller" remained the owner, paying taxable interest to the bank. See, e.g., Citizens National Bank of Waco v. United States, 551 F.2d 832 (Ct. Cl. 1977); Rev. Rul. 82-144, 1982-2 C.B. 34; Rev. Rul. 74-27, 1974-1 C.B. 24.
productive effort in order to repay the loan. In none of these cases, however, did the seller guarantee the payment or provide security so that the seller bore no risk with regard to the income. In other cases, where the seller was not personally liable or did not need to satisfy the obligation from independent assets (including the retained interest), the transaction generally was not characterized as a loan. For example, where the taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest. Under the current litigious state of the law, indistinguishable transactions are treated dissimilarly based on economically insignificant facts.

Equally troubling results have been reached in cases involving natural resources, which are analytically similar to a sale-leaseback scenario. Generally the three transactions that are prominent in the cases—the AB transaction, in which the owner A transfers a remainder interest to B, retaining a present interest, the BA transaction, in which the owner B transfers a term of years to A, retaining a remainder interest, and the ABC transaction, where A who has retained an income interest upon a transfer of a remainder to B, sells that income interest to C—are no different economically from other commercial carve-out cases, but the courts and Congress have developed an entirely different approach from that used in transactions not involving natural resources. The concept of economic interest is utilized to determine whether a taxpayer controls the right to the depletion of natural resources and to establish whether

150 Mapco Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977); see also Martin v. Commissioner, 56 T.C. 1255 (1971), aff'd, 30 AFTR 2d 5396 (5th Cir. 1972); Hydrometals, Inc. v. Commissioner, 31 T.C.M. (CCH) 1260 (1972), aff'd per curiam, 485 F.2d 1236 (5th Cir. 1973), cert. denied, 416 U.S. 938 (1974). These cases may be analogized to the mineral economic interest cases (see note 153) or to Alstores Realty Corp. v. Commissioner, 46 T.C. 363 (1966), in that the seller retained some responsibility as to the underlying property.

151 Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973). The transferee's only source for the recovery of his capital was the dividends. He alone bore the risk of loss if the stock did not pay dividends. Id. at 871.

152 These transactions are discussed exhaustively in Joyce & Del Cotto, note 18.

153 Palmer v. Bender, 287 U.S. 551, 558 (1933); Reg. § 1.611-1(b)(1). Unlike other areas in which ownership generally is attributed to one person, the Code recognizes that more than one taxpayer can have an economic interest in the same property and thus the depletion allowance can be apportioned among "owners."

As the nomenclature implies, the focus is on the taxpayer's investment in a natural resource to which he must look for a return of capital; a pecuniary advantage derived through production is not sufficient. Reg. § 1.611-1(b)(1). In order to have retained an economic interest, the taxpayer not only must look to the minerals for profit, but must continue to bear the risk of loss occasioned by nonproduction. Although a retained share of profits of leased properties is sufficient to create an economic interest, if the lessee's obligation to pay is secured by other property, the lessor's interest is not dependent solely on extraction. See Anderson v. Helvering, 310 U.S. 404 (1940). For example, if the purchaser gives the seller a mortgage against the remainder interest as security for payment of the income, the purchaser must include the in-
the taxpayer has disposed of his ownership interest. If so, he no longer has the right to deplete the property, and the disposition is treated as a sale on which gain or loss is recognized.

Under our proposed rules, the characterization of the transaction would no longer matter since it would not be possible to accelerate income in this manner. The results are more satisfactory regardless of whether the transaction is treated as a sale or a loan.

To illustrate how a sale of an income interest would be treated under the proposed rules, consider the following:

Example 4: A, with an expiring NOL, buys Blackacre for $1,000. It is subject to an outstanding lease that will produce $100 of rent for each of the next three years. On the date of acquisition, A sells to B his right to the rent from Blackacre for the next three years for $249.

Applying the proposed rules: When A sold the income interest, he would have an amount realized equal to $249 and a basis offset of $249; therefore, he would realize no gain or loss. In the year of the sale, A would have only $75 of income from his reversionary interest, which would be added to his basis. Over the three years, A's reversionary interest would generate income in the aggregate amount of $249.

---

154 For the proper tax treatment where the taxpayer has not disposed of, but merely squirreled away the property, see Cunningham & Schenk, note 8, at 485 n.154.

155 A "disposition" of mineral properties can be characterized as either a sale or a lease. If a sale, gain (or loss) may be realized, but this is not depletable income since the seller has not retained an economic interest. West v. Commissioner, 150 F.2d 723, 726 (5th Cir.), cert. denied, 326 U.S. 795 (1945). If characterized as a lease, the amounts received are royalty income rather than capital gain, but the payments received are depletable. Id. at 725. Generally, payments dependent on production are evidence of a lease and payments that are payable in all events and are not dependent on extraction evidence a sale. Lesher v. Commissioner, 73 T.C. 340, 353-54 (1979), aff'd, 638 F.2d 64 (8th Cir. 1981).

The Code treats both a reserved economic interest (an AB transaction) and a carved-out economic interest (a BA transaction) as a purchase money mortgage loan and in neither case is the production payment considered an economic interest. IRC § 636(a), (b).

The economic interest concept also is used when a taxpayer disposes of coal or domestic iron ore and retains an economic interest. See IRC §§ 613(b), (c).

156 A naked assignment of income (for example, rents, interest, dividends) would trigger the proposed rules. The underlying property would not need to be transferred. For tax purposes, the legal incidents of the transfer under local law would be irrelevant as would the transferor's continuing control over the underlying property. So long as the transfer created an enforceable right to receive the income for a term, the rules would apply.

157 The portion of his initial $1,000 basis allocable to the financial interest sold is $249. Reg. § 1.61-6(a).

158 If the asset had changed in value since the date of acquisition, gain or loss would be recognized.

159 A would report $75, $83 and $91 of income over the three years.
which would be added to his basis, giving him a $1,000 basis when he retakes possession of Blackacre. B would have current depreciation deductions of $75, $83 and $91 leaving net income of $25, $17 and $9. These are precisely the same results that would flow from characterizing this transaction as a loan. Under this characterization, A would be deemed to have borrowed $249 from B and would have $100 of income from Blackacre per year for three years and interest deductions of $25, $17 and $9 on the $249 loan.

b. Purchase of Remainder

Under current law, the purchaser of a remainder interest in property does not report taxable income from that property before it vests. For example, the purchaser of a remainder interest in Blackacre that does not vest for ten years, does not report any income during the ten-year period, although the value of the interest increases annually, and would not report the increase in value upon possession either. This result can be utilized to reduce the tax base dramatically. If the purchaser acquired an interest in a trust funded with cash, the gain would be recognized on possession, but the purchaser still would have enjoyed the benefit of deferral.

The proposed rules would require the holder of the remainder to report income until his interest vests. If in Example 4, B had purchased an interest in Blackacre with A reserving a three-year lease, B would report $249 of income during the three years before he takes possession.

---

160 This assumes that the interest is deductible. See note 62 for other implications of the characterization of the payment as interest.

161 If A had acquired Blackacre with borrowed funds, A usually would have interest deductions which would be netted against the income. If B had borrowed to purchase the term interest, he would have interest as well as amortization deductions.

162 Throughout, the term “vests” is used to denote the remainderman’s taking possession, rather than its usual connotation of indefeasibility.

163 Because there is no realization event, the taxpayer does not report the increase in value when the remainder interest becomes possessory. If the taxpayer had purchased a remainder interest in a trust, there also would be no taxable income. The remainderman’s basis would be the trust’s basis. IRC § 643(e).

164 See Alvin D. Lurie, Depreciating Structures Bought Under Long Leases: An Adventure in Blanderland, 18 Inst. on Fed. Tax’n 43 (1960); Note, Purchaser’s Depreciation Rights in Property Subject to a Lease, 82 Mich. L. Rev. 572 (1983); W. Reed Quilliam, Jr., Depreciation of Property Acquired Subject to a Lease: Premium Lease Rentals as a Wasting Asset, 4 Val. U. L. Rev. 261 (1970); Rubin, note 15. The opportunity for income shifting exists whether cash is paid for the remainder or the remainder is purchased for an annuity. Both of these transfers are discussed in Lane, note 15, at 297-305.

165 See Lane, note 15, at 299-300, who notes that although there is no authority for this treatment, the similarity to IRC § 1286 makes the current treatment questionable.
c. Sale-leaseback

A sale-leaseback is another transaction where characterization is critical under current law, but would be irrelevant if the proposed rules were adopted. Suppose, for example, $A$ transfers $\text{Blackacre}$ with a fair market value of $1,000$ to $B$ for $751$, retaining a three-year leasehold. Such a case could be viewed as a sale of a remainder with $A$ retaining a term of years. Each party would be an owner of an interest in the property. $A$'s gain would be measured only by the portion of the property sold and his remaining basis should be amortized over the retained term. He also would be entitled to any other tax benefits associated with ownership of that interest. $B$ would have a correspondingly smaller asset to depreciate and since he purchased a future interest, there may be no tax consequences until it vests in possession.

The transaction also could be viewed as a sale of a fee simple with a lease back to $A$. $B$ would be deemed to have acquired a fee simple for $1,000$. Although he paid only $751$ in cash, he also would be deemed to have received $249$ of prepaid rent, which he reconveyed to $A$ as part of the purchase price. He would be entitled to immediate depreciation of $\text{Blackacre}$ using $1,000$ as his basis. $A$ would be deemed to have sold the entire property offsetting his total basis against the $1,000$ amount received. He also would deduct $249$ in rent over the three-year period.

In most cases, the alternative characterizations are economically the same, but because the tax consequences differ, the courts have felt obligated to develop a test to distinguish between them. In general, the courts look to the intention of the parties, the form of the transaction chosen, and the retention of traditional indicia of ownership such as the obligation to pay expenses and to bear the risk of loss or damage, or the assumption of obligations appropriate for a lessee. Occasionally, a

---

167 See Geneva Drive In Theatre, Inc. v. Commissioner, 622 F.2d 995, 997 (9th Cir. 1980).
170 Alstores Realty Corp. v. Commissioner, 46 T.C. 363, 371 (1966). The most important factor to the court was the obligation of the purchaser to pay the seller a certain amount per square foot if the seller lost occupancy. The court felt such a liability was completely inconsistent with a theory of a reserved estate and treated it as a reimbursement of prepaid rent. Id. at 372.
172 Alstores Realty, 46 T.C. at 372. It is obvious that these factors can cut both ways. In Kreusel, 63-2 U.S.T.C. ¶ 9714, the seller-lessee was to pay utilities and the purchaser-lesser
court will consider all factors, but no court has either weighed the factors or created a super factor. Because these factors are within the control of the parties, they can choose between economically similar forms to structure the transaction in a way to produce the desired tax results.

Under the proposed analysis, the characterization of this transaction would be unimportant because under either characterization, the tax consequences would be practically identical. If viewed as a sale of a remainder interest, A would have a basis of $249 in the retained leasehold that he would be entitled to recover over a three-year period. B would have an initial basis of $751 (his purchase price) and income of $75, $83 and $91 over the next three years. Similar results would obtain if the transaction were viewed as a sale of a fee simple and a leaseback of the property. Once again, the seller would have an initial basis in the leasehold of $249 and the purchaser would have an initial basis in the remainder of $751. The only significant difference under the proposed rules dependent on characterization of the transaction is the timing of the seller's recognized gain or loss in the property. If the transaction were viewed as a sale and leaseback, all of A's gain or loss would be realized; if viewed as a sale of only the remainder interest, only A's gain or loss in that portion of the property would be realized. Similar results could be achieved by simply changing the rules with respect to prepaid rent.

---


174 Another economic equivalent of a financing arrangement similar to a sale-leaseback is the sale of a business to a party who retains the seller to run the business pursuant to a management contract. See, e.g., Batastini v. Commissioner, 53 T.C.M. (CCH) 1500 (1987). Although the purchaser takes title and possession, the seller is entitled to continue to use the property and to share in profits through its fee arrangement. The management contract may run for the entire useful life of the asset or alternatively, after a specified period, the seller-manager is often able to exercise a repurchase option. This technique is discussed in Faber, note 4, at 805-08.

175 In this portion of the article, we are concerned only with the accurate measurement of economic income. If Congress chooses to allocate an incentive based on ownership, the question of whether A or B is the "owner" remains important. We discuss that question in Section IV.B.

176 The purchaser would have paid $1,000 for the fee simple, giving him a $1,000 basis. He then sold a three-year lease to A for $249. His basis in the portion he sold would be $249; his basis in the retained interest would be $751.

177 Prepaid rent could be reported under rules similar to those of § 467, or it could simply be treated as a loan.
This section explores whether the proposed analysis would change if multiple interests were created in depreciable property. The first part of this section assumes that the cost recovery system in place is based on actual economic depreciation and is, therefore, not intended to subsidize any investment. The second part considers the utility of the analysis where the system of depreciation is designed to subsidize investment.

1. Economic Depreciation

The following facts will be useful in exploring the application of the rules to multiple interests in a single piece of depreciable property.

Example 5: On January 1, 1993, A buys for $1,000 cash a piece of equipment with a useful life of five years to use in her business. The market rate of return is 10%. The equipment is expected to produce a level income stream of $264/year for five years with no salvage value. The equipment declines in value at the following rate:

<table>
<thead>
<tr>
<th>Year</th>
<th>Decline in Value (Depreciation)</th>
<th>Remaining Value at Year End</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$164</td>
<td>$836</td>
</tr>
<tr>
<td>1994</td>
<td>180</td>
<td>656</td>
</tr>
<tr>
<td>1995</td>
<td>198</td>
<td>458</td>
</tr>
<tr>
<td>1996</td>
<td>218</td>
<td>240</td>
</tr>
<tr>
<td>1997</td>
<td>240</td>
<td>0</td>
</tr>
</tbody>
</table>

These rules have only limited application to a single owner. Where there is a single owner of depreciable property, the second rule is of limited utility since, by definition, depreciable property is expected to decrease in value. It is, therefore, the rare case when its value should be assumed to increase solely due to the passage of time. The application of the proposed rules to a single owner of property is discussed in Section VI.

Theoretically, the value of any asset at equilibrium equals the present value of the expected cash flow from the asset. If the cash flow to be generated by an asset is known, economic depreciation can be determined by simple present value calculations. Economic depreciation for a year is the excess of (1) the present value of the remaining cash flows, computed at the beginning of the year, over (2) the present value of the cash flows, computed as of the end of the year. This is often referred to as sinking fund depreciation. For a straightforward explanation, see Chirelstein, note 69, at 142-44.

The essential difference in the debate between those who favor economic depreciation and those who favor cost method allocation is whether to reduce the cost that was paid for a year's use of an asset by the increase in value of the remaining income stream. Economic depreciation implicitly takes into account that expected increase in value in determining the decline in value of an asset. See, e.g., Calvin H. Johnson, Soft Money Investing Under the Income Tax, 1989 Ill. L. Rev. 1019, 1046. Professor Kahn, the leading proponent of the cost allocation method, apparently supports the failure to take this unrealized appreciation into account.
If \( A \) uses this property in her trade or business over the equipment’s entire useful life, \( A \) is entitled to depreciation deductions equal to the equipment’s annual decline in value. \( A \) would have the following net income stream over the equipment’s useful life:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Depreciation</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$264</td>
<td>$164</td>
<td>$100</td>
</tr>
<tr>
<td>1994</td>
<td>264</td>
<td>180</td>
<td>84</td>
</tr>
<tr>
<td>1995</td>
<td>264</td>
<td>198</td>
<td>66</td>
</tr>
<tr>
<td>1996</td>
<td>264</td>
<td>218</td>
<td>46</td>
</tr>
<tr>
<td>1997</td>
<td>264</td>
<td>240</td>
<td>24</td>
</tr>
</tbody>
</table>

In order to compare various transactions described below, it is useful to assume that \( A \) places each rental payment she receives in a “side fund.” Assume that the side fund also has a rate of return of 10% per year. On this assumption, \( A \) will have the following annual income from the side fund:

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Balance</th>
<th>Income from Side Fund</th>
<th>Addition to Side Fund</th>
<th>Year End Balance in Side Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$0</td>
<td>$0</td>
<td>$264</td>
<td>$264</td>
</tr>
<tr>
<td>1994</td>
<td>264</td>
<td>26</td>
<td>264</td>
<td>554</td>
</tr>
<tr>
<td>1995</td>
<td>554</td>
<td>55</td>
<td>264</td>
<td>873</td>
</tr>
<tr>
<td>1996</td>
<td>873</td>
<td>87</td>
<td>264</td>
<td>1224</td>
</tr>
<tr>
<td>1997</td>
<td>1224</td>
<td>122</td>
<td>264</td>
<td>1610</td>
</tr>
</tbody>
</table>

\( A \)’s aggregate net income for each year from the equipment and the side fund is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income from Equipment</th>
<th>Net Income from Side Fund</th>
<th>Total Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$100</td>
<td>$0</td>
<td>$100</td>
</tr>
<tr>
<td>1994</td>
<td>84</td>
<td>26</td>
<td>110</td>
</tr>
<tr>
<td>1995</td>
<td>66</td>
<td>55</td>
<td>121</td>
</tr>
<tr>
<td>1996</td>
<td>46</td>
<td>87</td>
<td>133</td>
</tr>
<tr>
<td>1997</td>
<td>24</td>
<td>122</td>
<td>146</td>
</tr>
</tbody>
</table>

Now consider the following transaction:

account because to do otherwise would violate the realization requirement, what he describes as a normal or neutral tax principle. See Kahn, Depreciation, note 48, at 1081. Needless to say, we favor economic depreciation in part because it takes into account the expected appreciation in the income stream.

