The Virtual Reality of Eliminating Tax Deferral

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Recommended Citation
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* Associate Professor of Law and Director of the Center for Pacific Rim Legal Studies, Southern Methodist University School of Law, Dallas, Texas. I would like to thank Larry Lokken for his numerous comments and suggestions which proved invaluable. I would also like to thank Alan Bromberg, Greg Crespi, Steve Gertzman, Dan Halperin, Calvin Johnson, Susan Kalinka, Hank Lischer, Jack Mylan, Sammy Olchyk, Robert Scarborough, and Roy Strowd for their helpful comments and suggestions. In addition, I would like to thank my research assistants Jeff Blair, Brett Enzor, Greg Mitchell, and Chuck Thompson for their valuable research assistance. I wish to emphasize that any errors or omissions are entirely my responsibility. Finally, I wish to thank Dean C. Paul Rogers III and Southern Methodist University for its summer research grant.
I. Introduction

Much of the tax legislation and commentary in the last 25 years has focused on the benefits of tax deferral and the time value of money issues that accompany deferral.\(^1\) For example, as part of the Tax Reform Act of 1969,\(^2\) Congress began seriously addressing the time value of money rules through large scale changes to the original issue discount regime currently found in sections 1271 through 1275 of the Internal Revenue Code. This focus on time value of money is attributable, in large part, to the late Professor

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1. As to the tax legislation, see, e.g., the original issue discount regime contained in sections 1271 through 1275 (major changes in 1969, 1982, and 1984), the market discount regime contained in sections 1276 through 1278 (enacted in 1984), the below-market loan rules contained in section 7872 (enacted in 1984), the rules regarding certain payments for the use of property or services contained in section 467 (enacted in 1984), the installment sale rules contained in sections 453, 453A, and 453B (major changes in 1980, 1986, 1987, and 1988), and the passive foreign investment company rules contained in sections 1291 through 1297 (enacted in 1986).


Stanley Surrey.³ Professor Surrey raised Congress' and taxpayers' awareness of the benefits of tax deferral during his tenure at the Treasury Department.⁴ This awareness increased during the late 1970s and early 1980s, partly as a consequence of the persistence of very high interest rates.⁵ During most of the 1980s, increasing numbers of tax shelters took advantage of the time value of money.⁶ Unfortunately, the focus on tax deferral and time value of money increases the complexities of the tax system to almost nightmarish proportion.

In many cases, Congress specifically intended for taxpayers to receive the benefits of tax deferral when it enacted particular sections of the Code. For example, the numerous nonrecognition provisions in the Code are designed to defer recognition of gain (or loss) even though a realization event has taken place.⁷ More specifically, sections such as 351, 721, and 1031, all defer gain (or loss) because Congress thought that an incorporation, contribution of property to a partnership, or a like kind exchange was not an appropriate time to impose a tax. In a number of other cases, however, the creation of opportunities for tax deferral was inadvertent. For example, in the 1980s, Congress decided that sellers who made large installment sales in certain circumstances should still be entitled to defer any gain on the sale but not to receive the time value of money benefits that accompany deferral.

In focusing on the time value of money benefits that accompany tax deferral, the analysis seems consistently to involve application of the same model: the Cary Brown model. The Cary Brown model, named after its originator E. Cary Brown, was first published in 1948. Generally, the model holds that immediately deducting the cost of an asset is equivalent to exempting from gross income the future annual return on the asset. Its application to expensing and depreciation is well-established and has been dis-

³. Professor Surrey was a Harvard law professor who was the Assistant Secretary of the Treasury for Tax Policy from 1961 to 1969 under Presidents Kennedy and Johnson.
⁴. After leaving the Treasury Department in 1969, Professor Surrey wrote a number of influential books and articles on tax deferral and time value of money issues. See, e.g., Surrey, supra note 1; Surrey, Pathways, supra note 1, at 108-11, 117-25, 317-19, 323-24 (1973); Stanley S. Surrey et al., I Federal Income Taxation 413-19 (1972). See also Stanley S. Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 ILL. L. REV. 779 (1941) for an early article by Professor Surrey on tax deferral.
⁵. See, e.g., Lokken, supra note 1.
⁶. Id.
discussed by a number of commentators. The Cary Brown model, however, can also be applied to a number of other situations in the tax laws, many of which are overlooked by academics and practitioners. For example, it also applies to sales of property under the installment method. This application of the Cary Brown model to installment sales was apparently discovered by Congress in the early 1980s (even though the installment sales rules were enacted over 60 years ago) and partially addressed as part of the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988.

This Article applies the Cary Brown model to a number of different fact patterns, including expensing, installment sales, and prepaid income, as well as to some other less obvious situations. If the Cary Brown model is applicable to a given fact pattern, the taxpayer is, in essence, excluding the future annual return of the asset from gross income. The different areas of the tax laws selected in this Article for analysis under the Cary Brown model have not been selected at random. Some traditional areas have been selected. But other areas have been selected because they seem to have caused a lot of confusion among tax commentators, some of whom are even familiar with the original Cary Brown model. The Cary Brown model can be applied not only to the deduction side, which is where it has traditionally been applied, but also to the income side, for example, to unrealized appreciation.

This Article's primary focus is on how Congress and the Treasury have eliminated, or attempted to eliminate, the benefits of the Cary Brown model. In recent years, the government has implemented a number of methods in removing the benefits of tax deferral. Each of the methods has its non-tax advantages and disadvantages. Ideally, it would be much simpler and more efficient if the government could adopt and implement one overall method in


9. Tax deferral can be a difficult concept to fully understand even for tax specialists. In 1969, Professor Shoup wrote that "[t]he fact that completely accelerated depreciation, when coupled with complete loss offset, is equivalent to exemption of net return from the asset, under an income tax, was discovered by E. Cary Brown [in 1948]...." CARL S. SHOUP, PUBLIC FINANCE 302 n.20 (1969). In response, Professor Surrey wrote: "Perhaps a Congressman can be pardoned for not appreciating the benefit of deferral if its ramifications apparently eluded public finance specialists for 35 years of our income tax history." SURREY, PATHWAYS, supra note 1, at 123.
ELIMINATING TAX DEFERRAL

eliminating tax deferral. Admittedly, this does not appear to be possible. Even more important than adopting one method, however, is that the government be consistent in terms of eliminating tax deferral. In other words, each method of eliminating tax deferral should do so in a fair and neutral manner so as not to give one method a tax advantage over another method. As this Article will demonstrate, unfortunately, the government has not achieved this ideal. A number of recommendations will be made as to each method so that the tax system will achieve fairness and neutrality among the many methods of preventing tax deferral.

The Haig-Simons model, which generally defines income as the value of consumption plus the net increase (or decrease) of a taxpayer’s personal wealth, will also be discussed in terms of eliminating the benefits of the Cary Brown model. The Haig-Simons model will be discussed along with four other methods of preventing tax deferral. The Haig-Simons definition of income and the Cary Brown model have dominated the tax literature generated by academics in recent years. It appears that the Cary Brown model is simply a method of analyzing a particular transaction or tax provision and determining whether the taxpayer is receiving the time value of money benefits that accompany tax deferral. Implementation of the Haig-Simons definition of income is merely one method of removing the time value of money benefits that accompany tax deferral.

10. As to the Cary Brown model, see, e.g., E. Cary Brown, Business Income Taxation and Investment Incentives, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 309-10 (1948); Graetz, supra note 1, at 384-90; Myron S. Scholes & Mark A. Wolfson, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH ch. 3 (1992); Ginsburg, supra note 8, at 603-05; Christopher H. Hanns & Samuel Olchyk, Interest Under Section 453A(c): Is It or Isn’t It?, 56 TAX NOTES 1345 (1992); Calvin H. Johnson, supra note 1; Lee A. Sheppard, Ginsburg Discusses Taxing the Privilege of Tax Deferral in Installment Sales, 27 TAX NOTES 457 (1985); Warren, The Timing of Taxes, supra note 1; Warren, Accelerated Capital Recovery, supra note 1; 1 DEPT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 129-30 (1984).

II. THE CARY BROWN MODEL

A. INTRODUCTION

The Cary Brown model is named after its founder, E. Cary Brown. Brown published his model as a 17 page article in 1948 in a book containing a collection of essays, *Income, Employment and Public Policy, Essays in Honor of Alvin H. Hansen.* It has been reprinted since then. The Cary Brown model, as it is currently understood today, is discussed in less than one and a half pages of the Article. The model will be discussed in two parts below.

B. PRESENT VALUE OF TAX SAVINGS

The critical passage from the Cary Brown article is as follows:

As they [the taxpayers] telescope the depreciation deduction, the present worth of the tax rebates from the depreciation increases as the rebates are shifted closer to the present. In the limiting case, the asset could be written off in one year. In such an event, the tax rebate from depreciation would be proportional to the tax. Investment incentives would be restored to the pretax level, since the tax would proportionately reduce both the prospective net receipts from investment and its cost. By paying the entrepreneur the tax on the asset's cost, the Government would literally be a partner in the firm. It would make a capital contribution on new investments at the same rate at which it shared in the future net receipts of the enterprise. The contribution would be made at the same time the investment was undertaken. In contrast, the full-loss-offset system with economic-life depreciation would spread the Government's contribution out over the life of the investment, and would require the firm to carry a larger debt and interest cost until this contribution was finally received.

In the above passage, the author is describing the tax effect when the cost of an asset can be spread (or recovered) over a shorter period than its economic life or, in the extreme case, be immediately deducted in computing taxable income. By shortening the period during which an asset's cost can be recovered, the present value of the tax savings is increased. For example, assume an

14. *Id.*
asset used in business has an economic life of ten years. The cost of the asset is $10,000. If the asset is depreciated over its economic life of ten years, using straight line depreciation, and a tax rate of 40 percent, the taxpayer would have $1,000 of depreciation each year for ten years. This would save $400 in taxes each year for ten years. Using a discount rate of six percent, the present value of $400 each year for the next ten years would be $3,120.68.

If, however, the asset can be depreciated over four years, then the taxpayer would have $2,500 of depreciation each year for four years. This would save $1,000 in taxes each year for four years. Using a discount rate of six percent, the present value of $1,000 each year for the next four years would be $3,673.01, which is greater than the present value of the tax savings if the asset were depreciated over ten years. This difference in present value is what Cary Brown is referring to when he states that "the present worth of the tax rebates from the depreciation increases as the rebates are shifted closer to the present."

If the cost of an asset can be deducted immediately, or "expensed," the amount of tax saved is equal to the tax rate times the cost of the asset. In the above example, if the asset's cost of $10,000 could be deducted immediately, the taxpayer would save an immediate $4,000 in taxes. Of course, the present value of the tax savings would also be $4,000 because of the immediate deduction. The taxpayer could take this immediate tax savings and invest it. If this additional $4,000 capital investment could also be expensed, the taxpayer would save another $1,600 in taxes, which could be invested in another deductible capital investment. By expensing the cost of the investment, the investor can increase the investment to \( I/(1 - t) \), where \( I \) is the amount of income to be invested and \( t \) is the tax rate. In this case, it would be $10,000/(1 - .40) equalling $16,667.

C. INVESTMENT INCENTIVES RETURNED TO PRETAX LEVEL

Expensing, or immediate deduction of an expenditure, is the classic situation to which the Cary Brown model has been applied.\(^{16}\) Taking the above analysis one step further, expensing the cost of an asset is equivalent to exempting from gross income the future annual return on the asset. This is what Cary Brown is re-

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15. Id.
16. For a thorough discussion of the Cary Brown model as it applies to expensing, see Johnson, supra note 1, at 1019.
ferring to when he states that "[i]nvestment incentives would be restored to the pretax level, since the tax would proportionately reduce both the prospective net receipts from investment and its cost." 17 To illustrate this equivalence in its most basic form, assume investor A has received $16,667 in salary income. Assume that A is subject to tax at a 40 percent tax rate and that any tax liability is due immediately. Also assume that A has three investment options: First, a tax-free municipal bond paying nine percent interest annually; second, a regular bond paying nine percent interest annually; and finally, a regular bond paying nine percent interest annually, and the cost of the bond is immediately deductible, i.e., expensed.

Under the first option, investing in a tax-free municipal bond, A will only have $10,000 to invest because she has to pay $6,667 (40 percent times $16,667) in taxes on her salary income of $16,667. Using a rate of return of nine percent annually, A will earn $900 of tax-free interest income each year until maturity. At maturity, A will not recognize gain or loss because her basis in the bond is $10,000.

Under the second option, investing in a regular bond, A again will only have $10,000 to invest because she must pay $6,667 in taxes on her salary income of $16,667. A will earn $900 of interest income each year until maturity. At a 40 percent tax rate, A will pay $360 in taxes on the $900 of interest income leaving A with $540. At maturity, A will not recognize gain or loss because her basis in the bond is $10,000.

Under the third option, investing in a regular bond in which the investment is deductible, A will have $16,667 to invest because the amount is fully deductible. By investing $16,667 in a deductible bond, A can utilize the deduction to offset A's salary income of $16,667 leaving A with zero taxable income at the time of the original investment. A will earn $1,500 in interest income each year until maturity (9 percent times $16,667). At a 40 percent tax rate, A will pay $600 in taxes on the $1,500 of interest income leaving A with $900. By immediately deducting the cost of the bond, A will receive $900 after-tax each year—the same position A would be in by investing in a tax-free municipal bond. When A collects $16,667 on the bond's maturity, A will have gain of $16,667 because the basis of the bond is zero. At this time, A will owe taxes of $6,667 (40 percent times $16,667).

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The following table summarizes the three options:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Tax-Exempt Bond</th>
<th>Taxable Bond</th>
<th>Deductible Taxable Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>16,667</td>
<td>16,667</td>
<td>16,667</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deductions</th>
<th>0</th>
<th>0</th>
<th>16,667</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes (40%)</td>
<td>6,667</td>
<td>6,667</td>
<td>0</td>
</tr>
<tr>
<td>Cash to Invest</td>
<td>10,000</td>
<td>10,000</td>
<td>16,667</td>
</tr>
<tr>
<td>Return at 9%</td>
<td>900</td>
<td>900</td>
<td>1,500</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>Exempt</td>
<td>360</td>
<td>600</td>
</tr>
<tr>
<td>Net Return</td>
<td>900</td>
<td>540</td>
<td>900</td>
</tr>
</tbody>
</table>

By allowing A to deduct immediately the cost of the bond, the government, according to Cary Brown, "would literally be a partner in the firm." According to the Cary Brown model, it is as if the government had contributed $6,667 toward purchase of the bond. Since the government contributed this amount, which is 40 percent of the cost of the bond ($6,667/16,667), it seems only fair that the government collect 40 percent of the interest on the bond. As a result, the government will collect $600 of each interest payment on the entire investment ($600/1,500) and will recoup its investment when the bond matures (or is sold). At maturity, A will have gain of $16,667 resulting in taxes of $6,667 assuming that the tax rate remains at 40 percent. The government will therefore receive $6,667 in taxes from A, which is equal to the amount that the government originally contributed.

