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Realization, Recognition, Reconciliation, Rationality and the Structure of the Federal Income Tax System

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REALIZATION, RECOGNITION, RECONCILIATION, RATIONALITY AND THE STRUCTURE OF THE FEDERAL INCOME TAX SYSTEM

*Patricia D. White**

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Federal income tax reform is much talked about these days. No longer the sole province of the person with a professional interest in the tax system, tax reform is discussed, at some level or other, by people in every walk of life. This recent popularity is due largely to the widespread unpopularity of the current system. This popularity is also responsible, unfortunately, for making large-scale, reflective, and systematically coherent reform highly unlikely, and for ensuring that frequent, politically motivated, piecemeal legislative change will continue. The Tax Reform Act of 1986 probably illustrates the most

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to be hoped for in the present climate.¹ Nonetheless, talk of real reform will surely persist, and theoreticians of tax policy will continue to do the hard work that ought to underlie tax reform.

Despite the skepticism revealed by the above remarks, this article, too, is a plea for reform. It is not, however, directed at the ills that have stirred public discontent and made tax reform such a popular topic. Instead, it addresses the conceptual features that characterize the federal income tax system as a system. I am interested in changing the way we think about certain fundamental aspects of any income tax system and thereby in clarifying the way we describe, explain, understand, and argue about our own system, whatever it may look like at a particular time. Call this an argument for conceptual reform.

Serious normative discussion about our tax system typically falls into one of two broad spheres. The first is concerned principally with the interpretation of existing law. Such discussions are normative because they attempt to establish how a particular circumstance or sort of circumstance *ought* to be treated by the tax law as it in fact exists. This sort of normative discussion is very common, since a salient characteristic of federal income tax law is the frequent opportunity for disagreement about the details of its application. Arguments about the actual intent or content of the Code, Regulations, administrative positions, and case law fall within this category.

The second sphere of discussion is more obviously normative, encompassing accounts of what the tax law ought to be. Usually these fall under the broad rubric of discussions of "tax policy." In this group I include discussions of the hard questions surrounding social and economic goals, political expediency, administrability, and other questions concerning the proper role in society of the tax rules, their effects, or both. I conceive of policy questions as those focusing on what makes a *good* system or *good* rule or set of rules within a system. Policy discussions can concentrate on asking what the goals of the set of tax rules ought to be as well as on asking how best to implement particular goals.

The distinction between discussions that purport to be about how existing law should be interpreted and those that purport to be about

1. For a brief and characteristically wise account of the nature of the reform achieved by the Tax Reform Act of 1986, see Bittker, *Tax Reform — Yesterday, Today, and Tomorrow*, 44 WASH. & LEE L. REV. 11 (1987). For a lively account of the background to the 1986 legislation, see Chirelstein, *Back from the Dead: How President Reagan Saved the Income Tax*, 14 FLA. ST. U. L. REV. 207 (1986). For an analysis of the prodigious rate of recent tax reform, see Doernberg & McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

what the law ought to be is rough at best,² and it is not my intention to make overmuch of it. Indeed, discussions within each sphere often make use of arguments from the other. Thus, for example, it is common practice to invoke fairness in an argument for reading the Code (or legislative history or administrative pronouncements or case law) one way rather than another. Similarly, an argument that something constitutes good policy may make persuasive use of the claim that current law can be interpreted in a particular way.

Normative discussions of both sorts sometimes rely on claims about the internal coherence of the tax system itself. Arguments for or against a particular interpretation or policy frequently are based on concerns for the internal coherence or rationality of the system. Professor Wayne Barnett's celebrated *amicus* brief in *Commissioner v. Tufts*³ provides an instructive example.

In *Tufts* the Supreme Court was asked to determine the amount realized by a taxpayer who had sold property subject to a nonrecourse mortgage whose face value exceeded the fair market value of the property. The United States Court of Appeals for the Fifth Circuit had held that the amount realized was limited to the fair market value of the property. The government argued that the amount realized for the asset included the full face value of the assumed mortgage. The government's argument was based on the view that the *Crane*⁴ rule's inclusion of an assumed loan's face value in a seller's amount realized and its corresponding inclusion of the amount of a purchase money mortgage in an asset's basis should be generalized to apply to the unusual case where the value of the property is less than the outstanding amount of the mortgage.⁵ The Supreme Court overruled the Fifth

2. Some might deny even the possibility of such a distinction on the ground that law can be read or interpreted to say almost anything the interpreter desires, but that sort of analysis seems ill-suited to interpretation of the Internal Revenue Code.

3. Brief for *Amicus Curiae*, *Commissioner v. Tufts*, 461 U.S. 300 (1983) (No. 81-1536). Barnett's position was rejected by the Court but was accorded respect unusual for an *amicus* brief. The majority opinion devotes a footnote to describing his argument and says that, "[a]lthough this indeed could be a justifiable mode of analysis, it has not been adopted by the Commissioner." *Commissioner v. Tufts*, 461 U.S. 300, 310-11 n.11 (1983). Justice O'Connor, concurring, endorsed Barnett's view in theory, saying, "were we writing on a slate clean except for the decision in *Crane v. Commissioner*, 331 U.S. 1 (1947)," she would take Barnett's approach. *Tufts*, 461 U.S. at 317 (O'Connor, J., concurring). Barnett's brief has also provoked unusual interest among commentators. See, e.g., M. GRAETZ, *FEDERAL INCOME TAXATION* 234 (1985); Andrews, *On Beyond Tufts*, 61 *TAXES* 949 (1983); Lurie, *New Ghosts for Old — Crane Footnote 37 Is Dead (Or Is It?)*, 2 *AM. J. TAX POLY.* 89 (1983).

4. *Crane v. Commissioner*, 331 U.S. 1 (1947).

5. Whether the *Crane* rule should be generalized to apply to this kind of circumstance was put into doubt in footnote 37 of the *Crane* opinion itself. There, in a celebrated piece of dictum, the Court wrote:

Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a

Circuit and adopted the government's position.

Barnett's *amicus* brief argued that the issue had been miscast by the government and that it was a mistake to view the case simply as presenting the question of how much the seller had realized for the asset upon its sale. Instead, he argued, the transaction should be viewed as *two* dispositions and the "amount-realized" question should be asked for each. Thus, the seller is indeed selling the property, but he is also disposing of a liability. Each disposition has an associated gain or loss. Any gain associated with the asset is capital gain, subject, at the time of *Tufts* (and probably soon again), to a preferential tax rate, while any gain associated with relief from the liability is ordinary income. The *Tufts* facts suggest a capital loss on the sale of the asset and an ordinary gain as a result of the liability relief.

Barnett's argument is interesting in part because he maintains that the law, properly interpreted, *does in fact* require the kind of bifurcation he describes and because he gives as evidence for that claim an argument that appeals to the coherence and rationality of the system:

A rational system for measuring income also requires, however, that all receipts and expenditures be accounted for at some time and hence that those that are not finally accounted for when they occur be kept in a suspense account so that proper account can be taken of them at another time. In the case of an asset, the amount that needs to be kept track of (the unaccounted-for prior expenditures) has by statute been given a name — it is the taxpayer's "basis" for the asset (§ 1012) — and the necessity of having such an account is therefore familiar. But there is obviously just as much need to keep track of a taxpayer's unaccounted-for prior receipts with respect to a liability, and that amount too needs to have a name.⁶

Thus, Barnett appeals to the coherence and rationality of the system as a justification for his interpretation of the law. Yet, only if one assumes that the tax system *is* in fact consistently coherent and rational, or if a tax system (or at least our tax system) *ought* to be coherent and rational, can the requirements of rationality be a reason for accepting Barnett's interpretation. The first proposition is clearly false. The second is a normative claim and itself requires justification. An appeal to internal systemic coherency or rationality does not, by itself, provide a reason — sufficient or otherwise — either for inter-

different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

Crane, 331 U.S. at 14, n.37. The first case directly to address the issue was *Millar v. Commissioner*, 577 F.2d 212 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978), which held that the taxpayer's gain was not limited by the fair market value of the abandoned property. *Millar*, 577 F.2d at 215-16. For a brief, but clear and illuminating, discussion of this part of the background to *Tufts*, see *Andrews*, *supra* note 3, at 950-52.

6. Brief for *Amicus Curiae*, *supra* note 3, at 3-4 (emphasis added).

preting the tax law in a particular way or for making a policy judgment. Moreover, any argument for the claim would itself be an instance of a normative discussion about what the law should be rather than a discussion about how the law as it is should be interpreted. As it happens, Barnett neither makes nor acknowledges the need for such an argument.⁷

Barnett is not unusual in this respect. Even people who rely on claims about systemic coherence or rationality when arguing for a particular interpretation of tax law or for some tax policy do not directly confront the question whether the system *should* be rational or coherent. Yet given the obvious lack of consistency and coherence among the hundreds of provisions in the current Internal Revenue Code and the piecemeal character of tax legislative activity, it is an argument that must not seem self-evident to those who formulate our tax law. To what extent, if any, should internal coherence and rationality be goals of an income tax system?

Having asked the question, this article does not purport to answer it.⁸ It does, however, try to do some of the work that a serious answer would require. To that end, it focuses on the underlying structure on which the content of the tax law hangs. By isolating the structure of tax systems generally, perhaps we can come to understand and describe our own system better, and to begin to develop a more useful and richer conceptual vocabulary that is independent of concerns about the content of the tax base. Only then can we be more self-conscious about exactly what coherence and rationality in our tax system might mean, and about the possible tradeoffs between that value and other values that we might want the system to embody. Further, we should gain a better understanding of the structure of our arguments about the content of the income tax system.

I begin, then, with the observation that systemic coherence and rationality are not necessary qualities of a tax system. Are there, nonetheless, any structural features that must, as a matter of logic, underlie *any* tax system? On examination, there *are* a few structural requirements that are necessarily common to any tax system. In Part

7. This may be somewhat unfair to Barnett since he only speaks here of rationality and not of coherence. If it is rational — as indeed it might be — to talk about its being rational for a tax system to be comprised of an incoherent collection of rational parts, then Barnett need only argue that the component parts of the tax system ought to be rational. He does not make this argument either. Moreover, at another point in his brief he writes, “And that, of course, is just as it *should and must be*: given the treatment of the ‘opening’ transaction as an independent liability-creating transaction, no other treatment of the ‘closing’ transaction would be *coherent*.” *Id.* at nn.7-8 (emphasis added).

8. Nor does it argue for or against particular applications or interpretations of current federal income tax law, nor make recommendations about what the content of the tax law ought to be.

I of this article I examine those requirements. I show that by isolating the necessary structure of a tax system from its particular content or goals, we can better understand the role played within the federal system of certain of its most characteristic features. In particular, I trace the function of the realization requirement for the recognition of income and distinguish it from another sort of function that could lead to the recognition of income within an income tax system. This second function is a corrective one, and it is achieved in the federal system by a mechanism I call "reconciliation."

Reconciliation has considerable descriptive power within the federal system. I show this in Part II by examining, as examples, three general circumstances that are well described as instances of reconciliation. Two of the three lead to the recognition of income, yet neither can be properly described in terms of realization.⁹

Finally, in Part III, I argue that the notion of reconciliation can play an important role in normative discussions about the federal income tax system. This role has two parts. First, reconciliation describes actual phenomena within the federal system with more coherence and rationality than traditional vocabulary and concepts allow. Those who accept coherence within a tax system as a value will attach some value to that description. Second, describing those phenomena in that way implies certain further descriptions of other parts of the tax system. Sometimes, however, these further descriptions do not fit the law as it actually is, and so the overall coherence of the system will turn out to be less than it would have been if the law had been otherwise. In such cases, a desire for coherence above all else would indicate that the law ought to be changed. However, other, sometimes competing, values such as administrability or equity, can be relevant to determining whether the law really should be changed. When values compete, one will have to choose between particular aims on the one hand and the coherence and rationality of the system on the other. My purpose here is not to recommend a particular choice among these options, but rather to establish that self-conscious articulation and exploration of those values and their importance should be a goal of normative discussion about our income tax system. In Part

9. My interest in this sort of inquiry stems from my observation of our current system's inability to account easily for amounts that it includes in taxable income under the rubric of the tax benefit rule. The system seemed to struggle unduly to describe in its own terms what seemed to be a reasonably plausible, common-sense principle. It appeared to be missing the explicit conceptual apparatus that it should have for that task. In an earlier paper I suggested a conceptual framework within which the tax benefit rule could be more easily understood and described as a feature of the federal income tax system. See White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486 (1983).

III, I illustrate this argument by showing that, in contrast to the usual description, reconciliation allows us to describe the tax treatment of simple borrowing in a way that is internally consistent and coherent. I discuss the implications of this coherent description for the analysis of purchase money mortgages and for the central issue in *Tufts*. Ironically, although my analysis does suggest the kind of transactional bifurcation advocated by Barnett, the requirements of rationality turn out to be somewhat different from what he claims, and to come closer to the current system than we might expect. There are important respects, however, in which the analysis is not consistent with current practice. Instead of arguing that the law ought either to be reformed or differently interpreted, I explore one significant administrative cost of implementing the analysis and suggest that a full articulation of the issue in *Tufts* would be more complicated than indicated by either Barnett or the Supreme Court.

I. THE BASIC STRUCTURE OF ANY TAX SYSTEM

Any tax system must make some effort to determine what is potentially taxable. If it is a system that purports to tax income, it need not define "income," but it must nonetheless offer some means of identifying that which might be taxed.¹⁰ Once something has been deemed potentially taxable, a system has three possible responses: it can tax the item or amount currently, it can tax it later, or it can exempt it from taxation.¹¹

No tax system need employ all three basic responses, much less any of their variations.¹² The simplest system would first determine

10. I use the phrase "potentially taxable amount" rather than the word "income" to designate that which falls within the purview of a taxing system. This is because all that is logically required of the structure of any income tax system, as of any tax system of whatever description, is some means of dividing the world into those items that might possibly be taxed and those items that could not be.

11. Actually, there is a fourth general possibility — some combination of the other options — but since it is clearly a derivative of the others, I shall not isolate the idea of an allocation scheme in the following discussion.

12. Items that satisfy the threshold criterion (whatever that may be) must be reacted to by the system in one of the three basic ways. Those items that do not (and there need not be any of them), simply elicit no reaction (although this effect, of course, is equivalent to being excluded). A system with a clear definition of "income" might use that definition as the threshold criterion for dividing the world. Any system (like the federal income tax system) with no clear definition of "income," could employ other criteria to make the division — or it could employ none, and make no division at all. A system might well operate with some implicit sense of what should be included in "income," and its reactions to the items it considers could be arranged so as to tax only those items deemed to be "income." (In fact, the federal income tax system may operate to some extent in this last way. In the federal system, taxable income is determined in part by deducting from gross income those expenses that it is thought appropriate to net against revenue included in gross income. For an interesting criticism of the idea that tax accounting should accept this sort of matching as a central principle, see Gunn, *Matching of Costs and Revenues as*

that something is potentially taxable and then immediately tax it. Perhaps some sort of periodic accounting convention would be instituted for administrative ease, but the principal inquiry in such a system would be *what* to tax.¹³ The only significant additional complications in such a system would involve the quantification and valuation of what was to be taxed.¹⁴

A more complicated system might allow either of two reactions to the determination that something is potentially taxable: tax it now or tax it later. As before, if something were deemed to be within the aegis of the tax system it would be taxed, but in this sort of a system the timing could vary. Various sorts of criteria might be used to determine which reaction was appropriate: random choice, alternating reactions, or reactions designed to bring about a particular state of affairs. The many examples of the latter include the desire to maximize revenue, administrative ease, social welfare, aid or comparative advantage to some group or other, and economic parity among taxpayers. Here the system must answer both the questions *what* to tax and *when* to tax it.

A system that admits of the third possible response and reacts to the determination that something is potentially taxable by taxing it currently, taxing it later, or by not taxing it after all is significantly more complex than either of the first two types. The same range of criteria is available to guide its choices as in a system with two possible reactions, but, because exclusion is now a possibility, everything that is potentially taxable need not eventually be taxed. This means that the system can use exclusion to tailor its tax base and that the determination that something is potentially taxable is not necessarily determina-

a *Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984). But see Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POLY. 191, 204 n.18 (1986). In any event, however, labeling everything that falls within the scope of some income tax system "income" for the purpose of the system would be misleading. Moreover, the term itself is so fraught with meaning that it seems ill-advised to use it schematically.

13. A system could answer the question "what is potentially taxable?" in an infinite variety of ways. Possible potentially taxable items include: salary, free time, bagels consumed, use of one's own winter jacket, and impacted wisdom teeth. Moreover, the *what* to tax question is inextricably tied to the question of *whom* to tax. Thus, the examples might include: a taxpayer's own salary, a taxpayer's spouse's free time, bagels consumed by the taxpayer's family, use of any jacket by a taxpayer's nephew, and incidents of impacted wisdom teeth on the taxpayer's block (or on some block which the taxpayer has never seen). See *infra* note 39 and accompanying text; see also McIntyre, *Implications of US Tax Reform for Distributive Justice*, 5 AUSTL. TAX F. 219, 239-40 (1988).

14. Quantification is a different issue from valuation. It arises because the world is not naturally described in numerical amounts, and a tax system would seem to require some common denominator for quantifying whatever is to be taxed. Valuation involves the actual assignment of value to whatever is to be taxed. Quantification and valuation issues can both be intractable, and I have no intention of minimizing either their importance or their difficulty.

tive of what will in fact be taxed. The increased flexibility offered by the possibility of exclusion would serve no purpose if the determination of what was potentially taxable fully satisfied the normative goals for the tax base. As a result, a system that makes use of exclusion in addition to deferral must answer an additional question: *whether* to tax that which it has deemed potentially taxable. The *what* to tax question is no longer fully answered by the determination of what is potentially taxable; instead, it is only answered as the *whether* to tax question is answered. Indeed, it may only be completely answered after the timing issues implicit in the *when* to tax question are fully resolved. The federal income tax system is a good example of this phenomenon. It does not, although its authors could have allowed it to, rely on a definition of "income" (perhaps a Haig-Simons standard)¹⁵ to determine what is potentially taxable and then use current taxation, deferral, and exclusion as mechanisms for departing from the standard established by the definition. Instead, it uses the responses themselves (particularly deduction and exclusion) to achieve something very loosely approaching a standard for income.