\(^{180} \text{This is precisely the return from investing$1,000 for five years at 10\%}. \)
Example 6: A leases the equipment to B for three years at an annual rent of $264. B will use the equipment in his business. A retains the reversionary interest.

Under current law, A is considered the owner of the equipment for tax purposes. She must include each annual rental payment and is entitled to depreciation. Her net income for each year is set forth in Example 5. B, the lessee, is allowed an annual deduction of $264 each year as the annual rent is paid or accrued. Suppose instead, A sells the leasehold:

Example 7: A leases the equipment to B for three years for a single payment of $656 payable on January 1, 1993. The present value of $264/year for three years is $656. A retains the reversionary interest.

This transaction is economically the same as the lease with annual payments, but the tax consequences differ dramatically. Under current law, A is treated as the owner of the equipment and is entitled to depreciation. The amount paid by B to A is treated as prepaid rent which is includable in full by A upon receipt without regard to his accounting method. A has the following income for the term of the lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Depreciation</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$656</td>
<td>$164</td>
<td>$498</td>
</tr>
<tr>
<td>1994</td>
<td>0</td>
<td>180</td>
<td>(180)</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
<td>198</td>
<td>(198)</td>
</tr>
</tbody>
</table>

B, on the other hand, is entitled to deduct the $656 ratably over three years as rent ($218.67/year).182

The only difference between the two transactions is the timing of the rental payments. In all other ways, the two transactions should be treated the same for tax purposes. In our view, the current treatment of the first transaction is correct, while the current treatment of the second is incorrect. The second transaction can be characterized in either of two ways that would result in the identical and proper tax treatment: (1) a sale-purchase of property (that is, a three-year leasehold) or (2) a loan in conjunction with a lease.

If the transaction were characterized as a purchase by B of a three-year leasehold in the equipment, he should be able to depreciate the interest in the leasehold (a wasting asset). B paid $656 for an asset that he expects to produce a constant income stream of $264 a year. Thus, depreciation would be at the following rate:

---

181 See depreciation schedule in Example 5.
182 Query whether § 467 would apply to this example.
Under a sale characterization, $A$ would be viewed as selling $656/1000$ of the equipment (the leasehold), retaining a reversionary interest with a present value of $344$. Because the reversion predictably increases in value, $A$ should report income each year on her retained interest,\footnote{A would report $34$ in 1993, $38$ in 1994 and $42$ in 1995.} which would be added to her basis. When she took possession, her basis would be $458$.\footnote{Note that had $A$ retained the property, her basis at the end of three years also would have been $458. Since she would have used the property in her business, she would have taken depreciation on a $1,000$ basis for three years resulting in an adjusted basis of $458$. See Example 5.} Tabulating these results, the parties would have the following annual tax consequences:

<table>
<thead>
<tr>
<th>Year</th>
<th>Decline in Value (Depreciation)</th>
<th>Remaining Value at Year End</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Basis</td>
<td>$656$</td>
<td>$656$</td>
</tr>
<tr>
<td>1993</td>
<td>$198$</td>
<td>$458$</td>
</tr>
<tr>
<td>1994</td>
<td>$218$</td>
<td>$240$</td>
</tr>
<tr>
<td>1995</td>
<td>$240$</td>
<td>$0$</td>
</tr>
</tbody>
</table>

This transaction also could be viewed as a loan of $656$ from $B$ to $A$, with principal and interest payable by $A$ to $B$ in the form of annual rent forgiveness.\footnote{On these facts, $A$ would allocate $656$ of her original basis to the sale of the leasehold and therefore would not have any gain or loss. Unless a mark-to-market approach is in place, this would not always be the case. For example, suppose that $A$ had only a $500$ basis in the property at the time of the sale of the lease. In that case, only $328$ of $A$’s basis would be allocated to the leasehold ($656/1,000 \times 500$), and $A$ would have a gain of $328$.} $B$ would have interest income of $66$, $46$ and $24$.\footnote{For example, in Year 1, $B$ owes $A$ $264$ in rent and $A$ owes $B$ $264$ in debt service ($66$ in interest and $198$ in principal). Instead of $B$ actually transferring $264$ to $A$ and $A$ retransferring $264$ to $B$, $A$ pays principal and interest with annual rent forgiveness.} In addition, $B$ would have annual rental deductions of $264$. Correspondingly, $A$ would have interest deductions and rental income each year in
similar amounts. A would retain the deduction for depreciation. Under this characterization, B and A would have the following net tax consequences for 1993, 1994 and 1995:

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>B</strong> (lender)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>$ 66</td>
<td>$ 46</td>
<td>$ 24</td>
</tr>
<tr>
<td>Rent Deduction</td>
<td>(264)</td>
<td>(264)</td>
<td>(264)</td>
</tr>
<tr>
<td></td>
<td>(198)</td>
<td>(218)</td>
<td>(240)</td>
</tr>
<tr>
<td><strong>A</strong> (borrower)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income: Rent</td>
<td>264</td>
<td>264</td>
<td>264</td>
</tr>
<tr>
<td>Deductions:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>(66)</td>
<td>(46)</td>
<td>(24)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(164)</td>
<td>(180)</td>
<td>(198)</td>
</tr>
<tr>
<td></td>
<td>$ 34</td>
<td>$ 38</td>
<td>$ 42</td>
</tr>
</tbody>
</table>

The net tax consequences to B are identical whether the transaction is treated as the purchase of a leasehold or as a loan, and the tax consequences to A are practically identical. This can be demonstrated by taking into account the income from the $656 paid by B to A (whether as loan proceeds or the purchase price of the leasehold). For purposes of illustration, assume that A invests this sum in a side fund. The income from the $656 invested in this side fund for the years at issue would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$656</td>
<td>$66</td>
</tr>
<tr>
<td>1994</td>
<td>722</td>
<td>72</td>
</tr>
<tr>
<td>1995</td>
<td>793</td>
<td>79</td>
</tr>
</tbody>
</table>

Combining the income from this side fund with the net income from the transaction with B, A's income is identical to that received for three years in Example 5 where she used the property in her business and that in Example 6 where she received annual rental payments.

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
<th>Income from Side Fund</th>
<th>Net Income From B</th>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$656</td>
<td>$66</td>
<td>$34</td>
<td>$100</td>
</tr>
<tr>
<td>1994</td>
<td>722</td>
<td>72</td>
<td>38</td>
<td>110</td>
</tr>
<tr>
<td>1995</td>
<td>793</td>
<td>79</td>
<td>42</td>
<td>121</td>
</tr>
</tbody>
</table>

\footnote{A's tax treatment under the sale/purchase characterization may be different from the loan characterization either because she may have gain (or loss) when she sells the leasehold (see note 185) or because the interest A pays is not deductible. See note 160.}
The previous discussion assumed that the tax system is designed to measure income and thus a system of economic depreciation was in place. At least since 1954, however, the tax system generally, and the cost recovery system specifically, have been used to encourage capital formation. The two most frequent mechanisms used to achieve this goal have been accelerated depreciation and the investment tax credit. These tax incentives, with certain notable exceptions, generally have been made available only to the owner of property, thus placing a significant amount of tension on the definition of ownership. Since most of the controversy has centered on determining the owner in real property and equipment leveraged leases, transactions largely driven by tax incentives, we use them as our examples. As the discussion of the current state of the law reveals, the tax results frequently appear arbitrary and inconsistent. The taxpayer often can designate which party to the transaction is to be the owner and thus will be entitled to the tax incentives. As with the fact patterns considered previously, the identity of the owner is a false issue. Parties currently share the tax benefits generated by a trans-

---

189 Prior to 1981, the Code contained no rules to distinguish between true leases and conditional sales or financing arrangements, and the common law leasing doctrine usually applied. Generally, unless the transaction had "nontax economic substance," leasing transactions in theory could not be used to transfer tax benefits. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 203, 214, however, permitted the transfer of tax benefits through a leasing arrangement provided certain requirements were met. IRC § 168(f)(8) (before amendment in 1986). In effect, tax benefits were no longer tied to ownership, although another way of looking at safe harbor leasing was that Congress statutorily determined ownership. In general, the nominal lessor was treated as the owner for federal tax purposes even though, under case law, the lessee would be treated as the owner and the transaction would not be considered a lease. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 209, 96 Stat. 324, 442, repealed safe harbor leasing, replacing it with finance leasing which generally codified case law. Generally, this meant that the transaction had to have economic substance independent of tax benefits and the lessor reasonably must have expected to derive a profit. Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 12-18 (Comm. Print 1984) [hereinafter 1984 Bluebook]. With narrow exceptions, the finance leasing rules never went into effect. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 12(a), 98 Stat. 494, 503-04, postponed the effective date of the finance lease rules until 1988 with a narrow grandfather provision. The Tax Reform Act of 1986 repealed the rules. Pub. L. No. 99-514, § 201(a), 100 Stat. 2085, 2121.

Section 42 also effectively sanctions the transfer of tax benefits. An investor in a low-income housing project usually acquires a limited partnership interest with little expectation of any return other than the low-income housing credit. The owner of the building is permitted to offer a right of first refusal to the tenants without jeopardizing the right to the credit, IRC § 42(h)(7), even though under the usual analysis, the partnership might be considered a lender rather than an owner. Implicitly, Congress has determined that it is not concerned with the identity of the building's owner; the credit is put in the hands of someone who can provide funding for the desired form of housing.
action;\textsuperscript{190} a rule preventing such sharing is impossible to police. Our analysis seems to dictate that Congress rethink the mechanics for distributing these incentives and the restrictions it places on them.

1. Current law

a. Real Property Leveraged Leases

To facilitate discussion, consider the following example:

\textit{Example 8:} A transfers Blackacre to \( B \), an investor for \$1 million, \$975,000 of which \( B \) obtains from \( L \), a lender. \( L \) takes a security interest in Blackacre. At the same time, \( B \) leases Blackacre to \( A \) for 20 years with an option to renew. \( A \) also has an option to repurchase at that time for a strike price that will yield an overall rate of return to \( B \) of 10\% per year on his cash investment. The annual rent \( A \) pays \( B \), which is sufficient to service the debt, has been calculated to amortize the price plus a return on investment.

Although the economics of a leveraged lease (apart from the tax consequences) are often the functional equivalent of a loan, the tax consequences are quite different. Where the form of the sale-leaseback is recognized, the seller recognizes gain or loss on the sale, if any.\textsuperscript{191} The purchaser is not able to deduct the purchase price, but instead can depreciate the property\textsuperscript{192} and deduct interest paid to the lender on the financing.\textsuperscript{193} Depreciation and interest deductions, at least initially, together should exceed the taxable rental payments made by the seller to the purchaser. Assuming the rents are business related, \( A \) can deduct the payments made to \( B \).

If, on the other hand, the arrangement is treated as a financing, the amount \( B \) transfers to \( A \) is a nontaxable loan and \( A \) retains the right to depreciation. In addition, the “rental” payments made by \( A \) to \( B \) are

\begin{itemize}
\item Complexity is generated because taxpayers do not technically share the depreciation or credit. An owner of the property may not be able to use the tax benefits because it has net operating losses or because it is a start up company with insufficient income. A taxpayer who could use the tax benefit may, however, transfer it because it may not be able to incur or wish to put on its financial statement the liability generally associated with purchasing the property. See Staff of the Joint Comm. on Tax’n, 97th Cong., 1st Sess., Proposed Depreciation and Investment Tax Credit Revisions 71-72 (Comm. Print 1981). Even taxpayers with positive income may transfer the benefits to profitable firms with a higher effective tax rate. See Note, Safe Harbor Leases: The Costs of Tax Benefit Transfers, 34 Stan. L. Rev. 1309, 1309 n.4 (1982). As the following discussion illustrates, such a taxpayer shares the credit by transferring it to a taxpayer who can use the full benefit in exchange for another financial benefit.
\item \textsuperscript{191} IRC § 1001(a).
\item \textsuperscript{192} IRC §§ 167, 168.
\item \textsuperscript{193} IRC § 163(a).
\end{itemize}
recharacterized as nondeductible principal and deductible interest. Conversely, B cannot depreciate his security interest and must include the interest in income, but not the principal.

As an economic matter, in either case, B will want to recover the amount advanced plus a return. If, however, conventional mortgage financing can be structured as a sale-leaseback, a nondeductible repayment of principal may be recharacterized as deductible rent. Because the economics of the transactions are almost identical, regardless of the form, courts have been unable to rely on traditional notions of ownership to distinguish the sale-leaseback from the financing arrangement. This distinction was necessary because Congress apparently had determined that tax incentives (in the case of real estate, primarily accelerated depreciation) could be utilized only by the owner of the property. This approach led to decisions which probably can be explained best on the basis of desired result and not on the basis of the consistent application of an articulated standard. The current subjective standard provides little certainty and a significant incentive to transfer tax benefits.

b. Leveraged Equipment Leasing

The issue in cases involving leveraged equipment leasing is also to determine whether the lessor should be treated as owner of the property. Consider the following typical transaction:

Example 9: Manufacturer sells equipment to a leasing company or limited partnership that purchases it with a nonrecourse loan issued by a financial institution (or possibly from

---

194 Prior to the Supreme Court's 1978 decision in the leading case, Frank Lyon Co. v. United States, 435 U.S. 561 (1978), case law determined the ownership of real property for tax purposes on the basis of investment in the property. The leading pre-1978 decision, Helvering v. Lazard & Co., 308 U.S. 252 (1939) held that depreciation deductions go to the taxpayer who bears the loss from exhaustion of invested capital. That approach did not furnish a satisfactory standard for determining which investment in property should be respected when there was more than one. Effectively sanctioning a determination by the parties as to who should enjoy tax benefits, the courts generally adopted standards that would accommodate substantive business arrangements.

In Frank Lyon, the Supreme Court held that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." Frank Lyon, 308 U.S. at 584. The Frank Lyon inquiry is a two-pronged one that provides that the labels chosen by the parties will control as long as: (1) the transaction possesses economic substance and (2) the transaction is motivated by business (or regulatory) nontax considerations.

Subsequent courts have used the Lyon standard to achieve different results in transactions exhibiting few substantial differences, suggesting the potential for haphazard application of the Frank Lyon test. See, e.g., Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986); Hilton v. Commissioner, 74 T.C. 303 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982); Belz Investment Co. v. Commissioner, 72 T.C. 1209 (1979). Where the purchaser is a tax shelter partnership, the form is likely to be ignored.
the manufacturer). *Investor* purchases a limited partnership interest. The debt is serviced with rental payments made by *User* who leases on a net lease basis.

Although the transaction is economically similar to a debt-financed purchase by *User*, *Investor* must remain on the lease side of the line in order to obtain tax advantages. *User*, by permitting *Investor* to retain the tax benefits and possibly to share in future appreciation, is able to obtain better financial terms than might be available with a normal two-party purchase financed by debt. In effect, the tax benefits are assigned to the party to whom they present the largest advantage, but the savings are shared by all parties.\(^{195}\)

In determining whether transactions of this type will be respected, the prime consideration is whether the lessor has a profit motive for entering the transaction. Generally, this inquiry has two aspects: Subjectively, did the lessor enter into the transaction to make a profit (the business purpose test) and objectively, was it reasonable to expect that the lessor might make a profit (the economic substance test). Since the business purpose test is almost always met\(^ {196}\) and courts uniformly have blessed transactions in which an opportunity for profit was a demonstrated motive of the lessor,\(^ {197}\) current law is ineffective in restricting the transferability of tax benefits among the parties to a transaction as long as the parties are well advised.