The Cary Brown model, as it applies to expensing the cost of an investment, can be generalized algebraically. By expensing the cost of the investment, A can increase the investment to \( I/(1 - t) \), where \( I \) is the amount of income to be invested and \( t \) is the tax rate. In the above example, A would only have $10,000 to invest if the investment were not deductible. By being allowed to immediately deduct the cost of the investment, A would have $16,667 to invest ($10,000/(1 - .40)). Another way of looking at this is that A can increase the amount to be invested by the tax savings generated by expensing the cost of the investment.

18. Id.
III. TRADITIONAL APPLICATION OF THE CARY BROWN MODEL UNDER THE INTERNAL REVENUE CODE

A. EXPENDING

Expensing is the classic situation to which the Cary Brown model has been applied and discussed in some detail. To illustrate application of the model in the context of the current U.S. income tax system, assume a taxpayer purchases $10,000 of equipment to be used exclusively in the taxpayer’s trade or business. Under section 179, a taxpayer is permitted to immediately deduct up to $17,500 of depreciable business assets assuming that several other requirements are also met. If the taxpayer satisfies the requirements of section 179, he can immediately deduct the $10,000 cost of the equipment. At a 40 percent tax rate, the taxpayer would save an immediate $4,000 in taxes. The taxpayer could take this immediate tax savings and invest it. If this additional $4,000 capital investment could also be deducted, the taxpayer would save another $1,600 in taxes, which could be invested in another deductible capital investment. By expensing the cost of the investment, the investor can increase the investment to \( I/(1 - t) \), where \( I \) is the amount of income to be invested and \( t \) is the tax rate. In this case, it would be \( $10,000/(1 - .40) \) equalling $16,667.

This stimulus to investment, of course, is a result that Congress intended when it originally enacted section 179 in 1958 allowing a taxpayer to expense up to $2,000 (or $4,000 if married filing jointly) and subsequently increased the amount that could be deducted culminating in the current amount of $17,500 as part of the Omnibus Budget Reconciliation Act of 1993. Through enactment of section 179, Congress was trying to stimulate the economy by encouraging small businesses to increase their investment in depreciable assets. Obviously, in enacting and enhancing section 179, Congress was not trying to eliminate any tax deferral privilege because that is what it intended under section 179. If Congress

19. I.R.C. §§ 179(a) and (b)(1). Generally, the asset must be acquired by purchase and used in an active trade or business. I.R.C. § 179(d)(1). The dollar limitation of $17,500 is also phased out dollar-by-dollar by the amount by which the cost of section 179 property placed in service during the year exceeds $200,000. I.R.C. § 179(b)(2). Finally, the section 179 deduction cannot exceed the aggregate amount of taxable income for the year which is derived from the active conduct of any trade or business during the year. I.R.C. § 179(b)(3)(A). Any excess can be carried forward to future years. I.R.C. § 179(b)(3)(B).
feels that it is too generous, it can reduce the dollar limitation of section 179 or simply repeal it.

B. UNREALIZED APPRECIATION

The Cary Brown model can also be applied to property with unrealized appreciation. The realization doctrine is one of the cornerstones of the U.S. income tax system.\footnote{22} It has been described by one leading commentator as the “Achilles heel” of the income tax system.\footnote{23} Generally, gain or loss is not included in a taxpayer’s gross income until a realization event has taken place, which in many cases is a sale or exchange.\footnote{24} As a result, appreciation in property is generally not taxed until the property is sold or exchanged.\footnote{25} Assume T owns land long thought essentially worthless with a negligible basis. A valuable mineral deposit is discovered nearby immediately causing the value of T’s land to rise to $10,000. The land’s value continues to rise at ten percent annually for three years. At the end of three years, T sells the land (still undeveloped) for $13,310 resulting in $13,310 of gain. At a 28 percent tax rate, the tax owed is $3,726.80. Discounted back three years to the time of the $10,000 appreciation, the present value of the tax is $2,800, which is 28 percent of the appreciation. The example illustrates, in accordance with the Cary Brown model, that by delaying the taxation of gains until realization, the income tax system effectively exempts the future annual return on the appreciation from tax. In other words, immediately deducting the cost of an asset or initially excluding the gain in an asset is equivalent to exempting from gross income the future annual return on the asset.

\footnote{22} Much has been written on the realization doctrine. See, e.g., 2 BITTKER & LOKKEN, supra note 7, at ¶ 40.1; Noel B. Cunningham & Deborah H. Schenk, Taxation Without Realization: A “Revolutionary” Approach to Ownership, 47 Tax L. Rev. 725 (1992); David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa.L. Rev. 1111 (1986).


\footnote{24} I.R.C. § 1001(a), (c).

\footnote{25} But see, e.g., I.R.C. § 475 (mark-to-market accounting method for dealers in securities); I.R.C. § 1256 (mark-to-market accounting method for regulated futures, foreign currency, and certain other contracts).
IV. PREVENTING TAX DEFERRAL THROUGH ANALYSIS OF THE CARY BROWN MODEL

A. INTEREST CHARGE METHOD

1. Installment Sales

As stated earlier, the tax system generally does not tax gain until a realization event, such as a sale, has taken place. If a payment on the sale is to be received after the end of the seller's taxable year, this is referred to as an installment sale and the gain can be reported over time. More specifically, under section 453, income from an installment sale can generally be reported under the installment method. The installment method spreads the income from the installment sale over the period of time when payments are received by the seller. The Supreme Court has stated that purpose of the installment sales provision is to:

[Relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the difficult and time-consuming effort of appraising the uncertain market value of installment obligations.]

What makes an installment sale interesting with respect to the Cary Brown model is that a realization event has taken place, i.e., the sale, between the time of appreciation in the property and the recognition of the appreciation as gain.

Congress made significant changes to the installment sale rules in 1980 as part of the Installment Sales Revision Act of 1980 (1980 Act). These changes comprise much of the current installment sale rules. Seven years after substantial revisions to section 453 in the 1980 Act and as part of the Revenue Act of 1987 (1987 Act), Congress enacted section 453A(c) requiring sellers to pay "interest

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26. I.R.C. § 453(a). Generally, an installment sale is a disposition of property where at least one payment is to be received after the end of the taxable year in which the disposition occurs. I.R.C. § 453(b)(1).
27. I.R.C. § 453(c). The installment method is a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year that the gross profit bears to the total contract price. Id.
on deferred tax liability" on installment obligations arising from the sale of property, if the total amount of installment obligations that arose during the year and were outstanding at the end of the year exceeded $5 million. As originally enacted by Congress in the 1987 Act, the interest on deferred tax liability only applied to nondealer dispositions of real property. It did not apply to nondealer dispositions of personal property. In the Technical and Miscellaneous Revenue Act of 198831 (1988 Act), Congress extended the requirement of interest on deferred tax liability to include nondealer dispositions of personal property.

An example will demonstrate the mechanics and terminology of sections 453 and 453A(c). Assume in 1992, X Co. sold property for $12 million, of which $2 million was paid in cash and the remaining $10 million was evidenced by a seven-year interest-only installment obligation.32 X Co.'s basis in the property at the time of the sale was $6 million. The $10 million note is the only obligation arising during 1992. The underpayment rate in effect under section 6621(a)(2) for December 1992 is assumed to equal eight percent. Under section 453, the selling price33 and the total contract price34 are $12 million. The gross profit35 is $6 million and the gross profit ratio36 is 50 percent.

The amount of the interest on deferred tax liability under section 453A(c) is $68,000. This amount is calculated as follows: $5 million (the unrecognized gain as of December 31, 1992) times 34 percent (the maximum tax rate for capital assets in corporate solution in 1992) times 50 percent (the "applicable percentage" with

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32. This assumes that sections 483 and 1274 do not apply.
33. Treas. Reg. § 15a.453-1(b)(2)(ii). "Selling price" means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property and without reduction to reflect any selling expenses. Id. In addition, interest, whether stated or unstated, and original issue discount, are not part of the selling price. Id.
34. Treas. Reg. § 15a.453-1(b)(2)(iii). "Contract price" means the total contract price, which is equal to the selling price reduced by the portion of qualifying indebtedness assumed or taken subject to by the buyer that does not exceed the seller's adjusted basis in the property. Id. Generally, "qualifying indebtedness" means a mortgage or other indebtedness encumbering the property and other types of indebtedness not encumbering the property. Treas. Reg. § 15a.453-1(b)(2)(v).
35. Treas. Reg. § 15a.453-1(b)(2)(v). "Gross profit" means the selling price less the adjusted basis. Id. Generally, commissions and other selling expenses are added to the basis in determining the gross profit. Id.
36. I.R.C. § 453(c); Treas. Reg. § 15a.453-1(b)(2)(i). "Gross profit ratio" means the gross profit divided by the total contract price. Id.
respect to obligations arising during 1992)\textsuperscript{37} times eight percent (the assumed underpayment rate). The $68,000 of interest on deferred tax liability is reflected on the tax return as a payment of tax and is remitted to the government with the tax return.

Assuming the tax rate and the underpayment rate remain the same for 1993,\textsuperscript{38} the amount of the interest on deferred tax liability for December 31, 1993, will also be $68,000. This amount is owed the government every year until the $10 million note is paid off. Even when less than $5 million is left owing on the note, interest on deferred tax liability is still owed the government because the applicable percentage does not change from year to year as the note is paid off. No interest on the deferred tax liability is owed the government in the final year of collection of the note.

Apparently, the idea of requiring sellers to pay interest to the government on the deferred tax liability arising from an installment sale was developed a number of years before Congress finally acted on it in 1987.\textsuperscript{39} One of the reasons that Congress was reluctant to enact section 453A(c) prior to 1987 was its concern that many taxpayers would feel that no interest should be owed to the government if a seller did not have the use of the sales proceeds.\textsuperscript{40} In other words, sellers would not understand why they were paying interest to the government on money that they had not yet received.\textsuperscript{41}

The idea of requiring sellers to pay interest to the government on installment sales is simply a solution to the tax deferral benefits arising from the Cary Brown model, which has been known since

\textsuperscript{37} The applicable percentage, with respect to obligations arising in any taxable year, is equal to the portion of the aggregate face amount of such obligations outstanding at the close of such taxable year in excess of $5 million divided by the aggregate face amount of such obligations outstanding as of the close of such taxable year. I.R.C. § 453A(c)(4). Once calculated, this percentage will remain the same until all obligations in a given year are collected.

\textsuperscript{38} In actuality, Congress raised the top corporate tax rate under section 11 to 35 percent as part of the 1993 Act effective for taxable years beginning on or after January 1, 1993. Assuming an underpayment rate of eight percent, the actual amount of interest on deferred tax liability for December 31, 1993, will be $5 million times 35 percent times 50 percent times eight percent equalling $70,000.

\textsuperscript{39} See interview with Professor Martin D. Ginsburg, 12 ABA SECTION OF TAXATION NEWSLETTER 6, 10 (Fall 1992) ("The 1985 date, I guess, comes from something that was in Tax Notes. Actually, I think the proposal, to the extent I was involved in it, goes back some time, and appeared first—Lord help us—in an Eagle Lodge paper.").

\textsuperscript{40} See I Dep't of the Treasury, supra note 10, at 129-130; Sheppard, supra, note 10, at 457.

\textsuperscript{41} Id.
In other words, the interest charge rules represent a congressional judgement that the taxpayer can reasonably be thought of as owing the tax on the gain from the time of the installment sale and that the deferral of recognition is only a matter of legislative grace. Assume that, in 1992, X Co. sold investment property worth $10 million for cash and that its basis in the property is zero. At a 34 percent tax rate, X Co. will pay tax of $3.4 million. If X Co. invests the remaining $6.6 million at an interest rate of ten percent annually, X Co. will earn $660,000 the following year. After X Co. pays tax of $224,400 (34 percent rate times $660,000), X Co. will be left with $435,600.

If instead of receiving $10 million cash, X Co. were to receive a $10 million installment obligation paying 10 percent interest annually, X Co. would not report any gain in the year of sale under section 453. X Co. will earn, however, $1 million in interest the following year on the installment obligation. X Co. will pay tax of $340,000, thereby leaving X Co. with $660,000. This is the same position that X Co. would be in if it made a cash sale and was not taxed on the earnings of the after-tax proceeds of the sale. In other words, by making an installment sale, X Co. is in effect earning interest at a pretax rate of return of 10 percent. This example is simply an application of the Cary Brown model. Unlike expensing, the installment method allows for deferral of gain thereby deferring the tax on the gain. In essence, the government is making a loan to the seller equal to the amount of tax on the deferred gain of $10 million. The loan is outstanding until the seller pays the tax to the government. Or, in the alternative, Cary Brown would describe the government as being a partner with the seller.

The following table summarizes the two options:

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42. Assume for simplicity that the sale takes place on Dec. 31 and that the tax is due that same day.
43. Assume no payments are received on the installment obligation in the year of sale, X Co. does not pledge the installment obligation, and sections 483 and 1274 do not apply.
44. Cary Brown, supra note 10, at 309-310.
In 1987, the government apparently decided that it did not want sellers using the installment method on large sales of property to reap the benefits of the Cary Brown model, i.e., excluding from gross income the future annual return. It apparently was faced with two choices: (1) eliminate use of the installment method for large installment sales or (2) charge the seller interest on the tax deferred by use of the installment method. Congress had eliminated the use of the installment method in a number of situations, including the sale of inventory, the sale of marketable securities, and the sale of depreciable property between related entities. Congress opted for the second alternative with respect to large installment sales by enacting section 453A(c) requiring sellers to pay interest to the government on large installment sales. According to the Treasury Department, "[c]harging interest on the amount of the deferred tax liability for taxpayers electing the installment method would make the tax law neutral as to the financing of property sales and would end use of installment sales as a vehicle for tax deferral."