The crucial observation is that the three possible responses to what has been deemed potentially taxable provide a crude model for a tax system of whatever degree of complexity. By themselves, they neither prescribe nor proscribe any criteria for their application. Nor do they entail any requirement that the criteria chosen be applied consistently.¹⁶ Thus, whatever treatment an income tax system ultimately accords anything it identifies as potentially taxable can be described in terms of current taxation, deferral, or exclusion. A system need not determine at the point of the item's characterization as potentially taxable which of the three treatments it will receive. That decision may be deferred, but ultimately the item will either be taxed or excluded.¹⁷

Any criteria could be employed by an income tax system to decide whether to tax currently something deemed potentially taxable, to defer its taxation, or to exclude it from taxation. A system could be more or less systematic in its selection and articulation of these criteria. Doubtless at some point the taxing mechanism would cease prop-

15. The Haig-Simons definition of income is an ideal much favored by economists. Henry Simons' classic statement of the definition: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

16. Two distinct sorts of consistency might be required. The first is that the criteria treat the same item in the same way in identical circumstances, the second is that similar items or circumstances be accorded at least similar treatment. A *system* would seem to require consistency of the first sort. It is consistency of the second type that I am referring to in the text.

17. See *infra* text accompanying notes 38-60.

erly to be called a "system" if the choices about recognition were thoroughly *ad hoc*, but there is an enormous range within which a system could operate.¹⁸ In the United States and elsewhere there might, of course, be constitutional or other legal constraints on the content of an income tax system, but such limitations bear on the system's legitimacy, not on its status as a system.¹⁹

A system might well include some means of keeping track of how potentially taxable amounts have been treated.²⁰ This would seem particularly desirable if the system were designed so as not to tax any potentially taxable amount more than once. Income tax systems generally are characterized by this feature and, indeed, it may usefully distinguish an income tax from a wealth tax, a property tax, or a receipts tax. In the federal income tax, basis is the mechanism used to keep track of what has been taxed and what has not been.²¹ Nonetheless, a tracking mechanism is not a necessary feature of a tax system — even of an income tax system.

The essential structure of an income tax system, then, requires only a mechanism or mechanisms for identifying what is potentially taxable and a mechanism or mechanisms for determining whether that amount is to be recognized at the point of its identification, to have its recognition deferred, or to be given permanent nonrecognition treatment. The system could, of course, provide that all potentially taxable amounts are to be treated in the same specific way. In that case, there would not be any need for any separate mechanisms to determine whether or when to tax them. It is easy to lose sight of this fundamental structural simplicity when confronting a system as complex as the one embodied in the current Internal Revenue Code. Nevertheless, for

18. For example, a system could provide for the immediate recognition of everything potentially taxable, yet exclude (or permit the deduction of) all (potentially taxable) salary earned by an employee of an American automobile manufacturer (or, better yet, by a university professor). Or it might provide for a ten-year deferral of the recognition of one third of all potentially taxable amounts credited to each taxpayer born on the same day as the Commissioner of the Internal Revenue Service (a date that would doubtless vary from Commissioner to Commissioner) and for the nontaxation of all potentially taxable amounts attributed to 100,000 (or 1000 or 10) taxpayers chosen, freely with no constraints whatever, by the head elephant keeper at the National Zoo.

19. See generally Bittker & Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code*, 82 YALE L.J. 51 (1972); Norton, *The Limitless Federal Taxing Power*, 8 HARV. J.L. & PUB. POLY. 591 (1985).

20. I am indebted to Charlotte Crane for forcing me to focus on this point at this point.

21. I.R.C. § 1012 (1988) defines a property's "basis" as its "cost" to the taxpayer. I.R.C. § 1016 (1988) sets forth rules for adjusting basis upward or downward to reflect additional costs incurred by the taxpayer with respect to the property or returns to the taxpayer of the costs previously included. See *infra* note 101. Adjusted basis is the operative amount wherever the Code makes use of basis. William Andrews aptly describes adjusted basis as reflecting "the whole history of the tax treatment of an item." Andrews, *supra* note 3, at 954; see also Crane, *supra* note 12, at 217-23.

reasons that I trust will become increasingly clear, it is instructive to examine the underlying fundament.

A. *The Role of Realization*

In the federal income tax system, one mechanism used for determining that a potentially taxable amount will be currently recognized is the notion of realization. Articulating the exact content of the concept may well be impossible (if indeed there is a single coherent concept),²² but its function in the structure of the system is apparent. Simply put, our system²³ generally regards the realization of a potentially taxable amount as the occasion for its recognition. It does not, however, always recognize potentially taxable amounts when they are realized.²⁴ Nor, as long as a system has some means of determining how to treat potentially taxable amounts, is there any systemic reason why realization as intended by the federal system need play any role in the recognition/deferred recognition/nonrecognition determination.

These observations about the general structural requirements of an income tax system seem almost too obvious to be worth making. They become important, however, because they were so little understood in the early evolution of our system. As a consequence, that system became enormously complex without the degree of structural self-consciousness that one might have hoped for. This complexity, in turn, obscures both the actual relationships between central features of the

22. See, e.g., 1 B. BITTKER & L. LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* § 5.2 (2d ed. 1989); M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* ¶ 5 (5th ed. 1988); R. MAGILL, *TAXABLE INCOME* pt. I (rev. ed. 1945).

23. I emphasize "our" because an income tax system need not rely on or even have a realization requirement.

24. Several Internal Revenue Code provisions *defer* the taxation of realized amounts. See, e.g., I.R.C. § 351 (West Supp. 1990) (exchange of appreciated property for stock or securities of equal value in a corporation controlled by the transferor); I.R.C. § 354 (1988) (exchange of appreciated stock or securities in a corporate reorganization); I.R.C. § 721 (1988) (exchange of appreciated property for partnership interest); I.R.C. § 1031 (West Supp. 1990) (like-kind exchanges of appreciated business or investment property); I.R.C. § 1033 (1988) (involuntary conversion of appreciated property); I.R.C. § 1034 (1988) (sale of appreciated principal residence combined with purchase of new principal residence); I.R.C. § 1035 (1988) (certain exchanges of life insurance and annuity contracts); I.R.C. § 1036 (1988) (certain exchanges of stock for stock in the same corporation); I.R.C. § 1041 (1988) (transfers of appreciated property between spouses or incident to divorce). Elliott Manning observed to me that, as Andrews points out, some of these deferral provisions allow us to finesse difficult realization issues by postponing the question of whether income has been realized until it is no longer difficult. See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1130-31 (1974).

Other Code provisions *exclude* realized amounts from taxation altogether. See, e.g., I.R.C. § 71(c) (1988) (child support payments); § 101 (certain death benefits); § 102 (gifts, inheritances, devises); § 103 (interest on certain government obligations); § 104 (certain compensation for personal injury and sickness); § 112 (certain armed forces combat pay); § 117 (certain scholarships); § 119 (meals or lodging furnished for an employer's convenience); § 121 (gain on sale of principal residence by an individual aged 55 or older); § 132 (certain employee fringe benefits).

Code and the fact that there are a few structural requirements. One of these requirements is the need for a mechanism or mechanisms whereby a system can determine when and whether to tax that which it deems potentially taxable. I am not, in this article, going to address directly the issues surrounding the choice of what to deem potentially taxable, but it is through its response to the determination that something is potentially taxable that any system prescribes whether and, if so, when, the item will be taxed.

Realization was first articulated by the Supreme Court as a condition of taxability in 1920 in *Eisner v. Macomber*.²⁵ Few transactions are as famous as Mrs. Macomber's receipt of a stock dividend from Standard Oil, and no one who has borne with me thus far can have avoided acquiring more than passing acquaintance with that case.²⁶ It is repeatedly cited both as the case that held that the Constitution imposed limitations on what could be deemed to constitute income²⁷ and as the case that actually tried to spell out a definition of "income."²⁸ Both the notion of defining income for tax purposes and the notion of grounding that definition in the Constitution now strike us as quaint, and the case seems to be preserved largely for its antiquarian value.²⁹ I think, however, that its actual legacy is greater than is commonly thought.

25. 252 U.S. 189 (1920).

26. On January 1, 1916, Standard Oil Corporation issued a 50% stock dividend to Mrs. Macomber and the other Standard Oil stockholders as a result of its transfer of an equivalent par amount from its surplus account to its capital account. Of this amount, 18.07% represented surplus earned between March 1, 1913 (the effective date of the sixteenth amendment), and the date of distribution. Therefore, when Mrs. Macomber received 1100 shares of the new common stock in the distribution, the Commissioner of Internal Revenue assessed income tax on her "income" of \$19,877, an amount equal to 18.07% of the par value of the total stock she received. Mrs. Macomber paid the tax under protest but lost her appeal to the Commissioner. She then sued for a refund, contending that the Revenue Act of 1916, which provided that stock dividends constituted income taxable under the Act, was unconstitutionally taxing her Standard Oil stock dividend as income.

The Supreme Court agreed and held that the stock dividend was not income within the meaning of the sixteenth amendment because a mere growth of value in a capital investment did not constitute income. To be income, the gain had to proceed from capital, be severed from it, and be received by Mrs. Macomber for her own separate use or benefit. Since the stock dividend represented undistributed corporate earnings, the Court declared that the Revenue Act of 1916 unconstitutionally required that stock dividends be taxed as income.

27. *Macomber*, 252 U.S. at 211. See, e.g., W. ANDREWS, BASIC FEDERAL INCOME TAXATION 123-24 (3d ed. 1985); B. BITTKER & J. EUSTICE, FUNDAMENTALS OF FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.60 (1980 & Supp. 1989); M. GRAETZ, *supra* note 3, at 201.

28. *Macomber*, 252 U.S. at 207. See, e.g., W. ANDREWS, *supra* note 27, at 212; M. CHIRELSTEIN, *supra* note 22, at 8-9; M. GRAETZ, *supra* note 3, at 110.

29. The *Macomber* result is encompassed today by § 305 of the Code. However, § 305 limits the extent to which stock dividends are nontaxable. For example, a stock dividend is fully taxable if the shareholder can elect whether to receive it either in stock or property. I.R.C. § 305(b)(1) (1988).

The task the Court set itself in *Macomber* was to discover what "income" meant in common parlance. The Court interpreted the sixteenth amendment as using the word in its ordinary sense and thought its task was to give "only a clear definition of the term 'income,' as that used in common speech, in order to determine its meaning in the Amendment."³⁰ This general view had been articulated two years earlier by Learned Hand in *United States v. Oregon-Washington Railroad and Navigation Co.*³¹ The meaning of "income" in the sixteenth amendment, Hand wrote, is "to be gathered from the implicit assumptions of its use in common speech."³² The *Macomber* Court attempted to do so:

Here we have the essential matter: *not* a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; — that is income derived from property. Nothing else answers the description.³³

Here, the *Macomber* Court was making not as much a constitutional claim as a linguistic one. To be sure, the decision gave constitutional status to the requirement that gain from property be realized, but that status was presumably derived from the Court's finding about the ordinary meaning of "income," rather than the other way around. If the ordinary understanding of the word had been different, the content of *Macomber's* constitutional requirement should have differed accordingly. Realization was important to the Court because they viewed it as part of what people meant when they spoke about income. Thus, it would seem that the content of the concept of realization could, in principle at least, evolve as the language evolved.

Although *Eisner v. Macomber* has long since ceased to be important as a source of a definition of income or as constitutional interpre-

30. *Macomber*, 252 U.S. at 206-07. The Court noted that economists distinguish between "capital" and "income" in various terms, including likening "capital" to a tree or a piece of land with the resulting fruit or crop constituting the "income." However, the Court viewed the case at hand as requiring only an "ordinary" definition of income. The Court cited as examples of its "ordinary" definitional approach two earlier excise tax cases, *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913), and *Doyle v. Mitchell Bros.*, 247 U.S. 179, 185 (1918), in which the Court had rejected "theoretical" distinctions between capital and income for a definition in its "natural and obvious" sense. *Macomber*, 252 U.S. at 207.

The Court relied on this same "common speech" approach in subsequent cases as well. See, e.g., *Merchants' Loan & Trust v. Smietanka*, 255 U.S. 509, 519 (1921) (income given its "commonly understood meaning," not as defined by "lexicographers or economists").

31. 251 F. 211, 212 (2d Cir. 1918).

32. 251 F. at 212.

33. *Macomber*, 252 U.S. at 207.

tation,³⁴ the sense that realization is intimately tied to the *meaning* of "taxable income" has survived. Although some writers are careful to refer to realization as an administrative rule intended to establish the time for taxation,³⁵ others write of it, at least implicitly, as a *requirement* of taxability.³⁶ Possibly because the effort to define income for purposes of the tax system has been dropped, often no clear line is drawn between the part of the phrase "taxable income" that is concerned with *what* might be taxed (the potentially taxable amounts) and the part that is concerned first with *whether* and then with *when* it is taxed. From the point of view of understanding the structure of an income tax system, the difference is crucial.

As a theoretical matter, of course, unless a requirement of realization is built into an income tax system's very conception of taxable income, a potentially taxable amount need not be realized to become taxable income.³⁷ It may be, however, that amounts which are potentially taxable within the system must be realized to be taxed. If a system conditions taxability on realization (or on anything else for that matter), while nonetheless maintaining that the basic notion of potential taxability is independent of realization (or independent of that "anything else"), it necessarily has a concept of taxable income distinct from its concept of potential taxability. My discussion throughout reflects this distinction.

The taxonomy of the relationship in the federal income tax system between the determination of a potentially taxable amount and the determination of whether and when to tax it is more complex than appears at first blush. It begins with the identification of an item as within the aegis of the system (that is, as potentially taxable).³⁸ The identification can be complicated by questions of *whose* potentially tax-

34. See, e.g., B. BITTKER & L. LOKKEN, *supra* note 22, at § 5.1; M. CHIRELSTEIN, *supra* note 22, ¶ 5.01, at 68-69; M. GRAETZ, *supra* note 3, at 110, 202.

35. See, e.g., M. CHIRELSTEIN, *supra* note 22, ¶ 5.01, at 68; H. SIMONS, *supra* note 15, at 207-08; Andrews, *supra* note 24, at 1140-48; Kahn, *Accelerated Depreciation — Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 7-9 (1979).

36. See, e.g., B. BARTON, R. CAMPFIELD, *et al*, *Taxation of Income 1988-1989*, at ¶ 2511 (1988); D. POSIN, *FEDERAL INCOME TAXATION OF INDIVIDUALS* 146-48 (1983). Perhaps the clearest current counterexample to this view can be found in I.R.C. §§ 1271-1275 (1988). These provisions set forth the rules for taxing original interest discount, a form of unrealized income.

37. Even the federal income tax system occasionally taxes unrealized amounts. See, e.g., *supra* note 36; I.R.C. § 1256 (1988) (relating to certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options).

38. It is important to notice that the status of being potentially taxable within the federal income tax system is not equivalent to any of the categories identified by the Code. The broadest category specified by the Code is I.R.C. § 61 (West Supp. 1990) gross income. However, some amounts are statutorily excluded from gross income (e.g., I.R.C. § 102 (1988) (amounts received as gifts, bequests, inheritances, and devises); see *supra* note 24 for other examples) and their exclusion would be unnecessary if they were not potentially taxable.

able amount it is³⁹ and questions about the point at which it became potentially taxable (a different set of questions from questions about whether or when it should be taxed). The initial identification of something as potentially taxable very often does happen to coincide with the identification of an amount that has been realized by the taxpayer. In simple terms, something often becomes potentially taxable (although maybe not taxable income) in the eyes of the tax system at the same time that the taxpayer realizes it in the eyes of the tax system. For example, in the federal income tax system, a cash basis taxpayer's receipt of his paycheck marks both the receipt of a potentially taxable amount and its realization. But its status as potentially taxable is independent of the fact that it was realized.⁴⁰ It is clear, moreover, that amounts identified as potentially taxable are not always realized at the time of their identification. One obvious example in the federal income tax system is the so-called unrealized appreciation of an asset. Presently the federal system does not tax the appreciation of an asset until the taxpayer disposes of it and realizes its increase in value.⁴¹ There seems to be widespread sentiment among tax commentators however, that Congress could, if it chose to, tax appreciation currently.⁴² This view reflects the sense that a potentially taxable amount need not be realized to become taxable income.

Once something has been identified within the system as a potentially taxable amount, it becomes relevant to ask whether and when it should be taxed; to ask, in other words, whether it should be recognized, have its recognition deferred, or be excluded altogether from taxation (receive permanent nonrecognition treatment). These three basic responses to a potentially taxable amount are the only ones available to any income tax system. It is easy to think of examples of each

39. The question of attribution in the context of ascertaining potential taxability is likely the same as the question of attribution in the context of ascertaining actual taxability ("taxable income" in the federal system). This is because once an amount has been identified as potentially taxable to *X*, the response of the system can be to tax it (to *X*) now, to tax it (to *X*) later, or to exclude it from taxation (to *X*). If the last option is selected and the amount is instead taxed (now or later) to *Y*, then the amount can be construed as having been reidentified as potentially taxable to *Y*. Indeed, the amount may be taxed to *Y* even if it is also being taxed to *X* (and perhaps to others as well). This simply means that the same amount has been identified as potentially taxable to more than one taxpayer. In fact, because the federal system does not explicitly isolate the question of potential taxability at all, it is difficult to tell in which context an attribution question is being asked.

40. Although here it is the receipt that constitutes the realization, receipt is not a necessary condition of realization.

41. See, e.g., Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 228 (1979).

42. See, e.g., M. CHIRELSTEIN, *supra* note 22, ¶ 5.01, at 68-9; M. GRAETZ, *supra* note 3, at 201; Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 49 (1967); Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

in the context of the federal income tax. The paycheck received by the cash basis taxpayer above probably will be recognized currently,⁴³ the compensation put into an Individual Retirement Account by a taxpayer has its taxation deferred,⁴⁴ and the amount received by a taxpayer as a bequest is excluded from his income tax permanently.⁴⁵

Although a system that provides for the possibility of exclusion can only tax (now or later) or not tax amounts that it deems within its scope, it need not make the choice when it identifies those amounts as potentially taxable. Of course, if the choice is deferred, taxation at the time of identification is no longer an option and any subsequent decision to tax will have resulted in a deferral of the amount's recognition. Our system does exactly this when refusing to recognize the unrealized appreciation of an asset. Such appreciation is potentially taxable within the system and is not taxed currently, but its ultimate treatment is not settled until some later time (often the time the asset is disposed of). If, for example, appreciated stock with a basis in the hands of the taxpayer of \$10 has a fair market value of \$50 on March 3, the taxpayer has a potentially taxable \$40 that the system could tax currently. Instead the system does nothing. This leaves open both the possibility that the amount will be taxed later and the possibility that it will be excluded altogether. If the price of the shares remains at \$50 until April 2, when it drops to \$45, and if the taxpayer sells the shares on April 2 for \$45, he will normally recognize \$35. Thus, from the perspective of the situation on March 3, he has deferred the recognition of \$35 and excluded \$5 altogether. If, instead, the taxpayer were to die on April 2, holding the appreciated shares with a fair market value of \$45, current federal income tax law would exclude both the \$35 of potentially taxable, but untaxed, appreciation that the taxpayer held at his death and the potentially taxable \$5 that he had held on March 3 but that he no longer held on April 2.