2. *Application of Proposed Rules*

In order to examine both the effect of incentives on our proffered analysis and whether the analysis can be used to eliminate the tension among

\(^{195}\) Where Congress believed incentives were allocated to the “wrong” party, it prevented their transfer by lease. See, e.g., IRC § 168(g)(1)(B) which denies the benefits of ACRS to property subject to a disqualified lease, that is, property financed with tax-exempt obligations. Tax-exempt entities would enter into leasing arrangements for the same reason other entities used equipment leasing: They could not use the tax benefits associated with ownership, but could dispose of the benefits in exchange for lower rental payments. Congress found the transfer of such benefits unacceptable in that incentives intended for taxable entities were providing advantages for tax-exempt entities. 1984 Bluebook, note 189, at 43. A similar concern arose in connection with the investment tax credit. See Reg. § 1.48-1(j), (k) (denial of the credit where the property was owned by or leased to a tax-exempt entity). For an example of the folly of trying to determine the “owner” in this situation, see Rev. Rul. 68-590, 1968-2 C.B. 66.

\(^{196}\) The business purpose motivating the lessor is, in the main, the potential for profit on realization of the equipment’s residual value at the end of the lease. See, e.g., Green v. Commissioner, 87 T.C. 1471 (1986). For the lessee, the business purpose is the opportunity to pay a rental lower than that commonly available in other leasing arrangements (that is, those made directly with the equipment manufacturer or with equipment brokers for shorter terms). See, e.g., Estate of Thomas v. Commissioner, 84 T.C. 412 (1985).

\(^{197}\) Basically, this has meant that the owner’s expected economic return (unlike the lender’s) cannot be fixed. For a prototypical example of the approach taken by the courts, see *Estate of Thomas*, 84 T.C. 412.
competing plausible characterizations, we begin by examining the investment tax credit (ITC).\textsuperscript{198} The assumption of the case law, and perhaps Congress, is that the owner is the only and the intended beneficiary of the ITC. Almost surely, however, an incentive is shared among the parties to a transaction. To illustrate, consider the following example:

\textit{Example 10:} In 1993, Congress enacts a 10\% ITC for the purchase of equipment, to take effect on January 1, 1994. The credit does not reduce the basis of the purchased asset. On January 1, 1994, \textit{A} buys a piece of new equipment from \textit{M}, the manufacturer, which has a useful life of five years. The market rate of return is 10\%. Prior to enactment of the credit, \textit{M} would have been willing to sell the equipment for $1,000, and a user, \textit{U}, would have been willing to rent the equipment from \textit{A} for $264 a year for five years.

It is possible, though unlikely, that after enactment of the ITC, \textit{M} still would be willing to sell the equipment to \textit{A} for $1,000, and that \textit{U} would be willing to pay $264 a year to \textit{A} as rent. If so, \textit{A} would receive the entire benefit of the ITC and his after-tax rate of return on his investment would increase to 10\%.\textsuperscript{199} \textit{A}'s depreciation schedule would be as follows:\textsuperscript{200}

\begin{tabular}{|c|c|}
\hline
\textbf{Year} & \textbf{Decline in Value (Depreciation)} & \textbf{Remaining Value at Year End} \\
\hline
Initial Value & $1,000 & \\
1994 & $164 & 836 \\
1995 & 180 & 656 \\
1996 & 198 & 458 \\
1997 & 218 & 240 \\
1998 & 240 & 0 \\
\hline
\end{tabular}

More likely, as a result of increased demand, \textit{M} would raise the price of its equipment and thereby increase its profit on each sale. Simultane-

\textsuperscript{198} Although the ITC has been repealed, it nevertheless serves as a good example. Furthermore, since tax benefits, whether in the form of a credit or accelerated depreciation, can be expressed in present value terms, the principle illustrated by the ITC should apply equally to accelerated methods of depreciation.

\textsuperscript{199} The before-tax rate of return is 14.3\%. Although it is true that the enactment of the credit would temporarily increase the rate of return on equipment, when the economy reaches equilibrium, the market would take these incentives into account and arrive at a new rate of return for all investments. The net effect of the incentive generally would be to increase the after-tax rate of return on all investments throughout the economy, and to increase the stock of favored assets to the point that equilibrium is re-established.

\textsuperscript{200} This schedule is based upon a rate of return of 10\% and is identical to the schedule in \textit{Example 5}.\textsuperscript{1992}
ously, $U$ may insist on lower rental payments so that he also can benefit from the incentive.\textsuperscript{201} Most important for our purposes is that, without trying to quantify the sharing arrangement, we can safely predict that the nominal beneficiary of the credit ($A$, the investor) almost surely must share the benefit of the credit with the other parties to the transaction. In most situations, this benefit would be shared on the basis of the parties’ bargaining power regardless of who was nominally deemed to be the owner. To illustrate, consider the following variation:

\textit{Example 11:} Assume the same facts as in \textit{Example 10} except that as a result of an increase in demand, $M$ raises the price of the equipment to $1,050. $A$ purchases the equipment and leases it to $U$ for $260$ a year for five years.

This variation demonstrates how the parties to a transaction might share the tax incentive. On these facts, $M$ raised its price, and therefore its profit, by $50$; $U$ reduced its annual rental payments by $4$ per year; and $A$, as a result of the $105$ tax credit, reduced his real purchase price to $945$ and thereby increased his overall return on this investment from $7\%$ to $8.17\%$.\textsuperscript{202}

Practically identical results would occur if the nominal beneficiary of the incentive were $M$ or $U$ (or even the lender). Suppose, for example, Congress had granted a $105$ credit to the manufacturer rather than $A$. How might the parties in \textit{Example 11} share this incentive? Assuming the parties retain the same economic clout, $M$ now could reduce the price of the equipment to $945$ while simultaneously increasing its profit by $50$. If $A$ bought the equipment at this price and leased it to $U$ for $260$ a year for five years, all three parties to this transaction would be in close

\textsuperscript{201} See Staff of the Joint Comm. on Tax’n, 97th Cong., 2d Sess., Analysis of Safe-Harbor Leasing 5 (Comm. Print 1982) [hereinafter Analysis]. If $A$ is not willing to lower the annual rental charge, $U$ may choose to lease from a more accommodating lessor. $U$ also may be a potential buyer of the equipment.

\textsuperscript{202} The $8.17\%$ ($11.67\%$ before tax) rate is based on the assumption that $A$ would recover his gross investment of $1,050$ under the depreciation schedule prescribed for this type of equipment. The credit has created a difference between the value of the asset and its adjusted basis. In a $10\%$ world, an income stream of $260$ a year for five years has a value of $986$; $A$, however, paid $1,050$ for the asset and therefore would have an adjusted basis in the asset of $1,050$. Simply allowing $A$ a deduction for the decline in value of the asset each year would not enable $A$ to recover his entire basis and would leave an unrecovered basis of $64$.

The cost recovery deductions associated with this $64$ can be viewed as part of the incentive for investing in the equipment. The rate at which this is recovered relates not to income measurement, but to the value of the incentive that Congress wishes to bestow on investors. We assume Congress intended that the excess of basis over value be recovered at the same rates as the depreciation schedule for the equipment. Thus, in determining the proper amount of cost recovery for each of the five years, the same depreciation rate could apply to the portion of basis that is actually part of the incentive. This would permit application of a single percentage to the original basis each year to determine the appropriate cost recovery deduction.
to the same economic position as they were in Example 11. Nominal granting the incentive to $U$, or for that matter, any other party to the transaction, would produce the same economic results.

This analysis also can be applied to a subsidy in the form of accelerated methods of depreciation. To illustrate, consider the following:

Example 12: Suppose in Example 10 that Congress, instead of enacting an ITC, adopts a system of expensing for certain investments, that is, it allows the cost of such investments to be deducted in the year of acquisition.

The present value of the deductions to which $A$ is entitled under a system of economic depreciation is $260. Since the present value of expensing the equipment is $300 [the amount of the deduction ($1000) times the tax rate (30%)], the amount of the subsidy would be $40. This subsidy (or one slightly higher if $M$ raises its prices) could be shared by the parties to the transaction in the same fashion as the credit. For example, suppose $M$ raised its price by $20 and $U$'s rent was reduced by $2 a year. $A$'s rate of return on this investment would increase from 7% to 8.97% after taxes. All three parties would share the subsidy.

As with the credit, it would not matter which party is the nominal beneficiary of the subsidy; so long as all are in the same tax bracket, they would share the subsidy. For example, suppose that as a simplification measure, Congress changed the law so that the formal holder of title is the only party entitled to depreciation, regardless of who is the actual beneficial owner. Furthermore, assume that Congress adopted a system of expensing. Reconsider the facts of Example 12, assuming that $M$ retained title to the equipment as a security device. So that we can compare directly the results under this regime, assume that $M$ is entitled to a current deduction of $1,020. The present value of this deduction is $306, which means that $M$ could sell the equipment to $A$ for $714 and still maintain the same profit as in Example 12. Even though $A$ would not be entitled to depreciation under this regime, he still could lease the

---

203 The only difference in economic positions would be caused by the fact that in Example 11 the subsidy is slightly larger than in this variation. Although in both cases, a tax credit of $105 is granted, in this variation, $A$'s basis would be $945 while in Example 11, $A$'s basis would be $1,050, resulting in an additional incentive through depreciation of the difference. If the two subsidies were the same, the economic positions could be made identical, for example, by forcing $A$ to reduce his basis in the equipment by the amount of the credit.

204 This amount was determined by assuming that $A$ would have the benefit of the first year's deduction on the date of acquisition, the second year's deduction one year after acquisition, and so on. A 7% after-tax rate of return was used (10% discount rate and 30% tax rate).

205 There is tremendous pressure under current law to identify the party in the highest marginal bracket as the owner of the property in a sale-leaseback.

206 $M$ has raised its price to $1,020. Under this assumption, the amount of the subsidy would be precisely the same as in Example 11.
equipment to \( U \) for $262 a year and maintain an after-tax rate of return on the equipment of 8.97%.

As this analysis illustrates, an attempt to limit the use of the incentives to the "owner" is a fruitless exercise leading to rule and transactional complexity.\textsuperscript{207} It is highly likely that allocating the incentive to the owner is an inefficient way to execute the subsidy. Whether to create a subsidy is a political decision to be made by Congress. Clearly a case can be made for not limiting the utilization of tax benefits to particular taxpayers,\textsuperscript{208} but it is inefficient to build in extraordinary transaction costs in order to obtain the subsidy. Any argument against the transfer of benefits\textsuperscript{209} loses its persuasive force once it is acknowledged that tax benefits will be shared despite statutory restrictions, resulting in a waste of government resources. Thus, tying tax benefits to ownership is a costly mistake.

\textsuperscript{207} There is a parallel in the corporate area although the stakes are often reversed. A corporate borrower that compensates a lender with equity participation will want to avoid having such participation recharacterized as an ownership interest so as to retain a deduction for payment of "interest." Although the lender clearly has a property interest in the corporation, the character of that participation is an all-or-nothing proposition, that is all debt or all equity for tax purposes. See, e.g., Note, Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes, 66 Ind. L.J. 273 (1990); cf. IRC § 385(b). Trying to determine whether a corporation should be able to deduct the cost of capital based on whether the supplier is an "owner" sets up artificial distinctions and creates distortions. See Edward D. Kleinbard, Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System, 67 Taxes 943 (1989). Similar confusion reigns with respect to the lender/joint venturer distinction in the partnership context. See, e.g., Estate of Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963); Luna v. Commissioner, 42 T.C. 1067 (1964).

\textsuperscript{208} The most common argument in support of the transferability of tax benefits is competitive neutrality. The notion is that the payment of subsidies to some companies, but not others, may decrease economic welfare where the subsidized companies are not those able to make the most socially desirable investments. David G. Raboy, The Economic Justification for Safe Harbor Leasing, 14 Tax Notes 795, 796 (Mar. 29, 1982); Alvin C. Warren, Jr. & Alan Auerbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harv. L. Rev. 1752, 1758-62 (1982). Others have argued that permitting benefits to be transferred prevents uneconomic mergers as firms holding tax benefits become targets of tax-motivated mergers. See Treasury Describes Leasing Provisions of Tax Cut Act, 13 Tax Notes 867, 868 (Oct. 12, 1981).

\textsuperscript{209} The usual argument supporting limitations on the use of tax benefits is that "trafficking" undermines the tax system. See, e.g., H.R. Rep. No. 432, 98th Cong., 2d Sess. 103 (1984) ("[T]he tax system exists fundamentally to collect tax from taxable entities. It is not meant to be used as a mechanism for making payments to parties, as could happen if transactions structured essentially for the purpose of transferring the benefits of income tax credits and deductions were freely recognized as leases for income tax purposes."). Critics also fear the demoralization resulting from taxpayer perception that the transfer of benefits is inequitable. See, e.g., Analysis, note 201, at 22. In particular, the concern is the derivative erosion of taxpayer compliance. See, e.g., id.; S. Rep. No. 494, 97th Cong., 2d Sess. 424 (1982). Ultimately, however, the real objection may be revenue loss. See, e.g., id.
In the previous section, we analyzed how traditional split interests in property might be taxed under our proposed rules. This section extends the analysis to options. Options, like the examples in the preceding section, are no more than interests in the underlying property. Therefore, the above analysis can be utilized to inform us as to the appropriate taxation of options.\textsuperscript{210} The application of this analysis to options has implications for nonrecourse financing, which is taken up in the following section.

The current tax treatment of options\textsuperscript{211} is quite unusual in that, although the grantor of the option has transferred an important interest in the property (the right to appreciation), the transfer is not treated as a realization event.\textsuperscript{212} As with the split interests described above, the income produced by the property is allocated incorrectly between the two parties with interests in the property. Under current law, from the time an option is issued until it is exercised or lapses, the seller (or writer) of the option, is taxed on the investment income generated by the premium. The ensuing analysis demonstrates, however, that it is the holder of the option, rather than the seller, who benefits from this income. Therefore,

\textsuperscript{210} An interesting example of a transaction resembling an option where the Service stretched to eliminate unsatisfactory results is the prime and score, a financial package momentarily popular in the 1980's. For a description, see Douglas H. Walter & Paul A. Strassen, The Americus Trust “Prime” and “Score” Units, 65 Taxes 221 (1987). A shareholder would transfer a share of stock to a trust and receive a prime, which gave him dividend and voting rights and a right to the stock up to a certain value (termination claim), and a score entitling him to the stock’s capital appreciation over a specified price as of a specified date. Although the Service determined that the basis must be allocated between the two components based on the relative fair market values on a sale of either unit, GCM 37535 (May 15, 1978), it did not satisfactorily tax the increase in value. Although the score was essentially an option, likely to increase in value with time, that increase was not taxed and could even be deferred on a sale. For example, suppose $T$ transfers a share of stock with a basis of $100$ to a trust when the prime unit is trading at $75$ and the score unit is trading at $25$. Assume the termination claim is $120$, and as the stock price approaches that amount, $T$ sells the score for $31$ when the prime is trading at $94$. Because the score represents 25\% of the combined value, the basis of $100$ is allocated $25$ to the score and $75$ to the prime. The taxable gain on the score would be $6$ even though it has increased in value $11$. The utility of this device was curtailed by changes in the definition of an investment trust. Reg. § 301.7701-4(c)(Ex. 3).

\textsuperscript{211} An option is the right, but not the obligation, to buy or sell property at a stipulated price, the strike price, on or before a specified future date, the strike date. An option that may be exercised at any time prior to the strike date is referred to as an American option, while an option that can be exercised only on the strike date is known as an European option. An option to buy is a call, while an option to sell is a put. The amount paid for an option is the premium or price of the option. Typically, the premium for the option is paid to the seller (or writer) of the option when the option contract is entered into, and therefore, at least nominally, the seller is taxed on the investment income earned by the premium during the term of the option. See generally John C. Cox & Mark Rubinstein, Option Markets 1-3, 21 (1985).

\textsuperscript{212} Others have noted current law’s failure to tax the time value of money element in an option. See, e.g., Lawrence Lokken, New Rules Bifurcating Contingent Debt—A Good Start, 51 Tax Notes 495, 502 (Apr. 29, 1991).
under an accretion-type income tax, this income should be taxed to the 
holder and added to his basis in the option.