<table>
<thead>
<tr>
<th></th>
<th>Cash Sale</th>
<th>Installment Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$10,000,000</td>
<td>Deferred</td>
</tr>
<tr>
<td>Basis</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Gain</td>
<td>10,000,000</td>
<td>Deferred</td>
</tr>
<tr>
<td>Taxes (34%)</td>
<td>3,400,000</td>
<td>Deferred</td>
</tr>
<tr>
<td>Investment</td>
<td>6,600,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Return on</td>
<td>660,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Investment (10%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes (34%)</td>
<td>224,400</td>
<td>340,000</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>435,600</td>
<td>660,000</td>
</tr>
</tbody>
</table>

45. I.R.C. §§ 453(b)(2) and (l)(1). The term installment sale does not include a dealer disposition or a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.
46. I.R.C. § 453(k)(2). If stock or securities are traded on an established securities market, then all payments to be received on the sale of the stock or securities are treated as received in the year of disposition.
47. I.R.C. § 453(g). In the case of an installment sale of depreciable property between related persons, all payments to be received are treated as received in the year of disposition. I.R.C. § 453(g)(1). An exception is provided where tax avoidance is not one of the principal purposes. I.R.C. § 453(g)(2).
48. 1 DEPT OF THE TREASURY, supra note 10, at 129.
Returning to the above example, the seller should pay interest to the government on the deferred tax liability. Ignoring the $5 million de minimis exception in section 453A(c)(4) and using an underpayment rate of 10 percent, X Co. will pay $340,000 as interest on the deferred tax liability. If this amount is not deductible, X Co. will be left with $320,000 ($660,000 less $340,000). If the interest on the deferred tax liability is deductible, however, then X Co. will be left with $435,600 ($660,000 less $340,000 plus $115,600 ($340,000 times 34 percent)). By being able to deduct the interest on deferred tax liability, X Co. will be in the same economic position as if it had received cash in the year of sale. Consequently, in an ideal income tax system, deductibility of the interest on the deferred tax liability should be the proper result.

The following table summarizes the three options:
<table>
<thead>
<tr>
<th></th>
<th>Cash Sale</th>
<th>Installment Sale</th>
<th>Installment Sale with Deductible Interest Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$10,000,000</td>
<td>Deferred</td>
<td>Deferred</td>
</tr>
<tr>
<td>Basis</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Gain</td>
<td>10,000,000</td>
<td>Deferred</td>
<td>Deferred</td>
</tr>
<tr>
<td>Taxes (34%)</td>
<td>3,400,000</td>
<td>Deferred</td>
<td>Deferred</td>
</tr>
<tr>
<td>Investment</td>
<td>6,600,000</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Return on Investment (10%)</td>
<td>660,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Taxes (34%)</td>
<td>224,400</td>
<td>340,000</td>
<td>340,000</td>
</tr>
<tr>
<td>Deductible Interest on Deferred Tax Liability</td>
<td>0</td>
<td>0</td>
<td>340,000 (tax savings of 115,600)</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>435,600</td>
<td>660,000</td>
<td>435,600 (660,000 minus deductible interest of 340,000 plus tax savings of 115,600)</td>
</tr>
</tbody>
</table>

This example can be generalized algebraically. In the case of a cash sale in which tax is immediately imposed, an amount $A$ of gain is reduced by tax $T$ such that $A(1 - T)$ may be invested. At an annual rate of return $r$, $A(1 - T)$ invested will earn $rA(1 - T)$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA(1 - T)$. The seller's net annual after-tax position each year will be:

$$rA(1 - T) - trA(1 - T)$$ which equals $rA(1 - T)(1 - t)$

In the case of an installment sale to which section 453A(c) applies, the amount $A$ of gain is not reduced by tax $T$. At an annual rate of return $r$, $A$ invested will earn $rA$ per year, which will be
subject to tax at rate \( t \), so that the after tax amount each year is \( rA(1 - t) \). If interest \( r \) is charged on the deferred tax \( TA \), then the interest on the deferred tax liability is \( rTA \). The deduction of the interest on deferred tax liability will be \( trAT \), leaving the seller with an interest burden of \( rAT - trAT \) which equals \( rAT(1 - t) \). The seller's net annual after-tax position will be:

\[
rA(1 - t) - rAT(1 - t) \text{ which equals } rA(1 - T)(1 - t)
\]

This is equal to the seller's net annual after-tax position when a cash sale is made and tax is immediately imposed.

If the seller cannot deduct the interest on deferred tax liability, then the seller's net annual after-tax position is \( rA(1 - t) - rAT \). The seller is worse off by the amount of tax that would be saved by the deduction of the interest on deferred tax liability.

Unfortunately, in the case of individuals, it appears that interest on deferred tax liability is treated as interest on an underpayment of tax. It is therefore classified as personal interest under section 163(h) and is nondeductible therefore overtaxing the seller. Corporate taxpayers, however, should be allowed to deduct interest on deferred tax liability because corporations can deduct interest on an underpayment of tax. Apparently, to compensate for the nondeductibility of interest on deferred tax liability for individuals, the first $5 million of installment sales each year is excluded from the interest charge rule of section 453A(c). If so, this appears to be one bad rule trying to compensate for another bad rule. As one leading commentator describes it, "Essentially what we have is called chaos."

Alternatively, perhaps the $5 million

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49. For purposes of the formulas, the rate of return \( r \) is assumed to equal the rate of interest on the deferred tax liability.


51. Id. But see Miller v. United States, 841 F. Supp. 305 (D.N.D. 1993) summary judgment granted, 1994 U.S. Dist. LEXIS 15469 (D.N.D. 1994) (originally holding Temp. Treas. Reg. § 1.163-9T invalid to the extent that it treats interest on a tax deficiency arising from a trade or business as personal interest but later finding that the interest was not an ordinary and necessary expense). In an opinion released Sept. 7, 1995, the United States Court of Appeals for the Eighth Circuit affirmed the district court in denying the interest deduction but reversed the district court's decision which held that Temp. Treas. Reg. § 1.163-9T is invalid. Miller v. Commissioner, 1995 U.S. App. LEXIS 25200 (8th Cir. 1995).

52. Corporations are not subject to the personal interest rules. I.R.C. § 163(h)(1).

As to when the interest should be deductible, see Hanna & Olchyk, supra note 10, at 1349-51 (arguing that the interest is an advance charge for the delay in paying the tax through use of the installment method and should therefore be deductible in the year following the year of calculation, assuming that the calculation is made on December 31 of each year).

53. Ginsburg, supra note 39, at 6, 10.
threshold is to simply confine the rules to sellers with large amounts of installment sales.

Congress should lower the threshold on the interest charge rule under section 453A(c) from $5 million, possibly to as low as $150,000 or even lower. Lowering the threshold to $150,000 would bring the interest charge threshold in line with the pledging rules threshold contained in section 453A(d). Congress should also allow interest on deferred tax liability to be deductible by all taxpayers, including individuals. Only by allowing deductibility of interest on deferred tax liability does Congress achieve parity between a seller who sells property for cash and one who sells using the installment method. In fact, the goal of achieving parity was Treasury's rationale for the enactment of section 453A(c) in 1987. Several commentators have suggested that interest on deferred tax liability should, at a minimum, be treated as investment interest for individual taxpayers. This appears to be a sensible result.

It is interesting to note that Congress has utilized an interest charge rule in a number of different areas of the Code. For example, section 453(l)(3) also contains an interest charge rule on a disposition of certain timeshares and residential lots as part of the ordinary course of the taxpayer's trade or business. Somewhat strangely, the computation of the interest under section 453(l)(3) is completely different than the computation of interest on deferred tax liability under section 453A(c). Yet, they are both installment sale provisions and are intended to reach the same result, i.e., to deny the seller the time value of money benefits of tax deferral. Under section 453(l)(3), the interest is computed from the date of sale to the date the payments on the obligation are received. For example, A, an accrual basis corporation, is a calendar year dealer in undeveloped residential lots. In 1987, A receives two installment obligations to which section 453(l)(3) applies. The face amount of each obligation is $180,000. Each obligation provides for adequate stated interest under sections 483 and 1274 and monthly principal payments of $1,000 for a period of 15 years. The dates of the two sales are June 1, 1987, and July 1, 1987. The first monthly pay-

54. See infra text at part IV.A.3.
ment on the June 1, 1987, obligation is due on July 1, 1987, and on
the first day of every month thereafter until satisfied. The first
monthly payment on the July 1, 1987, obligation is due on Septem-
ber 1, 1987, and on the first day of each month thereafter until
satisfied.

Under section 453(l)(3)(B)(iii), no interest is imposed on pay-
ments received in the year of sale.\textsuperscript{57} The first payments on which
interest is imposed occur on January 1, 1988. With respect to the
June 1, 1987, obligation, the first payment is received seven whole
monthly compounding periods from the date of the sale. With re-
spect to the July 1, 1987, obligation, the first payment is received
six whole monthly compounding periods from the date of the sale.
Assume the gross profit ratio for the first sale is 66 percent and for
the second sale is 45 percent. Also assume that \( A \) has taxable in-
come unrelated to the installment sales of $21,000.

With respect to the June 1, 1987 sale, \( A \) receives a $1,000 pay-
ment on January 1, 1988, of which $660 is gain and $340 is recov-
ery of basis. With respect to the July 1, 1987, sale, \( A \) receives a
$1,000 payment on January 1, 1988, of which $450 is gain and $550
is recovery of basis. During 1988, \( A \)'s gain on the other 11 pay-
ments with respect to the June 1, 1987, sale is $7,260 and the gain
on the other 11 payments with respect to the July 1, 1987, sale is
$4,950. Therefore, \( A \) recognizes total gain of $13,320 in 1988 based
on the two 1987 installments sales.

\( A \)'s tax liability for 1988 is $5,148 (15 percent times $34,320
= $21,000 + $13,320).\textsuperscript{58} \( A \)'s tax liability determined without regard
to the gain on the two 1987 installment obligations is $3,150 (15
percent times $21,000). The excess of \( A \)'s tax liability with regard
to the installment payments over its tax liability without regard to
such payments is $1,998. Of this excess, $99 ($1,998 times $660/
$13,320) is allocated to and treated as the tax liability attributable
to the January 1, 1988, payment on the June 1, 1987, obligation
and $67 ($1,998 times $450/$13,320) is allocated to and treated as
the tax liability attributable to the January 1, 1988, payment on
the July 1, 1987, obligation.

The long-term applicable federal rate in effect on the date of
the June 1, 1987, sale is 8.34 percent, compounded monthly. The
long-term applicable federal rate in effect on the date of the July 1,
1987, sale is 8.57 percent, compounded monthly. The amount of

\begin{itemize}
\item \textsuperscript{57} \textit{See also} Temp. Treas. Reg. § 1.453C-8T(b)(1).
\item \textsuperscript{58} This example assumes that \( A \) has no minimum tax liability for the year.
\end{itemize}
interest due with respect to the January 1, 1988, payment on the June 1, 1987, obligation is $4.92. The amount of interest due with respect to the January 1, 1988, payment on the July 1, 1987, obligation is $2.92. These payments are treated as interest on an underpayment of tax for purposes of (non)deductibility and are treated as an addition to tax due on the due date of A's 1988 tax return. A must also determine the interest due on the gain with respect to each monthly payment received on the two obligations in taxable year 1988. A may, however, adopt the midpoint method and treat all 1988 payments as being received on July 1, 1988.

As the above example based on the temporary regulations demonstrates, the computation of interest under section 453(l)(3) is much more complex than the interest computation under section 453A(c). Under section 453(l)(3), the seller must count the number of days from the sale until each payment is made and also must determine the tax liability with and without the gain recognized on the installment sale. There is also no de minimis rule under section 453(l)(3) comparable to the $5 million de minimis rule of section 453A(c). As is the case under section 453A(c), however, the interest charge on sales of timeshares and residential lots is treated as interest on an underpayment of tax and therefore personal interest. Ideally, it should be treated as deductible interest to achieve parity with a cash sale of timeshares and residential lots.

2. Passive Foreign Investment Companies

Some other areas where Congress has enacted an interest charge rule include the domestic international sales corporation provisions (DISC), accumulation distributions from foreign trusts, and long-term contracts. Congress has also provided for an interest charge rule in section 1291(c)(3) relating to passive foreign investment companies (PFIC). Generally, this interest charge

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60. I.R.C. § 995(f).

61. I.R.C. § 668.

can be avoided if the shareholder elects passthrough treatment for the PFIC.\(^6\) This type of PFIC is referred to as a qualified electing fund (QEF) or simply a QEF PFIC.\(^6\) Congress enacted the PFIC rules as part of the Tax Reform Act of 1986 (1986 Act).\(^6\) The PFIC rules apply to a shareholder of a foreign corporation if 75 percent or more of the corporation's income is passive income or if 50 percent or more of the corporation's assets produce passive income.\(^6\) The PFIC rules only apply to U.S. persons who are shareholders of the PFIC. In addition, no minimum ownership amount is required for the U.S. person to be subject to the PFIC rules. Congress enacted the PFIC regime because it concluded that "eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds."\(^6\)

Under the PFIC regime, the computation of interest is different from the computation under either section 453A(c) for large installment sales or section 453(l)(3) for installment sales of certain timeshares and residential lots. Generally, the computation period is based on the due date of the tax return for the current and previous years to which the deferred tax is attributable.\(^6\) For example,\(^6\) assume X is a calendar year U.S. corporation. On December 31, 1986, X acquires a share of stock of FC for $500. FC has been a section 1291 fund since FC's taxable year that began January 1, 1987. Generally, a section 1291 fund is a PFIC in which the shareholder has not elected passthrough treatment under section 1295, i.e., it is not a QEF.\(^7\) On December 31, 1990, X sold the FC stock for $1,000 incurring no foreign tax on the disposition. X's gain on the sale of $500 is taxed as an excess distribution and is allocated pro rata over X's four year holding period. Therefore, $125 is allocated to each year. Generally, an excess distribution is the excess of the amount of the distribution over 125 percent of the average amount received by the shareholder over the previous three

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63. I.R.C. § 1291(d)(1).
64. I.R.C. § 1295.
69. This example is taken from Prop. Treas. Reg. § 1.1291-4(e) Example 1.
years.\textsuperscript{71} The $125 allocated to 1990, the current shareholder year, is included in ordinary income for that year. The allocations to 1987, 1988, and 1989, the prior PFIC years, are subject to the deferred tax amount as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Increase in Tax</th>
<th>Interest Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$49.94 ($125 x 39.95%)\textsuperscript{72}</td>
<td>3/15/88 - 3/15/91</td>
</tr>
<tr>
<td>1988</td>
<td>$42.50 ($125 x 34%)</td>
<td>3/15/89 - 3/15/91</td>
</tr>
<tr>
<td>1989</td>
<td>$42.50 ($125 x 34%)</td>
<td>3/15/90 - 3/15/91</td>
</tr>
</tbody>
</table>

Under the PFIC regime, an interest charge is computed separately for each net increase in tax using the rates and methods provided in section 662\textsuperscript{1}.\textsuperscript{73} The interest is treated as interest on an underpayment of tax\textsuperscript{74} and therefore nondeductible interest for noncorporate taxpayers.\textsuperscript{75}

3. Comments on the Interest Charge Method

It would seem much simpler if Congress were to adopt one interest computation scheme for section 453A(c), section 453(l)(3), and section 1291 as well as possibly the other areas of the Code where an interest charge rule is utilized. However, with respect to installment sales under sections 453 and 453A and the PFIC rules under section 1291, this does not seem possible. Under the installment sale rules, interest accrues on gain from the date of sale until the date of recognition. Under the PFIC rules, gain on the sale is prorated over the period from the purchase to the sale of the stock. Consequently, gain prorated to each year bears interest from the return due date for that year until the return due date for the year of sale. In other words, the installment sale rules deal with post-realization periods, while the PFIC rules deal with pre-realization periods, and the two do not appear similar enough to allow one set of rules to be used for both purposes. It does, however, seem unnecessary to have different types of interest charge regimes for installment sales when they are both intended to reach the same re-

\textsuperscript{71} I.R.C. § 1291(b).
\textsuperscript{72} The rate of 39.95\% is a weighted average rate determined under section 15(e). The calculation is: 46\% rate: 181/365 times 46\% = 22.81\% + 34\% rate: 184/365 times 34\% = 17.14\% totalling 39.95\%.
\textsuperscript{73} Prop. Treas. Reg. § 1.1291-4(d)(1).
\textsuperscript{74} Prop. Treas. Reg. § 1.1291-4(b).
ELIMINATING TAX DEFERRAL

result, i.e., eliminate the time value of money benefits of tax deferral.

