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Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market

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I. INTRODUCTION

When last we looked, Professor Surrey[1] persuaded us that the Supreme Court abandoned the constitutional realization requirement it enunciated in the case of *Eisner v. Macomber*.[2] According to Surrey, the Court relegated the concept of realization to the realm of administrative convenience. However, when invited to overrule *Macomber*, the Court refused, thereby declining to confirm Surrey's conclusions.[3]

Over the past forty years, most commentators who have proposed major revisions to the tax system have turned their attention to loftier, more theoretical planes than the existence or absence of the constitutional realization requirement. The 1960s, for example, saw a myriad of proposals to broaden the tax base and to eliminate tax preferences. Much of the literature has since referred to these proposals as a movement toward a comprehensive tax base.[4] Later, integration of the corporate and individual tax systems became the subject of extensive discussion,[5] and Congress began to tinker with the longstanding, corporate nonrecognition rules which flowed from the Supreme Court's decision in *General Utili-*

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[1] Stanley S. Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. Nw. U. 779 (1941).

[2] 252 U.S. 189 (1920). Eisner v. Macomber is discussed infra note 33 and accompanying text.

[3] In a lengthy opinion, the Court declined the government's request to overrule *Macomber* in Helvering v. Griffiths, 318 U.S. 371 (1943), discussed infra note 148 and accompanying text. See also Helvering v. Sprouse, 318 U.S. 604 (1943), discussed infra note 150 and accompanying text.

[4] See generally, Boris I. Bittker et al., A Comprehensive Income Tax Base? A Debate (1968) (collecting a series of essays concerning the concept and administrability of an income tax employing a comprehensive tax base); Comprehensive Income Taxation (Joseph A. Pechman ed., 1977) (collecting a series of essays concerning the concept and administrability of an income tax employing a comprehensive tax base).

[5] See e.g., Joseph A. Pechman, Federal Tax Policy (5th ed. 1987); Charles E. McLure Jr., Must Corporate Income Be Taxed Twice? (1979); American Law Institute, Federal Income Tax Project Subchapter: C (1982); Alvin Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 719 (1981).

ties & Operating Co. v. Helvering.[6] Ultimately, Congress repealed most vestiges of the *General Utilities* rule.[7]

Recent theoretical debate concerning a major overhaul of the income tax system[8] has been primarily between the proponents of a cash flow tax model, or consumption tax,[9] and the proponents of

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[6] 296 U.S. 200 (1935). In *General Utilities*, the taxpayer corporation owned appreciated stock of another corporation and distributed these shares to its shareholders. The government asserted that the corporation had declared a dividend in cash and discharged its liability to its shareholders by distributing to them the appreciated shares, thereby recognizing gain under the doctrine of United States v. Kirby Lumber Co., 284 U.S. 1 (1931), see discussion infra notes 151-52 and accompanying text. The Supreme Court found that General Utilities had not declared a dividend in cash which it paid in kind, but rather declared a dividend in kind. The Court concluded that the lower courts correctly ruled that there was neither discharge of indebtedness nor sale to the shareholders and thus that General Utilities derived no taxable gain.

Unlike the *Macomber* decision, the Court identified no constitutional basis for its decision and, according to Boris I. Bittker & James S. Eustice, refused to consider the government's argument, not raised below, that the mere distribution was sufficient to cause the corporation to recognize gain as if it had sold the shares for their fair market values. Federal Income Taxation of Corporations and Shareholders ¶7.20 at 7-46 n. 143 (5th ed. 1987).

[7] Congress gradually eroded the principle of corporate nonrecognition of gain in distributions of appreciated property in kind through a series of statutory changes. Section 631 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2269 (1986), repealed most of the remaining characteristics of the *General Utilities* doctrine. Congress amended § 311(b) and § 336 of the Int. Rev. Code of 1954, as amended, as it recodified the tax laws in the Internal Revenue Code of 1986. Under current law, both § 311(b) governing current distributions and § 336 governing liquidating distributions, with certain exceptions, require the distributing corporation to recognize gain upon distribution of appreciated property to its shareholders as if the corporation had sold the property to the distributee at fair market value. To date, taxpayers have not challenged the validity of the legislation on constitutional grounds.

Constitutional affirmation of the anti-*General Utilities* legislation would support the argument that there is no barrier to enactment of legislation compelling the recognition of the gain on appreciated assets when the owner dies or makes a gift of the appreciated property. See discussion of the proposals on this matter infra part II.C.3.