The failure to tax the appropriate person is important for two reasons. 
First, the seller of the option may be in a lower bracket than the holder, 
resulting in rate arbitrage. \footnote{This is not a case, like accelerated depreciation, where Congress apparently has chosen to mismeasure income by creating an incentive. See text accompanying note 189.} Second, in the case of a call option that is 
exercised, the investment income is not treated as part of the holder's 
cost of the acquired property; in effect, current law allows the holder to 
expense this portion of his cost. \footnote{Economically, the amount paid for the option, and therefore the underlying property, includes the investment income earned on the premium. This income should be taxed to the holder and capitalized as part of the cost of the property. Under current law, however, since the seller is taxed on this income, the holder neither includes nor capitalizes this amount. This is economically the same as if the holder included and deducted the income. See Cunningham & Schenk, note 8, at 469.}

An option can be analyzed either as a carved-out or future interest in 
the underlying property, or as a separate investment, analogous to a loan. 
Both analyses suggest similar tax treatment. Although both approaches 
are illuminating, the carve-out analysis can become unduly complex es-
pecially as applied to put options, while the separate investment analysis 
is fairly straightforward for all options. For this reason, our analysis sug-
gests that the following rules for options (based on a separate investment 
model) would result in more appropriate tax results:

1. A minimum rate of return on the option would be im-
posed on the holder. The amount taxed would be added 
to the holder's basis in the option. \footnote{This application is consistent with our general proposal in that the holder of an option has invested in an asset that predictably will not have a current taxable yield.}
2. The seller of an option would be entitled to an "interest" 
deduction for a similar amount. \footnote{These deductions should be treated as interest for all purposes of the Code. Cf. IRC § 1286.}

The principal effect of these two rules operating in tandem would be to 
shift the incidence of the tax on the investment income from the seller to 
the holder of the option and to treat the income as an additional cost of 
the option.

\section{Current Law}

Under current law, the sale of an option is not treated as a disposition 
by the seller of any portion of the underlying property \footnote{Elrod v. Commissioner, 87 T.C. 1046 (1986) (option treated as current sale); Koch v. Commissioner, 67 T.C. 71, 83-89 (1976), acq.; cf. Rev. Rul. 82-150, 1982-2 C.B. 110.} and, corre-
spondingly, the purchase of an option is not an acquisition of the property by the holder. Thus, in the case of a put, the holder pays for the right to sell the underlying property to the seller of the put at a specified price, but is not deemed to have disposed of any portion of the underlying property prior to exercise; nor has the seller acquired any interest in the property. In the case of a call, the holder pays for the right to acquire specific property at a stated price in the future, but is not deemed to have acquired any interest in the underlying property until exercise; nor has the seller disposed of any interest in the property.

The premium paid by the holder is a nondeductible capital expenditure, but this amount is not income to the seller in the year the option is granted even if credited against the ultimate purchase price. If a call is exercised, the option price is added to the basis of the underlying property purchased. The seller treats the option price as part of the amount realized for the underlying property. If a put is exercised, its cost reduces the amount realized upon the sale of the underlying property. The seller treats the option amount received as part of the basis of the property purchased. If an option lapses, the option price is treated as a loss to the holder and as gross income to the seller on the expiration date. The seller is permitted to defer reporting this premium, and this is so even though the option amount may exceed the basis of the underlying property.

In a limited number of situations, the grant of an option is treated as a disposition and the option holder is treated as the owner. Where the amount paid for the option is to be created against the sales price and is such a significant portion thereof that exercise is certain, it may be treated as a down payment with a nonrecourse purchase money mortgage or even as a transfer. In addition, the purchaser of a deep-in-the-

---

221 See, e.g., Koch v. Commissioner, 67 T.C. 71 (1976). Current law also does not account for any change in the value of the option.
223 Commissioner v. Dill Co., 294 F.2d 291 (3d Cir. 1961); Hunter v. Commissioner, 140 F.2d 954 (5th Cir. 1944); Virginia Iron, Coal & Coke Co., 99 F.2d 919. But see Elrod v. Commissioner, 87 T.C. 1046 (1986) (option treated as current sale).
225 IRC § 1234(a)(1), (2).
226 In this respect, the treatment of the option premium is similar to a nonrecourse mortgage exceeding basis. See Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).
money option may be treated as the owner of the underlying property because the seller may be in a relatively risk-free position if the exercise is virtually guaranteed.

It follows from the principle that an option is an asset separate from the underlying property that the sale or exchange of an option is not treated as a disposition of the underlying property, although the character of any gain or loss is determined with reference to that property.

Under current law, there are no direct tax consequences to either the holder or the seller until the option is disposed of, exercised or lapses. Since the seller of the option has the use of the option premium for the period the option is outstanding, the investment income generated by the premium is taxed to the seller. If the seller is the correct taxpayer to report the income, current law is satisfactory. If, however, it is more appropriate for the holder to report the income, the effect of the current rule is to tax the wrong taxpayer.

The appropriate taxpayer is the party who has an accession to wealth as a result of the investment income, or put somewhat differently, the one to whom the benefit of the investment income inures. Superficial arguments can be made that the seller should be taxed on the investment income from the premium while the option is outstanding. The seller has possession of the premium and has an unrestricted right to do with it as he pleases. Although the seller may have to deliver the underlying property, or otherwise close out the transaction, in no event will he be required to return the premium to the holder. This line of argument treats the writing of an option as a closed transaction in which the seller has an unrestricted right to the full payment for the option and the holder assumes whatever rights he has purchased.

It is more accurate, however, to tax the holder of the option on the investment income from the premium. The rationale is that the holder has invested his capital for the term of the option and will demand a market rate of return on that investment. Indeed, this is precisely how

An example of a deep-in-the-money option is a call option that is sold with a strike price below the market price of the underlying property on the date the option is written. Cf. Rev. Rul. 85-87, 1985-1 C.B. 268 (defining "in-the-money put").

See Rev. Rul. 82-150, 1982-2 C.B. 110; cf. Reg. § 1.1361-1(1)(4) (deep-in-the-money option may be treated as if it were a class of stock for purposes of the one class of stock limitation on S corporations).

IRC § 1234(a)(1).

See IRC §§ 421, 422 (incentive stock options granted to employees); Reg. § 1.83-7(a) (nonqualified stock options granted for the performance of services). This is not true for those options described in § 1256(b). These are subject to mark-to-market rules. IRC § 1256(a), (b).

Even this characterization is not consistent with current law in that the seller does not take the premium into account when received, even if it exceeds his basis. See Bittker & Lokken, note 228, at 40-40. To be consistent, the seller would have to account for the option price upon receipt, either as income or as an amount realized.
the market prices options. One of the most widely used methods of valuation is the Black-Scholes formula.\textsuperscript{234} Although the mathematics are daunting, the value of an European option under this formulation essentially is the present value of the "expected intrinsic value" of the option on the strike date. On that date, the intrinsic value of the option is the difference between the strike price and the property's fair market value at that time, but not below zero. Thus, the current value of an option is equal to the present value of its expected intrinsic value on the strike date. To illustrate, assuming a market rate of return of 10\%, if the expected intrinsic value of an option to acquire \textit{Blackacre} for $1,000 in one year is $110, the appropriate price for that option today is $100. The holder who invests in an option is, therefore, the beneficiary of the investment income from the option premium and should be taxed on the expected increase in value of the option.

This conclusion as to the holder of the option applies whether the option is a put or a call, and is not dependent on whether an option is viewed as a carved-out interest in the underlying property, or as a separate investment, analogous to a loan. The results under either characterization are similar, and both suggest that the proposed rules would produce more satisfactory results.

\textbf{B. Analysis}

1. \textit{European Call Options}

In connection with this analysis, consider the following transaction involving a European call option:\textsuperscript{235}

\textit{Example 13:} On January 1, 1993, \textit{A} purchases \textit{Blackacre} for $1,000. \textit{Blackacre} generates $100 per year in net rentals. On the date of purchase, \textit{A} sells to \textit{B} for $100 a European option to purchase \textit{Blackacre} on January 1, 1996 at a strike price of $1,000. \textit{A} places the $100 premium in a savings account that yields 10\% per year.

Under current law, \textit{A} is taxed on the entire $100 annual rental from \textit{Blackacre} until the strike date. In addition, \textit{A} also is entitled to the earnings on the premium in the savings account for the three-year period. \textit{A} therefore has income of $110, $111 and $112 for 1993, 1994 and 1995 respectively. \textit{B} reports no income or deduction until the strike date. On the strike date, if the call is exercised, \textit{A} will have an amount realized,


\textsuperscript{235} A European option is one that can be exercised only on the strike date and not before.
and B a basis in *Blackacre*, of $1,100. If the option lapses, A will have income of $100, and B will have a $100 loss.

If, however, an option is viewed either as a carve-out or as a separate investment, B, not A, would be taxed on the income from the premium. Both approaches are considered below.

a. Carve-out Analysis

A's purchase of *Blackacre* can be characterized as the acquisition of two separate interests in *Blackacre*: a three-year leasehold with value of $249 and a remainder interest with a value of $751. When A sells the option to B for $100, economically, A has sold $100 of his beneficial interest in the underlying property. A has sold to B his right to any appreciation above the strike price of $1,000. If *Blackacre* is worth more than $1,000 on the strike date (ignoring transaction costs), B will exercise his option.

Under this approach, both A and B have financial interests in the remainder; B's option is a carved-out future interest in *Blackacre*. Each may be seen as holding a contingent remainder interest, that is, a remainder contingent on whether *Blackacre* is worth more or less than $1,000 three years hence. Under the rule developed above, A and B would have income from their respective interests in the remainder of:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial value</td>
<td>$651</td>
<td>$100</td>
<td>$751</td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>65</td>
<td>10</td>
<td>75</td>
</tr>
<tr>
<td>1994</td>
<td>72</td>
<td>11</td>
<td>83</td>
</tr>
<tr>
<td>1995</td>
<td>79</td>
<td>12</td>
<td>91</td>
</tr>
<tr>
<td></td>
<td>$216</td>
<td>$33</td>
<td>$249</td>
</tr>
</tbody>
</table>

A would have additional income from the savings account each year in the amounts of $10, $11 and $12 respectively and from the leasehold in the amounts of $25, $17 and $9 respectively. A's net income in each of the three years would be $100; B's would be $10, $11 and $12 respectively.

236 See text accompanying note 141.

237 On these facts, A would have neither gain nor loss on the sale of this $100 carve-out because he would have a basis exactly equal to his amount realized. Where the property's value is different from the owner's basis, this analysis would generate a gain or loss.

238 These amounts represent the $100 annual rentals less depreciation of the leasehold. This analysis is developed more fully in text accompanying notes 142-43.

239 Note that the total amount of income taxed would be the same as under current law. The person to whom it is taxed would differ, however.
TAXATION WITHOUT REALIZATION

On the strike date, $B$ would have a basis of $133$ in his interest and the option will either lapse or be exercised. If the option lapsed, $B$'s interest in *Blackacre* would become worthless, resulting in a loss to $B$ of $133. If the option were exercised, $B$ would take a basis of $1,133$ in *Blackacre*. $A$ would have a gain of $133. This analysis produces two important conclusions: First, $B$, the holder of the option, rather than $A$, the writer, would be taxed on the investment income generated by the option premium. Second, if the call were exercised, $B$'s basis in *Blackacre* would reflect this income. In contrast with current law, this amount of $B$'s cost would be capitalized rather than expensed.

b. Separate Investment Analysis

The call also can be analyzed as a separate investment. Under current law, the principal reason an option premium is not taken into account until exercise or lapse is that it is unclear until that time whether the premium constitutes part of the price paid for the underlying property or is income (or loss) from the lapse of the option. In either event, the premium paid for the option relates to a transaction that will or will not occur on the strike date. In fact, the amount of the premium is determined with reference to this transaction: It is the present value of the expected intrinsic value of the option on the strike date. Therefore, the premium paid for an option could be viewed as a payment relating to a transaction that will occur (or not) on that date, in effect, an advance payment. As an economic matter, an advance payment is the equivalent of a loan from the payor to the payee from the time of payment until economic performance occurs. For this reason, an option can be analyzed usefully as a loan without stated interest. If the transaction were characterized in this way, the option holder (that is, the lender), would bear the tax burden, rather than the seller (that is, the debtor). The seller's investment income from the premium would be offset by an interest deduction.

---

240 Under this approach, $A$ would not have income on the lapse, as $A$ would have taken into account the $100 received for $B$'s interest on the grant of the option. See text accompanying note 238. His remaining basis in *Blackacre* would be $900 (that is, $249 in the leasehold and $651 in the remainder).

241 $A$ would have an amount realized of $1,000 and a basis of $867. His basis in the remainder would be equal to his initial basis ($651) plus the income attributable to his remainder interest ($65, $72 and $79).

242 See Cunningham, note 18, at 610-11.

243 Most options to purchase (or to sell) equity securities or commodities that are traded on established markets are not related to any particular property. On or about the strike date, puts and calls are paired to "close out" an option transaction so that the underlying security need not change hands.
The holder of the option would be treated as if he loaned the seller an amount equal to the premium. Since this loan would not bear stated interest, interest should be imputed, which would be includable in the holder’s income and deductible by the seller. Under this approach, the holder of the option would have income during the period the option is outstanding, and the seller would have deductions in the same amount. At maturity (that is, the strike date), the loan transaction would be closed out. The principal and accrued interest would be cancelled in exchange for the right to acquire the underlying property for the strike price. In the case of exercise, an amount equal to the principal and accrued interest would be treated as part of both the seller’s amount realized and the holder’s cost basis. In the case of lapse, this amount would be treated as income to the seller and a loss to the holder.

Applying this analysis to the call transaction described above, B would be considered to have loaned A an amount equal to the $100 premium for the term of the option, with principal and interest in the amount of $133 due in three years on the strike date. Each year the amount of “interest” that accrues would be taxable to B and added to the principal of the outstanding loan (that is, to his basis in the option); concurrently, A would be entitled to an interest deduction in the same amount. Under this approach, A, not B, would bear the burden of the tax. Although A nominally would be taxed on the income produced by the $100 option price, he also would be entitled to annual interest deductions, thus producing no net income.

On the strike date, if the option were exercised, A would have an amount realized, and B a basis of $1,133. If the option lapsed, A would have income, and B a loss of $133.

In sum, although there are certain technical differences between the carve-out and separate investment approaches, both analyses suggest

---

244 Cf. IRC § 7872.
245 A necessary corollary of this characterization is that the seller be given the equivalent of an interest deduction; otherwise, the relevant investment income would be taxed twice.
246 At a rate of 10% per year, $100 equals $133 in three years. Note that the expected return that the holder will demand is a function of who is nominally paying the tax on the investment income; that is, the holder will make his decisions based on his after-tax rate of return.
247 Ignoring transaction costs, B will exercise the option as long as Blackacre is worth at least $1,000. This means that B will have an inherent loss in the property if the option is exercised and Blackacre is worth less than $1,133 and will have inherent gain if Blackacre has a value of more than $1,133. This is a function of the proposed rule. An investor would be taxed on the expected rate of return on certain investments, not their actual return. On these facts, the expected intrinsic value of the option at the time of the grant was $133. The rule presumes that if the option is exercised, the option will be worth that amount on that date.
248 These technical differences are as follows: (1) At issuance, under a carve-out analysis, the seller of the option would have gain or loss realized whenever there is a difference between the seller’s basis and the property’s fair market value; under the separate investment analysis, the issuance would not be a taxable event. (2) If the option lapses on the strike date, under the
that the holder of the option is the person who should be taxed on the income from the premium, and that this income should be treated as part of the cost of the option. Although the results reached under the carve-out model are plausible, as will be seen below in analyzing put options, these rules would be unduly complex.

2. European Put Options

The analysis of a put option is quite similar to that for a call. A put also can be viewed as a carve-out or as a separate investment. To illustrate, consider the following transaction:

Example 14: On January 1, 1993, A purchases Blackacre for $1,000. Blackacre will generate $100 of net rentals each year. On the date of purchase, A buys a put from B for $100 that entitles (but does not obligate) A to sell Blackacre to B on January 1, 1996 for $1,000. B places the $100 in a bank account yielding 10% per year.

Under current law, no tax consequences result from this transaction until the put is exercised or lapses. Thus, the income generated by the premium is taxed to B, the seller of the put, rather than A. On the strike date, if the put is exercised, A has an amount realized of $900 ($1,000 paid less $100 premium); B's basis is $900. If the put lapses, B has income, and A a loss, of $100.