Other examples are less straightforward. Suppose the stock price fluctuates between March 3 and April 2. If the price were \$48 on March 4, \$47 on March 5, \$52 on March 6, and \$50 from March 7 until the stock was sold for \$50, we cannot simply compare the sale price with the price on March 3 and say that, from the perspective of the situation on March 3, the taxation of the \$40 identified on that

43. I.R.C. §§ 61(a) and 446 (1988).

44. A qualified individual may contribute up to a specified amount (currently \$2000) to an Individual Retirement Account and deduct that amount from her gross income. I.R.C. § 219 (West Supp. 1990). Any distributions from the I.R.A. will be included in the taxpayer's gross income, so the deduction has the effect of deferring taxation on the contributed amount until a distribution is made. See I.R.C. § 408 (1988).

45. I.R.C. § 102(a) (1988).

date as potentially taxable had been deferred. Instead, it would seem as if \$2 of that amount had been lost on March 4 and another \$1 of it lost on March 5. Those lost amounts are permanently excluded from taxation. Five additional dollars were earned on March 6, and two of them were lost (and hence excluded) on March 7. Thus, from the perspective of the \$40 identified on March 3 as potentially taxable, the sale of the stock for \$50 should represent the (deferred) recognition of \$37 and the exclusion of \$3. The remaining \$3 recognized as taxable income was identified as potentially taxable on March 6, along with \$2 that was subsequently excluded.⁴⁶

This last example raises a question about the first one. What does it mean to say "from the perspective of the situation on March 3"? Unless the entire \$40 of appreciation present on that date was first identifiable on that date, it, no less than the appreciation measured on April 2, represents a net figure established over the life of the investment. In the absence of special circumstances, the choice of March 3 as a time to measure the unrealized appreciation of the stock is arbitrary. At least some of the amount identified on that date as potentially taxable likely could have been identified earlier and traced forward to March 3, just as it was traced beyond March 3 in my examples. The point of the examples is to show that the federal income tax system sometimes defers the determination of whether and when to tax a potentially taxable amount until some time after it has identified the amount as potentially taxable. It is not necessary, for this purpose, actually to specify when the identification could first have been made.

46. The federal income tax system allows some losses to be deducted from a taxpayer's gross income. In contexts where losses are fully allowed, the potentially taxable amounts that are permanently excluded from taxation because of downward fluctuations in the value of the asset would not have been taxed even if they had been recognized. Thus, in the example in the text, the \$35 gain recognized from the sale of the shares on April 2 for \$45 is the same amount that would ultimately have been recognized if the shares had been sold and repurchased each time that their value had changed and the attendant losses and gains had been recognized.

<i>Date</i>	<i>Basis</i>	<i>Sale & Repurchase Price</i>	<i>Gain or (Loss)</i>
March 3	\$10	\$50	\$40
March 4	\$50	\$48	(2)
March 5	\$48	\$47	(1)
March 6	\$47	\$52	5
March 7	\$52	\$50	(2)
April 2	\$50	\$45	(5)
Net gain = \$35			

The result would not be the same, however, in contexts where losses are not fully allowed. *See, e.g.*, I.R.C. § 165(c) (1988) (limitation on losses deductible by an individual to those incurred in a trade or business or in a transaction entered into for profit or from casualty or theft); I.R.C. § 267 (1988) (disallowance of losses with respect to transactions between related taxpayers); I.R.C. § 1091 (1988) (disallowance of losses from wash sales).

It is sufficient that the amount has been identified and that its ultimate treatment has not yet been decided.

If a decision is made not to recognize currently an amount identified by a tax system as potentially taxable, at least three general types of nonrecognition are possible. One is to exclude the amount from taxation.⁴⁷ Within the federal income tax system this result is achieved both by provisions cast explicitly as exclusions⁴⁸ and by provisions cast as deductions.⁴⁹ It is also achieved preliminarily by the realization requirement itself. Since the system normally conditions taxation on realization, much that is potentially taxable is excluded because it is lost before it is realized. This effect is illustrated by the downward fluctuations in the unrealized appreciation of the stock in the earlier examples.⁵⁰

A second possible kind of nonrecognition is deferral. A decision not to recognize currently a potentially taxable amount could be a decision to defer its recognition until some future date or event. This means, of course, that the amount would be recognized, but later. Parenthetically, it should be noted that in a pure deferral, the amount of the later recognition would be at least the amount identified as potentially taxable at the time of the decision to defer its recognition. To the extent that the later recognition were contingent upon the occurrence of a subsequent event⁵¹ or upon the taxpayer's surviving until some later date,⁵² "pure deferral" would be something of a misnomer, but it is one with which I propose to live for the moment. I am not

47. This response is possible, of course, only in a system that is sufficiently complex to include exclusion as a potential reaction.

48. See *supra* note 24 for examples.

49. See, e.g., I.R.C. § 163 (1988) (deduction for certain interest payments); I.R.C. § 164 (1988) (deduction for certain taxes).

50. See Grauer, *The Supreme Court's Approach to Annual and Transactional Accounting for Income Taxes: A Common Law Malfunction in a Statutory System?*, 21 GA. L. REV. 329, 393-97 (1986) (characterizing the realization requirement as an example of transactional accounting).

51. For example, I.R.C. § 1034 (1988) provides that a taxpayer will recognize current gain on the sale of his principal residence only to the extent, if any, that the adjusted sales price exceeds the cost of a newly purchased principal residence. The taxpayer's basis in his new residence is reduced by any nonrecognized gain. This basis adjustment serves to defer recognition of the earlier gain until the new residence is sold. The recognition is still contingent, however, on the new residence's being sold for more than its adjusted basis, on the taxpayer's not buying yet another principal residence for more than the sale price of the second one (thus falling once again within the nonrecognition provided by § 1034), and on the taxpayer's not qualifying and electing under I.R.C. § 121 (1988) (a one-time exclusion of up to \$125,000 of gain on the sale of a principal residence by a taxpayer age 55 or older) to exclude all or part of the previously deferred gain.

52. I.R.C. § 1014(a) (1988) provides that a person who inherits property takes it with a basis equal to its fair market value at the date of the decedent's death. Because no Code provision requires that either the decedent or his estate recognize any difference between the decedent's actual basis in the property and its fair market value, any previously deferred gain which was reflected in the decedent's basis (under § 1034 for example) will be permanently forgiven.

certain in fact that there are any examples of genuinely pure deferral within the federal income tax system.⁵³

A third general sort of nonrecognition is the result of a decision to ignore an event that ordinarily would trigger recognition. A decision to ignore in this context is obviously similar to the choice, discussed above,⁵⁴ to defer the decision about whether or when to tax something identified as potentially taxable.

In our current tax system, this phenomenon is illustrated by provisions tying nonrecognition to a carryover basis. There are many such provisions,⁵⁵ but a single example should illustrate the point. If taxpayer *A* buys a building for \$20,000 and its value appreciates to \$100,000, we call her gain unrealized as long as *A* continues simply to hold the building. If the building is destroyed by fire and *A* receives insurance proceeds of \$100,000, she has realized \$80,000 gain. The federal tax system generally regards the realization of gain as an occasion for the recognition of income. Section 1033 of the Internal Revenue Code allows *A* to avoid recognition of that gain if she reinvests it within a specified time⁵⁶ in "similar" property.⁵⁷ If the cost of the similar property is \$100,000, the replacement property will have the same basis as the original property.⁵⁸ Here the Code appears to indulge in a bit of metaphysical fiction and treats the replacement property *as if it were* the original, undiminished by fire. If that is indeed what is happening, then section 1033 is properly characterized as a provision that ignores the realization that the receipt of the insurance proceeds represented. That moment of realization, under this analysis, cannot be regarded as an occasion for deferral or forgiveness of the

53. I.R.C. § 1363(d) (1988) may come close to being an example of pure deferral. That section requires a corporation that converts from C status to S status to recapture the amount of any excess of its inventory valued as of the end of its last tax year as a C corporation using a first-in-first-out cost flow assumption, over its last-in-first-out value. The tax is paid in four equal installments and its amount is independent of any subsequent value of the inventory. The first installment is due on the due date for the S corporation's last return as a C corporation and the remaining three are due on the due dates of the S corporation's return for the three succeeding years. If the S corporation fails to survive for three years, liability for the uncollected amount would presumably pass through to its shareholders under I.R.C. § 1366 (1988).

54. See *supra* text accompanying notes 45-47.

55. See, e.g., I.R.C. § 351 (1988) (exchange of property for stock or securities in corporation controlled by transferor); I.R.C. § 354 (1988) (exchange of stock or securities in a corporate reorganization); I.R.C. § 721 (1988) (exchange of property for partnership interest); I.R.C. § 1015 (1988) (gifts); I.R.C. § 1031 (1988) (like-kind exchanges of business or investment property); I.R.C. § 1033 (1988) (involuntary conversions of property); I.R.C. § 1035 (1988) (certain exchanges of life insurance and annuity contracts); I.R.C. § 1036 (1988) (certain exchanges of stock for stock in same corporation); I.R.C. § 1041 (1988) (transfers of property between spouses or incident to divorce).

56. I.R.C. § 1033(a)(2)(B) (1988).

57. I.R.C. § 1033(a) (1988).

58. I.R.C. § 1033(b) (1988).

amount realized. Taxation of the realized gain is not being deferred because the amount of gain taxed upon the final disposition of the second property is a function solely of the difference between the amount received for the second property and its basis and is in no way affected by the amount of the earlier realization. The gain is not being forgiven or permanently excluded because if the value of the replacement property persists, the appreciation of the original property *will* be recognized when the replacement property is disposed of.⁵⁹ The provisions that are commonly referred to as deferral provisions in the federal income tax system are in fact nonrecognition provisions of this sort.⁶⁰

B. *The Role of Reconciliation*

Because a tax system of any complexity will provide for various possible treatments of potentially taxable amounts, it makes sense to ask whether the choices that the system makes are irrevocable. For example, if a system included only the possibilities of immediate recognition (current taxation) and permanent exclusion from taxation, could it later include the previously excluded amount or exclude the item taxed earlier? The same question arises with respect to the characterization of items. The federal income tax system provides for differing tax results depending on the characterization of potentially taxable amounts as, for example, capital gain, passive income, or ordinary income. Clearly nothing inherent in the structure of an income tax system requires either that its particular choices, once made, be permanent or that they be susceptible to change.

A system that opted for revocable choices could incorporate any of a number of features to facilitate flexibility. For example, it could provide for reconsideration of earlier choices at pre-set intervals,⁶¹ it could institute some form of open-ended transactional accounting as a means of aggregating amounts identified as potentially taxable, or it could incorporate an amendatory mechanism for correcting earlier responses that later seemed inappropriate. The most likely motivation

59. Of course, if the value of the property fluctuates, as in the earlier stock example, *see supra* note 46 and accompanying text, the amount of the realized gain that is lost will thereby have been forgiven.

60. *See, e.g.*, I.R.C. §§ 721-723 (1988) (exchange of appreciated property for partnership interest); I.R.C. § 1031 (1988) (like-kind exchanges of appreciated property); I.R.C. § 1034 (1988) (sale of appreciated principal residence combined with purchase of new one); I.R.C. § 1035 (1988) (certain exchanges of life insurance and annuity contracts); I.R.C. § 1036 (1988) (certain exchanges of stock for stock in the same corporation); I.R.C. § 1037 (1988) (certain exchanges of U.S. obligations); I.R.C. § 1041 (1988) (transfers of appreciated property between spouses or incident to divorce).

61. It probably could not allow for criterion-less reconsideration at will and still remain a system.

for making the responses of a system revocable would seem to be the desire to prevent mistakes within the system from becoming permanent. It is important to note, however, that any such device is a mechanism whereby a system can determine whether and when to tax that which it deems potentially taxable and, to that extent at least, plays a role not unlike that played by realization in the federal income tax system.

Two general sorts of corrective devices are available to any tax system. The simplest way to correct a mistake is simply to undo it. Life seldom affords us that opportunity, but a tax system might come close. If, for example, a taxpayer within an income tax system includes in taxable income something that the system, its rules correctly applied, treats as excludable, the system could allow him to go back and recalculate his taxable income after he discovers his mistake. It could allow him to make whatever future adjustments are necessary to put him in precisely the position he would have been in had he initially made an accurate calculation. The federal income tax system provides for something like this kind of "return amendment" within three years of the filing date of the original tax return.⁶²

On the other hand, some kinds of mistakes cannot be undone. Sometimes we make decisions that turn out to be mistaken because things did not turn out as we reasonably had expected them to. I decide to drive to work and not to walk because I am in a hurry. I arrive at my office much later than I would have had I walked, because I was involved in an automobile accident on the way. Or I decide to go to Kauai for my vacation, and it is unexpectedly devastated by a typhoon while I am there. In cases like these, it would not be enough to be given the opportunity to return to the original point of decision. The decisions themselves were entirely reasonable when they were made. Only unforeseeable subsequent events cause these choices to be mistakes.

Analogous errors can be made in the context of a tax system. Assume, for example, an income tax system that allows the exclusion (through a deduction) of all potentially taxable amounts spent on food consumed by the taxpayer. Assume, too, that the system requires taxpayers to calculate and report their taxable income on a monthly basis and that it requires them to deduct money spent on food in the period

62. I.R.C. § 6511(a) (1988) allows a taxpayer to file an amended return which claims either a credit or a refund within the later of three years from the time the original return was filed or two years from the time the tax was paid. The amount of any credit or refund is limited to the tax paid within the applicable period plus interest. I.R.C. § 6511(b)(2) (1988); I.R.C. § 6611(a) (1988).

in which it is spent, even if the food will be consumed later. If a taxpayer in this system spent \$100 in May on meat that she planned to eat in June but did not eat because she discovered in June that the meat was tainted, two mistakes would have occurred. First, it was obviously a mistake for the taxpayer to have spent \$100 on tainted meat, but second, her deduction of the \$100 in May has turned out to have been a mistake too. If the taxpayer could have known when she bought the meat that it was spoiled or that it would spoil before she would eat it, then she likely would not have taken the May deduction.⁶³ This mistake, at least, would be amenable to the kind of corrective measure provided by return amendment. If, however, the taxpayer could not have known in May about the taint (perhaps because it came about as a result of a power outage in June), then her second mistake is analogous to my mistaken decisions to drive to work and to vacation on Kauai. Return amendment would not be an appropriate antidote because the mistake did not lie in the return. The return only became an inaccurate account of the taxpayer's income because of what happened in June.⁶⁴ But the May return *did* nonetheless present an incorrect picture of what happened in May since the taxpayer did not in fact spend \$100 for meat that she eventually consumed.

Mistakes of this sort are possible in any tax system that both is capable of giving more than one possible response to amounts identified as potentially taxable and requires periodic accounting.⁶⁵ A system could simply accept such mistakes as a cost of the enormous

63. Assume that no deduction is allowed in this system for the tainted meat.

I cannot forbear noting here, in anticipation of the discussion (*see infra* text accompanying notes 77-97) of the tax benefit rule, that there is a curious difference between the scienter requirement of provisions, like the hypothetical one in the example and, more importantly, like I.R.C. § 162 (West Supp. 1990) (business expense deduction), which condition deductibility on the intended and predicted use of the purchased item, and provisions, like I.R.C. § 164(a)(3) (West Supp. 1990) which provides for the deductibility of state income taxes paid, which condition deductibility simply on whether the expense was in fact incurred or accrued (as the case may be) regardless of the taxpayer's knowledge that he will later receive a refund of the expenditure.

64. *See, e.g., Stradlings Bldg. Materials, Inc. v. Commissioner*, 76 T.C. 84 (1981), for a good example of exactly this sort of inaccuracy. In *Stradlings* the taxpayer deducted prepaid intangible drilling expenses pursuant to a binding contract with a company called Thor. In a subsequent year Thor breached the contract by not drilling. The Tax Court upheld the original deduction:

The determination and payment of income taxes is based on annual accounting periods. This determination is based on the facts as they exist with respect to the particular year involved. . . . We do not see how respondent [the IRS] could have expected petitioner to foresee that Thor would breach his contractual commitment subsequent to June 30, 1973, the end of petitioner's 1973 fiscal year.

76 T.C. at 89-90.

65. Such mistakes might also arise where there has been transactional accounting if a transaction that was apparently closed (and had therefore been accounted for within the tax system) later reopened.

administrative benefits that come from periodic accounting. Consistent with this position, it would include no corrective devices designed to address this kind of mistake. The taxpayer who bought the meat in May would be allowed her deduction, and the fact that it spoiled in June would have no tax consequences for her. But a system might utilize a second general sort of corrective device. It is to that device that I now turn.

If a mistake cannot be undone effectively (either because of the nature of the mistake or because the system does not include a corrective mechanism of the first sort), it might still be mitigated by making an adjustment to the current period's accounting.⁶⁶ Consider, once again, the example of the tainted meat. The income tax system could respond to the fact that the meat is disposed of in June without being consumed by the taxpayer by adding some amount to June's reported income. I say "some amount" because the determination of the measure of the corrective adjustment in a case like the example raises a set of issues of its own. Put these aside briefly and focus instead on the nature of the adjustment. It is an adjustment that seeks to reconcile the present⁶⁷ with the past to make them compatible. Clearly such adjustments have considerably greater feasibility within the quantifiable context of a tax system than they do within most of the nonquantifiable contexts in which mistakes occur. But, to return to my hurried drive to work and my vacation in Kauai, it is as if I could see these calamities through somewhat rose-colored glasses — it was not bad, after all (and unpredictably), that I did not arrive at the office when I would have, had all gone as expected, and I am not unhappy that I got to experience a typhoon at close range on my vacation.

The second general sort of corrective device available to a tax system, then, is reconciliation.⁶⁸ The federal income tax system makes enormous use of this mechanism,⁶⁹ both by itself and in combination with return amendment. Although the applications of reconciliation

66. There are three other logical possibilities. The adjustment could be made to a future period's accounting, made to some other past period's accounting, or allocated in some way between the accounting of multiple periods. Nothing said in this article about adjusting the current period's accounting is inconsistent with the possibility of adjusting a past or future period's accounting instead or as well. None of these other sorts of adjustment would be as conceptually satisfying and none is much relied on by the federal income tax system. *But see* I.R.C. § 6511(d)(2) (1988) (establishing a period of limitation and procedures for adjusting for overpayments attributable to net operating loss carrybacks or capital loss carrybacks).

67. Or the future, if the adjustment were to a future accounting period.

68. *See* White, *supra* note 9.