In some respects Congress laid a partial foundation for integration of corporate and individual taxes by repealing the *General Utilities* doctrine. Without the imposition of a full tax at both levels, integration and, accordingly, elimination of one level of tax arguably could leave a gap for some transactions in which no tax at all would be levied.

[8] There of course has been discussion of other types of taxes to raise necessary revenues. One proposal is a value-added tax which imposes taxes throughout the production process through the sale of goods. It seems likely that United States tax writers will scrutinize Canada's new goods and services tax which is similar to a value-added tax imposed upon both goods and the provision of services. See James W. Wetzler, The Value-Added Tax: The Relevance of States' Sales Tax Experience, 52 Tax Notes 719-22 (August 5, 1991); Al Meghji & Doug Richardson, Canada's Goods and Services Tax: Impact on Nonresidents and International Transactions, 52 Tax Notes 693-718 (August 5, 1991).

[9] Probably the leading proponent of the consumption tax is Professor Andrews. See William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L.

an accrual or accretion tax,[10] who seek to construct a tax system based upon and approximating the Haig-Simons definition of income.[11] Commentators who view a realization requirement as a potential constitutional impediment to adopting an accretion tax system have chosen to ignore the constitutional problem because it is not pertinent to their theses.[12]

During the 1980s, Congress sought opportunities to broaden the tax base and to accelerate the moment of taxation. The inclusion of nearly all prizes and awards in gross income under section 74 of the Internal Revenue Code of 1986 (hereinafter the "Code") represents pure tax base broadening,[13] and the immediate recognition of recapture income in an installment sale constitutes pure acceleration.[14] In some cases the concepts of base broadening and acceleration overlap. Section 1256 of the Code,[15] for example, appears to be

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Rev. 1113 (1974). A consumption tax or expenditure tax operates on a cash-flow basis and ultimately taxes only consumption. Investment is deductible from the base and disinvestment—sale of investments—includable on a gross rather than net basis. Using the terminology of the income tax model, the taxpayer recovers her cost completely at the moment of investment.

[10] See David J. Shakow, Taxation without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); Jeff Strnad, Periodicity and Accretion Taxation: Norms and Implementation, 99 Yale L. J. 1817 (1990). To oversimplify, accrual or accretion taxation differs from the comprehensive tax base in that it would tax currently the appreciation in the value of the taxpayer's assets.

[11] 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. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.

Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938).

[12] See, e.g., Shakow, supra note 10, at 1113 n.9 (electing to ignore the constitutional problem and demonstrating that as an accrual system of taxation is administratively feasible, it would hardly add to his analysis to examine the constitutional issue).

[13] Section 122(a) of the Tax Reform Act of 1986 amended I.R.C. § 74 to eliminate the general exclusion from gross income of prizes and awards such as Nobel prizes.

[14] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 112(a), 98 Stat. 494 (1984) ("DEFRA"), amended I.R.C. § 453(i) to compel recognition of recapture income under I.R.C. §§ 1245, 1250 in the year of sale rather than the years in which the seller receives payments.

[15] The Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-34, § 503(a), 95 Stat. 172 (1981), added § 1256 to the Code. Section 1256 requires taxpayers to mark to market, i.e., determine the fair market value of, various positions they hold at the close of their tax year and then include in their income the gains or losses in those positions. See discussion infra part III.A.

an acceleration provision in that it causes taxpayers to recognize gains which they otherwise might have deferred until the year in which they sold or closed out the position. The gains, however, may never have been included in gross income if the position had depreciated in value or the taxpayer died before sale or closeout.[16]

Interest in broadening the tax base and accelerating income likely will continue throughout the 1990s. This interest may manifest itself without any clearly identifiable tax reform theme or goal.[17] As Congress scrambles to increase revenues without dramatically increasing rates, it nibbles further at the edges of the realization requirement with provisions modeled after section 1256 of the Code.[18] At the same time, advances in computer technology have removed many of the traditional administrative barriers to taxing unrealized appreciation.[19] For example, sophisticated algorithms and extensive data bases now enable evaluators to estimate asset value changes from one year to the next with considerable accuracy at a reasonable cost.

