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Liabilities and the Need to Keep the Income Tax Base Closed

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LIABILITIES AND THE NEED TO KEEP THE INCOME TAX BASE CLOSED

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I. INTRODUCTION

Liabilities are as common as assets. The negative values they represent are as important an indication of wealth as the positive values represented by assets. The basic rules for measuring them and for accounting for them should be as important a part of an income tax as the basic rules for measuring and accounting for assets. However, many recent developments suggest that this simply is not the case under the current income tax. This essay will explore two

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[*] Professor of Law, Northwestern University School of Law. Ryan Kim, Ian Lesch, Darrell Gardner, and Page Scully provided able research assistance in connection with this and related projects. Several hundred other Northwestern students, especially those in the Tax Program at Northwestern, showed great patience as I worked to understand why the issues considered herein have proved so intractable.

types of problems related to the lack of systematic thinking about liabilities: first, the pervasive misunderstanding about when relief from liability should result in income, and second, a failure to understand the difference between situations in which the appropriate tax results depend upon properly establishing the economic burden represented by a liability, and situations in which the proper tax results depend upon employing the amount previously used in accounting for the liability.

Many of the most egregious tax shelters that have plagued the administration of the income tax over the last decade or so have their source in the fact that the tax law simply does not contain an adequate vocabulary or set of internal rules for dealing with liabilities. Taxpayers have attempted to "earn" basis not just once or even twice, but multiple times for assuming a single liability.[1] Taxpayers have attempted to take advantage of the fact that in the real world, transferees will pay less for an asset they are purchasing whenever they are simultaneously assuming liabilities, even though the Internal Revenue Code (Code) seems to treat some liabilities as nonexistent.[2] Taxpayers have attempted to take advantage of the fact that there is no single set of rules for determining who the debtor for a liability is, or the fact that there is no absolute rule that there must be only one debtor for every dollar of liability, such that one taxpayer can claim that a debt should reduce the value she receives although the debt remains another taxpayer's liability.[3] And taxpayers have attempted to ignore the fact that liabilities will sometimes reduce value in ways that rules that are trying to account for value cannot detect.[4]

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[1] This particular shelter seems not to have acquired a popular name. It is described in Jasper L. Cummings, Jr., *ABA Tax Section Members Express Views on Corporate Reorg. Provision in IRS Restructuring Bill*, TAX NOTES TODAY (June 23, 1998) (LEXIS, FEDTAX lib., TNT file, elec. cit., 98 TNT 127-10), and the Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001(b)(1), 113 Stat. 127, 182 (1999), adequately addressed its most egregious versions.

[2] I.R.S. Notice 2001-17, 2001-1 C.B. 730 (discussing contingent liabilities transferred to subsidiary to trigger loss on sale of subsidiary stock). Note that the amendment to I.R.C. section 358(h) by the Consolidated Appropriations Act, 2001, Pub. L. No. 106-554, § 309, 114 Stat. 2763, 2763A638 (codified as amended at I.R.C. § 358(h)), discouraged most such transactions.

[3] I.R.S. Notice 99-59, 1999-2 C.B. 761 (discussing so-called "BOSS transactions" involving distributions of encumbered property to shareholders and payment thereon by corporation).

[4] *See, e.g.*, I.R.S. Notice 2000-44, 2000-2 C.B. 255 (discussing "Son of BOSS" (or "baby BOSS") transactions involving artificially high basis, some of which involve the

The inadequacy of the government's responses to these transactions – the notices, the regulations (temporary, proposed and final), and the intricate and contradictory legislative changes – is evidence of the persistent misunderstanding that surrounds accounting for liabilities in defining the income tax base. Some may disagree with laying some of the blame on the rules that were abused. After all, if we are actually doing a better job in defining the tax base, it should be harder for tax professionals to have anything to sell if they simply follow the rules. Under such conditions, there should be more willful disregard of even the most carefully developed rules. Thus, some of the abusive transactions involving liability assumptions may be willful misunderstandings on the part of tax professionals who are finding it increasingly difficult to have a product to sell if they do not try to stretch existing treatments as much as possible. These professionals might attempt to abuse the best rules we could possibly devise. Alternatively, tax professionals may be adopting more aggressive positions that push the limits of well-stated but incomplete rules, but do not reveal conscious disregard of the rules. The transactions mentioned above, under this view, may simply result from the fact that we have become more sophisticated in our understanding of liabilities and thus better able to identify positions that are inconsistent with income tax norms about liabilities even when there are no rules clearly implementing these norms. Consequently, we now recognize these positions more easily and are more apprehensive about the consequences of failing to react to them.

I doubt that pressure to ignore well-understood existing treatments was the only factor that contributed to the proliferation of these transactions, and I certainly do not believe we are seeing more of them only because we are appreciably better at identifying them. I fear that the lack of well-developed notions of what liabilities actually involve and how tax accounting deals with them has been a substantial contributing factor.[5] Neither more aggressive planning nor more

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presence of economic obligations that are not generally treated as "liabilities," including option obligations that apparently would not be captured by the existing section 704(c) regime); *see also* Treas. Reg. § 1.752-6 (2005) and § 1.752-7 (2005) (addressing similar transactions). Here even the categories get confusing. Many Son of BOSS transactions involved the same ambivalent treatment regarding whether an assumption had taken place at all that characterized the original BOSS transactions, but the structure and the end-play looked much more like the contingent liability transaction considered in I.R.S. Notice 2001-17, 2001-1 C.B. 730.

[5] At least one other author also blames the lack of a better understanding of liabilities in tax accounting on the rules regarding basis after section 351 exchanges of stock for property. *See* Glenn E. Coven, *What Corporate Tax Shelters Can Teach Us*

sophisticated responses to well-stated rules can explain why the government is having such great difficulty establishing some conventional understandings about which of its multitude of proposed solutions for problems related to accounting for liabilities are legitimate.[6]

More than twenty years ago, William Andrews declared that realization was "the Achilles' heel" of the tax system.[7] In my view, this assertion remains true, but only on an unconventional reading of Andrews' statement. Tax scholars have considered ad nauseum the choices that an income tax system makes in accounting for increases in value, and in particular the ways in which imputed returns can be substituted for actual returns in order to make up for the limitations of realization. Most such analysis simply assumes an upfront investment and, given that the return is contingent, attempts to analyze how the return on that specific investment should be taxed. Only rarely in the literature is any reference made to the fact that, in the real world, it is just as often the case that what is unknown is the

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About the Structure of Subchapter C, TAX NOTES TODAY (Nov. 8, 2004) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2004 TNT 217-28). While I agree with most of Prof. Coven's observations, I fear the fault does not lie solely with those rules but with the lack of a proper conception of how transactions with shareholders generally, and especially transactions involving liabilities, affect a corporation's income. *See* Charlotte Crane, *Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders*, 44 TAX L. REV. 113, 115–16 (1988).

[6] Perhaps most telling is the confession of ignorance that accompanied the regulations requiring the exchange of "net value" in transactions in order for the nonrecognition rules in subchapter C to apply:

> Although the proposed regulations do not define the term liability, the IRS and the Treasury Department intend that the term be interpreted broadly. Thus, for purposes of the proposed regulations, a liability should include any obligation of a taxpayer, whether the obligation is debt for federal income tax purposes or whether the obligation is taken into account for the purpose of any other Code section. Generally, an obligation is something that reduces the net worth of the obligor . . . .
>
> The proposed regulations provide no specific guidance on determining the amount of a liability. The IRS and the Treasury Department are currently considering various approaches to determining the amount of a liability.

Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903, 11,905 (proposed Mar. 10, 2005).

[7] William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S 278, 280 (Charls E. Walker & Mark A. Bloomfield eds., 1983).

total outlay itself, not the cash flow being generated. In the life of any project, all sorts of claims may be made against its owner, many of which claims will not materialize for years. In the meantime, income from the project must be calculated. To calculate income, we should compare the claims against the project to the value created by it. The total dollar value of all predictable claims that will be made against the project should be included in the accounting for the initial investment in order to state properly the owner's income from the project. In the world of financial models, there should be no insurmountable problem with a failure to predict these costs at the outset, since we should be able to collect all of the anticipated and unanticipated costs and subsequently translate them back into the same currency as the initial cash outlay or, if we prefer, translate them forward to the time of the last relevant event to calculate accurately an income tax base. However, as we try to improve the income tax base, or substitute a new tax base for it, we must first understand how best to account for these costs before we can hope to develop the rules for such a translations.

Why have the problems created by liabilities been so intractable? For all of the attention that has been given to the problems presented by liabilities in particular contexts, there has been far too little effort to identify either what liabilities represent economically or how they should be treated systematically by the tax law. This may come from a general difficulty inherent in thinking about negative numbers. A higher degree of fluency in negative numbers might have made the judges and bureaucrats who were involved in the earlier stages of the evolution of tax doctrine better equipped to deal with liabilities as the "negative assets" that they are, and enabled them to be more attuned to the need to establish consistent "realization" rules for them.

Unfortunately, the real world, especially the world of financial products, has created far more challenging problems for the Code than those created by the presence of simple negative values. Those who now try to rewrite the rules defining the income tax base to accommodate liabilities not only must understand negative values, but also must contend with the importance of timing in dealing with those negative values. The environment in which the tax law operates has become vastly more sophisticated about the time value of money. The tax law, in response to this increasing real-world sophistication, has itself developed a greater appreciation of the importance of timing in properly defining the income tax base. Unfortunately, attempts to incorporate this appreciation of timing into the Code have only exacerbated the problems created by a lack of understanding of even

simple liabilities.