69. Though not in *Stradlings Bldg. Materials, Inc. v. Commissioner*, 76 T.C. 84 (1981), discussed *supra* note 64, because the only year at issue was the year in which the deduction had been taken.

are familiar, they are seldom all viewed as instances of the same phenomenon. Nor is there any sense of the role of that phenomenon in the overall structure of the system.

II. THE DESCRIPTIVE POWER OF RECONCILIATION

Reconciliation itself is not, of course, a necessary feature of a tax system. A system might not provide for the sort of correction afforded by reconciliation. But a system might in fact allow for the possibility of nonamendatory revocability, and, if the foregoing account is correct, any such change *will* be an instance of reconciliation whether or not it is so described. Thus, I do not argue that each of the following examples of the operation of reconciliation within the federal income tax system is widely perceived as such.⁷⁰ None of them is. Indeed, as far as I know, "reconciliation" in this context is my own term.⁷¹ Instead, I am interested in exposing the structural framework that must underlie *any* tax system and hence any income tax system. Once the necessary features of the structure are understood, we can begin to give a much richer description of the details of our particular system.

A. *The Claim of Right Doctrine*

Perhaps the easiest context within the federal income system in which to see reconciliation operating as a corrective device is the so-called claim of right doctrine. Sometimes a taxpayer, in good faith, includes an amount in the taxable income of one year only to discover in a later year that the amount did not properly belong to him and must be returned. Sometimes a taxpayer claims in one year that he is entitled to an amount even though his claim is being disputed and in a later year may be resolved against him. Broadly stated, the claim of right doctrine requires a taxpayer to include in his or its taxable income any amount otherwise currently taxable and acquired or held under a claim of entitlement.⁷² Thus, in both circumstances, the tax-

70. Nor do I claim that any of these examples currently represents a fully consistent application of reconciliation. Still less do I wish to argue that good tax policy necessarily requires a consistent application of this (or any other) principle.

71. White, *supra* note 9, at 496. The term seems now to have been adopted in the context of the tax benefit rule by Chirelstein as well. M. CHIRELSTEIN, *supra* note 22, ¶ 10.03, at 217.

72. The claim of right doctrine has its genesis in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). A dispute arose between North American and the U.S. government concerning profits earned in 1916 from certain government-owned oil properties, from which the government was seeking to oust the company. The disputed profits were placed in the hands of a receiver appointed to operate the property and hold the income until the dispute was resolved. In 1917, the government's case was dismissed, and the receiver paid the money to North American. Meanwhile, the government pursued appeals without success until 1922. North American reported the income for the tax year 1916 through an amended return filed in 1918. The Com-

payer correctly includes the amount in the earlier year's taxable income but, as a result, may fail to meet the system's standards of accuracy for measurement of that year's taxable income. The tax system could, of course, make no effort to respond to the inaccuracy. Or it could require the taxpayer to amend its original return in the light of later events. In this context, the federal income tax system has developed a different response — it adjusts the current (later) year's taxable income.⁷³ The current situation, *i.e.*, the one in which the earlier included amount has been relinquished, is reconciled with the earlier one.

The notion of transcending strict adherence to annual accounting to reconcile the present with the past does not necessarily require that the reconciliation be complete. Thus, the *amount* of the corrective

missioner assessed a deficiency for North American's failure to report the income for 1917, the year the company actually received the income, rather than for 1916.

The Court held that the disputed profits became income to the company in 1917, when it first became entitled to them and when it actually received them, regardless of whether the company's return was filed on a cash or accrual basis.

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.
286 U.S. at 424.

The Court rejected North American's claim that the income was reportable in 1916, either by North American or by the receiver, who held the profits. The income was not taxable to the receiver because he was the receiver of only a part of the properties operated by the company and, therefore, was not required to file a return. The amount was not income to North American in 1916, because the company was not required to report as income an amount that it might never receive. Consistently with the position it had taken, the Court similarly rejected North American's alternative claim that the income was reportable in 1922 when the Government's last appeal failed and the dispute was finally resolved. The Court, however, did say, in *dicta*, that if the Government had prevailed in the final appeal, North American would have been entitled to a deduction from its 1922 income, since it would have paid the money to the Government in that year. This approach was subsequently adopted by the federal income tax system. *See infra* note 73.

The claim of right doctrine has been applied to require inclusion in income during the tax year in which the payment was received even if the payments were based on erroneous computations or were obtained illegally. The fact that the taxpayer might have to relinquish the money to a superior claimant in later years does not affect the income's taxability in a tax year when the taxpayer has unrestricted use of the income. *See, e.g.*, *James v. United States*, 366 U.S. 213 (1961) (embezzled monies income to embezzler regardless of duty to repay); *United States v. Lewis*, 340 U.S. 590 (1951) (compensation based on erroneously computed employer's profits includable in income under claim of right rule although later repayment of erroneous amount required). *See generally* B. BITTKER & L. LOKKEN, *supra* note 22, at ¶ 6.3; Lister, *The Use and Abuse of Pragmatism: The Judicial Doctrine of Claim of Right*, 21 TAX L. REV. 263 (1966).

73. This approach consists of two components, one of judicial origin and the other statutory. The judicially created aspect provides for deduction from gross income in the tax year in which repayment is made, rather than for amendment of the prior year's tax return. This result was suggested in *dicta* in *North American*, 286 U.S. at 424. *See supra* note 72. However, *United States v. Lewis*, 340 U.S. 590 (1951), is the case in which the Supreme Court first actually applied this approach.

The statutory component of this approach is embodied in I.R.C. § 1341 (1988). That section provides for the special computation of the tax due from a taxpayer who is deducting the restoration of an amount previously included in income under a claim of right.

adjustment is not dictated by the fact of the use of reconciliation. Two methods of measuring that amount have figured in the development of the claim of right doctrine. In *United States v. Lewis*,⁷⁴ the Supreme Court held that a taxpayer who had received a cash bonus in 1944, reported the amount as income on his 1944 return, was later notified that the bonus was greater than it should have been, and repaid half of the amount in 1946, could not reopen his 1944 return to reflect what had happened in 1946 but must instead be content to deduct the repayment amount in 1946. The taxpayer in *Lewis* had a higher effective tax rate in 1944 than he had in 1946, and so the deduction in 1946 did not fully correct for the tax overpayment of 1944. If his tax rate for 1946 had been higher than his rate for 1944, he would have been better off taking the deduction in 1946 than amending his 1944 return, but reconciliation would still have been an imperfect corrective device because it would have overcorrected for the earlier inclusion.

In 1954, Congress reacted to the *Lewis* side of this imbalance with section 1341 of the Code.⁷⁵ That provision allows a taxpayer in *Lewis*' situation to choose, instead of taking a deduction in the year of repayment, to lower his tax bill for the repayment year by an amount equal to the tax that would have been saved in the earlier year had the amount later repaid not been included in the first place.⁷⁶ Although

74. 340 U.S. 590 (1951).

75. It seems clear that I.R.C. § 1341 (1988) was enacted solely to cure the unfair situation present in *Lewis*. The House Report on § 1341 contains the following reference to the case:

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of \$3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case, the taxpayer is entitled to a deduction only in the year of repayment.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. A294, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4436 (citation omitted); see also S. REP. NO. 1622, 83d Cong., 2d Sess. 451, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 5095; H.R. CONF. REP. NO. 2543, 83d Cong., 2d Sess. 72, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 5280, 5333.

76. The provisions of I.R.C. § 1341 (1988) are applicable to a cash basis taxpayer in the tax year "in which the item of income included in a prior year under a claim of right is actually repaid" or in the year or years that the taxpayer relinquished his right to receive the income if the income was only constructively received in the prior year. Treas. Reg. § 1.1341-1(e) (as amended in 1978). For an accrual method taxpayer, § 1341 applies "to the year in which the obligation properly accrue[d] for the repayment of the item included under a claim of right." Treas. Reg. § 1.1341-1(e) (as amended 1978).

"Income included under a claim of right" means an item included in gross income because it appeared from the facts available in the year that the amount was included in gross income, that the taxpayer had an "unrestricted right" to the income. Treas. Reg. § 1.1341-1(a) (as amended in 1978). The deductible amount is considered "restored" for § 1341 purposes if its repayment results because it is established after the close of the prior tax year that the taxpayer did not have an unrestricted right to the income, as he had earlier believed. Treas. Reg. § 1.1341-1(a) (as amended in 1978).

There are certain limitations and exceptions to § 1341. For example, the section applies only

this provision clearly protects taxpayers from suffering poor Lewis' fate, it does not provide a perfect corrective either. Under section 1341, a taxpayer will not recover the costs to him (if any) associated with having actually paid the tax in the earlier year. Nor does section 1341 prevent the overcorrection that occurs when the effective tax rate in the year of deduction is *higher* than that for the earlier year of inclusion.

B. *The Tax Benefit Rule*

A tax system might also include some mechanism by which to correct the mistakes that result from *deductions* or *exclusions* that were properly taken in one year but turn out in a later year, usually (but not necessarily) because of the recovery of some (or all) of the amount deducted or excluded, not to reflect what the system deems to be the taxpayer's appropriately taxable amount. Here too, the federal income tax system reconciles the later and earlier situations. The general name given to our system's response to this kind of circumstance is the "tax benefit rule." Roughly speaking, the tax benefit rule applies to include the reclaimed amount in the later year's taxable income to the extent that the earlier deduction or exclusion resulted in an actual tax benefit.⁷⁷ Despite its obvious mirror-image-like relationship to what today passes as the claim of right doctrine, the tax benefit rule originated quite independently of its "converse." It has been an acknowledged feature of the federal income tax system since 1927, when the Board of Tax Appeals upheld the Commissioner's claim that a taxpayer who collected on accounts that had been listed on an earlier year's return as deductible worthless accounts, had to include the amount of the collections in income for the year of collection.⁷⁸ As

if the amount of income repayable (because the taxpayer does not have an unrestricted right to it) exceeds \$3000. I.R.C. § 1341(a)(3) (1988). Section 1341 does not generally apply to repayments of amounts initially included in gross income by reason of the sale or other disposition of inventory by the taxpayer, such as sales returns and allowances. I.R.C. § 1341(b)(2) (1988); Treas. Reg. § 1.1341-1(f)(1) (as amended in 1978). In addition, the regulations provide that § 1341 does not apply to deductions attributable to bad debts or legal fees and expenses incurred by the taxpayer in contesting the restoration of an item previously included in income. Treas. Reg. § 1.1341-1(g), (h) (as amended in 1978). Further, § 1341(b)(4) and (5) provide special rules regarding the treatment of net operating losses and capital losses.

77. For an extended discussion of the tax benefit rule, see White, *supra* note 9; see also M. CHIRELSTEIN, *supra* note 22, at ¶ 10.03.

The tax benefit rule has two aspects. The "inclusionary" component requires the inclusion in income of an amount equal to the amount deducted in an earlier year. The "exclusionary" component conditions inclusion on there having been a tax benefit as the result of the earlier deduction. The exclusionary aspect is currently set forth in I.R.C. § 111 (1988).

78. Lee v. Commissioner, 6 B.T.A. 541 (1927), *affd. sub nom.* Carr v. Commissioner, 28 F.2d 551 (5th Cir. 1928); see also Excelsior Printing Co. v. Commissioner, 16 B.T.A. 886 (1929) (recovery of debt earlier charged off as worthless held to be taxable income for year of recovery). In these early cases the principle was limited to its inclusionary aspect and was not typically given a

with any essentially nonstatutory rule, the contours of the tax benefit principle within the federal income tax system have evolved over time. Most recently, the Supreme Court, in *Hillsboro National Bank v. Commissioner*,⁷⁹ dealt squarely, and at some length, with the tax benefit rule.⁸⁰

The conventional description of what is happening when the tax benefit rule is applied to require inclusion of the amount of an earlier deduction in a taxpayer's income for a later year⁸¹ is straightforward. It is couched in terms of basis and realization. The item whose cost was deducted⁸² has a basis in the taxpayer's hands equal to its after-tax

name. The exclusionary component first surfaced in 1932 when it was rejected by the Board of Tax Appeals. *Lake View Trust & Sav. Bank v. Commissioner*, 27 B.T.A. 290 (1932). Congress codified the exclusionary aspect in 1942. Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798, 812-13 (1942) (current version at I.R.C. § 111 (1988)). The phrase "tax benefit rule" was used by the Board of Tax Appeals by 1942 primarily, if not exclusively, to refer to the rule's exclusionary component. See *Haughey v. Commissioner*, 47 B.T.A. 1, 4 (1942). Legal commentators from the same period varied in their use of the phrase. See, e.g., Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473, 473 (1942) (applies "tax benefit rule" to both components); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 130-31 (1943) (refers to inclusionary aspect as a "general rule" without naming it). Current use of the phrase encompasses both the inclusionary and exclusionary components.

For further background on the history of the tax benefit rule, see generally Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995, 999-1010 (1968).

79. 460 U.S. 370 (1983).

80. *Hillsboro* was a consolidation of two cases presenting rather different fact situations. In *Hillsboro*, *Hillsboro National Bank* paid a state property tax on behalf of its shareholders in 1972. *Hillsboro*, 460 U.S. at 373. Because the validity of the tax was under question, the state placed the collected amounts in escrow. *Hillsboro*, 460 U.S. at 373. When the tax ultimately was declared invalid, the state paid the amounts collected from the bank directly to the shareholders on whom the tax had been imposed. *Hillsboro*, 460 U.S. at 374. The Bank deducted its payment of the tax under § 164(e), which allowed a corporate deduction for shareholder taxes paid by a corporation, and it neither made any adjustment nor reported any income when the tax refund was made to the shareholders by the state. *Hillsboro*, 460 U.S. at 373-74. The Commissioner sought to use the tax benefit rule to include the amount of the refund in the bank's income. *Hillsboro*, 460 U.S. at 374. The bank argued that since it had not recovered the amount, the tax benefit rule did not apply. *Hillsboro*, 460 U.S. at 381.

The second case was originally known as *United States v. Bliss Dairy, Inc.* See *infra* text accompanying notes 87-91 for a summary of the facts.

The Court rejected the view that economic recovery is required before the tax benefit rule can apply. *Hillsboro*, 460 U.S. at 381-83. It went on to hold that when a later event is "fundamentally inconsistent with the premise on which the deduction was initially based," the tax benefit rule applies. 460 U.S. at 383. As articulated by the Court, the test is whether the later event would have foreclosed the deduction if the two had occurred within the same taxable year. 460 U.S. at 383-84. Curiously, despite its articulation of the tax benefit rule, the Court did not frame its consideration of whether the tax benefit rule actually applied to *Hillsboro National Bank* or *Bliss Dairy, Inc.* in terms of fundamental inconsistency. It held that the rule did not apply to the bank because of the legislative history of § 164(e) and that it did apply to the Dairy. See White, *supra* note 9, at 499-500.

81. One example would be the inclusion of a taxpayer's state income tax refund in her federal taxable income for the year received if she deducted it from her federal taxable income when she paid the state tax in an earlier year.

82. The "item" in the example in note 81 *supra* is the state income tax paid.

cost — zero if the entire cost was deducted. Thus, when the item is recovered by the taxpayer, the amount realized is offset against its basis in the taxpayer's hands and the difference is treated as a realized gain.⁸³

The conventional account, while adequate for many descriptive purposes, does not capture a significant subset of the circumstances in which the tax benefit rule has been applied. Nor, more importantly, does it *explain* the role that the tax benefit rule has within the structure of the federal income tax system. A couple of examples can illustrate the first problem. The second will itself require a bit of explanation.

The statutory portion of the tax benefit rule is set forth as section 111 of the Internal Revenue Code. That provision currently excludes from income any recovered amounts that did not produce a tax benefit when they were deducted in an earlier year.⁸⁴ It represents the statutory expression of what has long been known as the exclusionary aspect of the nonstatutorily developed tax benefit rule.⁸⁵ The adjusted basis of any item that was expensed in the earlier year will be zero, however, even if the deduction did not in fact yield a tax benefit. The limitation on the inclusion of the recovered amount to the actual amount of the earlier tax benefit is not simply the result of offsetting the amount of the recovery against the basis.

Another, quite different, sort of example of the failure of what I have called the "conventional account" to describe some core applications of the tax benefit rule is the Supreme Court's opinion in *Hillsboro*.⁸⁶ *Hillsboro* was the name under which two cases were consolidated. My point is best illustrated by the facts of the case originally known as *United States v. Bliss Dairy, Inc.*⁸⁷ Bliss Dairy, Inc. bought cattle feed for use in its business operations and deducted the full cost of the feed in the same year.⁸⁸ Two days into the next taxable year, the company liquidated under section 336.⁸⁹ The assets distrib-

83. See, e.g., M. CHIRELSTEIN, *supra* note 22, at ¶ 10.03.

84. I.R.C. § 111(a) (1988) currently provides: "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."

85. See *supra* note 77.

86. 460 U.S. 370 (1983).

87. See *supra* note 80 for a description of the facts of the case originally known as *Hillsboro Natl. Bank v. Commissioner*.

88. *Hillsboro*, 460 U.S. at 374.

89. *Hillsboro*, 460 U.S. at 374. At the time that Bliss liquidated, I.R.C. § 336(a) (1982) provided in pertinent part that "no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation." That section was substantially changed by the Tax Reform Act of 1986 to make nonrecognition the exception rather than the rule.

uted to its shareholders by Bliss in liquidation included unused, though previously expensed, cattle feed.⁹⁰ Bliss did not include the value of the unused cattle feed in its income for the second year on the ground that the tax benefit rule required an actual recovery of a previous tax benefit.⁹¹ The Supreme Court applied the tax benefit rule to Bliss Dairy saying, “[t]he purpose of the rule is not simply to tax ‘recoveries.’”⁹² Instead, the rule “ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction.”⁹³ The Court has been much criticized for its failure fully to spell out when a later event is “fundamentally inconsistent” with an earlier deduction.⁹⁴ Instead, the Court left both the content of the notion and the conditions of its application somewhat vague. The emphasis throughout the opinion however is on the *relationship* between the later year’s circumstances and the prior year’s report of taxable income. The Court makes no explicit effort to specify precisely the conditions that trigger the comparison, much less to tie the rule’s application to the current realization of some amount. Thus, although the amount included in taxable income under the tax benefit rule may well equal the difference between a current valuation and a previously established basis,⁹⁵ it is at least unhelpful to describe the rule solely in terms of an amount realized against which the adjusted basis is offset.

As a general matter, a tax system could build the possibility of understatement into its operating rules by allowing taxpayers to deduct or exclude amounts on the assumption (tacit or explicit) that certain future events would or would not occur. So long as the future is contingent, such a system includes the possibility that the taxpayer has understated his taxable income — at least that she would have stated it differently had she known then what she knows now. She has made a mistake akin to the ones I made when I took my vacation trip to Kauai or drove to my office. A system with this feature might or might not include a mechanism or mechanisms to correct the mistakes

90. *Hillsboro*, 460 U.S. at 374.