Suppose that Congress enacted an accretion model of taxation. Each taxpayer would have to evaluate all property she owns annu-

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[16] See I.R.C. § 1014. The taxpayer's basis in the position would increase or decrease, as the case may be, to the value of the position on the taxpayer's date of death (or alternate valuation date if the election under § 2032 is in effect) without the recognition of the gain or loss accruing prior to the taxpayer's death. Compare the deferred gain in the case of an installment sale where the estate or distributee of the installment obligation from the estate continues to recognize the decedent's gain as income in respect of a decedent under § 691. See discussion of Congress' consideration of proposals to tax unrealized gains of a taxpayer upon her death infra part II.C.3.

[17] See, e.g., the Revenue Reconciliation Act of 1993, Chapter 1, Title XII of the Omnibus Budget Reconcilation Act of 1993, Pub. L. No. 103-66, ___ Stat. ___ (1993) (the "1993 Tax Act"); the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990); Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989) (all lacking any recognizable tax reform theme). Congress' and the President's determination to hold the line on tax rates while enhancing revenues drove both the 1990 and the previous year's tax legislation. Similarly, the proposed Revenue Act of 1992, H.R. 11, 102d Cong, 2d Sess. (1992) ("1992 Tax Proposals"), which President Bush vetoed lacked a unified tax reform theme.

[18] See §§ 3001, 4402 of the 1992 Tax Proposals, supra note 17, which would apply the mark-to-market concept to dealer-owned securities and the shares of passive foreign corporations, respectively. Section 13223 of the 1993 Tax Act, supra note 17, added section 475 to the Code requiring securities dealers to mark their positions to market.

[19] Shakow, supra note 10, at 1113 (identifying the traditional "twin problems of valuation" [a computational problem] and "liquidity"). See references cited in Shakow's note 8. But see Bittker et al., supra note 4, at 1, 19 (not considering valuation to be a significant impediment to accrual taxation).

ally and include net accrued gains in, or deduct net accrued losses from, gross income. The usual arguments might be made in opposition to the legislation: (1) the system is unwieldy, expensive to operate and tends to be subjective; (2) some taxpayers will have a liquidity problem and be forced to sell assets in order to pay the tax; and (3) the flow of capital to various markets will be impeded, as investors become reluctant to invest when a short-term paper gain will be taxed, perhaps only to be matched by a paper loss in the next year.

Limiting the accretion system to assets which are easy to value and readily marketable will solve the first two problems. For example, Congress might apply this method only to exchange traded stocks, bonds and other interests.[20] Might such a choice place some industries at an advantage over others in raising investment capital? Would it spur a corporate drive to delist shares? Would *Macomber*[21] prevent enforcement of such legislation?

The goal of this article is to provide an understanding of the current status of the realization requirement and the potential risk that realization holds for statutes which tax specific industries on an accretion basis. Accordingly, part II of this article reviews, reevaluates and updates the post-*Macomber* history of the realization requirement. The article reexamines, and perhaps reopens, the debate about realization which originally resulted in a general acceptance of Surrey's conclusion that administrative convenience replaced the constitutional realization requirement.[22]

Part III of the article focuses on the commodity investment industry, the first domestic industry to become subject to accretion taxation and the only industry taxed generally in that manner. Initially, the article applies the observations of part II to section 1256 of the Code to determine the constitutional legitimacy of section 1256. In so doing, it endeavors to discern the characteristics of commodities investing which render accretion taxation appropriate. The article also attempts to ascertain why participants in the commodities industry, without objection, have accepted a differen-

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[20] Compare IRC § 475 marking dealer-owned securities to market and proposals to revamp the rules governing United States taxation of certain foreign corporations, supra note 18.

[21] 252 U.S. 189 (1920).

[22] See supra note 1 and accompanying text, and articles cited infra notes 26-27.

tial tax system. Finally, part III briefly examines the expansion of accretion taxation to other activities.

II. Tracing The Macomber Effect

A. Introduction

In the years following its decision in *Macomber*, the Supreme Court issued a series of decisions which limited what the tax community believed to be the full reach of *Macomber*.[23] Commentators almost universally accept Professor Surrey's conclusions regarding the following:[24] (1) there is no continuing vitality to *Macomber's* constitutional realization requirement, and (2) to the extent the tax law continues to include a realization requirement at all, it is solely a function of administrative convenience.[25] Debate concerning a constitutionally-based realization requirement ended forty years ago.[26] Yet, although the government has invited the Supreme

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[23] United States v. Kirby Lumber Co., 284 U.S. 1 (1931), discussed infra text accompanying note 151; Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216 (1937); Helvering v. Bruun, 309 U.S. 461 (1940), discussed infra text accompanying note 170; Helvering v. Horst, 311 U.S. 112 (1940), discussed infra text accompanying note 199; Helvering v. Eubank, 311 U.S. 122 (1940), discussed infra text accompanying note 202; Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), discussed infra text accompanying note 214. Among recent decisions, the most important from the perspective of realization are Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), discussed infra text accompanying note 218, and Cottage Savings Association v. Commissioner, 111 S. Ct. 1503 (1991), discussed infra text accompanying note 230.