For installment sales in which an interest charge is imposed, the section 453A(c) scheme would appear to be the more preferable scheme because of its simplicity. It is a relatively simple calculation done once at the end of each year the installment obligation is outstanding. Despite its simplicity, it also adequately achieves its goal of eliminating the time value of money benefits of tax deferral. Commentators have questioned whether the simplicity of section 453A(c) makes it less desirable than the interest charge rule of section 453(l)(3), which appears to be extremely precise by charging interest on the number of days from the date of the installment sale until payments are made. However, section 453A(c) is precise in its own way. The interest on the deferred tax liability under section 453A(c) relates to the delay in paying tax on the gain by use of the installment method. If, for example, a sale is made on January 1 and the sales price is collected on December 31 of the same year, interest on deferred tax liability is not owed the government because an installment sale has not taken place. If, however, the sales price is collected on January 1 of the following year, one year’s interest on deferred tax liability is owed the government. A one day difference has resulted in one year’s interest because the one day difference has resulted in a delay of one year in paying the tax. The interest on deferred tax liability relates to the delay in paying the tax from December 31 of one year to December 31 of the following year. Under section 453A(c) the interest is not prorated because the delay in paying the tax is exactly one year.

It also appears that an interest charge on taxes that are deferred should be deductible even if paid by an individual. As the above formulas demonstrate, in the case of an installment sale, the seller’s net annual after tax position each year will be: \( rA(1 - t) - TrA(1 - t) \) which equals \( rA(1 - T)(1 - t) \). If the seller cannot deduct the interest on deferred tax liability, then the seller’s net annual after-tax position is \( rA(1 - t) - rAT \). The seller is worse off by the amount of tax that would be saved by the deduction of the interest on the deferred tax liability. Consequently, parity is not achieved.

76. See, e.g., Sales & Financial Transactions Comm., ABA Sec. Tax’n, Comments Regarding Selected Provisions of the Omnibus Budget Reconciliation Act, (full text available in Tax Analysts Highlights & Documents, July 11, 1988; available electronically 88 TNT 142-14). The authors of the report believe that § 453(l)(3) is simpler and fairer than § 453A(c). As a result, they believe that the interest regime used under § 453(l)(3) should also be used under § 453A(c).

77. See Hanna & Olchyk, supra note 10.
In addition, under the PFIC regime, the interest charge should be deductible even if only as investment interest. If the interest is not deductible, then looking solely at the deductibility of interest under the PFIC regime versus immediate income under qualified electing fund status, it would appear to be more advantageous to elect qualified electing fund status.  

The issue of deductibility of interest on installment sales and under the PFIC regime in a sense leads to the broader issue whether interest on tax deficiencies in general should be deductible. For noncorporate taxpayers, the nondeductibility of interest on tax deficiencies generally operates as a penalty to the taxpayer. Perhaps, however, a distinction can be drawn between interest on installment sales and interest on tax deficiencies. Taxpayers generally have the obligation to pay their taxes on time. A penalty on tax deficiencies may therefore be appropriate. In contrast, there is no congressional policy to discourage use of the installment method. In fact, it is mandatory in the absence of a timely election not to use it. Arguably, the installment method interest charge should be deductible, even if interest on tax deficiencies is not, so that use of the installment method is not penalized. The same argument can be made for the non-QEF PFIC regime, which is also mandatory in the absence of a timely election not to use it. Although the government should limit the use of targeted legislation, i.e., fixing what it perceives to be problems without thoroughly thinking through all the ramifications, it appears to be appropriate to allow deductibility of interest on installment sales and PFICs while retaining general nondeductibility of interest on tax deficiencies. 

In addition, the interest charge method under the installment method only achieves parity to an all-cash sale if interest is imposed by the government at the same rate as the seller’s rate of return on investments. The rationale is that the benefit of the

78. J. ISENBERGH, INTERNATIONAL TAXATION ¶ 31.9.4 (1990) (“The QEF regime is likely, on balance, to be the more benign [in comparison to PFIC taxation], especially if the interest on deferred taxes paid to the Treasury is itself not deductible in full.”).
79. I.R.C. § 453(d).
80. I.R.C. § 1295(b).
81. See generally Christopher H. Hanna, Partnership Distributions: Whatever Happened to Nonrecognition?, 82 Ky. L.J. 465 (1993) (arguing that Congress in recent years has adopted targeted legislation in subchapter K that corrects one problem but raises a host of additional issues, thereby adding complexity to an already difficult area).
82. See, e.g., I DEP’T OF THE TREASURY, supra note 10, at 73-74; 1 BITTKER & LOKKEN, supra note 7, at ¶ 3.5.2.
deferral is equal to the taxpayer's rate of return on investment by being allowed to invest the deferred taxes. For example, if the government charges interest at a ten percent rate and the seller's rate of return is only eight percent, the seller is better off by making an all cash sale and avoiding the interest charge to the government. The seller will earn a rate of return of eight percent and avoid paying interest of ten percent. If the government's interest rate is less than the seller's rate of return, however, then the seller is better off making an installment sale, earning the higher rate of return on the sale, and paying the government at a lower rate of return as opposed to an all cash sale. It is possible that the government could look to the seller's rate of return on the particular installment obligation and use that figure as the seller's rate of return. However, focusing in on each installment seller's rate of return would lead to tremendous administrative difficulty for the government. It appears, however, that the only practical solution is the one currently in use, which is a uniform rate for all sellers.\(^\text{83}\)

In fact, the comparison of the interest rates is not an entirely accurate picture. If the government is charging interest at ten percent with no deductibility for the interest, then the ten percent figure should remain at that amount. If the seller is earning a rate of return of also ten percent, this figure must be reduced by the seller's tax rate because the interest earned is subject to tax. If, for example, the seller is in a 40 percent tax rate, the seller's rate of return is more accurately the after-tax rate of return of six percent. Therefore, the comparison is between a ten percent interest charge by the government and a six percent rate of return earned by the seller. Clearly, the seller is better off making a cash sale and avoid paying ten percent to the government in after-tax dollars. To achieve parity in a world where the interest charge is not deductible, the comparison should be between the government's rate of interest charge, which is based on a before-tax rate of return, and the seller's after-tax rate of return. For example, assume a seller makes an installment sale subject to an interest charge rule. Assume the interest rate on the installment obligation is ten percent, resulting in interest for the year of $100,000, and the seller is in the 40 percent tax bracket. If the government also charges 10 percent interest resulting in $100,000 of interest and the interest is deductible, then the interest income and deduction wash against each other. If the interest is not deductible, then the seller will end

83. I.R.C. §§ 453A(c)(2)(B) and 6621(a)(2).
up in a negative cash flow of $40,000 equal to the amount of taxes that would be saved by deducting the interest paid to the government.

B. IMMEDIATE INCLUSION OF INCOME

Rather than impose an interest charge rule, Congress could repeal each Code section allowing deferral and consequently require immediate inclusion in income. This would obviously eliminate the time value of money benefits that accompany tax deferral because no tax deferral would take place. For example, Congress could simply repeal the installment method rules and require immediate recognition of gain on an installment sale of property. In fact, in recent years, Congress has done just that by repealing the use of the installment method for dealers in personal property as well as dealers in real property. As a result, the installment method can no longer be used for sales of inventory. A seller of inventory must use the accrual method of accounting with respect to the inventory. This means that the gross income on each sale is included at the time of the sale since that is when the all events tests is generally met. Requiring an immediate inclusion in income obviously is an easy method of preventing tax deferral. Congress also has prevented the use of the installment method in a number of other situations, including installment sales of marketable securities and installment sales of depreciable property between related persons. For example, if a taxpayer sells 100 shares of IBM stock at a $10,000 gain, the entire gain must be included in gross income at the time of the sale even though payment of the sales price occurs over time. This example can be generalized algebraically. In the case of a cash sale in which tax is immediately imposed, an amount \( A \) of gain is reduced by tax \( T \) such that \( A(1 - T) \) may be invested. At an annual rate of return \( r \), \( A(1 - T) \) invested will earn \( rA(1 - T) \) per year, which will be subject to tax at rate \( t \) equalling tax each year of \( trA(1 - T) \). The seller's net annual after-tax position each year will be:

85. I.R.C. §§ 453(b)(2) and (1)(1).
86. Treas. Reg. § 1.446-1(c)(2)(ii). But see Treas. Reg. § 1.446-1(c)(2)(i) for a very limited exception to the use of the accrual method.
87. I.R.C. § 453(g).
88. I.R.C. § 453(k)(2).
89. I.R.C. § 453(k)(2).
ELIMINATING TAX DEFERRAL

\[ rA(1 - T) - trA(1 - T) \] which equals \( rA(1 - T)(1 - t) \)

Complete elimination of the installment method of accounting, however, could have harsh results by creating severe liquidity problems for taxpayers who would otherwise be eligible to use it. As a result, Congress should retain the installment method but simply eliminate the tax deferral benefits that accompany it. For the most part, this is what Congress has done through enactment of sections 453A(c) and 453(l)(3). If the seller does not want to pay the interest charge under sections 453A(c) or 453(l)(3), then the seller can elect out of the installment method pursuant to section 453(d) or not make the election under section 453(l)(2)(B)(i).

The qualified election fund provisions under section 1295 further illustrate the equivalence of imposing an interest charge rule or requiring immediate inclusion in income. Under section 1295, a taxpayer may elect to treat a passive foreign investment company as a qualified electing fund. If the election is made, the earnings of the QEF PFIC, in essence, flow through to the electing shareholders of the QEF PFIC. The electing shareholders are taxed on the earnings each year and no tax deferral is generally taking place. As a result, no interest is charged by the government. Although electing QEF status versus non-QEF PFIC status with the interest charge does not achieve complete parity to shareholders, it is reasonably close.\(^8^0\) For example,\(^8^1\) assume a U.S. shareholder of a PFIC is in the 40 percent tax bracket and earns a before-tax rate of return of ten percent annually. The PFIC also earns a rate of return of 10 percent and has $1,000 in assets. The U.S. shareholder has made the QEF election. During year one, the U.S. shareholder must include $100 in gross income and pay $40 in taxes. During year two, the U.S. shareholder includes another $100 in gross income and pays another $40 in taxes. At the end of two years, the U.S. shareholder has $123.60 ($60 from year one invested at an after-tax rate of return of six percent equalling $63.60 plus $60 from year two) if cash was distributed representing the U.S. share-

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\(^8^0\) One reason that parity is not accurately achieved is that the interest charge under the PFIC regime is treated as interest on an underpayment of tax and therefore personal interest for individuals. See Temp. Treas. Reg. § 1.163-9T(b)(2)(i)(B). In addition, under the PFIC regime, section 1291(a) requires that the excess distribution be allocated ratably over the applicable period. This may not accurately reflect the timing of the earnings of the PFIC. Finally, under the PFIC regime, gain on the sale of PFIC stock is treated as ordinary income. If the QEF election is made, however, the gain may be taxed as capital gain. See, e.g., 3 Bittker & Lokken, supra note 7, at ¶ 68.5.1.

\(^8^1\) This example is adopted from that given in ISENBERGH, supra note 78, at ¶ 31.5.3 (1993 Supp.).
holder's income. If the QEF election is not made and an excess distribution of $210 took place at the end of year two, it would be allocated $105 to year one and $105 to year two. At a 40 percent tax rate, $84 in taxes would be owed to the government. However, an interest charge would also be imposed. If the interest rate is ten percent, the amount is the increase in tax, $42 ($105 of year one income times 40 percent) times 10 percent, thus $4.20 is owed the government. If it is not deductible, the PFIC shareholder has $121.80. If the interest is deductible, then the PFIC shareholder has $123.48. This latter amount is almost the same amount as current taxation under the QEF regime, the slight difference of .12 attributable to the timing of the earnings under the QEF election ($100 each year) versus the ratable allocation under the PFIC regime ($105 each year instead of $100 in year one and $110 in year two). If, under the PFIC regime, the income were allocated in the actual manner that it was earned, $100 in year one and $110 in year two, and the interest charge to the government were deductible, then the PFIC shareholder would have $123.60 at the end of the second year. This would be the same amount as if the QEF election was made.

The idea of requiring immediate inclusion in income can be extended even further by eliminating the realization requirement and utilizing a mark-to-market method of accounting, sometimes referred to as an accretion method of accounting. While the use of such an accounting method would dramatically change the income tax system currently in place, mark-to-market accounting is not unprecedented in the Code. Congress has eliminated the realization requirement in certain areas of the Code beginning with the tax treatment of commodities futures contracts as part of the Economic Recovery Tax Act of 1981. In fact, as to dealers in securities, Congress has again eliminated the realization requirement as part of the Omnibus Budget Reconciliation Act of 1993 with the enactment of section 475. Under section 475, any dealer in securities must recognize gain or loss on any security that is not inventory in the hands of the dealer and is held at the close of the tax-

92. Professor Andrews has described the realization doctrine as the "Achilles' heel" of the tax system. See Andrews, supra note 23, at 280.
The recognized gain or loss is determined as if the noninventory security were sold for its fair market value on the last business day of the taxable year. If the gain or loss is required to be recognized at the end of each year, no tax deferral may take place except within the course of a particular year.