91. *Hillsboro*, 460 U.S. at 381; Brief for the Respondent Bliss Dairy, Inc. at 5, *Hillsboro* (No. 81-930).

92. 460 U.S. at 381.

93. 460 U.S. at 372.

94. See, e.g., 460 U.S. at 417-18 (Stevens, J., concurring in *Hillsboro* and dissenting in *Bliss*); Blum, *The Role of the Supreme Court in Federal Tax Controversies* — *Hillsboro* National Bank and Bliss Dairy, Inc., 61 TAXES 363, 366-67 (1983); White, *supra* note 9, at 495-99; Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CALIF. L. REV. 1257, 1270-78 (1984).

95. But see the example discussed *supra* text accompanying note 86.

it will inevitably breed. The federal income tax system does. The tax benefit rule is an example of one such mechanism.

The principal role of the tax benefit rule within the federal income tax system is corrective. It serves as an exception to the administrative requirement of annual accounting when annual accounting distorts a taxpayer's taxable income in a manner favorable to the taxpayer. Obviously, it does not apply in all instances where a taxpayer's income for some year has been understated,⁹⁶ but it *only* applies in instances where that has happened. Moreover, as *Hillsboro* tells us, the tax benefit rule only applies when the understatement occurs because a later year's events are "fundamentally inconsistent" with the picture of the future upon which the original deduction (or deductions) was premised. The rule applies to reconcile the past prediction of the future with the actual outcome. This is the principal function of the tax benefit rule, and it is this central feature that the "conventional" description of the rule fails to capture.

Finally, it should be noted that the notion of an understatement or distortion of a taxpayer's taxable income is a relative one. In this discussion, I am giving a schematic account of the structure of any tax system, and I began with a set of observations that emphasized the independence of the determination of *what* constitutes a potentially taxable amount within a system from the determination of *whether* and *when* to tax it. Although, for example, a system could certainly seek to employ a notion of potentially taxable amount identical to the economists' sense of income (whatever that sense is) and could further attempt to structure its taxing mechanisms so as to tax all amounts thus construed as soon as they became the taxpayer's, there is no necessary identity between a taxpayer's taxable income for any year and his income in the economist's sense for the same year.⁹⁷ Further, since a system could adopt *any* notion of potentially taxable amount and *any* standards for determining whether and when to tax it, an understatement of taxable income can only result within a system's own framework.

C. Recapture Provisions

My third example of reconciliation operating within the federal income tax system is, in a way, a variant of the tax benefit rule. The Internal Revenue Code includes a number of recapture provisions

96. In some circumstances return amendment is the appropriate antidote, in others the statute of limitations (normally three years after a tax return is filed; see I.R.C. § 6501(a) (1988)) operates to allow a taxpayer to ignore the earlier understatement.

97. See *supra* text accompanying notes 18-19.

whereby an amount is included in a later year as an adjustment for a deduction or credit taken in an earlier year.⁹⁸ Section 1245 historically has been the most important⁹⁹ of these provisions, and, although its current importance has been much reduced by the Tax Reform Act of 1986,¹⁰⁰ it illustrates reconciliation well. Another reason for using section 1245 as illustrative of recapture provisions generally is that its intimate connection with depreciation invites a look at depreciation, which itself illuminates the nature of reconciliation.

When an asset is depreciated for tax purposes, a deduction is taken from the taxpayer's taxable income and the taxpayer's basis in the asset is adjusted downward by the amount of the deduction.¹⁰¹ If, as usually happens, the fair market value of the asset has not in fact decreased by an amount as large as the depreciation deduction, a subsequent sale of the asset will result in gain to the taxpayer even if the fair market value of the asset has not increased during the period that the taxpayer has held it. Section 1231 of the Code provides for long-term capital gain treatment for net gain from the sale of depreciable assets. Until it was repealed by the Tax Reform Act of 1986, section 1202

98. *See, e.g.*, I.R.C. § 1245 (1988) (recapture as ordinary income of gains from certain depreciable property); I.R.C. § 1250 (1988) (recapture as ordinary income of gains from certain depreciable realty); I.R.C. § 1252 (1988) (recapture as ordinary income of certain amounts deducted under I.R.C. § 175 (1988) (soil and water expenditures) and I.R.C. § 182 (1988) (land clearing expenditures)); I.R.C. § 280F(b)(3) (1988) (recapture of excess depreciation of listed property not in fact predominantly used in a qualified business use); I.R.C. § 1254 (1988) (recapture as ordinary income of gains from disposition of certain oil, gas, or geothermal property).

99. At least as measured by frequency of application. The disposition of any tangible depreciable property connected with manufacturing, transportation, or any other business enterprise historically has been likely to trigger § 1245.

100. Section 1245 and other recapture provisions that transform capital gain into ordinary income have, temporarily at least, lost much of their importance because of the elimination of the capital gains preference. The statutory structure for distinguishing between ordinary income and capital gains remains intact, but both are currently subject to the same tax rates. ("The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." H.R. REP. NO. 841, 99th Cong., 2d sess. II-106, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4194 (Conference Report accompanying Tax Reform Act of 1986)).

101. I.R.C. § 1001(a) (1988) provides that the gain or loss realized from the sale or other disposition of property is measured as the difference between the amount realized on the disposition and the property's adjusted basis.

I.R.C. § 1011(a) (1988) provides that the adjusted basis for purposes of § 1001(a) is the basis, as determined under the appropriate basis section of the Code (*see, e.g.*, I.R.C. § 1012 (1988) (basis equals cost unless another basis provision applies); I.R.C. § 1014 (1988) (basis of property acquired from a decedent); I.R.C. § 1015 (1988) (basis of property acquired by gift); I.R.C. § 332 (1988) (basis of property received in corporate liquidation); I.R.C. § 722 (1988) (basis of contributing partner's partnership interest) (adjusted as provided by I.R.C. § 1016 (West Supp. 1990))).

Section 1016(a) provides for a reduction in basis for various items including deductions taken for exhaustion, wear and tear, obsolescence, amortization, and depletion deducted under sections of the Code such as I.R.C. § 167 (West Supp. 1990). The reduction amount required is the greater of the amount (1) allowed as a deduction to the extent the deduction resulted in a tax benefit or (2) the amount allowable under the Code for the applicable years. *See also* Treas. Reg. § 1.1016-3 (1960).

provided for a deduction from gross income of 60 percent of a taxpayer's net capital gains, thus providing for what was in effect a lower capital gains tax rate. Section 1245 was designed to prevent a taxpayer from taking advantage of this lower capital gains rate with respect to any gain that arose simply because of depreciation in excess of the actual diminution in value of the asset. Thus, if an asset were purchased for \$20,000 and depreciation deductions of \$6800 were taken over a three-year period, the asset's adjusted basis would be \$13,200. If the asset had then been sold before January 1, 1987, for its fair market value of \$16,000, section 1245 would have prohibited the taxpayer from characterizing the \$2800 gain as section 1231 gain subject to the long-term capital gain rate and would have required her to treat it as ordinary income. If the asset's actual value had appreciated as the asset had been depreciated, and if the asset had been sold before 1987 for \$25,000 (rather than \$16,000), the entire amount of the earlier depreciation deductions (\$6800) would have been treated as ordinary income and the rest of the gain (\$5000) would have received the benefit of the lower rate prescribed by section 1202. The amount of gain converted by section 1245 into ordinary income is said to have been "recaptured." Without the adjustment required by section 1245, the taxpayer would have received the full benefit of three years of depreciation deductions from ordinary income and then, in effect, have recovered the entire (or partial, in my first example) amount of the earlier deduction at the lower capital gains rate.¹⁰² Section 1245 ensures that the recovery (or recapture) occurs at ordinary income rates.

The practical motivation for a provision like section 1245 is clear enough — to prevent a taxpayer from both receiving capital gains treatment on the sale of a business asset and recovering his cost for the asset out of ordinary income.¹⁰³ This motivation arose because of the

102. *But cf. Kahn, supra* note 35, at 46-53 for an argument that the assumptions that underlie recapture are misguided.

103. The legislative history of I.R.C. § 1245 confirms this underlying motivation. Testifying before the Senate Finance Committee before the section was adopted, the Secretary of the Treasury, Douglas Dillon, said:

The President recommended that capital gain treatment be withdrawn from gains on the disposition of depreciable property, both real and personal, to the extent of prior depreciation allowances.

Such gain reflects depreciation allowances in excess of the actual decline in value of the asset and under the President's proposal would be treated as ordinary income. Any gain in excess of the cost of the asset would still be treated as capital gain. This reform would eliminate an unfair tax advantage which the law today gives to those who depreciate property at a rate in excess of the actual decline in market value and then proceed to sell the property, *thus, in effect, converting ordinary income into a capital gain*. It is particularly essential at this time in view of the impending administrative revision of depreciation guidelines.

Revenue Act of 1962: Hearings on H.R. 10650 Before the Senate Comm. on Finance, 87th Cong.,

special rate for long-term capital gains and goes away without it.¹⁰⁴ But even though the practical motivation for a special recapture provision seems to hinge on the rate differential brought about by a capital gains preference, the function of the provision within the structure of the income tax system is somewhat broader and can be described quite independently of that difference. Section 1245, together with the provisions which set forth the procedures for reducing basis to reflect deductions taken for depreciation,¹⁰⁵ is a corrective device. When a taxpayer recovers the cost (or a portion of it) of an asset which it acquired for business purposes by taking depreciation deductions,¹⁰⁶ it has taken a deduction — fully authorized by the federal income tax system — which, in rough theory at least, presumes a future outcome;¹⁰⁷ namely, that the taxpayer will use the asset (for business purposes) and that it will ultimately consume at least as much of the value of the asset through that use as it has deducted through the mechanism of depreciation.¹⁰⁸ As with any presumption about the future,

2d Sess. 87-88 (1962) (emphasis added). See also 2 B. BITTKER & L. LOKKEN, *supra* note 22, at ¶ 55.1; M. CHIRELSTEIN, *supra* note 22, at ¶ 18.02(b); Kahn, *supra* note 35, at 43-46.

104. Actually, I.R.C. § 1245 retains some practical effect in several circumstances. For example, capital gains are still offset by capital losses while ordinary income is offset only to a very limited extent, see I.R.C. § 1211 (1988). Thus, characterization of gain as ordinary income by § 1245 can increase a taxpayer's taxable income by reducing the deductibility of his losses. See also I.R.C. § 170(e) (1988) (reducing the amount of a charitable contribution of property by the amount that would not have been long-term capital gain if it had been sold for fair market value); I.R.C. § 453(i) (1988) (recognizing § 1245 recapture income in the year of the disposition of property sold in an installment sale).

105. See *supra* note 101.

106. The historic function of depreciation was to recover the cost of the property being depreciated over the period of its economically useful life. Indeed, the phrase "cost recovery" is often substituted for "depreciation." See, e.g., I.R.C. § 168 (1988) ("Accelerated Cost Recovery System"). A depreciation deduction has been a part of the federal income tax system since 1909. See Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 113. It has been explained by the Supreme Court as follows:

The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. *The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost.* The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.

United States v. Ludey, 274 U.S. 295, 300-01 (1927) (emphasis added).

See also *Friboirg Navigation Co. v. Commissioner*, 383 U.S. 272 (1966). See generally B. BITTKER & L. LOKKEN, *supra* note 22, at ¶ 23.1.1; M. CHIRELSTEIN, *supra* note 22, at ¶ 6.08. For a historical account of depreciation policies, see Lischer, *Depreciation Policy: Whither Thou Goest*, 32 Sw. L.J. 545, 546-71 (1978).

107. *Crane v. Commissioner*, 331 U.S. 1, 3-4 (1947).

108. See *supra* note 106. The original goal of tax depreciation seems to have been to devise methods by which the actual economic depreciation of the asset would be deducted as it oc-

this one can turn out to be mistaken. A capital gains preference exacerbates the mistake;¹⁰⁹ it does not cause it.

A fine-tooled analysis of depreciation is itself a complicated and controversial undertaking. Depreciation for tax purposes is a mechanism for spreading the deduction of an item's cost over multiple tax periods. Even in a world with a currency unaffected by inflation or deflation, where the single goal of depreciation was to deduct as much of an item's cost in any period as was consumed in that period, it would still be exceedingly difficult to allocate cost to use accurately. Much of the difficulty stems from the problem of measuring consumption. We would need to know a variety of things, including the value of the item at the beginning and end of each accounting period and how much of that value represented the original cost unaffected by fluctuations in the market price.¹¹⁰ The project is complicated still further if additional goals are introduced into the design of the depreciation mechanism. The federal system has in fact used depreciation schedules as a tool for directing investment behavior since at least 1954,¹¹¹ and a vast literature addresses the complex questions surrounding both the desirability of that practice and its implementation.¹¹² It might well appear, therefore, that reconciliation would ill-describe what has happened when depreciation is recaptured, because the amount of depreciation actually taken on an asset is often neither intended nor believed to be an accurate estimate of the cost that has in fact been consumed. Indeed, most theorists view the Accelerated Cost

curred. See M. GRAETZ, *supra* note 3, at 391-92. The goal of accuracy eroded over time as depreciation began to be seen as a vehicle by which investment behavior could be stimulated and directed. The Code introduced so-called accelerated depreciation methods in 1954, and the Accelerated Cost Recovery System was added to the Code as I.R.C. § 168 in 1981. ACRS shortened the period over which cost recovery would occur even beyond the period permitted by the earlier accelerated methods. In adding § 168, Congress made it clear that its intent was to stimulate capital investment. See S. REP. NO. 144, 97th Cong., 1st Sess. 47, reprinted in 1981 U.S. CODE CONG. & ADMIN. NEWS 105, 152. Nonetheless, the general notion persists that depreciation's basic justification is as a form of spreading the deductible cost of an asset over time.

109. Measuring the amount of the mistake is a separate and difficult issue.

110. For two quite different views about how, in theory, consumption should be measured, see M. CHIRELSTEIN, *supra* note 22, ¶ 6.08, at 137-39 (arguing that sinking fund depreciation is the only theoretically proper method for measuring the economic cost of an asset's use) and Kahn, *supra* note 35, at 30-43 (arguing that only some form of accelerated depreciation can accurately measure the cost of an asset's use); see also Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1172 (1980), and Kahn, *Accelerated Depreciation Revisited — A Reply to Professor Blum*, 78 MICH. L. REV. 1185 (1980).

111. See *supra* notes 106 and 108.

112. See, e.g., Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C. L. REV. 1327 (1982); Bradford, *Issues in the Design of Savings and Investment Incentives*, in DEPRECIATION, INFLATION, AND THE TAXATION OF INCOME FROM CAPITAL (C. Hulten ed. 1981); Hulten & Wykoff, *Economic Depreciation and Accelerated Depreciation: An Evaluation of the Conable-Jones 10-5-3 Proposal*, 34 NATL. TAX J. 45 (1981).

Recovery System, for example, as accelerating the rate of deduction beyond the rate of consumption.¹¹³ That was certainly the intention of Congress.¹¹⁴ In light of all this, it hardly seems appropriate to characterize accelerated depreciation deductions as “mistakes.”

In my earlier discussion of the distinction between mistakes that can be undone and mistakes that cannot be, I contrasted choices that *could have been* recognized as mistakes when they were made because *all* the data necessary for a fully informed decision was at least theoretically available by the time the choice was made with those whose ultimate resolution was in some sense contingent on the future.¹¹⁵ These latter choices could not, even in theory, have been decisively identified as mistakes when they were made. I illustrated the second kind of mistake with the example of my vacation trip to Kauai and the unexpected typhoon.¹¹⁶ But this kind of example does not really capture what has happened when a taxpayer takes fully authorized depreciation deductions in Year 1, only to sell the asset for more than its adjusted basis in Year 3. The amount of the allowable deduction is in no way affected by the taxpayer's reasonable belief (or even his knowledge) about the likelihood of his disposing of the asset for more than its adjusted basis.¹¹⁷ Neither predictions about the particular taxpayer's circumstances and plans nor predictions about the actual rate at which the taxpayer will consume the asset are relevant to determining the allowable deduction under the Accelerated Cost Recovery System, since the allowable deduction does not presume to represent an accurate assessment of an asset's rate of consumption. Thus, a more apt analogy would be my choosing to go to Kauai because I want to see a good friend who lives there even though I believe, correctly as it turns out, on the basis of apparently reliable weather forecasts, that a typhoon will strike.

Sometimes we choose to satisfy one goal (seeing my friend) at the likely expense of satisfying another (avoiding typhoons). When it turns out that we did in fact have to sacrifice the one goal (I was caught in the typhoon), we might look for some way to mitigate the situation (some might say “to have our cake and eat it too”). In some sorts of circumstances, like the typhoon, that may be difficult. But in

113. See, e.g., M. CHIRELSTEIN, *supra* note 22, ¶ 6.08.

114. See S. REP. NO. 144, 97th Cong., 1st Sess. 48, *reprinted in* 1981 U.S. CODE CONG. & ADMIN. NEWS 105, 153.

115. See *supra* text accompanying notes 62-65.

116. See *supra* text accompanying notes 62-65.

117. Indeed he is *required* to adjust his basis downward even if he does not avail himself of an allowable depreciation deduction. I.R.C. § 1016(a)(2) (1988).

others, it might be easier to make an adjustment, after the fact, which goes some way toward reconciling the conflicting goals. The recapture of depreciation is one of these easier adjustments.

Annual accounting sets short-term goals for taxpayers, whereas the fundamental goal of depreciation is a long-term one — to allow taxpayers to deduct the full cost of that portion of long-lived assets which they actually consume for business purposes but to require that they allocate that cost over multiple tax years. Since the allocation procedures established by the Code are not a function of either the particular taxpayer's actual consumption of the asset or his likely plans for disposing of it, there is the clear possibility of a conflict between his satisfying the depreciation requirements of annual accounting and the long-term goal of deducting the cost of only that portion of the asset that he has actually consumed. Whatever our expectations, we can only quantify the full extent of the conflict after the entire history of the taxpayer's ownership of the asset has been determined. The federal income tax system responds to this quantification by making an adjustment to a taxpayer's income in the year that he actually does dispose of a not-fully-consumed depreciable asset. The corrective is not perfect, but it does go some distance toward reconciling the conflict. Whether we call the quantification a "mistake"¹¹⁸ is of no real importance, but it does not seem an inappropriate label if we are clear about the sense of the word that I intend. The adjustment that is made after the "mistake" has been determined is an instance of what I mean by reconciliation. Like the tax benefit rule, this adjustment seeks to reconcile the present with the past presumption (not prediction) about the future (rate of consumption of the depreciated asset) to make them compatible with one another.