[24] See Surrey, supra note 1.

[25] Among the discussions contemporaneous with Surrey's article, cited supra note 1, are: Robert N. Miller, Gifts of Income and of Property: What the Horst Case Decides, 5 Tax L. Rev. 1 (1949); Erwin N. Griswold, Charitable Gifts of Income and Internal Revenue Code, 65 Harv. L. Rev. 84 (1951); Boris I. Bittker, Charitable Gifts of Income and Internal Revenue Code: Another View, 65 Harv. L. Rev. 1375 (1952); and Griswold, In Brief Reply, 65 Harv. L. Rev. 1389 (1952). More recent treatments of realization universally imply that the constitutionally-based realization requirement announced in *Macomber* is hardly worth serious discussion. See, e.g., Charles L. B. Lowndes, Current Conceptions of Taxable Income, 25 Ohio St. L. J. 151 (1964); 1 B. Bittker and L. Lokken, Federal Taxation of Income, Estates and Gifts § 5.1 (2d ed. 1989); Michael Chirelstein, Federal Income Taxation ¶ 5.01, at 68-69 (5th ed. 1988); Patricia D. White, Realization, Recognition, Rationality and the Structure of the Federal Income Tax System, 88 Mich. L. Rev. 2034 (1990).

[26] But cf. Edward T. Roehner and Sheila M. Roehner, Realization: Administrative Convenience or Constitutional Requirement?, 8 Tax L. Rev. 173 (1953) (disagreeing that realization is only a matter of administrative convenience, and concluding that Professor Surrey reads too much into the post-*Macomber* decisions); Phillip Mullock, The Constitutional Aspects of Realization, 31 Pitt. L. Rev. 615 (1970) (nearly twenty years after the Roehner article, Professor Mullock takes issue with Professor Lowndes' (Lowndes, supra note 25)

Court to overrule its 1920 decision in *Macomber*, to date the Court has declined the invitation.[27]

Under the guise of staunching widespread tax avoidance, Congress enacted both the foreign personal holding company provisions in 1937,[28] and legislation aimed at limiting tax deferral achieved by controlled foreign corporations in 1962.[29] Both the foreign personal holding company and the controlled foreign corporation provisions impute corporate earnings to shareholders without the shareholders consent.[30] But aside from these exceptions in the area of taxation of offshore operations, between the Supreme Court's *Macomber* decision and the enactment of section 1256 of the Code in 1981, Congress never sought to tax the unrealized appreciation in a taxpayer's property. Congress examined but rejected proposals to tax unrealized appreciation in assets upon the

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acceptance of the administrative convenience argument). And realization as a constitutional requirement continues to have adherents: Steven Lenz, Note, The Symmetry of the Realization Requirement and its Application to the "Mortgage Swap" Cases, 9 Va. Tax Rev. 359 (1989). This last-named note views the constitutional aspect of realization as requiring only "objectively measurable appreciation in the taxpayer's controllable economic position," not a disposition of property. Id. at 367. Thus, § 1256 of the Code is constitutional under the note's analysis although the note does raise the question of constitutionality with respect to that section.

[27] In a lengthy opinion, the Court declined the government's request to overrule *Macomber* in Helvering v. Griffiths, 318 U.S. 371 (1943), discussed infra note 148 and accompanying text. See also Sprouse v. Commissioner, 318 U.S. 604 (1943), discussed infra note 150 and accompanying text.

[28] The foreign personal holding company provisions now appear in I.R.C. §551 et seq. They originally became part of the tax law with the enactment of Revenue Act of 1937, Pub. L. No. 75-377, § 201, 50 Stat. 813 (1937). See discussion of foreign personal holding companies infra note 71 and accompanying text.