Mark-to-market accounting method (and eliminating the realization requirement) is consistent with the Haig-Simons definition of income. Under the Haig-Simons definition of income, "[p]ersonal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." This definition of income appears to be the widely accepted definition among tax academics and economists. For example, if a taxpayer bought General Motors stock for $1,000 on January 1, 1994, and Congress required that the taxpayer utilize a year end mark-to-market method of accounting and the stock was worth $1,500 on December 31, 1994, then the taxpayer would include $500 in income for 1994 with respect to the General Motors stock.

The obvious advantage to adopting the Haig-Simons definition of income is that tax deferral is thereby eliminated and no need exists for an interest charge method or any other prophylactic method of eliminating tax deferral. In other words, adoption of the Haig-Simons definition of income would eliminate the benefits of the Cary Brown model. Utilizing an earlier example, assume $T$ owns assets long thought essentially worthless with a negligible basis. The assets immediately rise in value to $10,000. Then the assets value continues to rise at ten percent annually for three years. At the end of three years, $T$ sells the assets for $13,310 resulting in $13,310 of gain. At a 28 percent tax rate, the tax owed is $3,726.80

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95. I.R.C. § 475(a)(2).
97. See, e.g., Cunningham & Schenk, supra note 22, at 733.
98. SIMONS, supra note 10, at 50. See also Haig, supra note 10.
99. See, e.g., 1 BITTKER & LOKKEN, supra note 7, at ¶ 3.1.1 ("Among contemporary American economists, however, the so-called Haig-Simons definition of income is the most widely accepted."); Cunningham & Schenk, supra note 22, at 733 ("Tax theorists generally have accepted the so-called Haig-Simons definition of income."); GRAETZ, supra note 1, at 110 ("The Simons definition, which is considered a refinement of the Haig definition, is the most widely accepted."); Alvin C. Warren, Financial Contract Innovation and Income Tax Policy, 107 HARV. L. REV. 460, 462 n.9 (1993) ("The classic exposition of the concept of income is Henry C. Simons, Personal Income Taxation 41-58 (1938).").
100. See, e.g., Surrey, supra note 4; GRAETZ, supra note 1, at 206-07 ("As Surrey indicates, realization is a question of the timing of taxation.").
leaving $T$ with assets of $9,583.20 (13,310 minus $3,726.80). Discounted back three years to the time of the $10,000 appreciation, the present value of the $3,726.80 tax is $2,800, which is 28 percent of the appreciation. If the realization requirement were eliminated for the original appreciation of $10,000 and it were immediately taxed at a 28 percent tax rate, then $T$ would owe $2,800 in taxes. $T$ would have $7,200 in assets remaining. That amount invested at a 10 percent before-tax rate of return would produce $9,583.20 at the end of three years, the same amount as when the tax on the gain is delayed until realization. The example illustrates the Cary Brown model: By delaying the taxation of gains until realization, the income tax system effectively exempts the future annual return on the appreciation from tax.

By eliminating the realization requirement, the benefits of the Cary Brown model can be removed. At an after-tax rate of return of 7.2 percent, $T$ will have $8,869.86 at the end of three years.

Eliminating the realization requirement and implementing an income tax on changes in the value of a taxpayer’s assets could lead to numerous problems, including liquidity in terms of paying the resulting income tax, administrability in determining the changes in fair market value of the taxpayer’s assets (particularly those not traded on a publicly traded exchange), and constitutional (or political) problems. In addition, some period of time, most often assumed to be a year, would have to be adopted in which to make the fair market value determinations. Most commentators have agreed that it is impractical to eliminate the realization requirement and adopt a mark-to-market approach. A more realistic approach might be to adopt a substantially different taxing scheme such as a cash flow tax, sometimes referred to as a con-
sumption tax.104

C. DEFERRAL OF INCOME WITH INTEREST COMPONENT METHOD (IMPUTED INTEREST METHOD)

1. Automobile Dealers

Generally, an accrual method taxpayer must include in income amounts currently received for services to be performed in the future.106 This has become a well-accepted principle of tax law, commonly referred to as the Schlude doctrine, with very few exceptions.104 In 1992, the Service issued Technical Advice Memorandum 9218004 (TAM), which created much controversy and uncertainty in the automobile industry. In the TAM, an automobile dealer sold extended service warranty contracts along with its automobiles. It received a lump-sum payment from each customer for the extended contract. The dealer would then keep a portion of the payment as a commission and remit the remaining portion to an insurance subsidiary of the automobile manufacturer to cover the warranty obligation to each of the customers. The dealer treated the lump-sum payment from the customer as income and included it upon receipt. It also immediately deducted the payment that was made to the insurance subsidiary of the manufacturer.

104. Under cash flow taxation, an investment is deducted when the cost of the investment is paid and is included in income when cash receipts are received. As to the literature on cash flow taxation, see, e.g., Andrews, supra note 23; Andrews, supra note 1; William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 HARV. L. REV. 947 (1975); Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 HARV. L. REV. 1575 (1979); Alvin C. Warren, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975); Alvin C. Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 YALE L.J. 1081 (1980).

105. See, e.g., Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Automobile Association v. United States, 367 U.S. 687 (1961); Schlude v. Commissioner, 372 U.S. 128 (1963). The Supreme Court's holding in these three cases is sometimes referred to as the Schlude doctrine. This doctrine basically states that an accrual method taxpayer that receives an advance payment for services must include the advance payment in gross income at the time of receipt. This doctrine has also been applied to advance payment for goods. See, e.g., Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969); Treas. Reg. § 1.451-5 (1971).

I would like to thank Professor Daniel Halperin and Robert Scarborough for their invaluable comments on this part of the Article.

The Service, in the TAM, concluded that the dealer must include the lump-sum payment from the customers in income upon receipt. But the Service also concluded that the dealer must deduct the payment to the manufacturer's insurance subsidiary over the life of the contract rather than immediately. Automobile dealers argued that this tax treatment created a mismatch of income and deduction and generated cash flow problems. They requested relief from the results of the TAM. A number of commentators commented on the TAM with one concluding that it "is so simple [and correct] that a second-year law student could answer it correctly." Another commentator immediately responded that "[i]f that is so, I suggest that it is because such a student has had her good sense corrupted by a first year of law school." In response to the outcry from automobile dealers, the Service issued Rev. Proc. 92-97 and Rev. Proc. 92-98 providing relief to the dealers, at least in terms of cash flow. Under the revenue procedures, automobile dealers are permitted to change their accounting method and defer inclusion of the lump-sum payment in income. The cost of the deferral is that the dealers must also include imputed interest income each year along with a portion of the lump-sum payment. The imputed interest income requirement removes the benefit of the tax deferral. Without it, the dealers would, in essence, be exempting from gross income the return on part of the lump-sum payment that was deferred into later years. The Service clearly did not want to give automobile dealers the benefit of exempting part of the income of the lump-sum payment from tax. More specifically, the Service did not want to give automobile dealers the benefits of the Cary Brown model. The government had convinced the Supreme Court many years ago that an advance payment for services must be included in income upon receipt. The Service did not want to alter this rule. At the same time, the Service wanted to provide some relief to automobile deal-

ELIMINATING TAX DEFERRAL

ers. As a result, the Service required dealers to include an imputed interest amount in gross income based on the length of deferral and the current interest rate under section 1274(d).

The Service has given the following example in Rev. Proc. 92-98 illustrating the mechanics of the deferral of income method with imputed income:111

A, a calendar year accrual basis taxpayer, elects...to use the service warranty income method of accounting for its qualified advance payment amounts on service warranty contracts. A sold 5 service warranty contracts on January 1, 1992, for $800 each. A also sold 5 service warranty contracts on December 31, 1992, for $800 each. All the service warranty contracts sold by A in 1992 carry a term of 5 years and run concurrently with the manufacturer's warranties. Further, A pays, within 60 days of the receipt of each advance payment, $600 per contract to an unrelated third party to insure...its obligations under the service warranty contracts. The applicable interest rate, determined in accordance with section 5.04 of this revenue procedure, is 10 percent.

A aggregates all its qualified advance payment amounts on its 5-year service warranty contracts, thus determining that $6,000 of qualified advance payment amounts were received in 1992 with respect to the class of 5-year service warranty contracts. Applying the “10% and 5-year” table factor of .2398...A determines that it must report income of $1,439 in 1992 through 1996...In addition, A must include in gross income in 1992 the $2,000 payment received for services that is not deferred...Gross income is reported by A as follows:

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-deferred</td>
<td>$2,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred Income</td>
<td>$1,439</td>
<td>$1,439</td>
<td>$1,439</td>
<td>$1,439</td>
<td>$1,439</td>
</tr>
<tr>
<td>Gross Income</td>
<td>$3,439</td>
<td>$1,439</td>
<td>$1,439</td>
<td>$1,439</td>
<td>$1,439</td>
</tr>
</tbody>
</table>

The Service uses the applicable federal rate (AFR) in determining the amount of imputed income112 that must be included each year. The AFR is the rate determined by the Secretary based on the average market yield on outstanding marketable obligations

112. In the Service’s example, the precise amount would be $1,438.90.
of the United States.\footnote{113}{I.R.C. § 1274(d).} In the above example, it was assumed that the AFR was ten percent interest annually. The AFR, however, seems to be a before-tax rate of return. Assuming that it is, this seems to be too high. The Service should use an after-tax rate of return in computing imputed income. The following table demonstrates the erroneous result reached if a before-tax rate of return is used.
<table>
<thead>
<tr>
<th>Advance Payment</th>
<th>Immediate Inclusion of Prepaid Income</th>
<th>Deferral of Income with Imputed Interest Income Using a Before Tax Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income less Deduction of 1,200</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>2,720</td>
<td>895.56</td>
</tr>
<tr>
<td>Investment</td>
<td>(720)</td>
<td>1,104.44</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>(43.20)</td>
<td>66.27</td>
</tr>
</tbody>
</table>

| Investment (Year Two) | 1,170.71 |
| Gross Income less Deduction of 1,200 | (1,200) | 238.90 |
| Taxes (40%) | (480) | 95.56 |
| After-Tax Return on Investment (6%) | 10.79 | 62.65 |
| Investment (Year Three) | (300.19) | 1,139.66 |
| Gross Income | (1,200) | 238.90 |
| Taxes (40%) | (480) | 95.56 |
| After-Tax Return on Investment (6%) | 40.24 | 60.67 |
| Investment (Year Four) | 190.60 | 1,106.75 |
| Gross Income | (1,200) | 238.90 |
| Taxes (40%) | (480) | 95.56 |
| After-Tax Return on Investment (6%) | 71.45 | 58.58 |
| Investment (Year Five) | 710.84 | 1,071.86 |
| Gross Income | (1,200) | 238.90 |
| Taxes (40%) | (480) | 95.56 |
| After-Tax Return on Investment (6%) | 71.45 | 58.58 |
| Total After-Taxes at the End of Five Years | 1,262.29 | 1,034.88 |
In the above example, the automobile dealer was better off from a tax standpoint by immediately including the entire $8,000 prepayment in gross income. Parity has not been achieved between immediate inclusion and the imputed interest income method because the before-tax rate of return that was used in imputing interest income was too high. The automobile dealer ends up being overtaxed.

Assume that taxpayer A in the example in the revenue procedure is in the 40 percent tax bracket. The after-tax rate of return would therefore be six percent interest annually. Applying the "6% and 5-year" table factor of .2240 . . . , A determines that it must report income of $1,344 in 1992 through 1996 . . .. In addition, A must include in gross income in 1992 the $2,000 payment received for services that is not deferred . . .. Gross income is reported by A as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-deferred Income</td>
<td>$2,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred Income</td>
<td>$1,344</td>
<td>$1,344</td>
<td>$1,344</td>
<td>$1,344</td>
<td>$1,344</td>
</tr>
<tr>
<td>Gross Income</td>
<td>$3,344</td>
<td>$1,344</td>
<td>$1,344</td>
<td>$1,344</td>
<td>$1,344</td>
</tr>
</tbody>
</table>

If A included the entire $8,000 prepayment as gross income in the first year upon receipt with a $1,200 deduction in the first year (and each of the next four years), A would pay taxes of $2,720 leaving A with a negative investment amount of $720. A would owe interest at an after-tax rate of six percent (assuming the interest was deductible) until the investment amount became positive at which time A could then invest it at an after-tax rate of return of six percent annually. At the end of five years, A would still have $1,262.29. Under the imputed interest income method, using an after-tax rate of return of six percent for five years, A would also have $1,262.29 at the end of five years. The following table demonstrates this equivalence if an after-tax rate of return is used.

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114. The precise amount would be $1,343.75.
<table>
<thead>
<tr>
<th></th>
<th>Immediate Inclusion</th>
<th>Deferral of Income with Imputed Interest Income Using an After Tax Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance Payment</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Gross Income less Deduction of $1,200</td>
<td>6,800</td>
<td>2,143.75 (3,343.75 minus 1,200.00)</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>2,720</td>
<td>857.50</td>
</tr>
<tr>
<td>Investment</td>
<td>(720)</td>
<td>1,142.50</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>(43.20)</td>
<td>68.55</td>
</tr>
<tr>
<td>Investment (Year Two)</td>
<td>(763.20)</td>
<td>1,211.05</td>
</tr>
<tr>
<td>Gross Income</td>
<td>(1,200)</td>
<td>143.75 (1,343.75 minus 1,200.00)</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>(480)</td>
<td>57.50</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>(16.99)</td>
<td>69.21</td>
</tr>
<tr>
<td>Investment (Year Three)</td>
<td>(300.19)</td>
<td>1,222.76</td>
</tr>
<tr>
<td>Gross Income</td>
<td>(1,200)</td>
<td>143.75</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>(480)</td>
<td>57.50</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>10.79</td>
<td>69.92</td>
</tr>
<tr>
<td>Investment (Year Four)</td>
<td>190.60</td>
<td>1,235.18</td>
</tr>
<tr>
<td>Gross Income</td>
<td>(1,200)</td>
<td>143.75</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>(480)</td>
<td>57.50</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>40.24</td>
<td>70.66</td>
</tr>
<tr>
<td>Investment (Year Five)</td>
<td>710.84</td>
<td>1,248.34</td>
</tr>
<tr>
<td>Gross Income</td>
<td>(1,200)</td>
<td>143.75</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>(480)</td>
<td>57.50</td>
</tr>
<tr>
<td>After-Tax Return on Investment (6%)</td>
<td>71.45</td>
<td>71.45</td>
</tr>
<tr>
<td>Total After-Taxes at the End of Five Years</td>
<td>1,262.29</td>
<td>1,262.29</td>
</tr>
</tbody>
</table>
At the end of five years, A would have $1,262.29 if A included the entire $8,000 payment in gross income upon receipt or if A included it over the five year period using an after-tax rate of return of six percent annually.