By itself, in fact, section 1245 only addresses the increment of the mistake that results from the preferred treatment given to capital gains. Alone, it does not remedy the central problem. That is corrected, to the extent that it is,¹¹⁹ by adjusting the basis of an asset each time a depreciation deduction is taken¹²⁰ and using the asset's adjusted basis to measure the asset's value when it is sold or otherwise converted.¹²¹ Let us return to the examples that illustrated the operation of section 1245: first, an asset bought for \$20,000, depreciated for

118. Albeit a mistake that has in many instances been voluntarily built into our tax system.

119. Recapture in a later year of the excess depreciation of earlier years does not take into account the time value of the amount by which the taxpayer's earlier taxes were reduced by the excess depreciation. That amount has, in effect, been loaned to the taxpayer without interest.

120. I.R.C. § 1016(a) (1988). *See supra* note 101.

121. I.R.C. § 1001(a) (1988). *See, supra* note 101.

three years by \$6800, and sold for \$16,000; second, the same asset sold for \$25,000 instead of \$16,000. In both of these examples the adjusted basis of the asset is \$13,200. The amount taken into taxable income upon the first sale is the difference between \$16,000 and \$13,200 or \$2800; upon the second, the difference between \$25,000 and \$13,200 or \$11,800. In the first case the entire \$2800 represents so-called excess depreciation. In the second case \$6800 of the \$11,800 does. In both cases the inclusion of the amount that represents excess depreciation is an instance of reconciliation.

III. THE NORMATIVE ROLE OF RECONCILIATION

As I have shown, reconciliation is a general corrective device, available to any tax system that chooses to provide for the possibility that a reporting decision may be revoked in some way other than by return amendment. It, like realization, is a mechanism that a tax system might use to determine whether and when to tax amounts it views as potentially taxable. Each of the preceding examples of phenomena within the federal income tax system is an instance of reconciliation. On the other hand, each traditionally has been described in terms that do not include reconciliation. What distinguishes the descriptions that make use of reconciliation from those that do not is that they are not purely descriptive. Recognizing reconciliation allows us to give a unified explanation of a number of features of the federal income tax system, an explanation that relates these features both to one another and to a schematic functional account of all tax systems.

Another feature of the federal income tax system that profitably can be discussed in terms of reconciliation is its treatment of loans.¹²² Conceiving of the tax treatment of simple borrowing in terms of reconciliation allows us to give a more coherent account of an important feature of the federal income tax system than is allowed by the traditional conceptual vocabulary. To the extent that coherence is a desirable feature of a tax system, this account is therefore preferable to others. However, conceiving of the tax treatment of simple borrowing in terms of reconciliation has implications for one's conception of the tax treatment of other kinds of loan arrangements as well. In this part of the article I shall explore those implications in the context of purchase money mortgages. It turns out, however, that the treatment of purchase money mortgages that is implied by the coherent account of simple borrowing is not consistent with the facts of current law. If

122. Although he might not want to associate himself with my actual product, the discussion of loans which follows was inspired by a remark of Martin Ginsburg's.

coherence is an overriding value, reform of current law would be warranted. If, on the other hand, coherence is allowed to compete with other values (assuming that it is a value at all), those values should be identified and their relative strengths assessed before a justified call for specific reform could be made.

My choice of the tax treatment of simple borrowing and the implications of coherence for the tax treatment of mortgages as examples is not accidental. Early in this essay, I referred to Barnett's *amicus* brief in *Tufts* as an example of an argument that relies on rationality as a sufficient reason for interpreting the law as having certain requirements.¹²³ Barnett's argument is about the tax treatment of purchase money mortgages upon the disposition of the asset they were used to purchase. Ironically, given the importance that he ascribes to the rationality of the tax system, Barnett's own argument seems tacitly to accept the traditional account of the tax treatment of simple borrowing.¹²⁴

A. Simple Borrowing

A system might treat borrowed funds as potentially taxable or not potentially taxable. The federal income tax system, of course, does not regard loan proceeds as taxable income to the borrower.¹²⁵ This might mean that the federal system chooses to exclude loans from taxation, even though it regards them as potentially taxable amounts, or it might mean that it does not regard them as potentially taxable at all. The familiar justification for the rule that loan proceeds are not included in taxable income is that the borrower's obligation to repay offsets the amount borrowed and leaves her net worth unaffected.¹²⁶ As she repays, her liability diminishes by the amount of the repayment and her net worth remains the same. By contrast, however, the federal system *does* include borrowed amounts in the basis of any asset they are used to buy.¹²⁷ This treatment is inconsistent with the view that

123. See *supra* text accompanying notes 3-7.

124. See Brief for *Amicus Curiae*, *supra* note 3, at 4-5.

125. See, e.g., *Shuster v. Helvering*, 121 F.2d 643, 645 (2d Cir. 1941); *Matarese v. Commissioner*, 34 T.C.M. 791 (CCH) (1975); *Gatlin v. Commissioner*, 34 B.T.A. 50 (1936); *Stayton v. Commissioner*, 32 B.T.A. 940 (1935), *nonacq.*, 1936 C.B. 44; *Dilks v. Commissioner*, 15 B.T.A. 1294 (1929), *aff'd.*, 69 F.2d 1002 (7th Cir. 1934); *Fisher v. Commissioner*, 7 B.T.A. 968, 969 (1927), *acq.*, 1928 C.B. 11. One exception to this rule is I.R.C. § 77 (1988), which permits taxpayers to elect to include loans from the Commodity Credit Corporation in gross income.

126. See, e.g., Brief for *Amicus Curiae*, *supra* note 3, at 3; B. BITTKER & L. LOKKEN, *supra* note 22, at ¶ 6.4.1; M. CHIRELSTEIN, *supra* note 22, ¶ 3.01, at 44; M. GRAETZ, *supra* note 3, at 216; Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CALIF. L. REV. 41, 63 (1986); Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 43 (1980).

127. *Crane v. Commissioner*, 331 U.S. 1, 11 (1947). Borrowed amounts are generally includ-

loan proceeds are not taxable income, since basis is supposed to be a measure of the after-tax cost of an asset,¹²⁸ and the borrowed dollars have neither been taxed nor repaid and, cannot, consistently with the view that they are not taxable income, be taxed. Despite the inclusion of untaxed loan proceeds in its measure, basis is nonetheless the amount used to calculate depreciation deductions.¹²⁹ This means, ob-

able in basis whether the debt is recourse or nonrecourse. 331 U.S. at 10-11; *see also* Commissioner v. Tufts, 461 U.S. 300, 307 (1983) (nonrecourse mortgage to be treated as "true" loan); Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976) (absence of personal liability does not deprive debt of its bona fide character). In *Tufts*, the Supreme Court emphasized that *Crane* had upheld the Commissioner's choice to treat nonrecourse debts as he treated recourse debt ("The Commissioner might have adopted the theory . . . that a nonrecourse mortgage is not true debt Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis." 461 U.S. at 308 n.5) and indicated that it was now merely reaffirming *Crane* ("We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and *Crane* were not on the books, whether that approach would be preferred over *Crane's* analysis." 461 U.S. at 308 n.5 (citations omitted)).

However, the Commissioner may attack nonrecourse indebtedness as lacking in economic substance if, at the time the debt is incurred, the foreseeable value of the property that secures it is less than the indebtedness amount, an indication that the borrower will not repay it. *See* Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983) (nonrecourse debt invalid since foreseeable value of encumbered property less than principal amount of debt), *modified* 752 F.2d 89 (4th Cir. 1985); Hilton v. Commissioner, 74 T.C. 305 (1980) (foreseeable value of the encumbered property must make abandonment imprudent for nonrecourse debt to exist), *affd.*, 671 F.2d 316 (9th Cir. 1982); Estate of Franklin v. Commissioner, 64 T.C. 752 (1975) (for debt to exist, nonrecourse borrower must have economic incentive to make capital investment in unpaid amount), *affd.*, 544 F.2d 1045 (9th Cir. 1976).

Inclusion in basis may also be denied if the indebtedness is adjudged contingent on its face. *See, e.g.*, Fox v. Commissioner, 80 T.C. 972 (1983) (notes payable out of proceeds too contingent), *affd. sub nom.*, Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984); Lemery v. Commissioner, 52 T.C. 367 (1969) (contingent on profits), *affd. per curiam*, 451 F.2d 173 (9th Cir. 1971); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), *affd. per curiam*, 333 F.2d 653 (2d Cir. 1964); Rev. Rul. 80-235, 1980-2 C.B. 229 (1980) (limited partnership nonrecourse note payable out of cash flow too contingent).

128. *See* I.R.C. §§ 1001(a), 1011(a), and 1016(a) (1988), described *supra* note 101, for the statutory structure from which this observation is derived. *See also supra* note 21 and accompanying text. There are notable exceptions to the general conception of basis as representative of after-tax cost. When a corporation exchanges its own stock (in which it has no basis) for property it recognizes no income. I.R.C. § 1032 (1988). Yet I.R.C. § 362 (1988) provides that the corporation's basis in the acquired property will be the same as it was in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. A similar rule governs the basis of property received by a partnership in exchange for a partnership interest. I.R.C. § 723 (1988). *See generally* Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 TAX L. REV. 159 (1984).

129. I.R.C. § 167(a) (1988), the basic authorization provision for depreciation deductions, provides for the deduction of a "reasonable allowance" for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or for the production of income. Section 167(g) provides that this deduction must be based on the adjusted basis provided in § 1011. *See supra* note 101. Tangible property placed in service after 1980 and before 1987 is subject to the Accelerated Cost Recovery System rules of old § 168. Under this provision, depreciation deductions are based on the taxpayer's "unadjusted basis" in the property as defined in old § 168(d). Property placed in service after December 31, 1986 is subject to the rules of current § 168, which relies on the definition of adjusted basis in § 167(d).

The at-risk rules of I.R.C. § 465 (1988) have the effect of placing some limitations on the deductibility of depreciation on assets purchased with nonrecourse financing. In general, § 465 limits a taxpayer's annual deductible loss for certain activities engaged in as a trade or business or

viously enough, that borrowed funds can produce significant tax benefits (not to mention the significant economic benefit of being able to invest the entire borrowed amount while deferring its repayment)¹³⁰ before they are taxed.¹³¹ For my present purposes, however, the more important observation is that borrowed funds are a sort of hybrid in the federal income tax system. For some purposes (e.g., calculating taxable income) they are not treated as taxable income, while for other purposes (e.g., cost recovery) they are treated as if they had been taxable income.

The apparent hybrid character of the tax treatment of loan proceeds suggests that the concern with net worth that characterizes the justification for noninclusion might not in fact function within the federal income tax system as a factor for distinguishing potentially taxable amounts. Rather, for good reasons or bad, it may function within the system as an indicator of *when* to exclude potentially taxable amounts from taxation. Otherwise, if "no change in net worth" is taken as seriously meaning "not within the scope of the system" (as opposed to "excluded from taxable income"), the inclusion of untaxed loan proceeds in basis represents a genuine systemic incoherence. To pose the question in terms of the simple structural model of an income tax system suggested in Part I of this article:¹³² Are loan proceeds not taxed at receipt because they are not even within the purview of the system, or are they potentially taxable amounts that are excluded from taxation? If they are conceived of as potentially taxable amounts that are excluded from taxation (probably *because* of the offsetting obligation and the resultant sameness of net worth) on the presumption that repayment will be made, systemic coherence can be preserved. A description of the account that would be given under this analysis of loan arrangements should illustrate the point.

for the production of income to the amount for which the taxpayer is economically at risk. When the at-risk rules were added to the Code in 1976, they classified nonrecourse debt as amounts for which the taxpayer was not at risk. This restriction was considerably modified in 1986. For post-1986 losses with respect to real property, an exception is now provided for "qualified nonrecourse financing." I.R.C. § 465(b)(6) (1988). Generally, qualified nonrecourse financing is nonrecourse financing which has both been provided by an organization that is in the business of lending and is secured by real estate used in the activity. For an argument that the at-risk concept is wrong in principle, see Coven, *supra* note 126.

130. See, e.g., Popkin, *supra* note 126, at 44-45.

131. "By holding that nonrecourse liabilities are includable in the taxpayer's basis for property, *Crane* laid the foundation stone of most tax shelters . . ." Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX L. REV. 277, 283 (1978). See, e.g., M. CHIRELSTEIN, *supra* note 22, at ¶ 13.01; Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975); McKee, *The Real Estate Tax Shelter: A Computerized Exposé*, 57 VA. L. REV. 521 (1971); Popkin, *supra* note 126.

132. See *supra* text accompanying notes 16-17.

If a taxpayer borrows \$1000 at a standard rate of interest¹³³ in Year 1 and pays back the principal per the loan agreement in a lump sum five years later, he is not taxed on the \$1000 that he borrowed (although he may well have repaid the loan with funds that have been taxed, their treatment is entirely a function of their *own* source). The suggested analysis would simply describe the taxpayer as having excluded the loan proceeds from taxation on the presumption that repayment in full would be made in the future. If the loan were forgiven in Year 2, the taxpayer would be taxed on the amount of the forgiven principal in Year 2. The suggested analysis would explain this result in terms of reconciliation. The loan proceeds were excluded in Year 1 on the assumption of their future repayment. When that proves false, the earlier exclusion is corrected by reconciling it with the current situation and including the forgiven amount in Year 2's taxable income. Year 2's taxable income is *not*, under this account, a new potentially taxable amount entering the purview of the income tax system for the first time because of the increase in the taxpayer's net worth. Reconciliation allows us to account coherently for the current treatment of simple borrowing and discharge of indebtedness.

B. *Purchase Money Mortgages, Footnote 37 and the Issue in Tufts*

This analysis of simple borrowing, consistently applied, implies an analysis of purchase money mortgages. If the \$1000 loan in the above example were a purchase money mortgage, and the asset acquired were sold later for an amount that included the assumption of the mortgage liability, the implied analysis of the loan relief would be stated similarly in terms of reconciliation.

1. *The Implications of Coherence*

Consider, then, a range of illustrative cases. In each of these examples assume, unless otherwise specified, that the asset held by the taxpayer is nondepreciable, that the sale takes place in Year 3, and that the outstanding principal on the loan remains \$1000.

133. Assume here, and throughout the discussion *infra* of examples A-M(NR), that the interest payments are based on a fixed rate and are unconditionally payable during the term of the loan at six-month intervals. This assumption will allow the discussion to proceed schematically without the added (but unnecessary for my purposes) complexity introduced by the original issue discount rules of I.R.C. §§ 1271-75 (1988 & West Supp. 1990). For a detailed analysis of how the original issue discount rules work see McCawley, *Time Value of Money: OID and Imputed Interest*, 333-3d Tax Mgmt. (BNA) (1990).

*EXAMPLE A**Mortgage Liability**Asset*

Face value = \$1000

Basis = \$1000

FMV = \$1200

Purchaser assumes the mortgage liability and pays an additional \$200 to acquire the asset.

This transaction, like any sale, has two conceptually distinct components to be accounted for by each taxpayer — the amount received and the amount given up. Here the seller has given up an asset with a basis of \$1000 and has received relief from a liability of \$1000 plus \$200 in cash.¹³⁴ Each of these components can be separately analyzed.

1. *The asset given up:* The taxpayer receives value of \$1200 for an asset in which he had a basis of \$1000. He realizes \$200 gain.

2. *The liability relief received:* At the time the loan was incurred the taxpayer had excluded the amount of the proceeds (\$1000) from his income on the presumption that he would later repay that amount in its entirety. Here the taxpayer is giving up an asset worth \$1200 to receive relief from the \$1000 liability plus \$200 in cash. Put another way, the taxpayer is repaying the \$1000 liability in full, as per the earlier presumption, and so no corrective measure is appropriate.

*EXAMPLE B**Mortgage Liability**Asset*

Face value = \$1000

Basis = \$1000

FMV = \$900

Purchaser assumes the mortgage liability and acquires the asset plus an additional \$100.

1. *The asset given up:* The taxpayer receives value of \$1000 in exchange for an asset in which he had a basis of \$1000 and an additional \$100 in cash. He received \$900 for the asset alone and thus he realizes a loss of \$100.

2. *The liability relief received:* The taxpayer is giving up an asset worth \$900, along with another \$100 in cash, in exchange for relief from a \$1000 liability. Thus he is repaying the liability in full, consistent with the presumption behind the original exclusion of the \$1000 loan proceeds.

134. For an analysis of this and the next three examples from the purchaser's perspective see *infra* text accompanying notes 151-57.

EXAMPLE C

*Mortgage Liability**Asset*

Face value = \$1000
 \$800 = cost to
 discharge at time of
 sale [or amount one
 could now borrow
 on the same terms]
 (*i.e.*, the prevailing
 interest rate for
 similar loans has
 gone up)

Basis = \$1000
 FMV = \$1000

Purchaser assumes the mortgage liability and pays an additional \$200 to acquire the asset.

1. *The asset given up:* Perhaps somewhat counter-intuitively, the seller only receives \$1000 of value for the asset. This can be seen if one focuses on the value of the assumed mortgage liability from the purchaser's perspective. Because interest rates have risen in the three years since the original loan was taken out, it would cost an additional \$200 now to borrow \$1000. This means that a promise now to abide by the repayment terms of the earlier loan would only finance a loan of roughly \$800 and that it would therefore cost the purchaser an additional \$200 simply to relieve the seller of the liability of \$1000.

2. *The liability relief received:* The taxpayer gives up an asset worth \$1000 in order to be relieved of a \$1000 liability and receive \$200 in cash. When he originally excluded the \$1000 loan proceeds he did so on the presumption that he would repay the full amount. In fact he is satisfying his entire liability for only \$800. The premise behind the earlier exclusion has therefore turned out to be mistaken. The mistake can be ameliorated by reconciling the current year's repayment of \$800 with the earlier year's presumption of repayment and consequent exclusion of \$1000. This results in \$200 being included in the current year's taxable income.

At least two things should be noted about this analysis. First, although its practical consequences are less in a system without a special tax rate for long-term capital gains than they would be in one whose rate structure distinguished between kinds of taxable income,¹³⁵ the \$200 gain to the taxpayer *results from* the sale of the asset but does not represent *gain from* that sale associated with the appreciation of the asset. The analysis therefore implies that if the asset were a capital

135. See *supra* note 101.

asset, the \$200 would *not* be long-term capital gain. This is in contrast to current federal income tax law. Current federal law does not, in fact, bifurcate transactions of this sort as the analysis suggests.¹³⁶ Instead, relying on *Crane's*¹³⁷ inclusion of the *face value* of any mortgage liability assumed by the purchaser as part of the seller's amount realized (and ignoring the fact that the cost to discharge the mortgage liability has changed), it simply focuses on the asset. Thus, the asset in Example C has a basis of \$1000 and the seller has received \$1200 (face value of the mortgage liability assumed plus the additional \$200) for it.¹³⁸ The gain is characterized as *gain from* the sale of the asset — capital gain if the asset was a capital asset.