[29] Sections 951-64 generally are referred to as subpart F (subpart F of part III of Chapter 1N of the Code). The controlled foreign corporation provisions were added to the Code by Revenue Act of 1962, Pub. L. No. 84-834, §12(a), 76 Stat. 960 (1962). See discussion of controlled foreign corporations infra note 87 and accompanying text.

[30] The Subchapter S corporation provisions, §§ 1361-1379 of the Code, which currently impute corporate earnings to the shareholders according to a partnership model, originally taxed earnings as if the corporation had distributed all its earnings as dividends, § 1371 of the Int. Rev. Code of 1954, as in effect before enactment of the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982), but the provisions apply only if the shareholders so elect. Passive foreign investment companies ("PFIC"), § 1291 of the Code, et seq., differ from foreign personal holding companies and controlled foreign corporations in that current inclusion of corporate level income in shareholder income is consensual under section 1295. In this respect, PFICs resemble S corporations. But in many instances, the imposition of maximum marginal rates and the interest charge on deferral under section 1291(c)(1)(B) economically compel the United States shareholders of the PFIC to elect current inclusion and thus render PFICs distinguishable from S corporations.

death of their owner.[31] Similarly, Congress has not attempted again to tax a corporation's distributions of its own shares with respect to its outstanding shares in the absence of a change (or potential change) in relationship between the corporation and its shareholders resulting from the distribution.[32]

B. *Stock Dividends: Macomber and Towne*

The Court required a second set of arguments before it rendered its 5-4 decision in *Eisner v. Macomber*.[33] Both the prevailing opinion and Justice Brandeis' vigorous dissent support their respective positions with economic arguments which highlight an important inconsistency in the corporate double-tax system. That inconsistency is the lack of a universal, economic correlation between corporate profit and the direct tax burden which corporate shareholders bear. It emanates from the impermissibility of, or, if one agrees with Brandeis' dissenting position, the Congressional decision against, taxing corporate earnings to the shareholders prior to distribution. As a result of this economic anomaly, *Macomber* fails to offer an appealing opportunity to decide the fundamental issue of the existence of a constitutional realization requirement.

An example may help crystallize the economic issue. Assume corporation A accumulates $100 in profits and makes no distributions with respect to the 10 shares it has outstanding. While it may be difficult to predict how much increase in value will result from the retained earnings,[34] one may assume that each outstanding

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[31] See discussion of the proposals infra Part II.C.3. Ultimately Congress did adopt and later repeal § 1023 of the Code, which caused the basis of the decedent to carry over to the estate's distributees in order to prevent the unrealized appreciation from escaping taxation permanently.

[32] See I.R.C. § 305. Section 305 includes distributions of a corporation's shares in the recipient shareholders' incomes in those cases in which inclusion would be permissible under *Macomber*. Actual change in relationship, however, is unnecessary. For example, if all shareholders may choose either a stock or a cash dividend, and all choose the stock dividend, all shareholders would be taxable despite the absence of an actual change in relationship. The shareholders constructively received the cash which they elected to reinvest in the corporation, as the cash was available for the mere asking. Compare the constructive receipt justification for the mark-to-market rules under § 1256 of the Code. See discussion infra part III.C.1.

[33] 252 U.S. 189 (1920).

[34] Use of the concept "retention of earnings" does not make any technical assumptions about the manner of computation but merely distinguishes between retention of earnings and distribution of earnings. For federal income tax purposes, a corporate distribution is a

share will increase in value as A retains its earnings.[35] Nevertheless, that increase does not result and may never result in a tax on the shareholder who held one or more of the shares at the time the corporation earned the income. Subsequent corporate losses may eliminate the share gain, or the shareholder may die before selling the shares or receiving a distribution. If the shareholder dies while holding the shares, his estate or other beneficiary receives a fair market value basis in the shares[36] and may sell them before the corporation makes a distribution. Moreover, if the corporation liquidates before the shares have changed value, with respect to the shares the decedent owned, retained earnings will never be taxed at shareholder level.[37] In these respects the corporate stock does not differ from other property which fluctuates in value in the marketplace. But the similarity ends there.

If a buyer purchases the shares for a price per share reflecting the retained earnings—assume for the sake of simplicity an additional $10—the original shareholder as seller may recognize and become subject to tax on the $10 gain. Yet, if the corporation distributes the $10 per share of retained earnings the following day,[38] the buyer becomes subject to tax on her share of the dividend dis-

dividend to the extent of the corporation's current or accumulated earnings and profits. Section 312 of the Code describes rules for adjusting earnings and profits but does not define the term with precision.