Simplifying the above example leads to a formula that is consistent with previously discussed formulas. Simplifying will also demonstrate how clearly erroneous the use of a before-tax rate of return is in the above example. The option that the revenue procedures essentially provide is whether to include the advance payment immediately in income or to delay inclusion until a later time. For this purpose, the deduction each year is irrelevant as it is the same amount whether or not the taxpayer elects to utilize the imputed income method of the revenue procedures. In the above example, the taxpayer's deduction is $1,200 each year for five years whether under the imputed income method or simply under the Schlude doctrine.

Focusing solely on the income side of the automobile dealer and ignoring the payment to the insurance subsidiary, the above example can be generalized algebraically using the following additional assumptions: (1) the deductions to the automobile dealer are disregarded and (2) the option is to either include the prepaid service income on receipt or defer it until the end of the contract. In the case of immediate recognition of income under the Schlude doctrine, an amount $A$ of prepaid service income is reduced by tax $t$ such that $A(1 - t)$ may be invested. At an annual rate of return $r$, $A(1 - t)$ invested will earn $rA(1 - t)$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA(1 - t)$. The automobile dealer's net annual after-tax position each year will be:

$$rA(1 - t) - trA(1 - t) \text{ which equals } rA(1 - t)(1 - t)$$

In the case of imputing interest income in which prepaid service income is recognized at the end of the contract (not over the life of the contract), an amount $A$ of prepaid service income is not reduced by tax $t$ at the time of receipt. At an annual rate of return $r$, $A$ invested will earn $rA$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA$. In addition, interest income is imputed each year in the amount of $rA(1 - t)$, which is an after-tax rate of return. This is subject to tax at rate $t$ equalling tax each year of $trA(1 - t)$. The automobile dealer's net annual after-tax position will be:

$$rA(1 - t) - trA(1 - t) \text{ which equals } rA(1 - t)(1 - t)$$

This is equal to the automobile dealer's net annual after-tax posi-
tion when immediate recognition of income is required and tax is immediately imposed.

If a before-tax rate of return is used in imputing interest income in which prepaid service income is recognized at the end of the contract, the amount $A$ of prepaid service income is not reduced by tax $t$ at the time of receipt. At an annual rate of return $r$, $A$ invested will earn $rA$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA$. In addition, interest income is imputed each year in the amount of $rA$, which is a before-tax rate of return. This is subject to tax at rate $t$ equalling tax each year of $trA$. The automobile dealer's net annual after-tax position will be $rA(1 - t) - trA$. The automobile dealer is worse off by the amount of tax that would be saved by only including imputed interest income at an after-tax rate of return.

2. Extension to Other Sections

There may be situations where the Service requires the taxpayer to defer inclusion of amounts currently received. For example, under the original issue discount (OID) regulations, an advance payment of interest, i.e., points, is not included in income when received by a private lender. Rather the points reduce the issue price of the loan and therefore create OID. As a result, the points are taken into income over the life of the loan. This is a change from prior law, which required the lender to include points in income under the lender's method of accounting. For example, assume lender loans $100,000 to borrower at a market rate of interest and charges $4,000 in points. Under the OID regulations, the borrower's payment of the points is not gross income to the lender upon receipt. Rather, the points reduce the issue price of the loan to $96,000 thereby creating $4,000 of OID. The points are accounted for by the lender and the borrower (assuming section 461(g)(2) does not apply) as OID under section 1272.

In addition, section 467, enacted as part of the Deficit Reduction Act of 1984, generally requires that lessors and lessees use

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the accrual method of accounting for rents regardless of their actual method of accounting if, in the absence of regulations, the rents are backloaded or escalate. Section 467 generally requires the parties to accrue rent on a level basis throughout the term of the lease if the lease agreement provides for escalating rental payments. Section 467(f) provides “[u]nder regulations prescribed by the Secretary, rules comparable to the rules of this section shall also apply in the case of any agreement where the amount paid under the agreement for the use of property decreases during the term of the agreement,” i.e., frontloaded. A schedule of decreasing rents may occur when the lessor is tax-exempt, is in a low tax bracket, has an expiring net operating loss or unused deductions, or the lessee wants to accelerate deductions. To date, no regulations have been promulgated under section 467.

Presumably, the regulations under section 467(f) would create a substantial change from existing law. Under existing law, prepaid rent must be included in income in its entirety by the lessor. If and when Treasury adopts regulations under section 467(f), part of the early rental payments may be treated as a loan from the lessee to the lessor. The lessor would include a portion of the advance rental in gross income as rental income and a portion would be treated as a loan with interest imputed between the lessor and the lessee.

3. Comments on Imputed Interest Method

It is difficult to determine why the Service would adopt an imputed interest method over the interest charge method. It seems just as easy to have the automobile dealers determine what portion of the advance payment is being deferred. Next, multiply this amount by the applicable tax rate (if a corporation, the highest section 11 rate) and then by the applicable federal rate. This amount would be remitted to the government as interest on deferred taxes very similar to the interest on deferred tax liability under section 453A(c). Theoretically, the interest would be deductible, whether paid by a corporate or noncorporate taxpayer. This seems to be much easier than imputing interest which, in terms of

120. See, e.g., 4 BITTKER & LOKKEN, supra note 7, at ¶ 105.7.
121. Treas. Reg. § 1.61-8(b) (“Gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer.”).
122. See, e.g., 4 BITTKER & LOKKEN, supra note 7, at ¶ 105.7.4.
the bottom line, reaches pretty close to the same result, i.e., an additional amount is owed to the government each year.

The advantage to the imputed interest method may be that the income generated is taxed at the taxpayer's marginal tax rate for the year. Under the interest charge method of section 453A(c), the government computes the deferred taxes using the highest tax rate in the Code as opposed to the taxpayer's marginal tax rate. As a result, the imputed interest method is probably a more accurate method of preventing tax deferral. However, the government could easily correct the disparity by also using the taxpayer's marginal tax rate for the interest charge method.

The application of the imputed interest method to automobile dealers through Rev. Proc. 92-97 and Rev. Proc. 92-98 may also be theoretically more sound than the use of the interest charge method. The underlying principle of the Schlude doctrine seems to be that a prepayment of income is in essence a loan to be repaid by the payee's performance under the contract. If so, then the proper approach is to impute interest income as the Service has done in its two revenue procedures. In contrast, the interest charge method is one of deferred tax payment between the taxpayer and the government and not of a disguised loan between taxpayers.

D. DEPOSIT METHOD

Prior to the Internal Revenue Code of 1954, a partnership could select any taxable year it desired. There were no taxable year conformity rules, and no business purpose was required to select a taxable year. Thus, a partnership with calendar year partners could select a taxable year ending January 31 and provide its partners with an eleven month deferral of income. Apparently, a number of partnerships did just that.

In the 1954 Code, Congress enacted section 706(b)(1), which for the first time placed statutory limits on a partnership's taxable year. As enacted, it then read:

123. See Schlude v. Commissioner, 372 U.S. 128 (1963). The Supreme Court held in Schlude that an accrual method dance studio had to include advance payments for future dance lessons in gross income upon receipt.


125. See Christopher H. Hanna, A Partnership's Business Purpose Taxable Year: A Deferral Provision Whose Time Has Passed, 45 Tax Law. 685, 688 (1992), from which part of this discussion is adapted.

126. Id. at 688.
The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.\footnote{I.R.C. § 706(b)(1) (1954).}

This provision required a new partnership to use the taxable year of all its principal partners. An existing partnership could not change to a taxable year other than that of all its principal partners. Both a new and an existing partnership, however, could use a taxable year other than that of all its principal partners if it could show a business purpose for such a taxable year.

As part of the 1986 Act, Congress further limited the taxable year that a partnership can select. After the 1986 Act, a partnership is subject to a three step analysis, commonly referred to as the taxable year conformity rules.\footnote{I.R.C. § 706(b)(1)(B).} First, a partnership must use a majority interest taxable year if one exists.\footnote{I.R.C. § 706(b)(1)(B)(i).} The term "majority interest taxable year" means the taxable year which, on each testing day, constituted the taxable year of one or more partners having on such day an aggregate interest in partnership profits and capital of more than 50 percent.\footnote{I.R.C. § 706(b)(4)(A)(i).} Second, if the partnership does not have a majority interest taxable year, then it must use the taxable year of all the principal partners of the partnership.\footnote{I.R.C. § 706(b)(1)(B)(ii).} A principal partner is defined to mean a partner having an interest of five percent or more in partnership profits or capital.\footnote{I.R.C. § 706(b)(3).} Third, if the partnership does not have a majority interest taxable year and does not have a taxable year based on all the principal partners of the partnership, then it must use the calendar year or any other taxable year prescribed by regulations.\footnote{I.R.C. § 706(b)(1)(B)(iii).} A partnership can use another taxable year if it can establish a business purpose to the satisfaction of the Secretary.\footnote{I.R.C. §§ 706(b)(1)(C). See generally Hanna, supra note 125.}

As a result of the tightening of the rules in 1986, most new
and many existing partnerships were forced to use a calendar year. This created considerable controversy with accountants who felt that the taxable year conformity rules would create a large burden on them. Since most partnerships would be required to use a calendar year, much of the accountants’ workload would fall during the first three and a half months following the end of the calendar year. In the 1987 Act, Congress responded to this concern by enacting sections 444 and 7519. Section 444 allows partnerships to elect a taxable year other than the required taxable year. If a partnership makes an election under section 444, however, it must also make a required payment with the Treasury under section 7519.

The first option under section 444 is that an existing partnership can elect to retain the same taxable year that the partnership had been using. For example, if XYZ Partnership had been using a June 30 taxable year, it could elect to retain its June 30 taxable year under section 444 even though section 706(b)(1)(B) otherwise would require it to change to a different taxable year. This option is not particularly relevant today because partnerships should have already made this election for it to be effective.

Second, an existing partnership can elect to change its taxable year but still not use the required taxable year. It is, however, limited as to which taxable year it can elect. The deferral period of the taxable year to which an existing partnership is changing cannot exceed the lesser of three months or the deferral period of the taxable year which is being changed. For example, assume XYZ Partnership has a June 30 taxable year, and its required taxable year under section 706(b)(1)(B) is December 31. XYZ’s current taxable year of June 30 has a deferral period of six months. It can elect a taxable year that does not have a deferral period longer

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135. See Hanna, supra note 125, at 709-10.
137. “Required taxable year” is defined to mean the taxable year determined under section 706(b) without taking into account any taxable year allowable by reason of a business purpose. I.R.C. § 444(e).
139. I.R.C. § 444(b)(3) and Temp. Treas. Regs. §§ 1.444-1T(b)(3), 1.444-1T(d)(2), and 1.444-3T.
140. I.R.C. § 444(b)(2).
141. I.R.C. § 444(b)(2). The term “deferral period” means the months between the beginning of a taxable year and the close of the first required taxable year ending within such year. I.R.C. § 444(b)(4).
than three months.\textsuperscript{143} Therefore, XYZ can elect a taxable year ending September 30, October 31, or November 30. As a result, the choices available to XYZ under section 444 are somewhat limited. It can retain its June 30 taxable year or elect a taxable year ending September 30, October 31, or November 30. Of course, it can also use its required taxable year of December 31. As with the first option, the second option is not particularly relevant today because partnerships should have already made this election for it to be effective.\textsuperscript{144}

A new partnership can only elect a taxable year that does not have a deferral period exceeding three months.\textsuperscript{145} Assuming the new partnership is required to use a calendar year under section 706(b)(1)(B), it can elect a taxable year ending September 30, October 31, or November 30 under section 444.

If a partnership has been using a taxable year based on a business purpose, it can continue to use that year without having to make the election under section 444.\textsuperscript{146} The obvious advantage is that it is not required to make the required payment under section 7519. In addition, a new partnership that can establish a taxable year based on a business purpose does not have to make the section 444 election and, therefore, is not required to make the required payment under section 7519.

As a result of Congress’ increasing concern with the time value of money and tax deferral, it enacted section 7519 as part of the 1987 Act.\textsuperscript{147} The required payment under section 7519 is intended to eliminate the tax deferral that a partnership gives its partners when it uses a year other than the required taxable year.\textsuperscript{148} It is, in essence, an interest-free loan to the Treasury. The required payment is determined through a complex set of calculations. To cal-

\textsuperscript{143} XYZ Partnership can elect a taxable year which does not have a deferral period longer than the shorter of three months or six months. Since three months is shorter, XYZ’s taxable year cannot have a deferral period longer than three months.

\textsuperscript{144} I.R.C. §§ 444(b)(2), 444(d)(2); Temp. Treas. Regs. §§ 1.444-1T(b)(2), 1.444-1T(d)(1), 1.444-3T.

\textsuperscript{145} No mention is made in the legislative history as to why a deferral period of up to three months was allowed. Hanna, \textit{supra} note 125, at 711.

\textsuperscript{146} Temp. Treas. Reg. § 1.444-1T(a)(3). The business purpose must have been established under Rev. Proc. 87-32 or any successor revenue ruling or revenue procedure, \textit{e.g.}, Rev. Rul. 87-57. Temp. Treas. Reg. § 1.444-1T(a)(3)(i). However, a taxable year that is a grandfathered fiscal year under Rev. Proc. 87-32 or any successor revenue ruling or revenue procedure will also suffice. Temp. Treas. Reg. § 1.444-1T(a)(3)(ii).

\textsuperscript{147} Pub. L. No. 100-203, § 10206(b)(1), 101 Stat. 1330, 1397.

ELIMINATING TAX DEFERRAL

calculate the amount of the required payment, the partnership must first compute its "deferral ratio." This is equal to the ratio of the number of months in the deferral period of the base year to the number of months in the partnership's taxable year.\(^{149}\) The base year means, with respect to any applicable election year, the taxable year of the partnership preceding the applicable election year.\(^{150}\) The deferral ratio is then multiplied by the partnership's net income for the base year.\(^{151}\) This amount is then added to the excess of the deferral ratio multiplied by the aggregate of applicable payments made by the partnership during the base year over the aggregate amount of such applicable payments made during the deferral period of the base year.\(^{152}\) The sum is the partnership's "net base year income."\(^{153}\)

The partnership's net base year income is multiplied by the applicable percentage of the "adjusted highest section one rate."\(^{154}\) The product is the required payment for the first applicable elec-
tion year. For subsequent applicable election years of the partnership, the required payment is the excess of the product of the net base year income multiplied by the applicable percentage of the adjusted highest section one rate over the net required payment balance. The net required payment balance is the excess of the aggregate of required payments for all previous applicable election years over the aggregate amount allowable as a refund for all previous applicable election years.