Appreciation of the importance of timing has led to a variety of tax accounting changes aimed at ensuring that the ways in which we account for income are as "closed" as possible.[8] By "closed," I mean a tax accounting system designed to ensure that no value is "dropped" once it has been included in the tax base. The incentive for saving through individual retirement accounts currently incorporated in the Code may be the easiest example to use to illustrate this familiar idea: a deduction for contributions to the account, combined with realization of income only on withdrawal from the account, effectively exempts the earnings on the account from income. The provisions for tax-preferred savings deliberately "drop" the funds saved (and the earnings thereon) from the overall tax base and to this extent the tax base is deliberately not "closed."

To have a completely closed system, it would appear that two conditions must be satisfied: any time a transfer of value from one taxpayer to another provides a deduction to the transferor, there must be income to the transferee (this is the end result of, for instance, sections 404 and 461(h)[9]); and any time the possible exhaustion of an

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[8] This idea of a "closed" tax base as it relates to transfers among taxpayers is a combination of the general idea explored in connection with the design of alternative tax bases in David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000) (emphasizing the importance of patrolling the boundaries between economic sectors subject to essentially different taxes). "Closed" tax bases are explored more generally in Daniel I. Halperin, *Interest in Disguise: Taxing the 'Time Value of Money'*, 95 YALE L.J. 506 (1986) (emphasizing the importance, within the income tax, of patrolling the boundary between accrual and cash basis taxpayers and noting the possibility of asymmetry between standards for accrual of items of income and of expense for accrual basis taxpayers). When I previously attempted to articulate the importance of the tax base being closed in the design of an income tax base and the inconsistency of that concept with other norms frequently incorporated in tax base design, I made the mistake of calling the concept of being closed "matching," a red flag in tax policy debates. *See* Charlotte Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POL'Y 191 (1986). Others have noted the incompleteness with which certain aspects of this type of closure have actually been accomplished and the usefulness of this type of closure as a tool for analyzing transactions and suggesting reforms. *See, e.g.*, Julie A. Roin, *Unmasking the "Matching Principle" in Tax Law*, 79 VA. L. REV. 813, 823 (1993).

I am unaware of prior uses of the notion of "closed" to describe the goal of establishing the appropriate timing of outlays intended to generate income. The literature emphasizing its importance in various contexts, most of which acknowledges the idea's origins in E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948), is voluminous.

[9] I.R.C. §§ 404, 461(h).

income-producing asset justifies a deduction to the user, the income from that asset must first have been included in the user's tax base (this is the goal of economic depreciation, which would deny a deduction to the extent there is any value, and thus unrecognized income, remaining in any asset[10]). The tax system could also be closed if these rules were violated but sufficiently accurate adjustments were made to the amount used to account for the liability to translate amounts deducted at earlier times into their equivalent at a later time.[11] We do not, of course, achieve a closed system (any more than our base includes every source of value we can infer Mr. Haig and Mr. Simons would have us include),[12] but many of our tax accounting rules can be best explained as attempts to keep the tax base as closed as possible (except, of course, for when we intentionally provide otherwise, as with traditional IRAs or with bonus depreciation). At the risk of oversimplification, failing to maintain a closed system causes problems because the excluded, or "dropped," values will escape income tax.

To the extent that we insist that every deduction from income, either for a value used up in generating income or for a value transferred to another, meet the criteria we set in the hopes of maintaining a "closed" tax base, we are implicitly assuming that every value, once included in the tax base, will always produce a return for someone somewhere in the system. In most transactions encompassed by the income tax, this will be true. To the extent that it is not, the error will be one we are willing to tolerate. The first

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[10] *See* Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604, 606 (1964) (defining economic depreciation as a tool for ensuring that depreciation deductions represent "putative decline in economic value").

[11] There have been many demonstrations of the economic equivalence of accounting treatments and cost recovery methods that allow deductions at varying points in time. A deduction of $100 this year will have the same economic effect on a taxpayer as a deduction of $110.25 in two years, so long as five percent is the appropriate after-tax interest rate. After the $100 deduction, a taxpayer paying a tax rate of thirty percent would have $70 to reinvest, and if reinvesting at five percent would have $77.175 in the second year, the same amount that a taxpayer enjoying a deduction of $110.25 in the second year would have. For an early primer on the subject, see Alan J. Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C. L. REV. 1327 (1982). For another proposal relying on the same principle, see Martin Feldstein, *Adjusting Depreciation in an Inflationary Economy: Indexing Versus Acceleration*, 34 NAT'L TAX J. 29 (1981).

[12] For the Haig-Simons definition of income, see, e.g., Henry C. Simons, PERSONAL INCOME TAXATION 50 (1938).

requirement, that the transferee include as income any value deducted by a transferor, makes sense given that in most transactions, an anticipated cost is someone else's anticipated receipt. What one taxpayer gains, another taxpayer loses, and one can assume that both sides have an incentive to ensure that they are rewarded for any timing discrepancies in their actual exchanges. We have designed our rules based on the assumptions that many taxpayers will insist on being so rewarded and that we care more about adequately taxing them than about overtaxing those who do not. The second requirement, that no deduction be allowed for an income-producing outlay before the income derived from that outlay is recognized, makes sense given that we do not expect taxpayers to "drop" real value by investing (at least in their business transactions) in ways that cannot be expected to produce an adequate return.[13] Our tax accounting rules, at least since the introductions of sections 404 and 461(h),[14] are thus largely designed to follow each transfer and use of value as if the value were a discrete fund, always generating a return even if that return will not ultimately be enjoyed by the taxpayer temporarily identified as the owner of the fund.

This approach suppresses the possibility of actual losses of value. Common sense tells us that real economic losses occur, and sometimes on a substantial scale: oil spills damage fishing grounds, bridges collapse, and accounting scandals destroy purchased goodwill.[15] Some of these losses are of values already counted in the tax base; others are not. In any event, such events result both in destroyed "funds," which we can usually account for fairly well, and in anticipated but ill-defined potential outlays, for which our current tax rules are simply inadequate.

To summarize, it is well understood that if income-producing values do not remain in the overall tax base until no additional return on them is expected, the return will be improperly excluded.

[13] Taxpayers may not expect every outlay to itself produce a positive return, but taxpayers can be expected to make investments that in the aggregate will produce a positive return. The tax law, in general, simply ignores this possibility, and treats every outlay as if it did in fact produce its "own" income stream.

[14] Section 404 was added to the Code by Act of Aug. 16, 1954, Pub. L. No. 54-591, ch. 736, 68A Stat. 3, 138 (1954). Section 461(h) was added to the Code by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 494, 598–600 (1984).

[15] In addressing "real economic losses," I want to focus on the loss of physical assets, which have their own inherent abilities to contribute new value to the economy. I do not want to focus on financial losses, which are essentially derivative of real losses.

Similarly, when real income-producing values are created but not taken into income, the return on them will also be improperly excluded. Hence there arises a fixation with realization, especially with respect to financial assets. It is less well understood, but equally true, that the failure to acknowledge a decline in income-producing values that have already been included in the tax base as the decline occurs will produce the same result as inclusion of nonexistent returns. In theory, such a decline in value should offset income as it occurs, but our tax accounting rules do not handle such offsets well, except as to explicit cost recovery for a fixed outlay, determinable and finite at the outset of the project. Our efforts to refine the tax base in response to concerns about timing seem to have hopelessly compounded the inadequacies of our basic rules for accounting for liabilities.

The seriousness of these shortcomings in the current tax law regarding liabilities and other "negative values" is revealed in the tax literature. First, consider that the literature that focuses on defining the tax base uses an entirely different vocabulary when discussing "realization" of income than it does when discussing accounting for liabilities and other offsets to income that do not involve traditional cost recovery of a single outlay. The concepts of "realization" and "recognition" of income are relatively concrete compared to the more general notion of "accrual" of a liability. And there seems to be no word at all appropriate for describing the time at which basis credit will first be allowed for a liability, as in the sentence, "the taxpayer ___ additional basis at the time a contingent liability becomes fixed."[16] Consider as well that the realization problem has given rise to a considerable amount of literature grandly theorizing about how it could be remedied,[17] while the acknowledgement of liabilities has been dealt with primarily in ad hoc regulations projects.[18] Discussions

[16] The lack of adequate vocabulary is particularly noticeable in new Treas. Reg. § 1.752-1(a)(4)(i), which takes the equivalent of three sentences to describe when a mere "obligation" as defined in Treas. Reg. § 1.752-1(a)(4)(ii) is no longer a "section 1.752-7 liability" but instead has become a "section 1.752-1 liability." Treas. Reg. § 1.752-1(a)(4)(i) (2005). (Surely there was a better way to regularize these concepts than by forcing every question through this particularly troubled set of regulations.) *But see, e.g.*, Treas. Reg. § 1.338-7 (2001), which speaks of the time at which liabilities are "properly taken into account under general principles of tax law."

[17] *See, e.g.*, Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722 (1990).

[18] *See, e.g.*, Treas. Reg. § 1.338-4(d) (2001) (dealing with assumed liabilities in computing deemed purchase price); Treas. Reg. § 1.752-7 (2005) (dealing with assumed liabilities in partnership contributions).

of losses are dominated by the assumption that taxpayers can trigger losses at will, and that cherry-picking of losses is the biggest source of disparity between true economic income and the tax base (which is defined by rules constrained by realization). Comparatively little attention has been paid to "losses" that are never associated with fungible individual assets, or to losses which, despite being associated with a particular product or income stream, are associated in a way that our tax accounting has been unable to accommodate.