For reasons similar to those developed above, A, the holder of the put, not B, should be taxed on the investment income from the premium. Both a carve-out and a separate investment analysis suggest that the holder of the put is undertaxed and the seller overtaxed.

a. Carve-out Analysis

A put is a carve-out different from those previously discussed in that what is carved out of the remainder is a liability, rather than a portion of the beneficial ownership. By purchasing the put, A has eliminated one of the risks inherent in the ownership of Blackacre—that it will go down in value. B now bears this risk. The acquisition of the put can be viewed

---

249 For this reason, the carve-out analysis may seem somewhat strained particularly since it involves the concept of negative basis. See George Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1962); see also Parker v. Delaney, 186 F.2d 455, 459 (1st Cir. 1950) (Migruder, J., concurring), cert. denied, 341 U.S. 926 (1951). But see Prop. Reg. § 1.358-6(a)(2) and Reg. § 1.1502-19, which effectively sanction a negative basis.

Imaged with the Permission of N.Y.U. Tax Law Review
as a capital expenditure that enhances the value of A's remainder interest. The present value of his remainder is higher by $100 (that is, $851 instead of $751), and Blackacre’s expected value (to A) is higher by $133 ($1,133 instead of $1,000).\footnote{The expected value is the weighted average of all possible outcomes. Blackacre's expected value to A is higher because, by virtue of the put, it cannot have a value of less than $1,000 to him.} A would increase his basis in the remainder by $100, which under the proposed rule would increase correspondingly the amount of his income over the next three years.

Although B has received $100 of cash, he has undertaken concurrently a future obligation with a "present cost" to him of $100. This receipt of the $100 should not result in any current tax consequences because, in the Haig-Simons sense, it is precisely offset by this liability. Thus, B also has an interest in Blackacre, albeit in the nature of a liability. If a basis were to be ascribed in this interest to B, it would be negative $100. Each year as the \textit{expected} amount of B's liability increases at the rate of 10%, B would be entitled to a \textit{deduction} and a negative basis adjustment for this amount. This would offset the income produced by the bank account so that B would report no net income. On the strike date, B would have a basis in his share of the remainder of $-133.

Under this analysis, A, the holder of the put, would be taxed on the investment income from the premium during the term of the option. This would be a result of the income generated by the increased value of the remainder interest. Concurrently, B, the seller of the put, would have annual deductions equal to A's inclusions due to the increase in the amount of the liability he assumed.

On the strike date, A would have a basis of $1,133 in his beneficial interest in Blackacre. B would have a negative basis of $133 in his interest in Blackacre: $100 due to the cash received, and $33 due to the deductions. Therefore, if the put were exercised, A would have a loss of $133 ($1,133 - $1,000), and B would take an aggregate basis in Blackacre of $867 ($1,000 - $133). If the put lapsed, A would have a basis in Blackacre of $1,133, and B would have income of $133 on the extinguishment of his liability.

b. Separate Investment Analysis

The separate investment analysis is identical to that developed above for calls.\footnote{See text accompanying notes 242-47.} Under this approach, the transaction would be viewed as a $100 loan by A to B for three years. Each year the interest that accrued on the loan (that is, $10, $11 and $12 for 1993, 1994 and 1995 respec-
would be includable in A’s income. B would be entitled to an annual interest deduction in identical amounts. On the strike date, the balance of the loan would be $133 ($100 principal and $33 in accrued interest) which would be discharged either by the exercise or lapse of the put. If the put were exercised, A would have an amount realized of $867, resulting in a loss of $133. B would take a basis of $867 in Blackacre. If the put lapsed, A would have a loss and B income of $133.

3. American Options

American options differ from European options in that they may be exercised at any time until, and including, the strike date. The value of an American option is the sum of the option’s current intrinsic value plus the option’s time value. At all times, the intrinsic value of an American option is the difference between the value of the property and the strike price. Because the option always can be exercised, there is no need to determine the present value of the expected intrinsic value on the strike date.

American options for which there is a market can be analyzed in the same way as European options because it is not advantageous to exercise an American option before the strike date. To do so would be to abandon the remaining time value of the option. Thus, it is more sensible to close out a position in an American option by selling the option.

To illustrate, suppose A is the holder of a marketable American call that entitles A to purchase X at any time on or before December 31 for $1,000. On June 30, X is selling at $1,200. On this date, the value of A’s call must be more than $200, because its value is equal to the current intrinsic value of the option, $200, plus the time value of the option. In the absence of special circumstances, there is no reason to exercise the option. If A wants to close out the investment, it is more profitable to sell the call than to exercise the option and sell the property. Holding the option allows A to benefit from all further appreciation in X without any additional investment, insulating A from any loss that might occur if X fell below $1,000.

These generalizations do not apply, however, to all American options. For example, if there is no market for the option, or if there are carrying

---

252 Under principles of economic accrual, interest on the loan would accrue at the rate of 10% so that the amount of interest would be $10, $11 and $12 for 1993, 1994 and 1995 respectively.

253 Under current law, the amount realized is equal to the strike price, $1,000, less the amount paid for the put, under this analysis, $133.

254 Under current law, B’s basis is equal to the strike price, $1,000, less the amount received for the put, under this analysis, $133.
costs associated with holding the option, the holder may choose to exercise the option before the strike date. An excellent example of this latter type of option that deserves special attention is nonrecourse financing. This analysis of options also can be used to inform one's judgment about the current tax treatment of nonrecourse financing.

4. Nonrecourse Financing

a. Premium for Nonrecourse Debt

Under current tax law, for most purposes nonrecourse financing is treated the same as recourse financing. The loan principal does not create income or deduction for either borrower or lender and the finance charges on both types of debt are treated as interest. Although the lender on a nonrecourse note bears the risk of loss if the property securing the note falls in value below the principal amount of the note, the borrower continues to be treated as the owner for all purposes, including depreciation, apparently because he has the right to the income and is entitled to any economic gain due to appreciation.

As an economic matter, a portion of what the lender charges is a premium for the nonrecourse nature of the loan. This feature can be described as disaster insurance, taken out by the borrower and underwritten by the lender, protecting the borrower from the risk that the underlying property will decline precipitously in value. The principal issue raised by nonrecourse financing is whether it is appropriate to treat the payment made by the borrower to the lender solely as interest, even though it is made not only for the use of the borrowed funds, but also for the right to put the property back to the lender. We do not believe that there is sufficient reason to treat interest and the amount paid for the

---

255 For example, although a strong argument can be made that the receipt of a nonrecourse mortgage in excess of basis should be treated as a recognition event, the courts have rejected this argument. Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952). This and other issues concerning nonrecourse financing are discussed in detail in Daniel N. Shaviro, Risk and Accrual: The Tax Treatment of Nonrecourse Debt, 44 Tax L. Rev. 401 (1989).

256 It, however, the taxpayer has no "investment" in the property involved, he is not entitled to depreciation. Estate of Franklin v. Commissioner, 544 F. 2d 1045 (9th Cir. 1976); but cf. Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3rd Cir. 1988), cert. denied sub. nom. Commissioner v. Prussin, 493 U.S. 901 (1989). If purchase money indebtedness exceeds the value of property at the time of acquisition, the taxpayer has no investment in that there is no economic incentive for him to make a payment on the indebtedness.

257 Although the following discussion assumes that the premium will be exacted in the form of higher interest, it also could be obtained through a higher principal amount or the combination of both. These alternative structures are discussed in Yishai Beer, Nonrecourse Loans: Do Not Forget to Tax the Option, 53 Tax Notes 837 (Nov. 18, 1991). Beer takes the current option rules as a given, but points out that even so, there is a distortion caused by the failure to acknowledge the option component on nonrecourse debt.
nonrecourse feature differently, and therefore do not consider it necessary to distinguish these amounts. Consider the following:

Example 15: A acquires the equipment described in Example 5, using $500 cash and borrowing the $500 balance on a non-recourse basis from Lender at 11% interest. The nonrecourse mortgage calls for four annual payments of $161 each. If the mortgage had called for 10% interest, the annual payments would have been only $158 annually.

On these facts, A not only has borrowed money from Lender, but also has taken out insurance against one of the normal risks of ownership: that the underlying property will decline in value below the outstanding principal amount of the mortgage. This risk is now borne by Lender. If the property does fall in value below this amount, A has the right to transfer the property to Lender in full satisfaction of the indebtedness. The premium paid for this insurance is equal to 1% of the outstanding principal. Since insurance premiums are properly includable/deductible in the year to which they relate, in the absence of special circumstances, the premium paid for the nonrecourse feature should be treated similarly. Thus, there would be no reason to differentiate the premium from the interest.

A nonrecourse mortgage also can be analyzed as a recourse obligation combined with an American put option. This is because the borrower on such a mortgage has, in effect, the right to "sell" the property secured by the mortgage to the lender at any time during the term of the mortgage for the outstanding balance of the indebtedness. This, however, is not a perfect analogy. In contrast with the traded puts described above, there is no market for these features. In this context, therefore, it would be highly questionable to assume the option will not be exercised before the strike date (that is, maturity). In this case, it does not seem

---

258 See text accompanying note 179.
259 We are cognizant that it may be difficult to determine the amount that is being paid for the nonrecourse feature. If, however, that amount is treated in a manner identical to the interest element of the payment, the exact amount of the premium is not important.
260 The nonrecourse lender also could be described as the owner of the underlying property (leased to the borrower) with a call held by the borrower to purchase the property at any time for the principal amount of the mortgage. See Reg. § 1.83-3(a)(2). The analogy to an option is not exact because the borrower can manage and use the property, powers usually not granted to an option holder. See Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. L. Rev. 1498, 1525 (1982).
261 Under certain circumstances, the nonrecourse feature also may resemble a European put. For example, suppose the underlying indebtedness is secured by leases on the property securing the loan. If these are "come hell or high water" leases, and if the rental payments from these leases are sufficient to meet the mortgage payments, the borrower has no incentive to put the property to the lender for the term of the leases.
unreasonable, however, to assume that the amount paid for the nonrecourse feature is earned over time in much the same way interest is earned. Under this assumption, one can treat that portion of each periodic payment that relates to the nonrecourse feature (that is, 1%) as attributable solely to the period during which it accrues.\textsuperscript{262} If so, the payments should be treated the same as any other current expense: income to \textit{Lender}, deduction to \textit{A}.\textsuperscript{263}

b. Depreciation

A related issue is the determination of who is entitled to depreciation on property subject to nonrecourse indebtedness.

In a world without tax incentives, where depreciation is based solely on decline in value, the borrower should be entitled to depreciation so long as his adjusted basis exceeds the principal amount of the nonrecourse loan. Once his adjusted basis falls below the principal amount of the nonrecourse loan,\textsuperscript{264} no one should be entitled to depreciation. There is no compelling reason to give a deduction to \textit{A}: Because his capital is not at risk,\textsuperscript{265} he can suffer no depreciable loss.\textsuperscript{266} There also is no need to give depreciation deductions to the lender: If the property value actually declines below the principal amount of the mortgage, he can foreclose on the property and take his loss at that time.\textsuperscript{267}

\textsuperscript{262} It is also possible that the 1% paid in the earlier years is in part prepayment for coverage in later years; that is, it is possible that the risk that the property value might fall below the principal amount of the loan is greater in the third and fourth years than in the first and second years even though the amounts paid for the put are greater in years one and two than in years three and four.

\textsuperscript{263} This is appropriate if the payment is the cost of keeping the put in effect for a year; if the period were longer, the cost should be capitalized. See INDOPOCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992).

\textsuperscript{264} In the absence of tax incentives, this would not be a common occurrence. In a tax system using economic depreciation, the adjusted basis should reflect the current fair market value since the depreciation would be appropriate only to account for loss in value during a given period. Furthermore, if the lender has taken only a nonrecourse mortgage, it reasonably can be inferred that the principal amount of the loan is supported by value. Thus, the value should be at least equal to the principal amount of the loan. One circumstance where the adjusted basis might be less than the principal amount of the nonrecourse loan is where there has been a dramatic change in the interest rates so that the terms of the mortgage will be observed even though the face amount of the mortgage is in excess of the fair market value of the property.

\textsuperscript{265} Since the debt is nonrecourse, he will not make payments once the value falls below the principal amount.

\textsuperscript{266} See Crane v. Commissioner, 331 U.S. 1, 24 n.37 (1947).

\textsuperscript{267} Although it is possible that the lender may not foreclose immediately or even in the same taxable year as the value of the property slips below the principal amount of the debt, there is no real justification for permitting depreciation to the lender for that period.
5. *Lease with Option to Purchase*

It is not unusual for a lease to be combined with an option. Where both the rent for the use of the property and the premium for the option are set at their respective fair market values, these amounts can be treated separately and the transaction presents no additional complications. This is illustrated below.\(^{268}\) In cases where the rent charged is excessive, or where the option price is very low, there is often an issue under current law as to whether the transaction is in fact a disguised sale.

a. *Current Law*

A long-term lease with an option to purchase, or automatic ownership when the rental payments reach a certain level, is economically similar to a conditional sales contract. Under current law, however, the tax consequences are markedly different. If the user of the property is treated as a lessee, the annual payments are deductible rent.\(^{269}\) The “transferor” remains the owner, entitled to depreciation and any other tax benefits associated with ownership, that would offset rental income. Alternatively, the user may be treated as if he entered into a conditional sales contract; the annual payments made on an installment purchase would be capitalized and the interest portion deducted.\(^{270}\) The user, as owner, would be entitled to depreciation. The seller could offset basis against the amounts received using the installment method.\(^{271}\)

---

\(^{268}\) As an illustration, consider the following:

*Example:* On January 1, 1993, \(A\) leases the equipment described in *Example 5* to \(B\) for three years at an annual rate of $264. On that date, \(B\) also acquires a call to purchase the equipment on January 1, 1995 for $458, the equipment's expected fair market value at that time. (See depreciation chart at text accompanying note 179.) \(B\) pays \(A\) $10 for this option at closing.

On these facts, \(B\) is “betting” that the property will be worth more than $471.31 (viz. the expected intrinsic value of the option, $13.31, plus the strike price). \(B\), however, will be compelled to purchase the equipment if it is worth any more than $458 (ignoring transaction costs) at the time of exercise. As with the simple options discussed above, this call can be viewed as either a carve-out or a separate investment. Under either characterization, \(B\) should be taxed on the investment income from the $10 premium. Under our proposed rules, the $10 would not be includable by \(A\), nor deductible by \(B\) during the term of the option. During the term, \(B\) would have income under the minimum rate of return rule in the amounts of $1.00, $1.10 and $1.21 for 1993, 1994 and 1995 respectively. \(A\) would be entitled to deductions of similar amounts. On the strike date, \(B\)'s basis in the option would be $13.31. If the option were exercised, \(A\) would have an amount realized, and \(B\) a basis of $471.31 ($458 + $13.31). If the option lapsed, \(A\) would have income, and \(B\) a loss in the amount of $13.31.

Because \(A\) actually receives a current taxable yield from the underlying property, there is no need to impute a return.

\(^{269}\) An up-front payment would be treated as prepaid rent amortizable over the term of the lease.

\(^{270}\) IRC §§ 1012, 163(a).

\(^{271}\) IRC § 453.
The Service and the courts generally have treated the characterization of these transactions as an all or nothing proposition: A given transaction is either a sale or a lease.\textsuperscript{272} The intent of the parties is usually determinative in characterization, but the Service has ruled that certain factors manifest a conditional sales contract.\textsuperscript{273} This has resulted in uncertainty and litigation. For example, under current law, a low option price would be persuasive evidence that the lessee had become the owner by purchasing the equipment. Since this possible recharacterization could significantly alter tax consequences and the parties' expectations, such a transaction might be contested by the Service. We next consider

\textsuperscript{272} The courts generally have followed the Service's lead by ascertaining the parties' intent and even going so far as to ignore the economics of the transaction. See, e.g., Benton v. Commissioner, 197 F.2d 745, 752 (5th Cir. 1952). Occasionally, a court will ignore objective evidence in favor of economic indicia such as whether the seller has retained any residual interest on which he could realize a profit. See, e.g., Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959); see also Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982) ("open-ended" automobile lease wherein lessee bore risk that at end of lease property would be worth less than estimated depreciated value (requiring payment of the difference by the lessee) and stood to realize profit if the value of the property at end of lease exceeded estimated depreciated value (requiring payment of the difference to the lessee), held a conditional sale; lessee was owner of property for tax purposes).