Second, under the suggested analysis, the \$200 gain does not represent a newly realized potentially taxable amount. Rather, it represents an amount that was excluded from taxable income when it was first identified as potentially taxable but which, in the light of the future that has come to be, should not be excluded after all. Its current recognition is not a function of its being newly realized but of the current reconciliation of the present situation with mistaken past presumptions.

EXAMPLE D

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$1100	FMV = \$1000
(The prevailing interest rate for similar loans has gone down.)	

Purchaser assumes the mortgage liability and acquires the asset plus \$100.

1. *The asset given up:* For reasons analogous to those given in this part of the discussion of Example C, the purchaser could borrow roughly \$1100 at Year 3's lower interest rate for the same total cost that he would have incurred to borrow \$1000 three years earlier. This means that in an arm's length transaction he would require \$1100 of value in exchange for his assumption of the three-year-old mortgage liability. Here, he receives \$100 in cash and the asset, which must be

136. However, if the lender conditioned the purchaser's assumption of the mortgage liability on the modification of its terms, I.R.C. § 1274(c)(4) (West Supp. 1990) and Prop. Treas. Reg. § 1.1274-1(c), 51 Fed. Reg. 12,082 (1986), appear to bifurcate the transaction in a highly stylized way by treating the modified mortgage liability as a new mortgage liability which was exchanged for the original mortgage liability.

137. *Crane v. Commissioner*, 331 U.S. 1 (1947).

138. I.R.C. § 1001(b) (1988); Treas. Reg. § 1.1001-2(a) (1980).

valued at \$1000. Since the seller-taxpayer's basis in the asset is \$1000, he has no gain or loss with respect to the asset.

2. *The liability relief received:* The seller gives up both an asset worth \$1000 and an additional \$100 to be relieved of a \$1000 liability. He has thus fully repaid the \$1000 which was earlier excluded from his taxable income on the presumption of later repayment. There is no mistake to correct, and hence no reconciliation is needed. He has, of course, spent an additional \$100 in order to procure the liability relief. A system could choose to characterize that expenditure as deductible or not.

Again, current federal income tax law yields a different result. It ignores the fact that the cost required to discharge the mortgage has changed, and simply treats this transaction as the exchange of cash and an asset with a total basis of \$1100 for mortgage relief of \$1000. The result is a \$100 asset loss. The bifurcation of the transaction into its "asset given up" side and its "liability relief received" side is a logical consequence of the suggestion that the apparent incoherence of the federal system's exclusion from tax of borrowed amounts and its concurrent inclusion of them in the basis of assets that they are used to acquire could be cured by conceiving of borrowed amounts as having been excluded from taxation on the presumption that full repayment would be made in the future. The inclusion in income of forgiven loan amounts could therefore be accounted for as instances of reconciliation.

As I indicated earlier, Barnett, in his *Tufts amicus* brief conceives of cases of this sort as *requiring* bifurcated analysis.¹³⁹ In his view, it is irrational to ignore the fact that the value of a liability can vary just as the value of any asset can. Thus he posits the general rule that "the gain or loss realized by a purchase of relief from a liability is equal to the difference between the adjusted basis of the liability and the amount expended for the relief."¹⁴⁰ According to Barnett, the amount of "the obligor's prior receipt for accepting the liability [is] his basis for the liability."¹⁴¹ Barnett values systemic rationality highly. There is some evidence that he regards it as a sufficient reason for interpreting the law as in fact providing one thing rather than another.¹⁴² Nonetheless, his own analysis does not proceed from concern that the federal system's basic treatment of simple borrowing is systemically incoherent. Indeed, he seems to accept the net worth rationale with-

139. See *supra* text accompanying note 6.

140. Brief for *Amicus Curiae*, *supra* note 3, at 5.

141. *Id.*

142. See *supra* text accompanying notes 5-7.

out question.¹⁴³ As a result, Barnett's bifurcated analysis is somewhat different from the one I am spelling out here. In each of the preceding examples, Barnett would analyze the liability relief received in terms of the taxpayer's basis in the liability (its face value in these examples) and the amount expended to procure relief. When the taxpayer, like the taxpayer in Example C, gives up assets worth less than the face value of the liability, he will realize liability gain in the amount of the difference between the face value of the liability and what he gave up for the liability relief alone, \$200 of ordinary income in Example C. This amount, and its characterization, should always be the same as that yielded by my analysis even though the descriptions of what has happened differ. However, when the taxpayer, like the taxpayer in Example D, gives up assets worth more than the face value of the liability in exchange for relief from the liability, the two analyses yield interestingly different results. Under Barnett's analysis, such a taxpayer would realize a liability loss in the amount of the difference between what he gave up in exchange for relief from the liability and his basis in the liability (face value). This would be a \$100 liability loss in Example D. My reconciliation analysis, by contrast, does not regard the taxpayer as having suffered a *loss*. He has simply spent \$100 more to procure liability relief than he expected to.

Example D is related to Example B just as C is to A. The form of the transaction in D is identical to that in B, just as that of C is identical to that in A. The difference in the analyses of the hypotheticals within each pair is entirely a function of whether either the value of the asset has changed from Year 1 to Year 3 or the prevailing interest rate for a purchase money mortgage of \$1000 is different in Year 3 from what it was in Year 1. One of the two variables remains constant in each of the four hypotheticals. In the next four hypotheticals, *both* the value of the property and the prevailing interest rate have changed.

EXAMPLE E

Mortgage Liability

Asset

Face value = \$1000

Basis = \$1000

Cost to discharge = \$800

FMV = \$1100

(The prevailing interest rate for similar loans has gone up.)

Purchaser assumes the mortgage liability and pays an additional \$300 to acquire the asset.

1. *The asset given up:* For precisely the same reasons as those

143. Brief for *Amicus Curiae*, *supra* note 3, at 3.

given in this part of the discussion of Example C, the seller here has received \$1100 of value for the asset; \$800 associated with the loan assumption and \$300 in cash. Since the asset's basis was \$1000 he realized a \$100 gain.

2. *The liability relief recovered:* The taxpayer repays a total of \$800 of the previously excluded \$1000 loan. He gives up an asset worth \$1100 in exchange for relief from \$1000 of liability plus an additional \$300 in cash. Reconciliation would square the previous assumption with the actual resolution of the debt and include \$200 in Year 3's taxable income.

For the reasons discussed above, Barnett's analysis would yield the same results. Federal income tax law currently lumps the asset gain and the liability gain together and characterizes all \$300 as asset gain.

By now the pattern of the analysis should be clear.

EXAMPLE F

Mortgage Liability

Asset

Face value = \$1000

Basis = \$1000

Cost to discharge = \$800

FMV = \$900

(The prevailing interest rate for similar loans has gone up.)

Purchaser assumes the mortgage liability and pays an additional \$100 to acquire the asset.

1. *The asset given up:* The taxpayer has received value of \$800 (mortgage liability assumed) plus \$100 (cash), or \$900. Loss on the asset equals \$100.

2. *The liability relief received:* \$1000 of relief received at a cost of \$900 (asset) less \$100 (cash received) equals \$800. Reconciliation gain is \$200.

Barnett's result would be the same. Federal law offsets the gain against the loss and calls it \$100 asset gain.

EXAMPLE G

Mortgage Liability

Asset

Face value = \$1000

Basis = \$1000

Cost to discharge = \$1100

FMV = \$1100

(The prevailing interest rate for similar loans has gone down.)

Purchaser assumes the mortgage liability in exchange for the asset.

1. *The asset given up:* The taxpayer receives value of \$1100 (mortgage liability assumed). Gain on the asset equals \$100.

2. *The liability relief received:* \$1000 of previously excluded loan receipts are repaid with the equivalent of \$1100. No reconciliation is called for (see the discussion in part 2 of Example D).

Barnett's analysis would differ exactly as it did in Example D and treat this as \$100 asset gain and \$100 liability loss. Under current law *no* gain or loss would be recognized.

EXAMPLE H

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$1100	FMV = \$900
(The prevailing interest rate for similar loans has gone down.)	

Purchaser assumes the mortgage liability and acquires the asset plus an additional \$200.

1. *The asset given up:* The taxpayer receives value of \$1100 (mortgage liability assumed) less \$200 (cash paid), or \$900. Loss on the asset equals \$100.

2. *The liability relief received:* \$1000 of relief is received at a cost of \$900 (asset) plus \$200 (cash) equals \$1100. No reconciliation is called for.

Barnett would treat the seller as sustaining \$100 asset loss and \$100 liability loss. The federal income tax treats the seller as having a \$200 asset loss.

A central tenet of federal income tax law ever since *Crane* was decided in 1947 has been that it does not distinguish between recourse and nonrecourse borrowing.¹⁴⁴ Thus, *Crane* held that the amount realized by someone who sells mortgaged property includes the face amount of the mortgage, regardless of whether the seller is personally liable for the debt. A corollary of this holding has been that the taxpayer's basis in the property includes the amount of any purchase money mortgage. However, the analysis of purchase money mortgages implied by the "reconciliation" analysis of simple borrowing suggests distinguishing between recourse and nonrecourse mortgages in some contexts.

If the purchase money mortgage is a nonrecourse loan, secured by the asset whose fair market value has dropped, the taxpayer would have no economic motivation to compensate a purchaser by paying him the difference between the face value of the loan and the fair mar-

144. See *supra* notes 5 and 131. For a concise and informative history of the tax treatment of nonrecourse debt in the federal income tax, see Shaviro, 44 TAX L. REV. 401, 420-27 (1989).

ket value of the asset. He does not need the purchaser in order to satisfy his obligation, but can simply turn the asset over to the lender/secured-interest holder. This fact suggests an important distinction between the *presumptions* that underlie recourse and nonrecourse purchase money mortgages.

Under the analysis that I have suggested, when someone borrows money, excludes it, but nonetheless includes the amount of the loan in the basis of the asset that it is used to acquire, a presumption is made. When the loan is a recourse loan, the presumption is that its face amount will be repaid in full. As Examples C, E, and F have illustrated, sometimes loans can be discharged for less than their face value. When this occurs, the analysis suggests that an adjustment might be made to the taxpayer's current ordinary income to reconcile actual events with the earlier presumption about the resolution of the loan.

But, when the loan is a nonrecourse loan, the presumption is slightly different: the face amount of the loan will be repaid in full as long as the fair market value of the property that secures it does not drop below the face amount of the loan. Otherwise, the loan will be repaid to the extent of the fair market value of the underlying property. The presumption, therefore, has two parts. First, like the case of a recourse loan, a presumption is made about the future cost of discharging the obligation. If this turns out not to be accurate, reconciliation might be appropriate. Second, and unlike the case of a recourse loan, an additional presumption is made about the future value of the asset acquired with the loan proceeds. The presumption is that the full face amount of the loan represents the appropriate amount to include in the asset's basis, because the fair market value of the asset will not fall below that face amount and the amount of after-tax investment in the asset (attributable to the loan) will thus turn out to be the face amount of the loan rather than a lesser amount. If this presumption turns out to be inaccurate,¹⁴⁵ the remedy might be to adjust the taxpayer's amount realized *for the asset* to reconcile actual events with

145. Current federal income tax doctrine distinguishes between "true" debt and contingent debt. A number of courts have upheld the Internal Revenue Service's contention that an inadequately secured nonrecourse loan is too contingent to be characterized as debt includable in the basis of the asset which secures it. Rev. Rul. 77-110, 1977-1 CB 58; *see, e.g., Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *see also Estate of Franklin*, 544 F.2d 1045 (9th Cir. 1976). My analysis of the two-part presumption underlying the inclusion of a nonrecourse loan in the securing asset's basis involves a different kind of contingency. Traditional contingent loan concerns center on uncertainty about the value of the securing asset *at the time that it is acquired*. This is hardly surprising since the issue invariably arises in the context in which the lender and the seller of the asset are the same taxpayer. The contingency which characterizes my presumption involves uncertainty about the value of the securing asset *at the time that it is sold*.

the earlier presumptions that the fair market value of the asset would not drop below the face amount of the loan that it secured.

Consider three more hypotheticals. ("NR" indicates that the loan is nonrecourse.)

EXAMPLE I (NR)

Mortgage Liability

Asset

Face value = \$1000

Basis = \$1000

Cost to discharge = \$1000

FMV = \$900

No purchaser would reasonably assume the mortgage liability. Taxpayer abandons the asset to mortgagee and is thereby relieved of his obligation.

1. *The asset given up:* The taxpayer's basis in the asset is the amount of the loan that it is presumed will be repaid. Precisely speaking, that amount should be the lesser of \$1000 or the fair market value of the asset at the time of its disposition or abandonment. Less precisely speaking, the basis is presumed to be \$1000. The basis has, in effect, been "rounded up" to the only determinable amount available at the time that the asset is acquired. When the fair market value of the asset drops to \$900 and the taxpayer abandons the asset to the mortgagee, it becomes apparent that the presumption of \$1000 has turned out to be incorrect, even though the more precisely stated presumption was correct. The current situation could be reconciled with the earlier presumption either by adjusting current income directly or by making an adjustment to the taxpayer's current basis in the asset. Adjusting basis to reflect the fact that the fair market value of the asset at the time of its disposition turned out to be less than the face amount of the loan would result, here, in a basis of \$900, and there would be no gain or loss on the abandonment of the asset.

2. *The liability relief received:* The taxpayer has been relieved of a liability equal to the lesser of \$1000 or the fair market value of the asset that secures it. He has achieved this relief by giving up the securing asset. He has thus repaid the liability in full, consistent with the repayment assumptions behind the original exclusion of the loan proceeds.

Example I(NR) is similar to Example B. Because his loan was a recourse liability, however, the seller in B could not simply abandon the devalued asset to the mortgagee without further consequence. Thus, he had to pay an additional \$100 to a purchaser to be rid of the obligation.

Example I(NR) is familiar to tax lawyers as the case whose out-

come was left in doubt by the Supreme Court in its famous footnote 37 to the *Crane* decision:

Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.¹⁴⁶

Thirty-six years later in *Tufts*,¹⁴⁷ the Supreme Court finally returned to that case. Its answer was somewhat anticlimactic. Since *Crane* does not distinguish generally between recourse and nonrecourse loans, and since *Crane* always includes in a seller's amount realized the face amount of any recourse liability assumed by a purchaser, the face amount of any nonrecourse debt assumed or forgiven (the practical effect of abandonment) should be included in a seller's amount realized as well.¹⁴⁸ The result in Example I(NR) is that the taxpayer recognizes no gain or loss on the abandonment of the asset because he is conceived as having realized \$1000 for an asset in which his basis is also \$1000. Although the rationale is different, the same result is suggested by the above analysis. Barnett's result would be the same as well.

EXAMPLE J (NR)

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$800	FMV = \$800
(The prevailing interest rate for similar loans has gone up.)	

Purchaser assumes the mortgage liability in exchange for the asset.

1. *The asset given up:* The taxpayer's basis in the asset should be described in exactly the same way as the taxpayer's basis in the asset in Example I(NR) was. Since the fair market value of the asset at the time of its disposition had dropped to \$800, the original basis was, in effect, overstated by \$200. As seller, the taxpayer is receiving value of \$800 (current cost to discharge the mortgage) for an asset whose basis is \$1000 but whose adjusted basis, as things turned out, should be \$800. Reconciliation could correct for the basis overstatement by disallowing the \$200 asset loss that would otherwise be indicated by this bifurcated form of analysis.

2. *The liability relief received:* The taxpayer has satisfied an obli-

146. *Crane v. Commissioner*, 331 U.S. 1, 14 n.37 (1947).

147. *Commissioner v. Tufts*, 461 U.S. 300 (1983).

148. *Tufts*, 461 U.S. at 307-10.

gation to repay the lesser of \$1000 or the fair market value of the asset that secures it, for the latter amount. There is no mistake to correct, nor is there any gain or loss to recognize.

Once again, this result is consistent with *Crane* and *Tufts*. The taxpayer would recognize no gain or loss on the transaction because he would have exchanged an asset with a basis of \$1000 for relief from a \$1000 liability. Barnett's analysis, on the other hand, since it does not distinguish between recourse and nonrecourse loans, would treat the taxpayer as having realized a \$200 asset loss and a \$200 liability gain.

EXAMPLE K (NR)

Mortgage Liability

Asset

Face value = \$1000	Basis = \$1000
Cost to discharge = \$800	FMV = \$900
(The prevailing interest rate for similar loans has gone up.)	

Purchaser assumes the mortgage liability and pays an additional \$100 to acquire the asset.

1. *The asset given up:* The taxpayer has received value of \$900. The basis was thus overstated by \$100, and there is no gain or loss.

2. *The liability relief received:* \$900 of liability satisfied for \$900 (fair market value of asset) less \$100 (cash received) equals \$800. Gain is \$100.

This is the same set of facts as those in Example F, except that the loan is nonrecourse. Since neither Barnett nor (in this context) current federal practice distinguish between recourse and nonrecourse loans, their analyses of Example K(NR) would not differ from their analyses of Example F.

It is important not to lose sight of the point of the suggested analysis. This analysis follows from an account of simple borrowing that can account for the hybrid treatment of loan proceeds by the federal income tax system without inherent incoherency. Since loan proceeds used to purchase a depreciable asset are included in the asset's basis, they are treated, for that purpose at least, as taxable income within the federal system. This flies in the face of any account of loans, like the net worth account, that explains their nontaxation by *distinguishing* them from taxable income.

Tufts forces us to confront the incoherence directly. It involves an asset whose original basis included the face amount of a purchase money mortgage, whose adjusted basis reflected depreciation deductions, and whose fair market value at the time of its sale was less than the face value of the loan assumed by the purchaser. The following

two hypotheticals are representative of facts like *Tufts*'. Example L assumes a recourse loan. Example M(NR) assumes a nonrecourse loan.

EXAMPLE L

Mortgage Liability

Asset

Face value = \$1000	Original basis = \$1000
Cost to discharge = \$800	Depreciation deductions taken = \$200
Adjusted basis = \$800	FMV = \$800

(The prevailing interest rate for similar loans has gone up.)

Purchaser assumes the mortgage liability in exchange for the asset.

1. *The asset given up:* The current cost to discharge a \$1000 mortgage at Year 1's interest rate is \$800. The value received by the seller is therefore \$800, and he realizes no gain or loss.