The remainder of this essay will attempt to provide a cohesive understanding of liabilities and consider how to tax them appropriately. Part I will demonstrate in more detail the nature of the problems manifested in current law, and Part II will attempt to offer some ground rules for thinking about liabilities and related values going forward. In order to gain an understanding of the nature of the problems in accounting for these losses and the liabilities related to them, we must begin with a broad understanding of the term "liability." Although many recent problems are the result of including too many different types of economic positions in the technical meaning of "liability" under the Code, any useful analysis must consider all of the possible meanings, and only after doing so can it explain why some liabilities should be treated differently for tax purposes. Therefore, initially, "liability" will mean any anticipated outbound payment, whether or not it has already been taken into account under the appropriate tax accounting rules.[19] Even this definition insufficiently specifies the problem, for it does not address what constitutes an "anticipated payment" as opposed to some other anticipated behavior that will involve economic outlays by the taxpayer.[20]

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[19] Some taxonomies, especially older ones grounded in accounting, use the term "obligation" to encompass what I will refer to as "unacknowledged" liabilities, and reserve the term "liability" for "acknowledged liabilities." *See, e.g.*, I.R.C. § 381(c)(16). This distinction seems to have lost its usefulness in tax doctrine, even for authorities that have tried to rely upon it. *Compare* Treas. Reg. § 1.752-1 (as amended in 2005) *with* Treas. Reg. § 1.752-7 (2005) (initially defining "obligation," but then essentially dividing obligations into those which are 1.752-1 liabilities and those which are 1.752-7 liabilities).

[20] Comments by the Tax Section of the American Bar Association have suggested that the concept of "liability," or at least the related concept of "obligation," should include all economic positions for which a negative net present value can be assigned at the same time that a positive net present value can be assigned to the counterparty. *ABA Warns of Problems with Guidance on Corporate Property Transfers*, TAX NOTES TODAY (Sept. 24, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 185-42). I do not disagree with the approach that produces

II. CONTEXTS IN WHICH RULES FOR LIABILITIES ARE NECESSARY: ACKNOWLEDGEMENT, RECONCILIATION AND VALUATION

There are four contexts in which there must be well-articulated rules for dealing with liabilities in defining the income tax base:[21] acknowledgement (i.e., allowing a present offset for a future repayment of value and allowing a subsequent deduction or an addition to basis for the use of that value), reconciliation on failure to pay (i.e., cancellation of indebtedness), reconciliation on substitution of a debtor (which involves both valuation and reconciliation issues, although we often ignore the valuation problem), and valuation itself.

A. Acknowledgment of a Liability

Acknowledgement of a liability appears at first to involve only the familiar question of when the liability will, in the most general sense, accrue for tax purposes. But the problem is actually more complicated than this familiar question suggests. Indeed, in order to understand the relationship between the larger questions involving acknowledgement of a liability and the more familiar concept of accrual, this article will avoid using the term "accrual" at all. Instead, this article will refer to the time at which the liability will first be "acknowledged" for tax purposes. Alternatively, one could refer to the time when liabilities will be "accounted for" or "taken into

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this definition; I have used something similar myself. *See* Charlotte Crane, *More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business*, 3 FLA. TAX REV. 615 (1997). However, I do not find it particularly helpful in this context, since it assumes much of the analysis that I think is important, that is, identifying the relevant positions to be "netted."

[21] Identifying "liabilities" or "indebtedness" for other purposes, including: whether carrying costs should enjoy treatment as deductible interest or as a nondeductible return to equity; when carrying costs can be classified as interest costs and must be allocated and assigned for various domestic and transnational purposes; and whether certain investment positions of tax-exempt entities should be considered "debt-financed," are related to but not central to the analysis considered here. Those analyses are related to the analysis here because at the core of each analysis there are assumptions about whether there is likely to be an interest-like component of the transaction and about what tax accounting treatment will tax that component most accurately. Although a concern for consistency often produces rules that are easier to implement — indeed, the need for consistency drives much of what will be said herein — consistency among the rules in those areas and the rules upon which this article will focus may not be possible given other concerns unrelated to defining income that are involved in those other contexts, such as enforcement of the double-tax regime and of allocation in the international context.

account," but "unacknowledged" has considerable syntactical advantages over "not yet taken into account."[22]

Acknowledgment questions arise in several ways. In the most basic, a taxpayer may face a demand for payment, even though he has not yet received anything which justifies the demand. For instance, a local government may impose a new annual property tax on the value of the business assets he holds. Although political economy may suggest that this taxpayer will not remain within the taxing jurisdiction of this government for long if he is not receiving services of equal or greater value than the tax he must pay, the value of such services received by the taxpayer is ordinarily thought to be properly excluded from the tax base. Whenever a taxpayer receives a demand for payment prior to the receipt of services justifying that demand, we have no way of determining when this anticipated cost should be taken into account, and we therefore default to the year that best corresponds to the payment as the time when it can be acknowledged. Note that a liability like this new tax burden, especially if unexpected and uncompensated, may have decreased the value of the taxpayer's business by an amount that is related to, but different from, the amount we will allow as a deduction in any one year.

This most basic acknowledgment situation — when the taxpayer is obligated to pay but has received no value — is actually a relatively trivial one. Most liabilities arise because the taxpayer has received value for which he must make a corresponding repayment, not out of thin air or from the votes of well-meaning public officials. The acknowledgment problem thus usually includes, as an initial matter, determining whether an anticipated payment should be allowed to offset this prior receipt of value by the taxpayer. Many of these situations are simply overlooked as possible taxable events, because the fact of the offsetting liability seems so obviously to justify the exclusion of the value received from the taxpayer's income. For instance, we do not think that a manufacturer should have income when his employees put in their time and transfer value to him in the course of their employment, because the manufacturer will have to pay them wages. Nor does he have income when he receives raw materials from his suppliers, because he will have to pay them as well.

This first acknowledgment of the liability would hardly seem

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[22] Readers familiar with the Internal Revenue Service's recent attempts to deal with these problems will recognize rough correspondences between what I refer to as "acknowledged liabilities" and the liabilities identified as section 1.752-1 liabilities and between my "unacknowledged liabilities" and those liabilities that are only "obligations" except for the purpose of Treas. Reg. § 1.752-7.

worth pointing out were it not for the fact that other taxpayers in very similar economic situations are taxed far differently. Those for whom a receipt of value is unambiguous, but the offsetting payment is not ambiguous (especially when it is in cash), e.g., an obligation to satisfy warranties, will be treated as having income at the time of the receipt of value. They will have income to the full extent of the receipt, even though the actual increase in their net worth is small or even nonexistent. These unhappy taxpayers — who most famously include the sellers of prepaid dance lessons[23] and auto service contracts[24] — will not be able to offset the value of their receipt by the burden undertaken when they receive it.[25] In other words, we are willing to acknowledge the manufacturer's obligation to repay his employees and his suppliers as an offset to the value they have transferred to him, but we are not willing to allow him an immediate offset to the amounts he receives from customers, if the offset represents his continuing obligation to provide services to them. There is a relevant difference between these two situations: the open-endedness of the obligation to repay in the warranty situation suggests the possibility that the manufacturer's repayment obligation may not in fact offset his receipt entirely, and this element of income should therefore be captured. However, when the manufacturer is not allowed to acknowledge this offset to his receipt, there is *always* a good chance that we are overstating his income.

When value has been received and yet not been included in

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[23] Schlude v. Commissioner, 372 U.S. 128 (1963).

[24] Auto. Club of N.Y., Inc. v. Commissioner, 32 T.C. 906, 911–13 (1959), *aff'd*, 304 F.2d 781 (2d Cir. 1962).

[25] The courts have held that bank-loan treatment is not appropriate for payments received before it is possible to know how much will eventually be returned to the payor. *See e.g.*, Union Mut. Life Ins. Co. v. United States, 570 F.2d 382, 385 (1st Cir. 1978); Westpac Pac. Foods v. Commissioner, 82 T.C.M. (CCH) 175 (2001). Elsewhere, the courts have asserted that amounts received by taxpayers to be paid down through the performance of services are taxable income, not loans, where the payor's intention to enforce repayment obligation was unclear, even though monetary payments were eventually required. *See, e.g.*, Johnson v. Commissioner, 108 T.C. 448 (1997), *aff'd in part*, 184 F.3d 786 (8th Cir. 1999); Beaver v. Commissioner, 55 T.C. 85 (1970). This approach to acknowledging ambiguous repayment obligations apparently applies only when the receipt nominally includes at least some component of income above and beyond the repayment obligation. However, if the transaction is styled as one that should not on its face include an income component, even though the parties have an overall commercial relationship that clearly contemplates the [illegible], the receipt of value may be styled a "deposit" and the offsetting obligation acknowledged. *See, e.g.*, Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990); Highland Farms, Inc. v. Commissioner, 106 T.C. 237 (1996).

income because of the anticipated payment, acknowledgement of the liability will at the very least mean that the taxpayer will have no income as a direct result of the receipt. This preliminary treatment of a liability will sometimes be referred to in the discussion below as "loan treatment" of the receipt. This preliminary acknowledgement of the liability is often conflated with the subsequent question regarding when the taxpayer will be allowed to offset his business income (the payment he receives when he retransfers the original value to his customers) by this original value received. When the original value is used up in the earning of income, the taxpayer will also enjoy an offset to his income for the retransfer of this value. Why is this deduction, which, once identified, appears to be a second and perhaps duplicative acknowledgment of the liability, appropriate? It is appropriate because otherwise both our manufacturing taxpayer and his employees/suppliers/payees will have included the entire amount of the entire value they transfer in income. However, each should ultimately include in income only the incremental value they have contributed to the overall tax base. It is appropriate to allow the manufacturer both the offset to the receipt of "income" from the work performed by his employees and the deduction on actual payment against the income he is generating in his business, so long as both he has income from the sale of his finished goods and his employees have salary income. Were all of these events to occur and be accounted for simultaneously, the tax base would remain closed.