A variation on this transaction occurs when the owner attempts to trigger a loss on depreciated property by transferring it for cash and simultaneously entering into a long-term lease-back without invoking the nonrecognition rules of § 1031. Assuming the transaction is viewed as a sale, the loss would be recognized. See, e.g., Leslie Co. v. Commissioner, 539 F.2d 943 (3rd Cir. 1976); Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959); City Investing Co. v. Commissioner, 38 T.C. 1 (1962) where the courts treated the transaction as a sale for cash independent from the subsequent lease. Any tax benefits connected with ownership shift to the purchaser. The annual payments made by the user are deductible rent. Alternatively, the disposition could be viewed as an exchange of realty for a leasehold and cash, which constituting a like kind exchange, would prevent deduction of the loss. See Reg. § 1.1031(e)-1(c)(2); Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951). A third, but generally unaccepted approach, would never reach the § 1031 issue, since the cash would be treated as mortgage proceeds, with an understanding that the lessee/mortgagee would relinquish the property at the end of the "lease" or alternatively that the residual interest had so little current value it could be ignored. See, e.g. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) in which the court treated a similar transaction as a mortgage. Viewed in this way, the owner does not recognize a loss because the amount received is treated as the proceeds of a mortgage and the annual payments would be only partially deductible as interest and principal.

\textsuperscript{273} See Rev. Rul. 55-540, 1955-2 C.B. 39. Since a number of the factors are objective, the taxpayer can manipulate them without economic cost to give him the preferred status. For example, although the Service indicates that a specific allocation of a payment to equity manifests a sales contract, the lack of such allocation may not change the economics. As a practical matter, where the lessee pays more than the fair rental value, he builds up equity that will be lost unless he exercises the option. Economically, the lessee's status is similar to a purchaser who uses nonrecourse debt financing in that he will exercise his option to protect the equity he has built up through excess rental payments assuming the value of the property has not declined. If, however, the rent is not excessive, the lessee presumably will have to pay the value of the property upon exercise. Although one might expect that a decision as to the nature of the transaction could be postponed until the option period expires, that choice has been rejected. Kitchin v. Commissioner, 353 F.2d 13 (4th Cir. 1965).
whether our rules, including their application to options, might lessen the stakes, and therefore, the tension between the parties.

To facilitate the discussion, consider the following transaction.

**Example 16:** On January 1, 1993, A leases equipment to B for three years at an annual rate of $372 payable at year end (instead of the equipment’s fair rental value of $264) and B has an option to acquire the equipment at the end of the term of the lease for $100, when the expected value of the equipment is $458.

On these facts, B is paying $108 each year in excess of the fair rental value of the equipment for this option. While that is easy to assume on these facts, any excess value is much more difficult to determine in the real world. Nevertheless, the issue of whether a particular transaction should be characterized as a sale or a lease almost always arises because the Service is able to assert either that the rental payments are excessive, or that the option price is too low, or both.

Under our analysis, if the amount of excessive rent is characterized as an option payment, the tax consequences of this transaction would be independent of whether it is a sale or a lease. The rent or the option payment essentially would be treated as a loan until the strike date. This would dramatically reduce the stakes involved in a dispute between the taxpayer and the Service.

To illustrate, suppose the Service asserts that the rental payments in the above transaction are excessive and should be subject to the option rules. Although the taxpayer might disagree, the dispute would relate only to the precise amount to which the option rules should apply, not to the characterization of the entire transaction.

If it were determined that $108 of each rental payment was actually an option payment, the transaction would be treated as follows: Of the $372 payment, $264 would be treated as rent, includable as such by A and deductible by B. The balance of each payment, $108, would be treated as the amount paid for the option and would neither be income to A upon receipt, nor deductible by B. Each year B would have income triggered by the expected increase in the value of the option under the minimum rate of return rule, all of which would be capitalized, and A would have a deduction for an identical amount. Putting these results in tabular form,

---

274 Alternatively, B could be viewed as having borrowed $269 from A to pay the present value of the option. B would make three $108 payments to repay the loan, producing interest deductions for B and interest income to A. In addition B would have income resulting from the increase in value of the option. The net results are exactly the same as for the three $108 prepayments shown in the chart in the text immediately following this note.
On the strike date, if the option were exercised, A would have an amount realized, and B a basis of $458 (the three $108 ($324) payments plus the accrued, but unpaid interest ($34) plus the $100 option price). If the option lapsed, B would have a loss of $358, and A would have income of an identical amount.

The analysis of this transaction as a carve-out yields similar results, which are set out in the note.276

VI. EXTENSION OF MODEL TO SINGLE OWNER

The logic supporting the application of the proposed rules to situations where more than one person owns an interest in a single piece of property inexorably leads to their application when a single person owns all inter-

---

275 This is the interest that accrues on the $108 loans from B to A. Note that since A has the use of the $108 payments during the term of the lease, he should have income approximately equal to these deductions.

276 This transaction also can be viewed as a purchase by B of a portion of A's reversionary interest. The analysis is somewhat more complicated, but the results are economically similar. The present value of the entire reversionary interest is $344 (that is, the present value of $458 in three years). Since the present value of the three $108 payments is $269, this also must be the present value of B's reversionary interest in the equipment; A has retained the balance of the reversionary interest having a present value of $75 ($344 — $269). Both B and A would take into account the income from their respective reversionary interests. These facts impose an additional problem in that B has acquired his interest in the reversion on credit. This transaction should be treated just as if B borrowed $269 from A, with interest and principal payable in three annual installments of $108 each (that is, the excess rent). Analyzed this way, the parties would have the following tax consequences:
Economically, ownership by one person includes both the income interest and the remainder interest in the property. As demonstrated below, there is no compelling reason to impute income to a single owner where the property produces a current taxable market rate of return. If, however, the property predictably will produce a low, or no current taxable yield, a minimum rate of return should be imputed to the single owner. Absent such an extension of the proposal, the tax where property was split into multiple interests would be greater than it would be if the property were held by a single owner.

A. Rationale

To understand the rationale for imputation of income to a single owner, it is useful to start with the tax treatment under current law where the property annually produces a taxable market rate of return. To illustrate, consider the following transaction:

Example 17: On January 1, 1993, A buys Blackacre for $1,000 and immediately leases it to B for three years for a net annual rental of $100, payable at year end.

Under current law, A would be taxed on the $100 of rents he receives each year.

If both proposed rules applied to this transaction, A would be treated as if he acquired two separate interests in the property—a three-year income interest for which he paid $249 and a reversionary interest for

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>$27</td>
<td>$30</td>
<td>$33</td>
</tr>
<tr>
<td>Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest (loan)</td>
<td>(27)</td>
<td>(19)</td>
<td>(10)</td>
</tr>
<tr>
<td>Rent</td>
<td>(264)</td>
<td>(264)</td>
<td>(264)</td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest (loan)</td>
<td>$27</td>
<td>$19</td>
<td>$10</td>
</tr>
<tr>
<td>Income</td>
<td>8</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Rent</td>
<td>264</td>
<td>264</td>
<td>264</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(199)</td>
<td>(218)</td>
<td>(240)*</td>
</tr>
</tbody>
</table>

$100  $73  $43

* Note that the depreciation schedule here is determined on the basis of an asset that will generate $264 of income a year for three years. This is because the reversionary interest (the last two years) is separately accounted for.

277 As with the multiple owner cases, courts have been reluctant to consider two interests in the same property as discrete assets. See Hort v. Commissioner, 313 U.S. 28 (1941). The taxpayer owned a lot and building subject to a lease. The court held that a payment to cancel the lease was ordinary income, as it was a substitute for the rent. The court refused to treat the lease as an asset separate from the land and building. If it had, the taxpayer’s basis in the lease probably would have exceeded the payment.
which he paid $751.\textsuperscript{278} For the three years of the lease, \(A\) would have income from the leasehold of $25, $17 and $9 respectively.\textsuperscript{279} Additionally, \(A\) would have $75, $83 and $91 of income from the reversionary interest. Each year \(A\) would have total income equal to $100, precisely the same amount as under current law.\textsuperscript{280} Putting these results in tabular form:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Interest</th>
<th>Reversionary Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$25</td>
<td>$75</td>
<td>$100</td>
</tr>
<tr>
<td>1994</td>
<td>17</td>
<td>83</td>
<td>100</td>
</tr>
<tr>
<td>1995</td>
<td>9</td>
<td>91</td>
<td>100</td>
</tr>
</tbody>
</table>

Current law generates the same result as the proposed rules because the overinclusion of the income interest is precisely offset by the underinclusion of the income from the reversionary interest. These errors offset one another whenever the underlying property currently produces a fully taxable market yield.\textsuperscript{281} Where both interests are held by a single taxpayer and the yield is taxable, the overinclusion/underinclusion mechanism is satisfactory. Thus, imputation is unnecessary.

Where the property held by a single owner does not produce a fully taxable yield, however, the errors are not offsetting. Where the income interest is held by a taxpayer other than the taxpayer holding the remainder interest, rate arbitrage or income exclusion will occur. As overinclusion only theoretically compensates for the underinclusion, it is important to correctly tax both interests. To illustrate, consider the following example:

\textit{Example 18:} Suppose at the time \(A\) buys \textit{Blackacre} for $1,000, it is subject to an existing three-year lease that calls for annual payments of only $70 of rent. \textit{Blackacre} is currently worth $1,000 despite the low current rentals because the market expects that it will be worth $1,099 at the end of the existing lease.

Under current law, for each of the three years of the lease, \(A\) would report only $70 of income attributable solely to the rental payments.

\textsuperscript{278} The total purchase price of $1,000 would be divided between the two interests based on their relative fair market values. The present value of the right to receive $100 at the end of each of the next three years discounted by 10% compounded annually is $249.

\textsuperscript{279} This reflects the $100 of rent reduced by economic depreciation of $75, $83 and $91.


\textsuperscript{281} These errors do not offset each other exactly. This mechanism ignores character differentials and structural distortions that may stem from having $175, $183 and $191 of gross income and $75, $83 and $91 of deductions rather than $100 of gross income.
If, however, $A$ were treated as if he purchased two separate interests, the amount of current taxable income would be quite different. Under this analysis, $A$'s purchase price and initial basis would be allocated $174 to the leasehold and $826 to the reversionary interest. $A$ would report income from the leasehold of $70 a year less depreciation of $52.60, $59.88 and $63.64, or net income of $17.40, $12.15 and $6.36 in each of the three years respectively. In addition, $A$ would have income from the reversionary interest over the next three years of $273.41 ($82.60, $90.86 and $99.95 for 1993, 1994 and 1995 respectively). He would add those amounts to his basis, giving him an adjusted basis at the end of the three year lease of $1,099. The table below shows the total income produced by the property for each of the three years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Interest</th>
<th>Remainder Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$17.40</td>
<td>$82.60</td>
<td>$100.00</td>
</tr>
<tr>
<td>1994</td>
<td>12.15</td>
<td>90.86</td>
<td>103.01</td>
</tr>
<tr>
<td>1995</td>
<td>6.36</td>
<td>99.95</td>
<td>106.31</td>
</tr>
</tbody>
</table>

Under current law, $A$ underreports by $30, $33 and $36 respectively for the three-year period. Thus, the single owner, like the holder of a remainder interest in a multiple-owner asset, is able to defer (and possibly avoid reporting) income where there is not a currently taxable market yield. This analysis suggests that this result is unacceptable and the proposed rules could be used to eliminate the deferral.

As applied to a single owner, our proposal would require that to the extent that an investment does not produce at least a minimum rate of return currently includable in the tax base, the difference would be imputed and capitalized. If an asset does not produce the current risk-free rate of return, its owner must expect that it will increase in value by at least that much. It is only this increase in value, which is expected to occur with the passage of time, that would be subject to tax before realization. The single owner of property, in effect, would be treated as if he had purchased the income interest and remainder interest separately.

---

282 The present value of $70 a year for three years discounted by 10% compounded annually is $174.

283 This is precisely the expected value of the reversionary interest at the end of the lease term.

284 The reason that the total income rises each year is that the expected value of the property is increasing at the rate of 3% per year and therefore the total return on the property goes up proportionately, that is, 3% per year.

285 We consider in Section VI.C. the types of assets to which this rule might apply.
The tax imposed on the whole interest would be equal to the tax on the parts.\footnote{286}

Mechanically, this could be accomplished more simply by imputing a minimum rate of return and crediting $A$ with any income otherwise taxed annually under $A$'s accounting method. For example, if the appropriate minimum rate of return were 10% in the above example, in 1993 $A$ would report $100 of income of which $30 would be added to basis.\footnote{287} This is illustrated in the table below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Basis</th>
<th>Rate of Return</th>
<th>Income</th>
<th>Cash Received</th>
<th>Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$1000</td>
<td>10%</td>
<td>$100.00</td>
<td>$70</td>
<td>$30.00</td>
</tr>
<tr>
<td>1994</td>
<td>1030</td>
<td>10%</td>
<td>103.00</td>
<td>70</td>
<td>33.00</td>
</tr>
<tr>
<td>1995</td>
<td>1063</td>
<td>10%</td>
<td>106.30</td>
<td>70</td>
<td>36.30</td>
</tr>
<tr>
<td>1996</td>
<td>1099\footnote{288}</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This rule would apply even where the property produces no current taxable yield.

\textit{Example 19:} On January 1, 1993, $A$ buys \textit{Blackacre} for $1,000 which he plans to develop beginning on January 1, 1995. He will allow the land to lie fallow until that time.

Since \textit{Blackacre} has no expected current taxable yield, a minimum rate of return would be imputed. Assuming a minimum rate of 10%, $A$ would have $100 of income for 1993 and $110 for 1994, which would be capitalized and added to his basis in \textit{Blackacre}. Because $A$ could have earned $210 over two years in an alternate risk-free investment, it is reasonable to assume that he must have expected \textit{Blackacre} to be worth (at least to him) $1,210 at the end of two years. Indeed, the foregone income could be viewed as simply an additional capital cost.\footnote{289}

\footnote{286} One could argue that the suggested rule is not fair to the taxpayer in the case where the property is producing a return greater than market. Our analysis might lead some to argue that the remainder may very well have depreciated in value.
\footnote{287} This is the same mechanism used to determine outside basis in a partnership interest and in a share of stock in an S corporation. See IRC §§ 705(a), 1367.
\footnote{288} These results are identical to those where $A$ was treated as owning two separate interests.
\footnote{289} We previously advocated this treatment in the context of self construction. Cunningham & Schenk, note 8. See also Blueprints, note 76, at 66-67. It is also the unstated purpose behind, and effect of, § 263A(f). See H.R. Rep. No. 426, 99th Cong., 1st Sess. at 626-28 (1985); Evans, Evolution, note 70, at 833-34.
B. Assets That Might be Subject to the Rule

As discussed above, concerns about liquidity and compliance support the proposition that taxpayers generally should report their income based upon their actual experience, not on their expectations. Thus, unless there is reason to believe that an investment’s current taxable yield does not accurately reflect the investor’s true economic income from an investment, we would not impose a minimum rate of return. For example, suppose A purchases an operating business for $100,000. Although the expected rate of return for this business is $10,000, it may generate $20,000 of income or $5,000, or even a loss. Thus, in the case of an investment where the current taxable yield reflects economic income, such as an operating business, there is no need to impute income.

In any case, however, where A acquires an investment that predictably will yield low, or no, current taxable income, the minimum rate of return rule would apply. We already have noted three examples of this type of investment: (1) where the taxpayer acquires property subject to a “sweetheart” lease, (2) where the taxpayer employs his capital in self construction and (3) fallow land. The following section considers the extension of income imputation to other forms of invested capital.

1. Investments

Various common assets do not produce a currently taxable market rate of return and as noted above, this creates the potential for deferral and distortion. While there may be other alternative approaches that are equally satisfactory, our proposed analysis should at a minimum increase our understanding of the underlying problems and inform our choice of the legal rules.

For example, there are a number of financial transactions that bear a remarkable similarity to debt instruments with OID. As noted previously, as to such instruments, the realization rule is suspended: The lender must report the OID as it accrues. Application of the imputed interest rule to similar types of transactions would result in more nearly identical taxation for similar economic arrangements. For example, under current law, market discount is not reported as it accrues, but upon disposition of the bond, the accrued market discount is treated as ordinary income. Because a bond with market discount does not produce a current taxable yield equal to the risk-free rate, additional income

\[^{290}\text{See text accompanying notes 39, 77.}\]

\[^{291}\text{If, however, the business owns a future interest or similar asset not producing a current taxable market yield, a minimum rate of return should be imputed on that asset.}\]

\[^{292}\text{IRC § 1276(a)(2). Congress apparently considered mandatory accrual under the OID regime, but rejected it. 1984 Bluebook, note 189, at 93. That the treatment under current law might be theoretically wrong may be gleaned from § 1277, which defers the deduction of inter-}\]
could be imputed. For example, assume on January 1, 1993, when the risk-free interest rate is 10% per year, A buys for $924 a $1,000 bond with a stated interest rate of 8% and a maturity date of January 1, 1998. Under the proposed rule, A would have $92.40 of income for 1993, $12.40 of which would be added to his basis.293 There is no apparent justification for treating market discount differently from OID and thus our least radical suggestion would be to apply the proposed rule to the purchaser of a market-discount bond.