[35] It would oversimplify the marketplace to assume that the value of each share increases by its proportional share of the earnings the corporation retains. Certainly the intrinsic value of the corporation has increased by the $100 retained. But the marketplace for shares generally will decide upon the degree of increment in share value on the basis of a series of factors in addition to intrinsic value. Most important among the factors is likely to be the market's impression of the ability of the corporation's managers to utilize effectively the retained profit in order to make it grow. If the corporate managers are efficient, the price per share may increase by amounts well in excess of the $10 per share earned. Conversely, a marketplace perception that the corporate managers are inefficient may severely limit the increase in share value.

[36] I.R.C. § 1014.

[37] See I.R.C. § 331. Section 331 treats the receipt of liquidating distributions as a sale by the shareholder of the shares for the amount of the liquidating distribution. Since the decedent's basis in the shares has adjusted to fair market value on date of death (or alternate valuation date, as the case may be), there should be no gain or loss on the shares.

[38] This assumes that the amount of retained earnings, the term used in corporate accounting but far more loosely in this article, see supra note 34, is at least equal to current and accumulated earnings and profits. Section 312 of the Code measures earnings and profits which may differ markedly from a corporation's retained earnings since the conventions in use for measuring the two amounts by no means are identical. See Bittker & Eustice, supra note 6, ¶¶ 7.03-7.04, for a discussion of the computation of earnings and profits.

tribution. Accordingly, in addition to the possibility that the corporate earnings may avoid taxation at the shareholder level, there is the possibility that they may be taxed twice at the shareholder level, once as a gain on the sale of shares and again as a dividend. Presumably, the shares held by the buyer will decrease in value as a result of the distribution, because the shares increased as a result of the retention of earnings. The buyer, then, has a potential loss on the shares. The buyer may obviate the anomaly, at least in part, by selling the shares in the year of distribution, thereby recognizing the potential loss.[39] In fact if the buyer is actually alert, or constructively alert—as should be the case in a free market—to the problem, she will discount the value of the shares to reflect the shareholder level tax cost embedded in the corporation's retained earnings. So long as Congress leaves the tax rules intact, discounting of share value may serve to eliminate the economic aberration while leaving the tax anomaly undisturbed.[40]

Macomber involved the 1916 declaration and distribution of a

[39] Sale of the shares may not eliminate the anomaly because the loss on the shares is likely to be a capital loss which the buyer may be unable to employ to offset the ordinary income dividend. Section 301(c)(1) of the Code includes dividends in gross income as ordinary income. Section 1001 governs sales of shares which, under § 1221, generally are capital assets. Section 1211 limits the deductibility under § 165 of losses arising from the sale of capital assets, in the case of an individual taxpayer, to gains from capital assets plus $3000 per year.

Corporate tax planners exploited this difference in character to reduce corporate income taxes for corporations having sizable capital gains until Congress severely diminished the opportunities for the practice in 1984. Since dividends a corporation receives from another corporation are deductible in whole or substantial part (seventy or eighty percent) under § 243, purchase by a corporation of the stock of another corporation immediately before the latter declares an extraordinarily large dividend enabled the former to deduct the dividend received and sell the shares post-dividend at a loss roughly equal in amount to the dividend received. The dividend went untaxed or taxed only in minor part while the loss was a deductible loss from the sale of the shares. This result obtained despite the loss being economically artificial since it was offset by the distribution. Section 53 of DEFRA, supra note 14, added § 1059 to the Code which causes corporations which are shareholders in other corporations to reduce their basis in the shares by the amount of extraordinary dividends they receive from the issuing corporation. Reduction of basis eliminates the opportunity to recognize a deductible loss equal to the amount by which the current distribution causes the share value to recede.