The same analysis applies when the employer receives raw materials. Again, he has no income because he will have to pay his suppliers. The value that he receives will not be included in his income upon receipt, but will, like the wages paid to employees, be deductible (that is, allowed as a cost of goods sold) so long as it is used up in the generation of additional income.

Finally, and more familiarly, consider the result if the employer takes out an explicit loan. He does not have income when he receives the loan proceeds, because there is an offsetting obligation to repay. Nevertheless, he will be allowed an offset to his business for the use of the loan proceeds, so long as the proceeds are used up in the course of generating additional income and retransferred in some converted form to his customers.[26]

[26] Some commentators have suggested that the traditional approach to bank loans (no tax on receipt but basis in proceeds) produces erroneous results. Although it is true that an investor who self-finances will enjoy a lesser return on his investment than one who borrows, *see, e.g.*, Martin J. McMahon, Jr., *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 ST. LOUIS U. L.J. 1029 (1985),

In all three cases, the taxpayer who receives value but is allowed "loan" treatment for the receipt will be allowed basis (or a deduction) as an offset to his income for the value used up in the generation of new income. There are, in effect, two stages of acknowledgment regarding what appears, when we focus on the manufacturer himself, to be only one value. First, there is the preliminary acknowledgment of the obligation to pay his transferee, of which obligation we are barely aware unless the transaction is an explicit loan, and which offsets the initial receipt of value. Second, there is the acknowledgment of the use of the value to generate other income, which in effect assumes that the value is replaced by income earned in the normal course of the taxpayer's business. There is a difference between the receipt of value from workers and the receipt from a bank only insofar as the latter receipt is in cash, and will always be used by the manufacturer in a way that will require us to allow him basis for its use. The bank, furthermore, will almost certainly be transferring value that we will assume has been taken into its tax base.

Viewed in this way, the timing of the preliminary stage of acknowledgment should give us pause in some cases. As laid out in the foregoing discussion, we are likely to allow the manufacturer/recipient an offset for his repayment no later than when he recognizes income on the sale of his product, even though we do not necessarily require the recipients of the repayments to take the amount they will receive in income. In the case of the value received from the employees, therefore, there is some potential for "dropped" values. The value created by the employees' efforts will not be

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this is only because the creditor who lends to an investor has been willing to give up a riskier return in exchange for securing a more certain return. The overall returns on the debt-financed investment, viewing debtor and creditor together, are no greater than the return to the self-financed investor. It is also true that allowing accrual of cost that is still available as a source of a return will exempt that return in furtherance of consumption tax values, but not income tax values. *See* Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998). This treatment will be erroneous for taxpayers who are always able to service their debt by earning at an after-tax rate that is greater than the after-tax cost of the interest they pay, which in turn will be true only if they are always able to earn income taxed at less than the rate that would apply to the income sheltered by their interest deductions. *See* Calvin H. Johnson, *Soft Money Investing under the Income Tax*, 1989 U. ILL. L. REV. 1019; Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX L. REV. 1013 (1983). Although the analyses of these writers is correct under some assumptions about the tax treatment of the lender in the transaction, see *supra* notes 15–20 and accompanying text, it nevertheless must be possible to equate the economic burden of loan repayment with some portion of the economic benefit of the receipt and allow offsets therefore.

acknowledged until the manufacturer has income in the ordinary course. However, the employees will usually not have income until they are paid, since they are likely to be cash basis taxpayers. It is less clear that there will be values dropped as a result of the value transferred by the suppliers, since they are more likely to be taking their income into account on an accrual basis. On the other hand, they may not be accounting for their costs in a way that ensures that no costs are allowed until the receipt of that income. It is unlikely, however, that there will be values dropped as a result of the loan, since a cash loan bearing market interest generally does not represent a transfer of value that presumptively includes the creation of an element of as-yet untaxed value, and thus does not anticipate the payment of an amount above and beyond the amount the lender has already taken into income.

So long as we are comfortable with the degree to which dropped values may occur as a result of the allowance of the offset to the receipt of value from the employees or suppliers, we should be able to allow the manufacturer to take into account the basis created as a result of his use of the "loan" proceeds by reference to the income that they are generating for him. If income is generated currently as a result of his sale of the goods created from the labor and raw materials he has received, we should allow him a deduction for his anticipated payment coincident with the recognition of that income. If income will be generated only in the future, we should allow him basis, to be recovered as the income is in fact generated. The allowance of this explicit basis or deduction should, as an initial matter, reflect the timing of the income being generated.

In practice, however, we are not always comfortable with the degree to which values might be dropped from the tax base as a result of the initial offset. The employees could ask the employer to keep their wages, invest them, and thereby take advantage of the fact that they practice cash basis accounting. These wages would be dropped from the tax base for some period of time, and after investment, the employer eventually would pay his employees the increased wages. If we nevertheless allow the manufacturer a deduction for the value he has received from the employees, the value that they have contributed to the overall tax base may be dropped. Therefore, despite the fact that we would ordinarily allow an offset against the manufacturer's income for his anticipated payments for labor, we may in this case decide that the manufacturer should not be able to take payments to his employees into account until they are actually made. This seems appropriate, since if he has agreed to pay his employees their wage

plus an amount that compensates them for the deferral, he must in fact have a fund that would otherwise be paid to them, on which it is appropriate to assume that he is in fact earning a rate of return.[27] However, note that we are delaying the time at which we would ordinarily allow an offset for the use of the value in generating against business income in order to eliminate the possibility of a "dropped" value as a result of allowing an offset upon initial receipt of value.

We are, in effect, willing to change the rule that prescribes the offsets the manufacturer can take in offsetting his income by his costs because we are unsure about the extent to which we should have allowed "loan" treatment on the initial receipt of value from the employees. We are, therefore, implicitly assuming that it is more important to tax the value added by the employees to the employees adequately than it is accurately to measure the manufacturer's income.

In sum, our current tax accounting rules for handling liabilities start with the premise that all received values are being deployed so as to command a rate of return, and that all such values should be included in the tax base. In order to ensure that this return is captured in the tax base, our tax accounting rules strive to ensure that no existing value is dropped from the tax base as a result of a deduction (that is, as being treated as if it no longer was available to a taxpayer) unless it both (1) has been included in the tax base of the taxpayer who receives it[28] and (2) has been replaced by a value that is

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[27] I have my doubts about whether, if we were able to calculate the value transferred by the employees properly, we would ever need to let the first condition override the timing that would result if we relied only on the second in determining the amount to be allowed as a deduction against manufacturer's income as it is recognized. Because I want to focus on the failure to take into account the possibility of the destruction of the value, if any, created by the transfer by the employees and by the transfer of value to the employer by others, I will assume that the problem in translating the value ultimately to be paid into the value to be received by the employees justifies the dominance of the first condition.

[28] One might imagine that there should be a parenthetical here alluding to the definiteness of the total absence of value to any taxpayer. Such deductions are actually rarely allowed. Although there are provisions in current law that anticipate actual losses — a business may deduct the cost of abandoned assets, and both businesses and individuals may deduct their casualty losses — these provisions are woefully inadequate as devices for allowing the "dropping" of value when it might be appropriate. For instance, imagine a prize rose garden, in which the owner has invested significant amounts but which he and others value much more than is reflected in the owner's out-of-pocket investment. If a neighbor fails to prevent his dog from damaging the rose garden and must pay for the some of the lost subjective value, neither he nor the owner of the garden is allowed a deduction for the loss. The

newly included in the income of the deducting taxpayer (or it is known that there will be no such value). The importance of the first

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casualty loss deduction under section 165 is available only for losses to the taxpayer's own property, *see* I.R.C. § 165, and the garden owner is not allowed a loss — even if the event was a casualty and he does have some basis — because he is reimbursed. Indeed, the owner will probably have a casualty gain, as if he had been willing to be paid to allow the dog to dig. In a sense, the tax law treats the entire event as value consumed by the dog owner, and consumption value transformed into cash by the garden owner. There is no big mistake here, however, when only personal consumption values are involved. Nonetheless, note that our accounting treatment, because the garden owner is likely to have gain, will end up treating a transaction that in fact involved a loss of economic value as if economic value had been created.

If the same business taxpayer is the owner of both the dog and the garden, the tax base will reflect that loss of the value of the garden even more imperfectly. The standards for establishing an abandonment loss are notoriously high, *see, e.g.*, A.J. Indus., Inc. v. United States, 503 F.2d 660 (9th Cir. 1974), so in effect only values that are subject to a casualty loss or can be sold after their destruction are likely to be easily "dropped."