The proposed rule also provides an alternative approach to the taxation of contingent instruments. Under proposed regulations, if debt is issued with both noncontingent and contingent interest, the contingent interest generally does not accrue for tax purposes until the amount becomes fixed, even where the contingent interest, if any, will not become fixed for several years.294 For example, suppose T lends X $1,000 for a term of five years with 1% interest paid annually and contingent interest due at maturity. The contingent interest cannot be determined until maturity and under current law, T will report interest income and X a deduction equal to the interest X then pays. This treatment does not correspond to the economics of the transaction. The combined expected return (the interest paid and the contingent interest) must be at least equal to the risk-free rate of return. Under an analysis that assumes an expected increase equal to a minimum rate, T would be required to accrue that amount and increase his basis in the obligation accordingly.295 X would be entitled to a correlative deduction.296 It would seem more reasonable to assume that an amount equal to the risk-free rate will accrue than to assume that no income economically will accrue until maturity.297

This analysis also raises the question of why other types of financial transactions that are similar to OID obligations, but do not actually in-

---

293 The $80 of interest A actually receives would not be added to basis.
294 Prop. Reg. § 1.1275-4(e)(3)(i). In certain circumstances, there is accrual. For example, where contingent payments are designed to front- or back-load interest payments for the purpose of tax avoidance, the Service may reallocate them. See Prop. Reg. § 1.1275-4(h)(1). This wait-and-see approach may not conform to the economic reality of the situation. See Committee on Sales and Financial Transactions, ABA Sec. of Tax’n, Report on the Proposed Original Issue Discount Regulations, 40 Tax Law. 481, 547 (1987).
296 To illustrate, if the minimum rate of return were 10% for 1993, T would have income of $100 and T’s basis would be $1,090 in the obligation. X would be entitled to a 10% interest deduction. At maturity, the difference between the actual amount due and T’s basis at that time would be taken into account.
297 Even a debt instrument with only contingent interest has a time value element that constitutes the minimum expected return required by the investor.
volve debt instruments, such as annuities, endowment and life insurance contracts and pensions are treated dissimilarly. For example, by contract the cash surrender value of a life insurance policy increases over time. That inside build-up nevertheless escapes current accrual for tax purposes (and in many cases is not ever subject to tax). This presents opportunities for tax arbitrage resulting in transactional complexity. Although there may be alternative ways to tax the inside build-up on life insurance, the income imputation rule could be applied to make the treatment of these “financial instruments” parallel the treatment of OID.

Yet another example of an asset that predictably increases with value over time is a pension plan. Under current law, economic income represented by the annual increase in the present value of the future retirement income is not subject to tax. If a minimum rate of return rule applied to pensions, a portion of the investment income would cease to be tax-exempt. Although Congress may view this exemption as a tax expenditure that can be justified on social policy grounds, the analysis suggests that there is no normative reason for the exemption.

There are also examples of investments, which although they may not as obviously increase with value over time, should be presumed to do so. The treatment of a growth stock exemplifies well the extent of our proposal. Like the taxpayer who acquires land subject to a sweetheart lease or the holder of a discount bond, the purchaser of a growth stock expects the stock to increase in value. At a minimum, he expects to obtain a return equal to what he could have obtained by investing in Treasury notes. We would tax that component of his expected return on an annual basis. The market return that he expects is too speculative to tax on an

298 IRC § 72. The receipt of an annuity is allocated between the return on capital portion and the income portion on a ratable, rather than an economic accrual basis.


300 Blueprints, note 76, at 60.

301 Section § 101(a) generally excludes from income the proceeds of a life insurance policy received by a beneficiary at the death of the insured. Whatever the policy justification for the nontaxation of the mortality exposure, it is unclear why the inside policy build-up should not be taxed under § 691 to the extent it reflects interest credited to the policy during the life of the insured.

302 Bradford, note 121, at 204.

303 See Blueprints, note 76, at 60; Michael J. Graetz, The 1982 Minimum Tax Amendments As A First Step in the Transition to a “Flat-Rate” Tax, 56 S. Cal. L. Rev. 527, 556 (1983).

304 See Blueprints, note 76, at 56.

305 In the case of a defined contribution plan, application of the rule would be simple since the amount of the employee's investment base is known. The allocation of the earnings to an employee participating in a defined benefit plan, although in theory more complex, can be simplified. Conceptually, the income is the change in present value of the accrued benefits, but they depend on the employee's continued employment and other variables. If, however, the minimum rate of return were to be applied to the employer's contribution, the subsequent earnings would not have to be actually allocated among employees.
ex ante basis. Because the Haig-Simons ideal can be approached more accurately on an ex post basis by marking to market shares of publicly held corporations, we would apply the imputation rule only to the shares of corporations that are not publicly traded.  

Thus, the imputation rule could be seen as a substitute for a mark-to-market regime where that system is administratively infeasible. We acknowledge that applying the proposed rule to stock may increase rule complexity, in that it will be difficult to determine at the margin which stocks are growth stocks. On the other hand, failure to apply the rule to stock may cause serious economic distortion and increase significantly the incentive to invest in such assets.

2. Homes and Consumer Durables

Since the inception of the income tax, imputed income has proven to be difficult to tax. Our analysis would appear to have a ready application to imputed income. Due to the exclusion from the tax base of imputed income generated by personal use assets, investments in homes and consumer durables have a predictably low current taxable yield. In the case of consumer durables, however, nontaxation is not attributable to expected appreciation in the underlying investment, but rather to the perceived insurmountable administrative problems inherent in taxing imputed income. The imputed income represents personal consumption that has never been subject to taxation and therefore is unlike the economic income discussed in the previous section. Thus, despite the fact that there is no current taxable yield, we would not subject consumer durables to the proposed rule.

See Charles McCandless Tile Service v. U.S., 422 F.2d. 1336 (Ct. Cl. 1970), which suggests that there should be some sort of return on capital investment in a closely held corporation. Absent such an imputation, the return on capital can be withdrawn as salary.

This type of imputation would be unnecessary if the corporate and individual taxes were integrated in such a way that the shareholder accounted for the entire change in wealth attributable to holding corporate shares. For descriptions of such a system, see U.S. Treasury Dep't, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once 27-37 (1992); Deborah H. Schenk, Commentary, Complete Integration in a Partial Integration World, 47 Tax L. Rev. 697, 719-23 (1992).

In order to avoid undue complexity, an annual minimum rate of return could be applied to the stock. If dividends in any given year were less than this minimum rate, income would be imputed.

Although beyond the scope of this article, it would be possible to address the problem of imputed income by applying the minimum rate of return rule to these assets. If we did, we would have to take into account that most consumer durables (and some homes) depreciate in value. That is, each year the asset would decline in value, producing less income in subsequent years. To implement our proposals for consumer durables, Treasury would have to create depreciation schedules for these assets so that taxpayers could determine the appropriate amount of income to report each year. This could be somewhat complicated and, without more study, we do not suggest that the minimum rate of return rule is the best solution to the imputed income problem.
The analysis is useful, however, for informing our choice of legal rules for assets, such an owner-occupied housing, that have both a consumption and investment element. Owner-occupied housing is analytically different from the typical consumer durable (and similar to art objects discussed below\textsuperscript{310}). The lack of a current taxable yield is a function of two factors. As in the case of consumer durables, there is no current taxable yield because of the tax system's failure to take into account imputed income. This is, however, only a partial explanation. A personal residence is also often an investment, which is expected to appreciate over time. That the net rental value of residential real estate may be below other investments may be due primarily to the tax benefits associated with such property, but also would indicate that many home buyers expect their investments to increase in value. To the extent the current imputed yield is below the after-tax rate of return in the market, the difference is likely to be due to the expected appreciation in the home.

Because of the investment aspect of buying a home (as well as the magnitude of the investment), it is possible to differentiate owner-occupied housing from consumer durables and apply the approach described below for art objects.

3. Art Objects

The possible application of the minimum rate of return rule to art objects\textsuperscript{311} raises a difficult issue: Is the imputed income from art to be treated as excludable consumption or is it attributable to expected appreciation that should be taxed and capitalized? Although it is safe to assume that some portion of the return is consumption and some portion is appreciation, it is impossible to make an accurate allocation. With some simplifying assumptions, however, a reasonable approximation can be made.

Suppose, for example, $A$ buys a $1,000 painting and places it in her living room. In a 10\% world, we can say with confidence that $A$ expects to obtain $100 worth of value from this painting for the year. The question is how much of the $100 of income is properly treated as current consumption and how much is attributable to the anticipated appreciation in the painting. Unless this painting is in storage and is not used for personal purposes (for example, it is in a closet), it is impossible to make an accurate allocation.\textsuperscript{312} This creates an additional problem in the see-

\textsuperscript{310} See text accompanying notes 311-14.

\textsuperscript{311} We use art objects as shorthand for the class of assets that have both investment and consumption elements such as paintings, wine and gems. These assets sometimes are referred to as collectibles.

\textsuperscript{312} In this case, a painting would be no different from fallow land; the entire $100 would be capitalized, increasing $A$'s basis to $1,100.
ond and all succeeding years. Since the amount of the first year's income that should be capitalized is unknown, the gross amount of income the investment will produce in the second year cannot be determined with any accuracy.\textsuperscript{313} All that is known is that the basis should be somewhere between $1,000 and $1,100.\textsuperscript{314}

Thus, an arbitrary rule for allocation of the income would need to be adopted. One set of rules that would be quite pro-taxpayer, but, from the government's perspective, better than the current rules, would be:

1. For purposes of determining current (and future) income, assume that all previously imputed income was properly allocated to consumption; thus, nothing would be added to basis or capitalized.
2. For purposes of determining gain or loss on the subsequent disposition, assume the previously taxed income was allocable to anticipated appreciation and capitalized.

To illustrate this rule, consider A and her painting. In the year of acquisition and each year thereafter, she would have $100 of taxable income, no part of which would be added to her basis to determine her next year's income.\textsuperscript{315} If, after holding the painting for three years, A sold the painting for $1,500, she would have a gain of $200, as, for this purpose, her basis would be $1,300.\textsuperscript{316} For purposes of determining a loss on a sale, the rules could provide A with either the same $1,300 basis or a split basis such as that used by § 1015.\textsuperscript{317}

C. Potential Problems

Extension of the proposed rule to a single owner raises two potential problems: (1) Would income imputation create unreasonable pressure to sell where the value of the asset, although expected to rise, actually declines in value?\textsuperscript{318} (2) Should income imputation be applied to all assets

\textsuperscript{313} The amount of income would be a percentage of the basis adjusted by the income reported in year one.
\textsuperscript{314} The basis would be $1,000 if all income were attributable to consumption and $1,100 if none were attributable to consumption.
\textsuperscript{315} Thus, her basis would remain $1,000 and her income would be a constant $100 (10\% \times $1,000).
\textsuperscript{316} For purposes of gain/loss only, each year's $100 would be capitalized into basis.
\textsuperscript{317} That is, $1,300 for purposes of calculating a gain and $1,000 for purposes of calculating a loss.
\textsuperscript{318} This is a potential problem with multiple owners in a single asset as well. There may be less pressure, however, because the owner of the property interest that increases in value usually would be taxed for a limited period of time (for example, during the term interest). We raise the issue in the context of the single owner because the period of income imputation is indeterminable and because we would apply the rule to a wide variety of assets.
not producing a current taxable yield? If not, does selective imputation produce such significant economic distortion and opportunity for arbitrage that it would cause more harm than good?

As to the first issue, we do not believe pressure to sell loss assets is so significant a problem as to derail imputation. When a taxpayer makes an investment, presumably he expects that it will generate a return at least equal to that of a risk-free investment. This may take the form of either a current yield or expected appreciation. While the value of the investment (as well as the absolute yield of the investment) might go down during the holding period, the appropriate time to take such a loss into account is upon disposition.319 In some cases, this would create pressure on the holder of depreciated property to sell the property in order to realize his loss and to reduce his income. The pressure could be especially severe where the property drops precipitously in value. For example, if in Example 19 A bought Blackacre for $1,000 and it fell in value by the end of Year 1 to $500, A would be under considerable financial pressure to sell the land in order to recognize his $500 loss and prevent the imputation of income in Years 2 and 3, calculated with respect to his basis. In cases where the taxpayer does not want to sell the property, it might be possible to permit him to mark his property to market.

Furthermore, this pressure is no different than that which would occur with any form of mark-to-market taxation or ex ante valuation. For example, it is not different from the pressure created by the rules for OID obligations320 except there is no sum certain due at maturity. Although a bond may decrease in value during the taxable year, the holder nevertheless is required currently to accrue OID. Under current law, the only way for the holder to recognize the unexpected decline in value is to sell the bond.321 Finally, it is worth noting that pressure to sell a loss asset created by the imputation system would be no different than the pressure created by the current rule to retain a gain asset in order to obtain the benefit of deferral.

The second potential problem is that unless all assets that predictably increase in value over time are subject to current accrual, tax arbitrage will occur. Selective imputation of income will skew investment decisionmaking by distorting the after-tax return on assets. Taxpayers will
clearly invest in tax-favored assets.\footnote{322} Thus, unless the suggested approach is used universally, it arguably could result in more harm than good.

There is, however, a mitigating factor that suggests this may not be the case. Clearly, some investment assets already are tax-favored. For example, “growth” assets with no current accrual are treated more favorably than debt with current accrual of interest. The proposed rules would reduce the number and types of such favored assets, thus decreasing the opportunities for arbitrage. Arbitrage would continue to occur to the extent taxpayers invest in assets not subject to current accrual that they otherwise would not. But the proposed selective abandonment of the realization requirement would sharply curtail the number of assets not subject to accrual and thus, would result in less arbitrage than presently exists.

Very little opportunity for distortion would exist if we draw the line at art objects, exempting, as does current law, the income on consumer durables. The failure to impute income on consumer durables would cause no more distortion than that caused by current law, and given the significant administrative costs, imputation is unwarranted. A failure to impute income on art objects and other mixed use assets, however, might cause serious distortion depending on their availability and substitutability.\footnote{323} Alternatively, to avoid complexity, the income on mixed personal/investment assets, such as homes or art objects, could be excluded. An imputation system that failed to tax the expected increase in value in those assets however, probably would cause a shift from other investments such as stock. On the other hand, a strong political preference to exempt the income from homes and thus encourage a shift to a residence as an investment may negate distortion concerns. While a comprehensive imputation system that covered personal/investment assets is theoretically desirable, there may be administrative or political considerations that make selective imputation acceptable. The scope of imputation and the determination of a tolerable or even desirable level of distortion is a political question best left to Congress.

\footnote{322} Although the market will capitalize the tax benefits into the cost, thus increasing market price and eventually reaching equilibrium, there will be an inefficient allocation of resources to the tax-favored assets.

\footnote{323} See Shakow, note 36, at 1121.
APPENDIX I

As we noted in the article, a possible objection to our proposals is that some taxpayers would be "overtaxed." Overtaxation would occur when an asset subject to the imputation of income rule does not actually earn the guideline rate of return. For the reasons explained above, we do not believe this is a serious problem. Nevertheless in this appendix, we consider the type of relief that might be granted to those who would be overtaxed if our proposals were adopted. We do this both to show that it can be done and to demonstrate that the relief generally is so complex as to be unwarranted.

A. Characterization

We start from the proposition that simply allowing a loss upon disposition of an asset subject to income imputation is not sufficient. Absent any other change, the OID-type income would be taxed as ordinary income. If, however, the underlying asset were capital, any loss recognized upon a disposition would be characterized as capital. The strongest case for relief is a rule that would recharacterize such a capital loss as ordinary to the extent it is a result of an inclusion of the OID-type income. While good arguments might be made for the repeal of the capital loss limitation on nonmarketable, illiquid assets, we propose repeal only in this limited way.

B. Interest on Overpaid Taxes

If a taxpayer sold property at a loss that occurred solely because of the OID-type inclusions, simply permitting a deduction for the loss does not accurately compensate the taxpayer. This is due to the fact that the income would be included in an earlier year and the loss in a later year, thus not taking into account the time value of money. One way to avoid this problem is through periodic, voluntary appraisals. It would be possible to permit taxpayers who hold assets expected to appreciate, but that do not appreciate as much as expected, to utilize periodic appraisals. If the appraised value were lower than the taxpayer's adjusted basis at the date of disposition, that is, the amount realized, was less than the expected value (the adjusted basis plus the imputed income).