2. *The liability relief received:* The taxpayer-seller has repaid a \$1000 loan with an asset worth \$800. Thus, the \$1000 loan proceeds that were excluded in Year 1 on the assumption that they would be repaid in full, have been repaid with only \$800. Reconciliation corrects for the mistake and prescribes a \$200 gain.

EXAMPLE M (NR)

Mortgage Liability

Asset

Face value = \$1000	Original basis = \$1000
Cost to discharge = \$800	Depreciation deductions taken = \$200
Adjusted basis = \$800	FMV = \$800

(The prevailing interest rate for similar loans has gone up.)

Purchaser assumes the mortgage liability in exchange for the asset.

1. *The asset given up:* The original basis of the asset turns out to have been, in effect, overstated by \$200. If one ignores for the moment the added complications of the effect of that overstatement on the depreciation deductions taken, reconciliation would suggest that the adjusted basis should be thought of as \$600, and a \$200 asset gain would seem to have been realized. Depreciation, however, complicates the answer in two ways. First, if we assume that there is no need to reconcile for the extra depreciation that resulted from the overstatement in the original basis, the gain that reconciliation suggests might well be treated as properly characterized in accordance with the applicable rules for the recapture of excess depreciation.¹⁴⁹ Theoretically anyway, all excess depreciation should be taken into income, characterized just as it was when it was taken out. Second, there is the issue of

149. For a schematic description of the role of a recapture rule see *supra* text accompanying notes 101-02.

how to adjust for the fact that the actual depreciation was based on an inflated basis. If a goal of reconciliation is to be wholly corrective, then the proper way to think of the new adjusted basis is as it would have been had the original basis been \$800 and had depreciation deductions been calculated and taken accordingly. This would result in a revised adjusted basis of something more than \$600. On the one hand, this would reduce the asset gain subject to the recapture of depreciation rules by the amount of adjusted basis in excess of \$600. On the other hand, it would introduce the need to reconcile for the fact that exactly this much extra depreciation was taken as a result of the inflated basis.

2. *The liability relief received:* The taxpayer-seller has repaid his loan in accordance with the presumptions that governed its terms — *i.e.*, with the lesser of \$1000 or the fair market value of the underlying asset at the time of its disposition. No gain or loss is realized, and no reconciliation is appropriate.

Tufts held that the taxpayer in this situation should be treated as having realized asset gain equal to the difference between his adjusted basis (\$800) and the face value of the mortgage liability relief he received (\$1000). This \$200 would likely be characterized either as capital gain or section 1231 gain, depending on the nature of the asset. Any portion of the gain that represented excess depreciation would presumably be recaptured in accordance with the applicable rules.¹⁵⁰ This is very nearly the *same* result as that yielded by the suggested analysis. Barnett's bifurcation analysis, on the other hand, results in no asset gain or loss and a \$200 liability gain.

If we are serious about systemic coherence, and insist on it throughout our analysis of borrowed funds, its implications turn out to be different in some circumstances, including *Tufts* itself, from those claimed by Barnett. And although the *results* of our coherent analysis differ from current federal income tax law in the context of many recourse loans, they are remarkably similar in the context of nonrecourse loans.

2. *A Significant Cost of Coherence*

Systemic rationality and coherence may well be desirable for a tax system to have. Most of us are doubtless inclined, at least, to think so. But other features might be desirable for our tax system as well. Unless we can show generally that systemic coherence trumps all other values — an argument that does not get made, even by those, like

150. See *Tufts*, 461 U.S. at 303 n.2.

Barnett, who seem to think that systemic rationality and coherence provide sufficient reason for interpreting the law one way rather than another — normative arguments about a tax system must articulate and weigh a variety of values. Hence, even if the implications of coherence are as described in the previous section, I have not yet made the case for reforming current law to conform to my rationale and results.¹⁵¹ Indeed, it is not my aim here to make that case, but rather to show something about how recognizing the necessary functions of any tax system can help both in describing our own income tax system and in structuring normative arguments about it. In any case, one should note that the administrative cost of the preceding analysis of purchase money mortgages would be considerable. Just how considerable can begin to be seen by revisiting Examples A through D above, this time analyzing them from the perspective of the purchaser.

EXAMPLE A_p

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$1000	FMV = \$1200

Purchaser assumes the mortgage liability and pays an additional \$200 to acquire the asset.

1. *The asset purchased:* The purchaser has purchased an asset at a cost of \$1200. His basis in the asset should be \$1200.
2. *The liability incurred:* The purchaser has, in effect, borrowed \$1000 of his \$1200 purchase price. The borrowed \$1000 is not currently taxed on the assumption that the taxpayer will repay it in the future.

EXAMPLE B_p

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$1000	FMV = \$900

Purchaser assumes the mortgage liability and acquires the asset plus an additional \$100.

1. *The asset purchased:* The purchaser has bought an asset for a net cost of \$900 and, accordingly, his basis in the asset should be \$900.
2. *The liability incurred:* The purchaser has borrowed \$1000 which he has used to acquire \$1000 of value (an asset worth \$900 plus

151. Since my results conform fairly well to both *Crane* and *Tufts*, such reform is not possibly impractical.

\$100 in cash). This amount is not currently taxed on the assumption that it will be repaid in the future.

EXAMPLE C_P

Mortgage Liability

Asset

Face value = \$1000

Basis = \$1000

Cost to discharge = \$800

FMV = \$1000

(The prevailing interest rate for similar loans has gone up.)

Purchaser assumes the mortgage liability and pays an additional \$200 to acquire the asset.

1. *The asset purchased:* The purchaser has acquired an asset worth \$1000. One would, therefore, expect the purchase price to have been \$1000. In fact, it was, since he paid \$200 cash and agreed to pay an amount equivalent to the amount he would have to pay had he borrowed \$800 for the same term at current interest rates.¹⁵² If basis represents cost, the purchaser's basis in the asset should be \$1000. But the face value of the mortgage is \$1000, and that amount plus the additional cash which he paid would appear to give the purchaser a \$1200 basis.

2. *The liability incurred:* By undertaking the mortgage obligation the purchaser has achieved a current purchasing power of \$800. This amount is not currently taxed on the assumption that it will be repaid in the future. But, once again, it must be noted that the face value of the liability is \$1000. If the value of the liability were measured by its purchasing power at the time it was undertaken (\$800), then the face value of the loan (\$1000) would not be the standard against which future dispositions of the loan would be offset. If, for example, two years later, the asset was still worth \$1000 and the face value of the unpaid mortgage was still \$1000¹⁵³ but its cost to discharge was now also \$1000,¹⁵⁴ the sale of the asset by the person I have called "the purchaser" for relief from the liability would seem to result in no gain or loss on the asset but in a \$200 loss on the liability. In effect, the purchaser would have spent \$1000 (his basis in the asset) in order to be relieved of what, in his hands, had started out to be an \$800 debt. On the other hand, if the value of the liability were measured by its face value, regardless of fluctuations in its purchasing power, then the

152. See *supra* discussion of Example C.

153. Perhaps because its terms required periodic interest payments with a balloon payment of the principal at some future date.

154. Perhaps because current market interest rates for similar loans had returned to those originally set forth by the terms of the loan.

purchaser's basis in the asset would be \$1200 and the transaction in this example would result in neither gain nor loss on the liability, but in a \$200 loss on the asset.

EXAMPLE D_P

<i>Mortgage Liability</i>	<i>Asset</i>
Face value = \$1000	Basis = \$1000
Cost to discharge = \$1100	FMV = \$1000
(The prevailing interest rate for similar loans has gone down.)	

Purchaser assumes the mortgage liability and acquires the asset plus an additional \$100.

1. *The asset purchased:* The purchaser has bought an asset worth \$1000 and has been given \$100 as well. Clearly, a fair price for this package would be \$1100. Because the purchaser agreed to pay back an amount equivalent to the amount he would have to repay had he borrowed \$1100 for the same term at current interest rates, it would be reasonable to assign him a basis of \$1000 in the asset (his cost less the \$100 he received with the asset). If the face value of the mortgage is determinative of basis, the buyer's basis in the asset would be \$900 (\$1000 obligation assumed less \$100 cash received).

2. *The liability incurred:* The purchaser here is in a position analogous to that of the purchaser in Example C_P. He has undertaken to pay back an amount equal to the amount he would have to repay had he borrowed \$1100. This gives him a current purchasing power of \$1100. He is not taxed currently because it is assumed that he will repay in the future. This example, no less than Example C_P, illustrates how the standard against which future dispositions of the loan are measured can differ from the loan's face value if the acquired asset is given a basis equal to its value and actual cost (here \$1000) and the loan assumption is viewed as having contributed its actual purchasing power (here \$1100) to the transaction.

Bifurcation of transactions that involve both the exchange of an asset and the exchange of a liability would seem to require that the value of the liability be adjusted to reflect its current cost to discharge. If face value were always used as the measure of the value of the liability, then there could be no fluctuation in the value of any given liability¹⁵⁵ and bifurcation would have no effective role. All gains and losses would be represented as attaching to the exchange of the asset.

155. Of course, the amount of the liability could change as it was partially paid or as additional amounts were borrowed, but such changes are not fluctuations in the value of a given liability.

The seller in Example C would be said to have sold the asset for \$1200 (even though its fair market value was only \$1000 and even though someone who paid fair price in any currency other than the assumption of the outstanding mortgage liability would be treated as having paid \$1000) and thereby as having realized a \$200 gain on the asset. Consistently with that result,¹⁵⁶ the buyer in Example C_p would be given a \$1200 basis in the asset. As the preceding discussion has shown, on the whole, the current federal income tax system in fact operates in this manner. It tends to treat the increase or decrease in the value of any liability relinquished or assumed in connection with an asset sale as if it had been assimilated into the price of the asset itself.¹⁵⁷

The actual purchasing power of a particular liability can fluctuate, however, as a result of differences in the prevailing interest rates. As long as these fluctuations are not accorded any special significance by the tax system, the system can operate using the dollar as a fungible standard for measuring gain, loss, and income. If bifurcation of the sort spelled out in Examples A through M(NR) were adhered to, and for tax purposes, the value of a liability were not automatically pegged to its face value but face value nonetheless governed the relationship between debtor and creditor, then accounting for the tax consequences of satisfying assumed obligations would become a different enterprise. Essentially, the face value of the dollar paid to satisfy an obligation would cease to function as the measure of the amount paid to satisfy the obligation. The complications arise because bifurcation allows a value *different* from the face value to be assigned to a liability for tax purposes, even though face value will necessarily continue to represent the amount that the borrower is contractually due to pay to the holder of the note. Thus, in Example C_p, if, three years after he had assumed it as part of his purchase price for the asset, the buyer were to pay off the entire outstanding mortgage liability of \$1000 as per the terms of the original note, his tax treatment would vary in accordance with the purchasing power of the dollar. If its purchasing power at the end of three years were the same as it had been anticipated at the beginning of Year 1 that it would be, then paying off the debt with 1000 Year-3 dollars would not have any tax consequences, even though the loan

156. Consistency in the treatment of buyer and seller seems, at the least, a desirable feature. Coven apparently thinks that it is a necessary one. See Coven, *supra* note 126, at 77; see also Brief for *Amicus Curiae*, *supra* note 3, at 20. Without such consistency it would be possible for a seller to be treated as having received a different amount from the buyer for the asset from what the buyer is credited (through his basis) with having paid.

157. An exception to this way of proceeding is suggested by *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

had been treated in Year 1 as having a purchasing power of only \$800. This result is a straightforward consequence of the fact that the purchasing power ascribed to the loan assumption in Year 1 *assumed* a payback of \$1000 at the end of Year 3 and necessarily made certain assumptions about what the value of 1000 Year-3 dollars would be. Things would become more complicated, however, if the purchasing power of a Year-3 dollar differed from what had been anticipated in Year 1. In that case, the satisfaction of the mortgage for \$1000 at the end of Year 3 would mean either that the buyer had not paid back the entire amount that he had borrowed and therefore had, in effect, benefitted from the discharge of some of his debt, or that he had paid back more than he had borrowed. Under either description, the payback might well trigger a response by the income tax system.

Embarking on a path that allows for the possibility that the face value of the dollar will not always be treated by the tax system as a fungible unit of measurement opens up a veritable Pandora's box of practical and theoretical difficulties. Any system, like the federal income tax system, that ever measures what is taxed by comparing current value with previous value needs some standard to serve as a common denominator. The dollar has traditionally served that purpose. As the preceding examples and discussion have shown, the bifurcation of a transaction that involves both the exchange of an asset and the exchange of a liability into two distinct transactions does not allow the dollar to play this role, nor does it suggest a ready substitute.

But this analysis has not attempted to articulate the practical or policy issues surrounding the specific choices that the federal income tax system might make with respect to the taxation of transactions involving purchase money mortgages, much less to resolve them. It is an effort, however, to provide a general conceptual framework within which those issues can be identified, articulated, understood, and debated.

IV. POSTSCRIPT TO PARTS II AND III: WHEN TO RECONCILE

Each of the foregoing examples of reconciliation within the federal income tax system illustrates *how* it functions as a corrective device. Reconciliation involves the comparison of the actual current circumstances with a position taken on an earlier return with respect to some potentially taxable amount. When it operates, it adjusts the current year's taxable income if the comparison reveals that the earlier position presumed a future that is relevantly different from what actually occurred. In this way it prevents at least some of the system's earlier choices about the treatment of potentially taxable amounts from being

irrevocable. At the same time, it determines whether and when to tax that potentially taxable amount.

Although none of the foregoing examples focuses directly on the question of *when* reconciliation might be appropriate, they certainly suggest the beginnings of an answer. In each example, reconciliation is invoked only when events have shown, once and for all, that some presumption about the future that characterized an earlier year's treatment of a potentially taxable amount has proved incorrect.¹⁵⁸ The relevant future has in some sense been resolved.

Not surprisingly, given the connection between reconciliation and the ultimate resolution of a contingent event, the identification of a mistake that triggers reconciliation often coincides with the realization of another potentially taxable amount. This is easily illustrated by my discussion of section 1245 recapture.¹⁵⁹ There, the event that made it certain that the earlier years' depreciation had been excessive was the sale of the depreciated asset. Any increase in the value of the asset was realized at the same time. Similarly, in Examples A through M(NR),¹⁶⁰ the final disposition of the loan made it certain that the earlier year's report of taxable income hinged on a mistaken presumption about the future. That disposition occurred at the same time the property securing the loan was sold or abandoned. In each instance, the event triggering reconciliation was also the event marking the realization of any potentially taxable amounts arising from the appreciation of the asset.

The frequent identity of a reconciliation event and a realization event has obscured the fact that reconciliation is different from realization and functions within our system as a separate and distinct means for determining whether and when a potentially taxable amount will be recognized. This is doubtless at least a part of the reason why the conceptual vocabulary of the federal income tax system has not included reconciliation. Instead the system has struggled unsuccessfully to account for all instances of taxation in terms of realization. This aggrandizement of realization has, in turn, necessarily led us to ignore the straightforward structural requirements common to any tax system, including one that purports to tax income. This essay is an effort to begin to look directly at those requirements and their implications for the structure of the federal system.

158. See White, *supra* note 9, at 502-05.

159. See *supra* text accompanying notes 98-121.

160. See *supra* section III.B.1.

CONCLUSION

I have claimed here that there are certain necessary questions that any tax system must ask. At the least, a system must make some determination about whether it considers an item within its aegis, and for each such item, must determine whether to tax it, and, if so, when.¹⁶¹ If this observation is correct, and I do not see how it cannot be, then any tax system, including the federal income tax system, can be described in terms that relate its particular features to the necessary functions. We can expect that any system will have some means of determining what falls within its province (even if that means is not terribly systematic)¹⁶² and some means of determining whether things within its compass will be taxed and when. In a simple system the initial division will obviate the later *whether* question, and only the *when* (now or later) question will remain.¹⁶³ This paper begins to describe the federal income tax system in terms that relate its features to these necessary functions.

The federal system is complex and does not neatly divide the world, first into a pile of things that are potentially taxable and a pile of things that are not, and then go about the task of deciding *when* to tax the things in the first pile. Instead, it conceives of exclusion (whether by initial exclusion or by deduction) from the tax base as a possible response to those items included in the first pile. This means that it asks the question *whether* to tax any item as well as the question *when* to tax it after it has made some initial attempt at dividing the world into two piles.¹⁶⁴ More importantly, it also means that the normative goals that determine the federal system's tax base are not fully specified by the criteria of initial division. Indeed, no criterion of initial division is ever really articulated by the system because it relies on the answers to the *whether* and, to a lesser extent, the *when* questions to determine the content of the tax base.¹⁶⁵

Any tax system, including the federal income tax system, will have

161. See *supra* text accompanying notes 10-21.

162. See *supra* text accompanying note 19.

163. Actually in the simplest sort of system there is no *when* question either; once an item is identified, it is taxed. See *supra* text accompanying notes 13-14.

164. Some attempt at division seems to have been made, since our system does not *ask* the *whether* and *when* to tax questions of everything in the world (my left big toe, for example). Or perhaps it does include everything as within its scope and can be conceived instead as determining not to tax my big toe in answer to the *whether* question. If so, everything in the world that is untaxed can be regarded as being potentially taxable and as having been excluded from the system. The criteria for inclusion in the system's tax base would be identical to the criteria for determining whether to tax. The general structural model is unaffected by this possible interpretation of the federal system.

165. See *supra* text accompanying notes 14-17.

mechanisms for answering the *whether* and *when* to tax questions which may be more or less systematic. The federal system explicitly identifies realization as playing a central role in its determinations of whether and when to tax. In fact, however, the federal system also relies importantly on another, unarticulated, mechanism to make these determinations. I call this mechanism "reconciliation."

Reconciliation has considerable descriptive and explanatory power. Distinguishing it allows us to give a more coherent account of a number of phenomena in the federal income tax system than we can give with the traditional conceptual vocabulary. But it is important to realize that coherence and rationality are only one (two?) of a variety of aspirations that we might have for a tax system. Thus, whenever a coherent account of an actual phenomenon within a system has implications for the description of certain other parts of the system, and the further descriptions turn out *not* to fit the facts, we cannot simply assume that the best course would be either to reform or to interpret the law so as to increase its coherence. Sometimes other, often competing, values, such as administrability, equity, economic growth, or political expediency are relevant to the question of what the law ought to be or how it should be interpreted. Self-conscious articulation and exploration of those values and their importance ought to be a goal of normative discussion about the content of the income tax system.

The federal income tax system has become grotesquely complex. On the one hand, the temptation to declare that it no longer has any structural foundations is great. On the other hand, the importance of a structure that can be looked to to help us understand what we have and to provide us with a conceptual apparatus within which to focus our critical and reforming efforts is also great. This paper is borne of the belief that there is reason to pursue the latter course.