This failure to acknowledge real losses is probably a small problem. First, we may not care if the income tax base overstates increases in value in the economy. Although we include as increases in value payments made for values previously enjoyed outside the income tax, no allowance is generally made for the destruction of values outside the tax base. The accounting for destroyed values previously included in the tax base simply assumes that a fund yielding a return has changed hands. Obviously this small discontinuity is not the greatest obstacle we face in obtaining an accurate measure of the income tax base. Second, other aspects of our base-defining rules probably mitigate the frequency with which the mismeasurement occurs. The dog owner is likely to be covered by insurance, and our overall scheme, under which the insurance company is taxed on the return on the reserves it uses to pay such claims, may well reduce the overstatement of income. Perhaps even more significantly, the system is not closed with respect to much of the damages actually paid for destruction of value, because recovery for physical injury to persons is excluded under section 104. I.R.C. § 104.

Also, any payment the gardener receives is likely to have been for a value that he could have continued to enjoy, absent the destruction, without it ever being included in the tax base at all. He would never have been taxed on the value of his rose garden at all, unless perhaps he cashed in the value by giving tours. (Note that there is likely to be value excluded even if we only include objective value.) He will be taxed however, on the receipt of the cash he receives to replace his continued enjoyment of his garden. To restate the point, many payments for destroyed value will involve a loss of value that, under a different state of the world, would have remained outside the tax base completely. This value has been brought into the tax base only because its destruction has produced a forced sale. Our insistence upon applying the rules aimed at keeping the tax system closed to these cases will result in including in the tax base the return on these values that were previously nonmonetized and therefore outside the tax base, even when the transferor is allowed a full deduction on payment.

condition has not always been consistently reflected in our tax accounting rules, and certainly is less well understood than the second condition, but it has in numerous instances assumed a priority over the second.[29] The first condition is satisfied if the value transferred has already been subject to tax and there was no deduction allowed for the transfer (as in the case of the traditional loan), or, if the value had not already been taken into account before the transfer, the transferor-of-the-original-value/recipient-of-the-repayment has already taken the repayment into income. Wherever it is unclear that the first condition will be met, the relatively newer rules associated with deferred compensation, the economic performance rules of section 461(h),[30] will override the rules for accounting for the use of that value in income. The importance of the second condition, and the need for capitalization of costs if the return therefrom is to be adequately taxed, has long been recognized. It is satisfied when the taxpayer has in fact used up the value in the generation of income (or is allowed for other reasons some stylized cost recovery for it).

When income is calculated using rules enforcing both of these conditions, the correct amount is usually, but not always, included in income. Suppose, for instance, that I run a small-scale butter churning operation. Each morning, I take from a trusting farmer milk that he could have sold to anyone else for $40 and for which I will pay at the end of each day; then my employee, to whom I pay $4 a day, churns the milk into butter that I can sell for $50. Each day I have receipts of $40 (the milk for which I do not pay until the end of the day), $50 (the price for which I sell the butter), and $4 (the value of my employee's services). I make payments of $40 (to the farmer), $4 (to my employee) and $44 (to my customer when I transfer the butter to him). Notice again, as it is important for the analysis used throughout this paper, that I am counting the transfer by the farmer to me as a receipt of value by me, and the transfer to my customer as a transfer

[29] This is the effect of the ordinary application of section 461(h) when the taxpayer must defer the deduction of an anticipated payment long after he has benefited from and recognized income associated with any earlier receipt of value, for instance, for a tort liability. Although the language of section 461(h) seems to allow a deduction before payment when "services and property" are provided to the taxpayer, the legislative history and regulations thereunder clearly do not allow the sort of earlier receipts that result in tort judgments to be included in such "services and property." *See* Treas. Reg. § 1.461-4(g)(ii) (as amended in 2004). It does not matter that the value that the taxpayer "bought" through his tortious actions is no longer generating value either to the taxpayer or to the tort victims. Note that this effect may also be the result of the delay in deduction required by section 404.

[30] I.R.C. §§ 404, 461(h).

of value by me to him.[31] Each day, my income should be $40 + $4 + $50 – $40 – $4 – $44 = $6, although this is affirmatively not standard tax accounting.

The trick for tax accounting is to take all of these items into account in the way most likely to reflect the fact that each day there is almost $50 of new value to be accounted for as a result of these transactions. (There is $40 produced by the cows, not counting the farmer's marginal costs, $4 added by my employee, and $6 by me, if the market will bear the price I charge through my ingenuity in arranging the transaction). This is relatively simple when, as in this example, everything happens in a relatively short time frame.

The general method for accounting for my activity should remain the same even if occasionally my dog eats the day's butter production. I will have the same obligations to all of those contributing value, and I will have to deal with a disappointed customer and a very sick dog. However, no serious error in the computation either of my income or the income of this little economy as a whole will result if I simply omit my lost receipt from my customer from the reckoning for the day ($40 + $4 – $40 – $4 – $44 = –$44). My dog has destroyed the value otherwise contributed by the cows and my employee before I could make my usual $6 contribution.

If any delays or contingencies are introduced, however, accounting for my position gets trickier. Suppose, for instance, the farmer and I agree that I will pay him only once a year. Because I will have the value of his milk, and the cash that I can get for selling the milk, it seems reasonable that I will be expected to pay him not just $40 for each day, but also some amount of interest that reflects what he could have done with the funds had I paid him each day. In the approach to tax accounting described above, this interest element will be the only change in the accounting above; my receipt of the milk will still be offset by my obligation to pay for it plus the obligation to pay for the privilege of delaying payment. Whether our tax accounting will continue accurately to report all of the value created each day, however, will depend upon how we treat the farmer. If he is required to anticipate my payment, the $40 contribution of his cows will be included every day, and the tax base will remain as it was. (He

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[31] Further note that I have omitted my own labor and the value added from the above. I should only count the $6 worth of my efforts as a value received if I count it as part of the value of the butter transferred. In an income tax, or in any tax that purports to tax a return to personal effort, the two items should wash. Under our current tax regime, which in effect taxes return to effort twice (once under the income tax and once under the payroll tax), better accounting for my effort will be necessary.

will be, in effect, a lender of cash in the form of a traditional loan as discussed above.) However, if he is not so required, then his cows' contribution will be missing for the interval between the time it is created and the day I pay him. Let us assume that the farmer uses cash basis accounting, and thus will not take his daily $40 plus interest into account. As a substitute for his income, however, we can delay my taking my obligation to pay him $40 into account until I actually pay him, which will offset the omission of income to the farmer.[32]

If we have shifted to this approach to accounting for my arrangements with the farmer, what should we do about the day when the dog eats the butter? Unless it is appropriate to charge me with a consumption value for keeping such a pest, or to count my dog's actual consumption as personal income to me, I clearly have less income and there is clearly less total value in the economy on that day. Therefore, I should be allowed to take the fact that I have lost one day's value into account on the day that value is lost, since no one will be able to earn interest on that value during the time before I pay the farmer. However, as long as we are using the timing of my payment to the farmer as a way of ensuring that the value created by the farmer is properly included in the tax base, this will be difficult to accomplish.

Other types of values transferred to me and patterns of repayment by me can create still greater problems. What if I discover, after many days of apparently successful butter production, that the above calculation does not accurately account for all of the costs involved (or to use language consistent with our analysis so far, all of the values I have used up)? Suppose that I have been dumping byproducts from my butter operations in a corner of what I thought was my land but is in fact part of my neighbor's sod farm. It turns out that one such byproduct is bad for the part of my neighbor's sod farm on which I have been dumping it, and I therefore promise to pay him a small amount of damages. This payment will represent not so much the value to me of being lazy about where I dumped, but the loss of value to him of the contamination. (Our financial models will probably simply assume that these values were equal, and it will seem unproblematic that I treat the amount paid as a cost, leaving only a relatively small timing problem.) Again, our simple daily accounting will not accurately reflect my income, or the overall net increase in value within the economy, without taking the damage done to my

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[32] Although it will not actually apply here, this is what section 461(h) does in situations where it applies. *See* I.R.C. § 461(h).

neighbor, and my compensatory payment, into account. I have received a value (my untaxed use of my neighbor's land) and used it up in the course of my butter operations with respect to which I have already accounted for all possible income. Is it necessary for me to wait until my neighbor accounts for the payment before I can deduct the economic burden of my payment to him? Here our problem lies in the possibility that we perhaps should not assume that my "use" of my neighbor's land contributed to the overall economy. Therefore, we cannot reach any conclusions about whether there is too little value included in the total tax base if I am allowed a deduction, or too much if I am not. Part of the problem is attributable to potential flaws in the system of income accounting my neighbor uses as he operates his sod farm. Indeed, if he were merely gardening for pleasure, the income tax accounting for the value of his use of the land would definitely be flawed. Assume for the moment, however, that if the economy as a whole were marked-to-market, my accidental dumping would result in a net negative adjustment, because good sod-producing acreage would no longer be producing good sod. Given that, unless either my neighbor or I was allowed a deduction to account for the damage at the time it occurred, our tax accounting will overstate the value in the economy as a whole during the time between when the damage occurred and when I pay him.