Assume a partnership is formed on January 1, 1994. All of its partners are calendar year individuals so the partnership’s required taxable year under section 706(b) is the calendar year. It cannot establish a business purpose to allow adoption of a different taxable year. The partnership, however, adopts September 30 as its taxable year as permitted by section 444(b)(1).

By adopting a September 30 taxable year, the partnership is giving its partners three months of tax deferral. To prevent this tax deferral, Congress requires that the partnership make a required payment under section 7519 to approximate the amount of tax deferral. Assume the partnership’s net income for each month is $10,000, and it makes no applicable payments or guaranteed payments. The partnership’s first applicable election year is the taxable year from January 1, 1994, to September 30, 1994. No payment is required for this first applicable election year because this is the partnership’s first year in existence.

The partnership’s second applicable election year is from October 1, 1994, to September 30, 1995. It must make a required payment by May 15, 1995.

155. If an applicable election year is the partnership’s first year in existence, the required payment for such year is zero. Temp. Treas. Reg. § 1.7519-1T(b)(4)(i). If the first applicable election year ends before the last day of the partnership’s required taxable year, the required payment for such year is zero. Temp. Treas. Reg. § 1.7519-1T(b)(4)(ii). If the required payment for an applicable election year does not exceed $500 and the partnership has not been required to make a required payment for a previous year, then no required payment is due. I.R.C. § 7519(a)(2) and Temp. Treas. Reg. § 1.7519-1T(a)(2).

156. I.R.C. § 7519(b).


158. Temp. Treas. Reg. § 1.7519-1T(b)(4)(i). The reason that a newly-formed partnership does not make a required payment for its first applicable election year is that it does not have a base year. Id.

159. In section 7519(f)(2), Congress established Apr. 15 of the calendar year following the calendar year in which the applicable election year begins as the due date for the required payment unless the Secretary establishes a later date. The Secretary has done so through regulations by establishing May 15 of the calendar year following the calendar year in which the applicable election year begins as the due date for the required payment. Temp. Treas. Reg. § 1.7519-2T(a)(4)(ii).
ELIMINATING TAX DEFERRAL

The deferral ratio of the partnership is 3/12 or 1/4. The base year is from January 1, 1994, to September 30, 1994. The net income is $90,000 for the base year and the annualized short base year income is $120,000. Therefore, the net base year income is 1/4 multiplied by $120,000 or $30,000. This amount is multiplied by the applicable percentage (currently, 100 percent) of the adjusted highest section one rate (39.6 percent plus one percent = 40.6 percent) to equal $12,180. This is the amount of the required payment. It is assessed and collected in the same manner as a tax imposed by subtitle C. No interest is paid by the Treasury to the partnership on the required payment.

For the third applicable election year from October 1, 1995, to September 30, 1996, the partnership must make the calculation again. However, because the partnership income has remained constant, the applicable percentage of the adjusted highest section one rate multiplied by the net base year income will again equal $12,180. From this amount is subtracted the net required payment balance of $12,180, leaving a balance due of zero. Thus, no amount is due for the third applicable election year. If the partnership terminates its election under section 444, then it is entitled to a refund of the net required payment balance.

It is interesting that Congress adopted the deposit method for partnerships in the 1987 Act rather than the interest charge method that it adopted for installment sales also as part of the 1987 Act. Both intended to achieve the same goal: eliminating the time value of money benefits that accompany tax deferral. By taking the deposit method one step further, however, Congress could transform the deposit method into the interest charge method. Congress could simply have partnerships compute the required payment under current section 7519. Then, rather than having the partnership remit this amount or subtracting the net required payment balance and remitting the difference, the partnership would multiply it by an interest rate, say the applicable federal rate, and only pay this amount to the government. This interest amount would not be refundable to the partnership.

The obvious advantage to partnerships under this method would be that they would not use a significant amount of their cash to make the required payments under section 7519 but rather

162. I.R.C. § 7519(c)(2).
use the significantly smaller amount of the interest on the required payment. The advantage to the government (and the partnership) is that it would not have to keep track of the net required payment balance from year to year and determine when to require additional deposits or refund deposits, either during the life of the partnership or its liquidation. The interest charge method is a one time payment each year. If it is used, there is no running balance to keep track of from year to year. To illustrate, assume the partnership during its second applicable election year, computes its required payment amount to be $12,180. Under the deposit method of section 7519, the partnership must pay this amount to the government. If Congress had adopted the interest charge method instead of the deposit method, then the partnership, using an applicable federal rate of ten percent, would pay $1,218 to the government. If the required payment amount were $12,180 during the third applicable election year and the applicable federal rate remained at ten percent, then the partnership would pay another $1,218 to the government. This would accomplish the same result as paying the full $12,180 and receiving it back when the partnership liquidates or terminates its section 444 election.

Under the deposit method of section 7519, the government has the use of the partnership’s money. Under the interest charge method, the government receives the benefit of the use of the partnership’s money. In terms of eliminating the benefits of tax deferral, these two concepts are identical. In addition, if the government were to adopt the interest charge method, the partnership ideally should receive a deduction for the interest paid to the government, which of course would flow through to the partners. This would achieve parity with the deposit method. Under the deposit method, the deposit that the partnership pays to the government constitutes a lost rate of return for the partnership. But this is offset by the lack of requirement to pay interest to the government. By offsetting each other, the partnership, in essence, is deducting interest that would be paid to the government.

E. DOUBLE INCLUSION IN INCOME METHOD

Generally, an accrual method taxpayer may deduct an item only when the all events test is met, i.e., when all events have occurred that establish the fact of the deduction and it can be deter-
mined with reasonable accuracy. In addition, this test is not met until economic performance also has taken place. Generally, a cash method taxpayer may deduct an item when payment is made. Section 461(f) provides rules with respect to contested liabilities. It reads:

If (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of [section 461(h)], then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

To qualify under section 461(f), the taxpayer must transfer the money or other property beyond his control by relinquishing all authority over such money or other property. Examples include transferring the money or other property (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to a court or public agency that the money or other property be delivered in accordance with the settlement of the contest.

Treasury issued proposed regulations on the taxation of 461(f) settlement funds on June 6, 1990. The proposed regulations were subsequently withdrawn pending the issuance of final regulations under section 468B (dealing with designated settlement funds). The proposed regulations, however, contained an interesting and apparently controversial example involving the taxation of 461(f) settlement funds. Many commentators wrote to Treasury and the

163. I.R.C. §§ 461(h)(1) and 461(h)(4).
164. I.R.C. § 461(h)(1).
165. Treas. Reg. §§ 1.446-1(c)(1)(i) and 1.461-1(a)(1).
166. I.R.C. § 461(f).
167. Treas. Reg. § 1.461-2(c)(1)
168. Id.
Service complaining that the example was simply wrong. The example in its entirety is as follows:

X, an accrual basis, calendar year taxpayer, contests a $9,000 liability asserted against X by Y for hazardous waste disposal services rendered by Y during 1990. In January 1991, X transfers assets having a fair market value of $9,000 and an adjusted basis of $7,000 to a trust in a transaction that satisfies the requirements of § 1.461-2(c). Under section 461(f), X is allowed a $9,000 deduction for 1991. In addition, the asset transfer is considered a disposition of the assets for fair market value for purposes of section 1001. Thus, for 1991, X recognizes a $2,000 gain from the transfer and has a new basis of $9,000 in the assets.

During 1991, the fund assets earn $600, which is included in X's gross income for 1991. X pays, and takes a deduction for, taxes attributable to this amount. The only other deduction X is allowed with respect to the fund is a deduction for administrative expenses.

The fair market value of the transferred assets remain the same. In 1992, the contest is settled and assets having a fair market value of $8,000 are transferred from the fund to Y. X must include in gross income for the 1992 taxable year the $1,600 remaining in the fund. Any amounts earned by the fund in 1992 must also be included in X's gross income for 1992. The transfer to Y of assets having a fair market value of $8,000 is considered a disposition of the assets for purposes of section 1001. Because the fair market value of the assets has not changed, the disposition does not require X to recognize additional gain or loss for 1992.

Many commentators argued that X was being double taxed on $600 of the fund's earnings. In other words, X was taxed on $600 of the fund's income in 1991. Then X is taxed on $1,600 of the fund's assets in 1992. This latter amount includes the $600 of income that X was previously taxed on in 1991. Several commentators argued that X should only be taxed on $1,000 of income in 1992. The reason for this apparent double taxation is to compensate for the fact that X took too large a deduction at too early a


173. See supra note 171.
time. In other words, X should have taken an $8,000 deduction in 1992 or the present value of $8,000 discounted by one year to 1991. Because the $9,000 deduction for 1991 essentially includes an expensing of an amount returned to X in 1992, an inclusion of this returned amount and income thereon in 1992 brings X to a zero tax situation and a greater inclusion is necessary to provide the government with a tax on X's pretax income on the amount. As a result, the example is really nothing new. Rather it is a somewhat complex variation of the Cary Brown model.

The methodology of the example in the proposed regulation can be seen in the following four steps:

1. At the fund's before-tax rate of return of 6.67 percent, the $8,000 payment to the creditor consumes $7,500 of the $9,000 payment ($8,000 divided by 1.0667) and the remaining $1,500 of the payment ultimately returns to X.

2. The income on the $7,500 is $500 (6.67 percent of $7,500). It is taxed to X at 40 percent of $500 or $200. X is allowed a deduction for this tax because it is an addition to the amount ultimately passing to the creditor. In other words, X pays it and the creditor gets the pretax amount.

3. The income on the remaining $1,500 is $100 (6.67 percent of $1,500). It is taxed to X at 40 percent of $100 or $40. X is allowed a deduction for this tax because it is also an addition to the amount ultimately passing to the creditor and so there is no need to distinguish between the $200 tax on the $7,500 and the $40 tax on the $1,500. In other words, X pays it and the creditor gets the pretax amount. X is taxed on a net amount of $60. Essentially, the expensing of the $1,500 made X and the government partners with respect to this amount ($900 net investment by X and $600 government investment). The income from X's share (6.67 percent of $900 or $60) is taxed and the income from the government's share's (6.67 percent of $600 or $40) is not taxed.

4. The $1,600 received by X on the liquidation of the fund is included in gross income, resulting in a tax of $640, which consists of $600 to return to the government its share of the $1,500 and $40 to pay the government its share of the income on the $1,500. Since the tax on the liquidation merely pays over to the government its share of the income on the $1,500 and income thereon, X in essence bears no tax at the time of the liquidation, and the tax on X's share of the income, imposed when the income is realized is essentially the only tax on X.

This four step methodology will now be discussed in greater detail using both before-tax and after-tax rates of return.

In the above example, ideally X should have transferred and
taken an $8,000 deduction in 1992 when the contest was settled. This is the amount that Y actually was entitled to when the contest was settled. Or possibly, X could have taken a deduction in 1991 equal to the present value of an $8,000 deduction discounted by one year. Using a before-tax rate of return of 6.67 percent, X’s deduction in 1991 would be $7,500. But instead, X took a $9,000 deduction in 1991. This is $1,500 too much, not merely $1,000 too much.

The following table demonstrates the equivalence between an $8,000 deduction in year two (where the cash is actually transferred from X to Y) and a $7,500 early accrual in year one (where the cash remains with X until year two when X transfers $8,000 to Y). The example assumes $7,500 of gross income for the first year and $8,000 for the second year.

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<tr>
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<th>Proper Deduction in Year Two</th>
<th>Early Accrual in Year One</th>
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<tr>
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<td>300</td>
<td>500</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>120</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Minus $80 if taxes are deductible = 120</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>4,680</td>
<td>7,880</td>
</tr>
<tr>
<td>Gross Income</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Deduction</td>
<td>8,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0</td>
<td>8,000</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>0</td>
<td>3,200</td>
</tr>
<tr>
<td>Investment Amount</td>
<td>4,680</td>
<td>4,680</td>
</tr>
</tbody>
</table>
Taking an $8,000 deduction in year two yields equivalent results to taking a $7,500 deduction in year one if the taxes on the earnings of the set aside funds are deductible.

The above example can be generalized algebraically. In the case of deductibility in year two, an amount $A$ of income is reduced by tax $t$ such that $A(1 - t)$ may be invested. At an annual rate of return $r$, $A(1 - t)$ invested will earn $rA(1 - t)$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA(1 - t)$. The net annual after-tax position each year will be:

$$rA(1 - t) - trA(1 - t)$$

which equals $rA(1 - t)(1 - t)$

In the case of immediate deductibility, an amount $A$ of income is not reduced by tax $t$ such that $A$ may be invested. At an annual rate of return $r$, $A$ invested will earn $rA$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA$. In addition, interest income is generated each year in the amount of $rA(1 - t)$, which is an after-tax rate of return. This is subject to tax at rate $t$ equalling tax each year of $trA(1 - t)$. The net annual after-tax position will be:

$$rA(1 - t) - rAt(1 - t)$$

which equals $rA(1 - t)(1 - t)$

This is equal to the net annual after-tax position when deductibility is delayed until the following year.

If a before-tax rate of return is used in generating interest income in which an immediate deduction is allowed, the amount $A$ of income is not reduced by tax $t$ at the time of receipt. At an annual rate of return $r$, $A$ invested will earn $rA$ per year, which will be subject to tax at rate $t$ equalling tax each year of $trA$. In addition, interest income is generated each year in the amount of $rA$, which is a before-tax rate of return. This is subject to tax at rate $t$ equalling tax each year of $trA$. The deduction of the tax will be $trAt$, leaving the taxpayer with a burden of $rAt - trAt$ which equals $rAt(1 - t)$. The taxpayer's net annual after-tax position will be:

$$rA(1 - t) - rAt(1 - t)$$

which equals $rA(1 - t)(1 - t)$

The above results should be equivalent to taking a $9,000 deduction in year one with double inclusion of the earnings of the fund and deductibility of the taxes on the earnings of the set aside funds. The following table demonstrates this equivalence and assumes $9,000 of gross income for the first year and $8,000 for the second year.
Proper Deduction Early Accrual in
in Year Two Year One

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>$9,000</th>
<th>$9,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction</td>
<td>0</td>
<td>9,000</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>9,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>3,600</td>
<td>0</td>
</tr>
<tr>
<td>Investment</td>
<td>5,400</td>
<td>9,000</td>
</tr>
<tr>
<td>Investment Return (6.67%)</td>
<td>360</td>
<td>600</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>144</td>
<td>240</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Minus 96 if taxes are deductible = 144</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>5,616</td>
<td>9,456</td>
</tr>
<tr>
<td>Gross Income</td>
<td>8,000</td>
<td>9,600</td>
</tr>
<tr>
<td>(8,000 plus return of set aside funds of 1,600)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deduction</td>
<td>8,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0</td>
<td>9,600</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>0</td>
<td>3,840</td>
</tr>
<tr>
<td>Investment Amount</td>
<td>5,616</td>
<td>5,616</td>
</tr>
</tbody>
</table>

In the above example, a before-tax rate of return of 6.67 percent was used in computing the proper amount of deduction in 1991. If an after-tax rate of return of 4 percent were used, X's deduction in 1991 would be $7,692.31. This will also yield equivalent results to taking an $8,000 deduction in year two if the taxes on the earnings of the fund are not deductible.