---

324 See text accompanying notes 112-20.
325 See Shakow, note 36, at 1122-24 for a description of a simpler, but less accurate deferral rule.
326 IRC §§ 1221, 1222.
327 Capital losses of noncorporate taxpayers are limited on an annual basis to capital gains plus $3,000. IRC § 1211(b).
329 This would occur where the market value at the date of disposition, that is, the amount realized, was less than the expected value (the adjusted basis plus the imputed income).
time of appraisal, the taxpayer would be entitled to an ordinary loss (and basis adjustment) for the difference (to the extent of income that had been included). This solution has little merit in that it is quite expensive and, given the nature of appraisals (that is, very subjective and often self-serving), highly suspect. To combat this latter characteristic, if voluntary appraisals were permitted, and the appraised valuations were inconsistent with actual sales price, a redetermination of taxes due (plus interest) could be made on disposition. This could become very complicated for very little additional accuracy.

Another approach is possible if the equity violation is understood as the taxpayer having made involuntary loans to the federal government in the amount of the taxes on the overpayments. To make the taxpayer whole, the government must pay the taxpayer interest on these “loans.” To determine the amount of interest to which the taxpayer is entitled, some assumptions need to be made as to which years within the period of inclusion the taxpayer overpaid his taxes. The simplest way to do this is to allocate the total overinclusion ratably over the period of inclusion. A more complicated and more accurate way is to allocate the overinclusion over the period of inclusion using a “revised yield to maturity.” Both of these alternatives are discussed below. Under either method, the taxpayer would be entitled to a refund in an amount equal to the taxes attributable to these inclusions, plus interest.

1. Ratable Inclusion

To illustrate the problem and how rules might be designed to address it, consider the facts in Example 5. In our analysis of that transaction, we suggest that A should report income over the three-year reserved term in amounts equal to $75, $83 and $91 respectively. The proposed rule creates no problem (except, possibly A’s liquidity) as long as the land has a value of at least $1,000 on January 1, 1996; the problem arises when the land is worth less on that date. For example, assume that A’s interest never increased in value and that on the day that A took possession, January 1, 1996, he sold the land for $751. A would report a loss of $249 on the sale of the land on his 1996 return, which he would file on April 15, 1997.

330 The adjusted basis, which we previously presumed to be the fair market value of the property, would be the original basis plus the annual expected increases in value subject to tax. 331 The overpayment is the expected increase in value that was taxed, but did not actually occur.

332 See text accompanying note 77.
333 As will become clear, this is the easiest case because the market has revealed exactly what the land is worth on the day the reversionary interest ripened.
334 The investor’s adjusted basis would be $1,000, his original basis of $751 plus the $249 of reported imputed income.
If the loss, and therefore the overinclusion, were allocated ratably over the period of inclusion, one-third of A's $249 loss would be allocated to each of the three years he held the property, that is, $83 each year. The amount of the loan would be the taxes attributable to the overinclusion of $83 times A's marginal tax bracket for each of those years. The government would owe interest on this loan from the date taxes were due for the relevant year until the taxpayer received credit. On the assumption that A was always in the 28% bracket and that the appropriate interest rate was 10%, A would be entitled to the following:

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Overinclusion</th>
<th>Tax Rate</th>
<th>Loan Amount</th>
<th>Interest Rate</th>
<th>Term of Loan</th>
<th>Interest Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$83.00</td>
<td>30%</td>
<td>$24.90</td>
<td>10%</td>
<td>4/15/94-4/15/97</td>
<td>$8.24</td>
</tr>
<tr>
<td>1994</td>
<td>$83.00</td>
<td>30%</td>
<td>$24.90</td>
<td>10%</td>
<td>4/15/95-4/15/97</td>
<td>5.23</td>
</tr>
<tr>
<td>1995</td>
<td>$83.00</td>
<td>30%</td>
<td>$24.90</td>
<td>10%</td>
<td>4/15/96-4/15/97</td>
<td>2.49</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$15.96</td>
</tr>
</tbody>
</table>

The above table assumes that the taxpayer made periodic loans to the government, all of which were repaid as a result of the disposition of the property. The amount due A is based upon a pretax rate of return. He would include this amount in income when he receives it in TY 1997. An alternative mechanism would be to determine the amount of interest due the taxpayer using an after-tax rate of return and giving the taxpayer a refundable tax credit for the amount of interest due. For example, if the pretax rate of return were 10%, one could assume that the after-tax rate of return was 7.2% (10% less taxes of 28%). If interest were calculated on the basis of 7.2%, the taxes on the amount due the taxpayer already would have been paid. Thus, this amount could be paid to the taxpayer as a tax credit.

There are a number of technical questions that would need to be resolved before implementing such a system. For example, would the taxpayer calculate the refund based on his actual tax bracket in each year, or as a simplifying assumption, could all taxpayers be presumed to be in a specific tax bracket? Furthermore, could one rate of interest be used, such as the AFR, and would the interest rate remain constant or would it float over time with the AFR?

2. Revised Yield Method

The most obvious objection to ratable inclusion is that the "loans" to the government did not occur ratably. For example, on our rarified

---

335 The loan created by the overpayment began when A paid tax for TY 1993. Thus, the loan began on 4/15/94. The loan ran until it was "repaid," when the taxes were paid on disposition of the property. Thus, the loan runs until 4/15/97.

336 This would be in addition to a loss of $249.
facts, exactly when the “loans” were made is known and thus how the loss should be allocated is known: $75 to 1993, $83 to 1994 and $91 to 1995. To achieve greater accuracy, we could devise a rule that allocated the loss in accordance with a revised yield. For example, in our illustration, our revised yield would be 0% ($751 − $751 over three years). The loss allocable to each year would be determined by taking the difference between the actual amount reported for each year and the amount that would have been reported if the revised yield had been used. Applying this rule to our facts, the amount actually reported for TY 1993 was $75 while the amount that would have been reported (using the revised yield of 0%) would be zero. The amount of the loss allocable to 1993 would have been $75. The entire holding period is described in tabular form below.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Over-Inclusion Tax Rate</th>
<th>Loan Interest</th>
<th>Term of Loan Due</th>
<th>Interest Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$75</td>
<td>30%</td>
<td>$22.50</td>
<td>10%</td>
</tr>
<tr>
<td>1994</td>
<td>83</td>
<td>30%</td>
<td>24.90</td>
<td>10%</td>
</tr>
<tr>
<td>1995</td>
<td>91</td>
<td>30%</td>
<td>27.30</td>
<td>10%</td>
</tr>
</tbody>
</table>

Note that the interest due A would be significantly more under the ratable allocation method than under the revised yield method. This is attributable to the fact that the ratable method overstates the loan in the earlier years and understates it in later years.

To illustrate how the revised yield method would work with a slightly more complicated set of facts, suppose the land were worth $869 when A obtained possession and sold the land. On the assumption that the land increased in value at a constant rate over three years, this implies a yield of 5%/year instead of the expected 10% rate of return. Using the revised yield to maturity, the overstatement of income for each of the three years would be as follows:

<table>
<thead>
<tr>
<th>(1) Taxable Year</th>
<th>(2) Expected Return @ 10%</th>
<th>(3) Revised Return @ 5%</th>
<th>(4) Overstatement (Difference)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$75.00</td>
<td>$37.50</td>
<td>$37.50</td>
</tr>
<tr>
<td>1994</td>
<td>83.00</td>
<td>39.48</td>
<td>43.52</td>
</tr>
<tr>
<td>1995</td>
<td>91.00</td>
<td>41.40</td>
<td>49.60</td>
</tr>
</tbody>
</table>

The amount of the loans to the government for each of three years would be the amounts in column (4) times A’s marginal tax rate. If A’s tax rate were 30% and the appropriate interest rate were 10% throughout the relevant time period, the amount due A would be as follows:

337 See note 335.
3. Allocation of Loss to Period of Inclusion

Compensating a taxpayer for a loss due to the inclusion of income is enormously complicated when he does not dispose of the relevant property until after the expiration of the period of inclusion, that is, sometime after his interest ripens. Since there is no market transaction at that time which reveals value, it is difficult to know whether in fact the taxpayer has overincluded income. Assuming that determination is delayed until there is a market transaction, it is also difficult to determine how the increase in value actually accrued.

For example, suppose A held onto the land for ten years (seven years after A’s retained interest expired) and then disposed of the land. Consider three possible scenarios:

(1) Assume the fair market value at the time A’s interest ripened was less than the expected value. The property, however, ultimately was sold for more than the expected value. Suppose, for example, that A sold the land for $1,220.

Under the proposed rule, since there was no loss to allocate, A would not be entitled to relief, even though he actually overpaid his taxes during the period of inclusion.

If the revised yield method is adopted for allocating the realized loss, one might argue that it also should be used to determine whether there was an overinclusion during the period of imputation. This argument should be rejected. To determine the property’s yield for the entire holding period would require an analysis of the cash flow from the land over the ten-year period. This does not seem warranted. The nature of the appreciation for the first three years is significantly different from the last seven years in that it is solely a function of the ripening of A’s possessory rights.

If applied to these facts on the assumption that the land lay fallow for the entire ten years, the implicit yield on the investment would be 5%/year. This implies that A overpaid his taxes for the first three years of his holding period. A should not be entitled to fully recover interest on this

---

338 Id.
loan as he has enjoyed an interest-free loan on the “unrealized appreciation” that accrued for the last seven years.

Another way to justify denying \(A\) relief is, in the absence of clear and convincing evidence to the contrary, to assume that the property neither appreciated nor depreciated after \(A\)’s interest ripened.\(^{339}\) Viewed this way, the market value on the date of disposition would be deemed to be the value at the end of the period of inclusion. On the facts, there would be no loss to allocate as the property would have appreciated more than expected during the three-year lease term.

Since there was no loss, it would be reasonable to deny \(A\) relief. Although \(A\) may have overpaid his taxes in the early years, he also benefitted from underpayments, as a result of the subsequent appreciation. Furthermore, a rule offering \(A\) relief in this situation potentially could create an enormous amount of controversy. For example, a taxpayer with a substantial gain after vesting would still be able to argue that during the lease, the property went down in value and thus he overpaid his taxes.

\(2\) Assume the fair market value of the land at the end of the period of inclusion was greater than the expected value, but thereafter drops precipitously in value so that \(A\) sold the land for less than its expected value.

No relief should be available. This could be accomplished by permitting the Service to prove that the property fell precipitously in value \textit{after} \(A\)’s interest vested.

\(3\) Assume the property was never worth its original expected value and was sold for a loss.

This example requires a determination of the time period to which the loss should be allocated. Only to the extent the property failed to increase in value at the expected rate, would relief be warranted. A simplifying assumption would be to allocate the entire realized loss to the period of inclusion. It is difficult to justify allocating the loss entirely to one period or another in the absence of empirical evidence. It would be more appropriate to allocate the loss ratably between the period of inclusion and the remainder of the holding period. To the extent the loss is allocated to the period of inclusion, it then could be allocated among the years within the period of inclusion using the revised yield method.

To illustrate the complexity of this relief, suppose \(A\) sold the property for $563 ten years after acquiring his future interest, sustaining a loss of $437. Of this loss, $249 would be characterized as ordinary. For purposes of determining how much interest \(A\) was due as a result of the

\(^{339}\) This is consistent with our redefined concept of realization.
overinclusions due to imputation, the loss first must be allocated between the period of inclusion and the remainder of A's holding period based upon the relative number of months within each period. On these facts, 3/10 of the $437 loss would be allocable to the period of inclusion, or $131. (This implies that the future interest was deemed to be worth only $869 at the end of the period of inclusion, not $1,000.) Next, this loss would be allocated among the three years within the period of inclusion using the revised yield method. As illustrated above, the revised yield during the period of inclusion was 5% and the amount of interest due A would be determined on that basis.
The model described above calls for the inclusion in income of the expected increase in value of an asset due solely to the passage of time. Because we propose to do this on an ex ante basis, a rate of return must be chosen. There are essentially two possible approaches: an internal rate of return and an externally-fixed rate of return. This appendix briefly discusses why we chose the latter approach.

The internal rate of return would accurately measure the income produced by a specific asset. Obviously, there is not a single rate of return for all investments. Different investments produce varying returns depending on their risk and liquidity. It is theoretically possible to use the risk-adjusted discount rate for each asset or class of assets. This rate takes into account the risk premium which is the difference between the expected rate of return on a particular risky asset and the rate of return on a riskless asset.\footnote{Victor Brudney & Marvin A. Chirelstein, Cases and Materials on Corporate Finance 66 (3d ed. 1987).} For purposes of our proposal, there are both theoretical and practical objections to this approach. Risk-adjusted rates lump together the pure time value of money as represented by the risk-free rate and the risk element represented by the premium.\footnote{See Eugene F. Brigham, Financial Management Theory and Practice 439 (4th ed. 1985).} We propose to accrue annually only the time value element. Furthermore, the risk premium for each individual or at least each class of assets would be needed. It is completely impractical for the tax system to demand such knowledge.

Alternatively, we could use an external rate of return that does not adjust for risk. Risk would be accounted for in the ultimate calculation of income, rather than the discount rate. We chose to use the riskless rate of return or the risk-free yield as the imputed rate of return. While this is clearly inaccurate as a measure of the present value of a particular asset,\footnote{It also may be inaccurate in that it assumes a flat yield curve. See note 29.} it does measure the \textit{minimum} amount of expected income from any investment.\footnote{This is the only amount we propose to tax on an annual basis.} An investor would not make a particular investment unless he believed the asset had the potential to yield a rate of return at least as great as the yield on risk-free assets. As a practical matter, the yield on treasury bonds could be used as a surrogate for the risk-free yield.\footnote{The use of the T-bill rate has been suggested by others for similar uses. See e.g., Morris & Glicklich, note 39, at 109.} This is a convention designed to avoid the complexities associated with the internal rate of return. Although it might not be acceptable if we were attempting to tax all unrealized appreciation, we find it an entirely satisfactory way to measure merely the expected risk-free yield.
A further question is whether a constant rate of return should be used during the period of imputation or whether the rate should vary. The latter rule is preferable because it would more accurately measure the income. Obviously the rate of return actually earned could vary with time. A constant rate is probably more appropriate where an investor locks in a rate of return for an extended period of time. Thus, if an investor holds an asset for an entire year, the rate of imputation should be a blended rate for that year. However, where an investor enters into a long-term arrangement (for example, a lease), a single rate of return, based on the rate in effect on the date of the arrangement, would be used for the term of the lease. This distinction is akin to that between a demand and a term loan.

To illustrate, reconsider A who acquired Blackacre and allowed it to lie fallow for two years. At the beginning of Year 1, the rate was 10%, but at the end of the first year, the market rate of return was only 5%; thus, the blended rate for the year was 7.5%. Because the blended market rate of return was only 7.5% for the year, A should not be required to include and capitalize more than that. Conversely, if the market rate of return went up during the year and the blended rate for the year was 13%, there is no reason to impute income at a lower rate. On our assumptions, at any time during the year, A could have sold Blackacre and invested his capital at the higher rate.

The analysis is more complex if the property was subject to a lease. Consider A who sold the three-year leasehold for $249, retaining the reversionary interest with a value of $751. At the time the leasehold was entered into, the market rate of return was 10% and the value of the land was $1,000. A expected Blackacre to hold value and still be worth $1,000 when he took possession. If the market rate of return during the lease term became 5% or 15%, the effect on the expected value of the land is not clear. Although such a dramatic change in the rate of return would change the value of the leasehold and A’s future interest, it might not change the expected value of the land. Under the proposed rule, A would use a 10% rate of return for the entire lease term, giving him a $1,000 basis at the time of possession.

Using a locked-in rate of return is less satisfactory where the current yield is below market. To illustrate, consider the example where A leased Blackacre to B for two years for $70 a year. A anticipated that the property would revert back in two years when it had an expected value of $1,066 and thus A expects a substantial portion of her return on this

345 See Strnad, note 46, at 1864 for a discussion of the reasons for a variation in the rates.
346 Cf. IRC § 7872 (treatment of certain demand loans).
347 See Morris & Glicklich, note 39.
investment to be appreciation. If the market rate of return fell to 5%, this might seriously affect the expected value of the land, which is predicated on a 3% annual increase in value.