Suppose, alternatively, that use of a poorly-designed butter churn has resulted in repetitive stress syndrome for my faithful employee. I change the set-up for the churn at relatively little cost to me, but find that I will be paying for physical therapy sessions for my employee for the next few months. We could simply treat his exchange of physical well-being for wages the same as we treat both his substitution of leisure and my payment of his therapy costs as wages to him. This, however, merely pushes into his income tax calculations the interesting question whether the therapy costs reflect a consumption value to him or a cost of working and earning wages. Note that this approach would overlook the fact that the overall production of butter did not create as much additional value in the economy as will appear from my receipts alone. I have received value for which I have not paid (the amount by which I have undercompensated him given the injury he was enduring), and I have already recognized all of the income related to my use of that value. However, my employee has not yet received either payment for his injury or the physical therapy necessary to restore his health. This may be reason enough to deny me a deduction for the economic burden of my obligation to him. Unlike the value I destroyed by my inadvertent use of my neighbor's

land, the value that I received when my employee's health was put at risk is not one that, as a normative matter, we expect to include in the tax base.[33] Our failure to include in the tax base the monetized value of my employee's good health in circumstances when his health has been destroyed should raise no greater concerns than it does when we fail to include it when it is not destroyed. Why should I be denied a deduction that would reflect the economic burden of the payments I will be obliged to make as soon as I know they must be paid?

In summary, what we customarily think of as the initial accrual of a liability will occur at a time that best satisfies two concerns: first, there will be some value received by the taxpayer to be used in the course of business for which repayment will be required, and second, the proper treatment of it will be to allow an offset for the way in which this value is used to produce income. Only when both concerns are satisfied will a liability be taken into account and a deduction or basis allowed. For the purposes of the following discussion, only then will a liability have been "acknowledged." However, we must remain aware that the more we limit the second phase of acknowledgement, the more likely it is that the overall tax base will be overstated and that there will be a nontrivial difference between the overall tax base and the new value actually present in the economy.

B. Reconciliation for Failure to Pay

The second context in which liabilities must be accounted for involves those situations in which a prior tax treatment has been premised on the assumption that the taxpayer will make a payment in the future, but circumstances change in a way that renders payment unlikely.

Should the failure to pay off a liability produce income, no matter what the nature of the liability? The answer usually should be "yes," but the answer is "no" in many more situations than that is commonly understood to be true. Suppose, for instance, that several years after an unexpected tax increase, and after extended litigation, it is determined that the tax was invalid from the beginning. If I have neither paid the tax nor deducted it against other income, should I have income simply because I no longer have a duty to pay? The answer clearly would seem to be that I do not. However, if I have paid and deducted the amount against other income, and then receive

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[33] *See generally* Crane, *supra* note 8 (discussing the exclusion of values not usually monetized).

a refund, I should be required to reconcile my later position with my earlier deduction and to take an amount into income.

What about those liabilities that were allowed as offsets to value transferred, in the preliminary sense that a taxpayer was allowed an offset to a receipt of value at the time they were received, even if they have not been allowed as an offset to income and thus have not been "acknowledged"? Should a failure to pay on such liabilities automatically result in income? Conventional wisdom would seem to say yes, but it is not clear exactly why. Consider, for instance, the manufacturer whose employees work and yet are never paid. Should the manufacturer have an element of income, simply because his employees are never paid? (Perhaps they were illegal workers who dared not collect their paychecks.) Surprisingly, the answer is that in the ordinary case, it probably will matter very little. There will be a "dropped value," but only for the time between the manufacturer's receipt of value from his employees and the time that he has income resulting from his retransfer of the value in the course of his income-producing business. If the employer never pays and has not been allowed a deduction for his anticipated payment, his costs will be lower and his income will be greater than it would be if the workers had been paid. If this sounds counterintuitive, consider that if the employer were paying his employees far less than the value they created, we would not tax him on the bargain purchase. The hypothetical is simply the extreme case in which no wages at all are paid.

Note, however, that if the rules allow the employer to acknowledge the cost as a deduction against his income, he must be required to reconcile the more favorable position with his prior deduction. Similarly, if we require him to take into income the value represented by the unpaid wages, he should be allowed a deduction therefore even if he never pays, since the value represented by the wages has been incorporated into the finished goods and thus into the amount realized on their sale.

Finally, what should the result be if the manufacturer does not have to pay on his bank loan? Here we face a different situation. There are *no* circumstances in which he (if he is a purely business taxpayer) will not have taken an offset to his income for his use of the loan proceeds, either as a deduction for a current expense or as basis allowed as the result of the use of the cash. He received cash proceeds from the loan, cash always has basis equal to its fair market value, and

the use of cash always generates basis.[34] Therefore, it will always be appropriate either to charge the manufacturer with income or to take away the basis he was previously allowed in his use of the loan proceeds.

To reiterate, there is frequently no compelling need for reconciliation just because a taxpayer was allowed, as a preliminary acknowledgement, to offset a receipt by a repayment obligation. Any excess value received will be taken into account by the increase in income resulting from the incorporation of that value into the taxpayer's product, and thus into his business income in the ordinary course. Only if the taxpayer has already *also* acknowledged the repayment as an offset to his other income must there be reconciliation on nonpayment. It is not the nontaxable receipt of the "loan" proceeds that requires the reconciliation — it is the allowance of the use of the proceeds as a deduction against income (from hereon simply referred to as "acknowledgement" of the liability) that requires the reconciliation.[35] When such reconciliation is required, a determination that repayment will not be made is generally accounted

[34] Perhaps the assertion that cash always generates basis should be limited to cash spent in a business context; unless otherwise indicated, for the purposes of this essay I am assuming all transactions occur in a business context. The text ignores those situations, which are not entirely trivial, in which deductions or basis are denied on grounds of public policy (e.g., section 162(c)). *Cf.* Treas. Reg § 1.752-1(4)(a)(i)(C) (as amended in 2005), making special provision for those liabilities that "[g]ive[ ] rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital." It is not at all clear, however, that the timing questions related to such liabilities can simply be ignored, since most will give rise to adjustments to earnings and profits.

[35] This is not a substantial variation, in the ordinary case, of the approach to discharge of indebtedness income put forward in Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CAL. L. REV. 1159 (1978), and refined in Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199 (1996). The difference results from having expanded, as has the tax law generally, the scope of the term "liability" to include receipts other than in cash or in situations in which the value is clearly "after tax."

Again, the analysis in this essay is limited to liabilities incurred in a business context. If nonbusiness expenditures were contemplated (either consumption by individuals, or dividends by corporations), the mere receipt of value would require reconciliation. This reconciliation would not always mean that the receipt and ultimate nonpayment should result in income, however, since the receipt could have been a gift or other transaction that normatively should not result in income to the recipient.

for as cancellation of indebtedness income.[36]

C. Reconciliation for Change in Identity of Owner of the Value/Bearer of Burden

A third context, related to but too often conflated with reconciliation for failure to pay, arises when there is a change in circumstances where the likelihood of repayment remains high, but the taxpayer who enjoyed (and may still retain) the prior benefit is not the taxpayer who will make the payment. Such transactions include, but are not limited to: taxable transactions in which an amount should be realized as relief from an acknowledged liability by the original obligor on the transfer of property; nontaxable transactions in which the auxiliary rules for implementing nontaxability must account in some analogous way for the fact that the transferring obligor will benefit to the extent that he does not ultimately pay on an acknowledged liability; and nontaxable transactions where the transferor retains a liability but transfers the loan proceeds. Again, it is less easy to generalize about the appropriate treatment of the substitution of obligors when it involves unacknowledged liabilities.

Obviously, the three contexts (acknowledgment, failure to pay, and repayment by a different taxpayer) are closely related. As I have already indicated, most of what should happen in the second and third contexts will depend on whether the liability has already been acknowledged as an offset to other income at the time of the change in expectation regarding payment. Most of our tax accounting rules that accomplish this reconciliation aim only at providing consistency between the prior acknowledgement of the liability and the later developments involving repayment. They do not ordinarily aim at forcing a restatement of the amount of liability to reflect its true economic burden on the obligor. For example, when property is transferred subject to a recourse liability, the debt will not be restated. Thus, the seller/original obligor ordinarily will not recognize gain or loss on the debt position, and the buyer will be treated as assuming the same amount of liability.[37] Suppose that property is transferred

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[36] Although I do not deny that under the current income tax, questions of character can be as important as the questions of timing and measurement with which I am concerned; I doubt that these questions can ever be answered in a systematically coherent way. On the other hand, I do believe that the other questions considered herein can be addressed in a coherent fashion.

[37] Treas. Reg. § 1.1274-5 (as amended in 1998), implementing Code section 1274(c)(4), lays out the general rule that restatement of the amount of the debt will

subject to a mortgage with a stated amount of $100,000, which mortgage bore market interest when it was issued. Interest rates have since gone down, and the mortgage now has a present value of $130,000. When the third party assumes the mortgage, we ordinarily will treat the seller as having realized $100,000 from the assumption of the liability, not $130,000; the buyer, similarly, will be given basis credit of only $100,000. We will only reconcile the liability at this point in time; we will not value it.

D. Valuation

The fourth, and least-examined, context arises when the actual economic burden of a liability must be taken into account because we want to measure the taxpayer's overall wealth. In this context, many tax treatments of liabilities fail to account for the taxpayer's true economic situation and therefore produce anomalous results — those frequently referred to as including the possibility of "artificial" or "accelerated" losses. Valuation of liabilities should be necessary, for instance, in determining whether a taxpayer is insolvent, or in any other context where we want to be able to compare the fair market value of a group of assets with the economic burden of liabilities associated with them.