The following table demonstrates the equivalence between an $8,000 deduction in year two (where the cash is actually transferred from X to Y) and a $7,692 early accrual in year one (where the cash remains with X until year two when X transfers $8,000 to Y). The example assumes $7,692 of gross income in year one and $8,000 of gross income in year two.
<table>
<thead>
<tr>
<th></th>
<th>Proper Deduction in Year Two</th>
<th>Early Accrual in Year One</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$7,692</td>
<td>$7,692</td>
</tr>
<tr>
<td>Deduction</td>
<td>0</td>
<td>7,692</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>7,692</td>
<td>0</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>3,077</td>
<td>0</td>
</tr>
<tr>
<td>Investment</td>
<td>4,615</td>
<td>7,692</td>
</tr>
<tr>
<td>Investment Return</td>
<td>308</td>
<td>513</td>
</tr>
<tr>
<td>(6.67%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>123</td>
<td>205</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>4,800</td>
<td>8,000</td>
</tr>
<tr>
<td>Gross Income</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Deduction</td>
<td>8,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0</td>
<td>8,000</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>0</td>
<td>3,200</td>
</tr>
<tr>
<td>Investment Amount</td>
<td>4,800</td>
<td>4,800</td>
</tr>
</tbody>
</table>

Taking an $8,000 deduction in year two yields equivalent results to taking a $7,692 deduction in year one if the taxes on the earnings of the set aside funds are not deductible.

By taking a $9,000 deduction in 1991, which was $1,500 too much (using a before-tax rate of return with deductibility of the taxes on the earnings), X has in essence expensed an asset with a cost of $1,500. If our tax system allowed X to do this, X would achieve the equivalence of exempting the income on $1,500 of cash or property that was contributed to the fund. During 1992, the fund earned income of $600. This amount can be bifurcated into the earnings on the proper amount that was contributed to the fund and the remainder is attributable to the excess amount. The proper amount that was contributed into the fund is $7,500. This amount generated earnings of $500. The tax at a 40 percent rate equals $200. The excess amount of $1,500 generated earnings of $100. The tax on this amount equals $40.

If X could immediately deduct $1,500, then X only needs to initially set aside $900 at a 40 percent tax rate. By expensing the
cost of the investment, \( X \) can increase the investment to \( I/(1 - t) \), where \( I \) is the amount of income to be invested and \( t \) is the tax rate. In this case, it would be \( $900/(1 - .40) \) equalling \( $1,500 \). Cary Brown would describe the government as being a partner with \( X \), with \( X \) contributing \( $900 \) and the government contributing \( $600 \). At a before-tax rate of return of 6.67 percent, the set aside funds of \( $1,500 \) will earn \( $100 \) of which \( X \) must pay \( $40 \) in taxes. If the taxes are deductible and the original \( $1,500 \) plus the investment return of \( $100 \) is included in gross income the beginning of the second year when the contest is settled, this is equivalent to never having set aside the excess \( $1,500 \). The following chart demonstrates this, assuming \( $1,500 \) of gross income in year one and zero gross income in year two:

<table>
<thead>
<tr>
<th></th>
<th>No Set Aside</th>
<th>Set Aside</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Deduction</td>
<td>0</td>
<td>1,500</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>1,500</td>
<td>0</td>
</tr>
<tr>
<td>Taxes</td>
<td>600</td>
<td>0</td>
</tr>
<tr>
<td>Investment</td>
<td>900</td>
<td>1,500</td>
</tr>
<tr>
<td>Investment Return</td>
<td>60</td>
<td>100</td>
</tr>
<tr>
<td>Taxes</td>
<td>24</td>
<td>40</td>
</tr>
<tr>
<td>After-Taxes</td>
<td>936</td>
<td>1,576</td>
</tr>
<tr>
<td>Gross Income</td>
<td>0</td>
<td>1,600</td>
</tr>
<tr>
<td>Deductions</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0</td>
<td>1,600</td>
</tr>
<tr>
<td>Taxes</td>
<td>0</td>
<td>640</td>
</tr>
<tr>
<td>Investment</td>
<td>936</td>
<td>936</td>
</tr>
</tbody>
</table>

In other words, by allowing \( X \) to deduct the taxes paid on the earnings of the fund of \( $1,500 \) and then requiring \( X \) to include \( $1,600 \) in gross income at the beginning of year two when the contest is settled, \( X \) will be in the same position as if \( X \) never contrib-
uted the $1,500 to the fund. Or, in the alternative, at the beginning of year two, X by including $1,600 in gross income and paying $640 in taxes on this amount is merely returning the government's portion as a partner. The government originally put up $600 for one year at a 6.67 percent rate of return and the government is getting this amount back totalling $640 ($600 plus 6.67 percent times $600). The benefits of the Cary Brown model, which X received in year one by immediately deducting $1,500 into a fund that X would eventually receive back, have been recaptured by X in year two. Tax deferral has been eliminated through yet another method.

Probably, the easiest method to eliminating tax deferral in the case of contested liabilities is a wait and see approach. The funds that are set aside are earning a rate of return that is still taxed to the settlor of the fund. In other words, for tax purposes, it is as if the settlor still has the use of the funds because the settlor is taxed on the earnings of the funds. If Congress were to allow a deduction when the contest is settled rather than when the money (or property) is set aside into a fund, then no tax deferral is taking place and no need exists to have a double inclusion in income when the contest is settled.

V. SUMMARY OF COMMENTS ON THE VARIOUS METHODS OF ELIMINATING DEFERRAL

In recent years, the government has developed and implemented at least five methods of eliminating the benefits of tax deferral, each of which has been described in this Article. All five methods are intended to eliminate the benefits of tax deferral, which they do. Although eliminating the benefits of tax deferral is an important goal of the government, it would be ideal if the government could select one method and utilize it on all occasions or at least on as many occasions as possible. Admittedly, however, it may not be possible to have one method that can apply in all situations.

The interest charge method appears to be a very straightforward and in most cases a relatively simple method of eliminating tax deferral. It is a payment to the government, which the government retains. There is no need for the taxpayer to keep a balance with the government or for the government to refund money at some time as it does under the deposit method. In addition, the interest charge method, at least the method under section 453A(c),
requires a relatively simple calculation to be performed once at the end of each year. The interest charge method also is more direct than the other methods, resulting in the amount owed to the government rather than the amount of a deposit, or an amount of imputed income, which must then be included in gross income to determine the amount of additional taxes owed the government.

The interest charge method as currently implemented by the government is not without its disadvantages. One major disadvantage appears to be that the government uses the highest tax rate in the Code instead of the taxpayer's marginal tax rate, which would be a more accurate measure, in computing the amount of deferred taxes. This problem could be easily corrected by adopting the taxpayer's marginal tax rate for each year in which the computation is made. A second disadvantage to the interest charge method is that the government treats the interest as interest on a tax deficiency, which is nondeductible personal interest for a noncorporate taxpayer. As demonstrated earlier in the Article, the nondeductibility of the interest destroys the parity that the interest charge method was intended to create. Finally, the rate of interest charged by the government may be substantially different than the taxpayer's rate of return. Depending on which rate is greater, this could be an advantage or disadvantage to the taxpayer or the government. Ideally, the rate of interest charged by the government should equal the taxpayer's rate of return.

There are situations in which the interest charge method has not been used. For example, it traditionally applies to transactions in which income is recognized but not with respect to claims for deductions. It could be modified so that it would apply to deductions. If a taxpayer ultimately took too large a deduction in a particular year, the taxpayer could be forced to pay interest to the government when the correct amount of the deduction is determined in a later year as is required under the interest charge for the PFIC regime. In addition, it appears that the interest charge method of section 453A(c) could be used for all installment sales rather than using a different method under section 453(l)(3) for dealers in timeshares and residential lots. Also, the interest charge method appears to be adaptable for use by automobile dealers in deferring income as opposed to the imputed income method.

More important than adopting and implementing one method for preventing tax deferral, however, is ensuring that each of the

174. See supra text at part IV.A.
ELIMINATING TAX DEFERRAL

methods currently in place prevents tax deferral in a fair and equitable manner. Unfortunately, the current provisions of the Internal Revenue Code do not achieve this result. As previously mentioned, under the interest charge method, the interest should be deductible even if paid by a noncorporate taxpayer. In addition, in computing the amount of deferred tax liability, it appears that a more accurate measure would be to use the taxpayer's marginal tax rate instead of the highest section 1 or section 11 rate. Finally, the rate of interest charged by the government should be equal to the taxpayer's rate of return.

The immediate inclusion of income method is probably the most direct method of preventing tax deferral. If a taxpayer is forced to recognize income each year, whether by denial of the use of the installment method for an installment sale or the more radical approach of adopting mark-to-market accounting, no tax deferral is taking place except within a particular year. Implementation of this method would force the income tax system closer to the Haig-Simons model, which most tax theorists feel is the ideal definition of income. There are the obvious disadvantages to the immediate inclusion of income method, including lack of liquidity to pay the tax liability. In addition, valuation and possibly constitutional problems would arise under a mark-to-market regime.

The imputed interest method also does not prevent tax deferral in a completely equitable manner. In computing the amount of imputed interest each year, it appears that an after-tax rate of return should be used as opposed to a before-tax rate of return. Under the current provisions that employ a before-tax rate of return, the taxpayer is better off by immediately including the prepayment in gross income. This lack of parity seems to violate the objective of the imputed interest method, which is to provide relief to automobile dealers in terms of cash flow, yet still achieve parity in terms of tax consequences. In addition, from a strictly theoretical standpoint, using a single rate of interest to compute the amount of imputed interest each year seems to lead to inaccurate results. The amount of imputed interest each year may be inconsistent with economic reality because short-term rates differ from long-term rates and also the term of the deferral keeps getting

shorter as time passes.\textsuperscript{176} As a practical matter, however, the use of a single rate of interest is probably the best method based in large part because of simplicity.\textsuperscript{177}

The deposit method also has its advantages and disadvantages. The use of the highest section one rate plus one percent for determining the amount of the deposit is too high. Prior to the 1993 Act, the highest section one rate was 31 percent and the maximum corporate rate was 34 percent. As a result, the rate under the deposit method of section 7519 was 32 percent (31 percent plus one percent). Use of a 32 percent rate could be justified, however, because, if a partnership had corporate partners, the corporate partners could be subject to tax at a top rate of 34 percent and achieve a three percentage point deferral if the lower 31 percent individual rate were used in calculating the deposit. The 31 percent plus one percent rate presented a compromise for partnerships, which may have a combination of individual and corporate partners. After the 1993 Act, however, the rate under section 7519 is 40.6 percent, which is 1 percent above the individual rate and 5.6 percent above the corporate rate.\textsuperscript{178} This rate no longer offers a compromise but rather provides a rate that is above both the individual and corporate rates. Consequently, as a practical matter, it appears that fewer partnerships will want to make the section 444 election today.

In addition, by making the deposit under section 7519, the partnership not only loses a rate of return on the money but also does not make a direct interest payment to the government. In other words, it is as if the partnership paid the government, as a deductible interest payment, its rate of return on the deposited funds. As a result, parity is achieved because the partnership’s rate of return equals the government’s rate of interest charge and the partnership receives the equivalent of a deduction so that a wash takes place. Thus, the deposit method offers an advantage over the interest charge method in which the government treats the interest payment as personal interest for noncorporate taxpayers.

The double inclusion method is a relatively simple method of preventing tax deferral. It seems to be just as easy to adopt a wait-and-see approach. Under a wait-and-see approach, the government

\textsuperscript{176} Bankman & Klein, \textit{supra} note 175, at 336.
\textsuperscript{177} See 2 BITTKER & LOKKEN, \textit{supra} note 7, at $\S$ 56.2 (1994 Supp.).
\textsuperscript{178} See Ann. 94-5, 1994-1 C.B. 901, in which the Service reminds partnerships and S corporations that the rate under sections 444 and 7519 has been increased to 40.6 percent.
would disallow a deduction for a contested liability until the con-
test is settled. Congress has adopted a similar approach for work-
ers' compensation and torts in that an accrual method taxpayer
cannot deduct such liabilities until payment is made. Treasury
has extended this requirement for other types of liabilities of an
accrual method taxpayer. On the other hand, the advantage to
the double inclusion method is that the taxpayer's deduction is ac-
celerated, which is justifiable because the taxpayer has parted with
cash or property.

VI. Conclusion

Regulating the time value of money benefits of tax deferral is
an important goal of the government. With interest rates at rela-
tively low levels for the last several years, the loss of revenue to the
government from tax deferral has not been as great as it would
have been in the late 1970s and early 1980s when interest rates
were near 20 percent. Prevention of tax deferral, however, remains
an important government objective, at least in terms of revenue.
Unfortunately, the government has not applied any type of uni-
form standard or method in preventing tax deferral. Five different
methods of tax deferral have been discussed in this Article. It is
possible (and unfortunately likely) that in the future the govern-
ment may implement other methods of preventing tax deferral.
For example, one possible method is to require a taxpayer to in-
clude an annual rate of growth in income each year from property,
similar to the imputed income method. As this Article has at-
ttempted to show, the last thing the tax system needs is another
method of preventing tax deferral.

A significant reform would be made if the government utilized
a single method of preventing tax deferral. If that is impossible,
then at a minimum each method of preventing tax deferral should
achieve the same results as the other methods. As this Article has
demonstrated, the Cary Brown model provides a unifying theory
showing how taxpayers can benefit from tax deferral and how the
government can prevent tax deferral. The Cary Brown model also

180. Treas. Reg. § 1.461-4(g) (payment constitutes economic performance for liabilities
arising under a workers compensation act, tort, breach of contract, or violation of law; re-
bates and refunds; awards, prizes, and jackpots; insurance, warranty, and service contracts;
certain taxes; and certain other liabilities).
181. See Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition
shows that with a few significant changes the government could achieve parity among the various methods.