Several recent developments suggest that there is profound confusion about the relationship between the problems inherent in reconciling liabilities and in valuing liabilities for other purposes. Take, for instance, the operation of section 358(h),[38] which is designed to prevent the creation of easily-recognized losses on the transfer of

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not be required if the debt is "assumed, or property is taken subject to the debt instrument, in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange [according to the standards in Treas. Reg. § 1.1001-3]." Treas. Reg. § 1.1274-5(d) further clarifies that only the unrestated amount of the debt will be included in the calculations of amount realized and buyer's basis. If prevailing interest rates have fallen since the debt was first incurred, this rule will result in a portion of what should be the buyer's basis in the asset being treated as interest, and the seller will have reduced her gain on the asset by her loss on the debt.

I.R.C. § 1274(c)(4) and Treas. Reg. § 1.1001-3 (as amended in 1996) by their own terms seem to apply only to "debt instruments," which, even without the technical jurisdictional thresholds in the statute dealing with the nature of the issuer and the scale of the transaction, probably does not encompass all "liabilities" of interest for these purposes. For instance, it would seem to include only those liability positions for which there is a counterparty whose position can be described as owning an asset, and perhaps only if that asset has the characteristics of an instrument.

[38] I.R.C. § 358(h).

property subject to under-acknowledged liabilities in exchanges governed by section 351. Creating easily recognized losses on the transfer of such property was the cornerstone of the shelter known as the "contingent liability" shelter.[39] Section 358(h) blocks the creation of such losses by reducing the basis of stock received by the transferor of assets to the extent that the fair market value of the stock is less than the basis of the stock because the transferee has assumed liabilities.[40] If the total basis of the assets transferred is greater than the total fair market value transferred, there must be a reduction in the transferring shareholder's basis "by the amount . . . of any liability[.]"[41] However, section 358(h)'s provisions apply only when excess basis is associated with unacknowledged liabilities assumed by the transferor. The drafters of the statute were aware that acknowledged liabilities will reduce the transferor's basis under the reconciliation rule provided by section 358(d);[42] therefore, they assumed that acknowledged liabilities, which are taken into account under section 357(c) and produce basis reductions under section 358(d), could not create excess basis. The problem with this assumption is that there is only a very loose connection between liabilities that have not yet been acknowledged and the overall effect that liabilities can have on the value of the assets with which they are associated, because the amount of the liability for purposes of section 358(d) can depart markedly from the amount by which the liability reduces the fair market value of the assets with which it is associated. In fairness to the drafters, there is some sense to dealing separately with unacknowledged liabilities. It is certain that there will be a disparity between the burden of an unacknowledged liability and the amount that should be reconciled when the transferor is relieved from it. The unacknowledged liability will reduce the value of the assets with which it is associated, but by definition, it will never appear as an amount in need of reconciliation.

To understand its importance, one must understand the relationship between the unacknowledged liability and its effect on value. Consider a piece of land purchased for $2 million. Shortly after it was purchased, a new environmental liability regime is

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[39] *See, e.g.*, I.R.S. Notice 2001-17, 2001-1 C.B. 730, *supra* note 2.

[40] I.R.C. § 358(h).

[41] I.R.C. § 358(h)(1).

[42] I.R.C. § 358(d)(1) provides that "[w]here, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange."

enacted, and an assessment of $200,000 is made against the property that will not be payable for another five years and bears no interest. Under these circumstances, the owner will not be allowed a deduction for the anticipated payment. Suppose further that the appropriate discount rate is five percent and that the burden of the liability is therefore only about $157,000.[43] The value of the land, taking into account the liability, will be about $1.83 million. If the land is transferred to a new corporation, the unacknowledged liability will properly be ignored for the purposes of section 357(c).[44] What will be the result of the calculation required under section 358(h)? The land is worth less than its basis because of the liability, so, ignoring for a moment the possible exceptions, the situation appears to be the sort for which the statute was intended. However, deciding whether the $200,000 nominal value or the $157,000 present value at the time of the transfer is the offending "amount" of the liability is more difficult. The statute's invocation of section 357(c) suggests that the nominal value of the liability should be adopted, but the actual mechanism of the statute will produce a basis reduction of only $157,000.[45]

The problems involved with this strange mix of reconciliation concerns and valuation concerns can be highlighted by looking at instances in which there are multiple properties or multiple types of liability. Suppose that in addition to the aforementioned piece of land there is another piece of land, this one with a basis of $2 million and a fair market value of only $1.5 million due to factors totally unrelated to any liability. The aggregate basis of the two properties is $4 million, but the fair market value is only $3.33 million. Of the excess basis, $157,000 is attributable to the burden of the liability with a nominal amount of $200,000, while $500,000 is attributable to market losses on the second parcel. Is the basis reduction anticipated by section 358(h) the full $200,000 nominal amount of the anticipated payment, or only the $157,000 burden of the liability? The mechanism of the statute appears to require the full $200,000.[46]

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[43] Future value = Present value/$(1 + r)^n$, where r is the discount rate and n is the number of years at the end of which the value is to be calculated. Using the numbers given here:

Future value= $\$200{,}000/(1 + 0.05)^5$

= $200,000/1.276281563

= $156,705.23

[44] I.R.C. § 357(c).

[45] *See* I.R.C. § 358(h).

[46] I.R.C. § 358(h) uses the term "amount," which as used in other sections within subchapter C has always been interpreted to mean the nominal amount of a liability,

Furthermore, what exactly is a liability for the purposes of section 358(h)? Suppose that a $2 million piece of land unexpectedly becomes subject to a new tax of apparently infinite duration, and as a result drops in value to $1.9 million. When the land is transferred, its basis will be higher than its fair market value. Is this a situation in which section 358(h) will require a basis reduction? If the full economic burden of the tax (the $100,000 by which the land value decreased) is not a "liability" for these purposes, then is the amount of the first year's tax such a liability? In this case, the section 358(h) adjustment will probably not be necessary, but it is not clear why. It could be because the new tax is not a "liability" in the sense the word is used in section 358(h), or because, as section 358(h)(2)(B) requires, "substantially all of the assets with which the liability is associated" have been transferred.[47]

Additionally, the possibility of the creation of an accelerated loss because of a section 351 transfer of property subject to a liability is not limited to situations in which the liability has not been acknowledged and therefore escapes section 357(c). Assume that the land above was purchased for $2 million with a purchase money mortgage of $1 million bearing twelve percent interest. Interest is paid currently, but principal is not due for twenty-five years. Interest rates fall to six percent, rendering the present value of the liability, which now bears interest well above market rate, almost $1.8 million. If the encumbered property is contributed to a new corporation under section 351, the net value to the corporation will be just over $200,000, while the transferor's basis in the stock will be $1 million ($2 million – $1 million face value of the loan). Nevertheless, section 358(h) will not adjust the transferor's basis, and the potential for the transaction to produce an accelerated or duplicated loss remains. The fact that the liability was previously acknowledged and subject to reconciliation under section 357(c) has not assured that the value of the liability has been properly taken into account.

In sum, with respect to the transactions that so vexed the Internal Revenue Service and that led to the enactment of section 358(h), that section creates a mechanism that reveals the tension between the need to reconcile liabilities (for which consistently using nominal amounts usually suffices) and the need to measure properly the actual burden of the liability. The problem the statute was aiming to solve is not

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not its economic burden. *See, e.g.*, I.R.C. §§ 301(b), 336(b), 356(d), 357(c). This appears appropriate, because the focus of this provision is mostly on reconciliation, not on valuation.

[47] I.R.C. § 358(h)(2)(B).

limited to situations involving unacknowledged liabilities, since even acknowledged liabilities can include unacknowledged burdens when market conditions change. Even the face amount or issue price of a fixed liability will reflect its true economic burden throughout the time it is outstanding only in the rare situation in which both market interest rates and the debtor's personal characteristics remain constant. Granted, the variations in value will be greatest for unacknowledged liabilities, since the expected value of a contingent liability (which ordinarily will be unacknowledged) can vary not only as a result of interest rate related changes, but also as a result of other changes that affect predictions about possible states of the world. Thus, variation is far more likely to occur between a prior valuation of an unacknowledged liability and its actual economic burden at any point in time. In the real world, however, this difference is not a qualitative one between those obligations that have already been acknowledged for tax purposes and those that have not.

Unacknowledged liabilities only seem more problematic because frequently an event that triggers reconciliation of an acknowledged liability will narrow the gap between economic reality and tax accounting. However, even when there is reconciliation there is no guarantee that the restated amount of the liability will accurately reflect value, because our rules for reconciliation simply correct prior tax accounting, and generally make no attempt to restate liabilities to reflect their actual burden. Reconciliation, tied as it currently is only to consistency of amounts across time, and not to restating the amount of the liability to reflect its actual economic burden, does not guarantee that tax accounting for liabilities will properly reflect economic reality. Distinctions between acknowledged and unacknowledged liabilities in situations where value is the real underlying concern are therefore likely to be arbitrary. To the extent that the values that keep liabilities unacknowledged are likely to have resulted in overstatements of the tax base generally, this arbitrariness should be avoided.

III. GROUND RULES FOR DEALING WITH LIABILITIES

The inadequacy of the existing rules for dealing with anticipated costs, both those that represent prior untaxed receipts and those that represent anticipated costs for which no prior receipt is clearly identified, is even more alarming given that the fundamental principles that should guide the development of these rules were established more than twenty years ago. In the early 1980s, the

Supreme Court decided *Commissioner v. Tufts*,[48] Congress took its first steps toward accommodating the time value of money in defining the income tax base,[49] and, perhaps not coincidentally, people outside of academia first began debating alternative tax bases, some of which would simplify these problems. The fundamental rules for handling liabilities in a "closed" system can be generalized as follows:

1. *Only one taxpayer should be allowed to acknowledge each anticipated cost.* In many circumstances, particularly those involving related taxpayers, this rule is best implemented by arbitrary all-or-nothing rules rather than attempts to quantify the precise exposure of the parties involved. Whenever changes occur to the identity of the taxpayer who will be called upon to pay, the tax law must determine whether to acknowledge the change. Practical limitations on the application of this rule will almost certainly produce reconciliation rules in tension with those that address valuation concerns.

The normal tax treatment of guaranties is best explained in terms of one principle: although a guarantor may face an enormous real economic burden, until the tax law acknowledges that his debtor will not pay, there is no "liability" for tax purposes.[50] Hence, a guarantor

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[48] 461 U.S. 300 (1983). In *Tufts*, the Court held that upon the transfer of property subject to a nonrecourse loan, the transferor receives income in the amount of the outstanding value of the obligation, regardless of the fair market value of the property. *Id.*

[49] Although the most significant changes to the Code in response to concerns about the time value of money were introduced in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (e.g. sections 461(h), 467, 1274, and 787), it is clear that Treasury had been attempting to grapple with these problems for a number of years previously. *See, e.g.*, Noel B. Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577 (1985), especially nn. 23 (referencing discussion of the issues in the academic tax literature), 28 (outlining the history of the original discount issue rules), and 107 (referring to the draft manuscripts of Seymour Fiekowsky, Office of Tax Analysis).

[50] The argument for allowing guarantors "basis" as a result of the economic burden assumed by guarantees to S corporations, *see, e.g.*, Babette B. Barton, *Economic Fables/Tax-Related Foibles: On The "Cost" of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans*, 45 TAX L. REV. 471 (1990), is therefore a difficult one, unless one is willing to view the guarantee as equivalent to an actual contribution of capital to the corporation, which (consistent with the prevailing rules relating to contributions to capital) would give rise to shareholder basis in corporate stock and to a nontaxable receipt by the corporation. This fiction would not be available to allow to a guarantor of an individual's debt basis or deductions relating to his guarantees before he is out of pocket, unless the guarantor is treated as having entered into a joint venture with the debtor, and is deemed to own a share of assets acquired with the loan proceeds and to enjoy a share of the basis relating thereto. This approach has long been rejected for mortgagees.

has no basis and can claim no loss until she is clearly out of pocket with respect to the debt (which, because of the guarantor's rights against the primary debtor, may be after payment by the obligor). Only when we require the obligor to reconcile her nonpayment should the guarantor be allowed basis. This does not mean, however, that the guarantor should not be allowed to reduce her net value in those rare instances in which a determination of her net value is required.

2. *If a taxpayer has been allowed to acknowledge an anticipated payment and circumstances change such that that taxpayer is no longer likely to make that payment, the taxpayer should realize income of some sort.* Whether as cancellation of indebtedness income or as an amount realized in a property transaction, any prior basis credit (or other tax benefit)[51] which was premised on a promise to pay that is

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See, e.g., Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939). *But see* Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115 (1995) (urging that the lender also be recognized as a party bearing loss). Given that the actual economic burden to guarantors is likely both to change over time and to be hard to compute, departures from the traditional approach for guarantors are unlikely to be worth the effort. Such departures would be especially inappropriate for guarantors of individual debtors unless consistency between the debtor and guarantor were strictly maintained.

Conversely, although ordinarily guarantees may be personal, because the beneficiary of the guarantee has previously received no value that could constitute loan proceeds or tax benefit, *see infra* note 51, relief from a guarantee should produce no tax consequences. *See* Aftergood v. Commissioner, 21 T.C. 60 (1953), *acq. in result*, 1954-1 C.B. 3 (holding that a guarantor who settled a liability for less than the amount owed, upon the failure of the primary obligor to pay the full amount, did not incur discharge of indebtedness income for the amount compromised). Perhaps the harshest rule applicable to guarantors is the rule that denies them a deduction for their payments, even after they are made, if there is any chance of recovery from the debtor. This rule cannot be justified by concern about deduction of the correct amount as an economic matter, *see supra* note 28, or by concern about coordination of treatment of the various sides of a transaction, *see supra* note 26. It can, however, be justified on the ground that any other treatment would allow guarantors and their debtors to control the timing of deductions.

[51] Although there is general agreement among commentators about the need to reverse the prior treatment of liabilities when the taxpayer is relieved from the obligation to pay the liability, it is remarkably hard to find a succinct but comprehensive statement of the various circumstances that call for such reversals. In her discussion of the operation of section 357(c), Babette Barton gives one of the better lists of the circumstances in which reversal is warranted:

> to prevent a taxpayer who had enjoyed tax benefits from a borrowing, either by pocketing the tax-free loan proceeds or by obtaining tax savings from depreciation deductions based on a cost basis increased by the borrowing, from shifting tax free to another the cost of and responsibility

broken must be undone. Note that in business transactions, if there has been no offset to income claimed as the result of a liability (and it is clear that there never will be), nonpayment need not result in "income."

3. *A taxpayer should be allowed to take costs into account in ways that are consistent, no matter what method the taxpayer chooses to meet the cost.* Therefore, when a promise to pay bears market interest, the burden of this promise should be taken into account in a way that produces the same overall economic result as if the taxpayer made payment with his own funds. (Usually, this should be the same overall accounting treatment.) From the taxpayer's perspective, failure to allow this will result in under-taxation to the extent that the accounting for the cost is accelerated or over-taxation to the extent that accounting for the payment is deferred. Only the most well-tailored departures from this rule should be made, and even then, only when accommodating for delay either in the treatment of the promissor or of the promisee.

4. *The amount of a cost that is acknowledged should be same as the economic burden of that cost at the time it is acknowledged.* Not only must the timing of the accounting for the cost be appropriate, but the amount must be as well. The face value of a promise to pay that bears interest at a below-market rate will overstate the economic burden, and therefore an immediate allowance based on the face value of the promise will be too great. However, a promise to pay that bears interest at an above-market rate will be understated, and an immediate allowance based only on the face amount of the promise will be too small. Note that this does not mean that there is a single correct time or value at which any particular cost should be taken into account. Indeed, it is frequently noted that any item can be included or deducted at any time, as long as there is an appropriate adjustment

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for repayment of the borrowing.

Barton, *supra* note 50, at 482. Even this statement fails to take into account tax savings claimed other than through depreciation deductions.

It may be easier to view these questions as involving two separate concepts: debt relief income, which can only arise when value has in fact been received by the taxpayer and thus "loan proceeds" can be identified; and the operation of the tax benefit rule, which simply requires a reconciliation of basis and deductions that are not tax-paid. *See, e.g.*, Richard C.E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation*, 14 VA. TAX REV. 153 (1994). If viewed in this way, however, the application of the tax benefit rule must always be invoked first, with debt relief income only arising in situations where the taxpayer should not have been afforded basis or a deduction in his use of the value received.

for the time value of money. The rule simply means that the only way a cost can be taken into account is if its economic burden is accurately reflected, which necessitates considering the expected value, and not just the time value of money.

5. *Any attempt to account for the effect of liabilities on value cannot rely solely on the amount of the liability that has already been taken into account for tax purposes or on the stated amount of the liability.* When liabilities are to be taken into account in order to reconcile past treatments, it is appropriate to use the amount originally stated. By contrast, when liabilities are to be taken into account in order to better reflect the taxpayer's current economic position, the economic burden of the liability is a more appropriate measure.

These principles may seem simple enough, but the devil is in the details. Current doctrine is inadequate in two general ways. First, the law too often assumes that "liabilities" have all been acknowledged under the general pattern applicable to bank loans, and even when the error of this assumption is admitted, too little thought is given to the alternative possible patterns. This inadequacy has been exacerbated by the recent statutory and regulatory developments, especially those related to section 461(h), which have resulted in postponing the time at which anticipated repayments are taken into account.

IV. CONCLUSION

In the last few decades, the tax law has developed a far more sophisticated awareness of the need to time properly items of income and expense. Included in these developments have been acceptance of the idea that alterations in the treatment of one taxpayer (for instance, the acceleration of income from prepayments or the deferral of deductions for anticipated costs) may be appropriate in order to adjust for an inability to treat properly another taxpayer (who, for instance, we suspect will be able to accelerate deductions or avoid income.) These approaches, manifested especially in sections 404 and 461, have been understood to be necessary in order to "keep the tax base closed," that is, to make sure that the earnings on every fund are included in the tax base.

In developing this approach, however, there has been too little attention paid to the fact that such approaches result in sometimes enormous disparities between values taxpayers own and the values attributed to taxpayers in their tax accounting records. While such disparities have always existed under a realization-based income tax,

most of the attention paid to correcting the errors has been focused on unrealized gain and the taxpayer's control over the triggering of losses.

The pressures on the rules defining the income tax base resulting from disparities in values recorded for tax purposes because of the deferral of allowances for real costs have not been so consciously examined. It should be no surprise that taxpayers faced with this overinclusion of value in the tax base have developed transactions that have strained the rules associated with accounting for liabilities, now that there are so many more unaccrued liabilities, and the potential for so much more mismeasurement. It is past time to make better sense about exactly what these rules should be.