[40] Changes in tax law tend to produce economic displacement as they correct tax problems because the marketplace has taken tax characteristics into account in pricing. For example, real estate values advanced materially when ERTA, supra note 15, shortened the depreciable lives of buildings to fifteen years. By the same token, real estate values retreated materially when the Tax Reform Act of 1986, supra note 7, lengthened those lives and reduced tax rates.

fifty percent share dividend by Standard Oil Company of California. Since, in the Court's view, the governing statute expressed Congress' unambiguous intention to tax stock dividends to the extent of their fair market values,[41] the issue squarely confronting the Court was whether or not the stock dividend was income. If not income, Congress had no power under the Sixteenth Amendment to tax the stock dividend without apportionment. Relying upon the *Doyle v. Mitchell Bros. Co.* definition of the word "income" as "the gain derived from capital, from labor, or from both combined,"[42] and its earlier decision in *Towne v. Eisner*,[43] the Court concluded that a stock dividend is not income but simply a change in the number of shares representing the same interest in the same corporation as before the distribution. The distribution itself did not enrich the shareholder since her aggregate bundle of rights before and after the distribution were precisely identical. In short, the shareholder derived nothing from the capital.[44] In addition, the Court correctly observed that a different outcome might result in the shareholder having to sell part of her interest in the corporation—viewed by the Court as capital—in order to pay the tax.[45]

In the government's view,[46] supported by Justice Brandeis in his

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[41] 252 U.S. at 200 n.1. The Court quotes § 2(a) of the Revenue Act of September 8, 1916, which expressly included dividends in net income and defined a dividend as:

> any distribution made or ordered to be made by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation . . . which stock dividend shall be considered income, to the amount of its cash value.

Id.

[42] 247 U.S. 179, 185 (1918).

[43] 245 U.S. 418 (1918). See discussion infra note 53 and accompanying text.

[44] *Macomber* 252 U.S. at 212. In the case of publicly traded stock, the aggregate value of all the shareholders' shares generally is not equal before and after the stock dividend. A stock dividend decreases the price per share and consequently increases demand for shares under standard economic price/demand theory. The immediate increase in demand will cause the price to rise simultaneously. Moreover, public perception that the corporation has devoted earnings permanently to capital by shifting account balances and issuing additional shares may cause an increase in the value of the shares if the public expects the corporation to continue to manage its capital efficiently.

[45] Id. at 213. One could view this argument as supporting a rule of administrative convenience not to create liquidity problems for taxpayers rather than one of constitutional jurisprudence. See discussion of the constructive receipt principle as applied to commodity positions infra part III.C.1.

[46] Id. at 190.

dissenting opinion,[47] Congress has the power under the Sixteenth Amendment to tax shareholders on their pro rata shares of corporate earnings. The Court majority, however, was unwilling to accept the partnership model of taxation as a permissible alternative for Congress. It refused to ignore the separateness of corporations and their shareholders and concluded that "enrichment through increase in value of capital investment is not income in any proper meaning of the term."[48]

The disagreement between Justice Brandeis and the Court majority seems to lie neither in their respective definitions of income nor in their acceptance or rejection of a constitutionally-based realization requirement. Rather, the conflict arises from the differences in their respective views concerning the proper relationship between a corporation and its shareholders. Premised in its view of the corporation as fully distinct from its shareholders, the Court majority treated increase in the value of corporate shares as equivalent to appreciation in any other property held by the taxpayer. Gain is not ripe for taxation, under this view, until the taxpayer realizes such by accepting, albeit even involuntarily, something for this appreciated property which is distinct from the property itself.[49] Brandeis rejected this notion, arguing that Congress' decision not to tax corporate profits to the shareholders was elective. Since Congress could have taxed corporate profits to the shareholders as the corporation earned them, Congress has the power to tax the shareholders when the corporation adjusts its accounting and distributes additional shares representing those profits.[50]

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[47] Id. at 230-31. Justice Brandeis reiterated this position in dictum in his opinion for the Court in Helvering v. National Grocery Co., 304 U.S. 282, 288 (1938), discussed infra note 69.

[48] 252 U.S. at 214-15. The Court also correctly pointed out that the stock dividend amount in fact bore no relationship to the enrichment of the shareholder as that relationship depends upon the period during which the shareholder held the shares.

[49] C.f. Treas. Reg. § 1.1001(a) (incorporating the concept that no realization takes place unless the taxpayer either receives cash or exchanges the property for "other property differing materially either in kind or in extent"). The Supreme Court recently addressed this regulation in the mortgage swap cases, Cottage Savings Ass'n. v. Commissioner, 111 S. Ct. 1503 (1991), and its companion case, United States v. Centennial Savings Bank FSB, 111 S. Ct. 1512 (1991). The issue in those cases is whether economically equivalent pools of mortgages differ materially from one another for purposes of the regulation. See discussion infra note 230 and accompanying text.

[50] While a logical conclusion, it does not necessarily follow from the tax law. The assump-

Absent the constraint of the majority's position that corporate shares are functionally and economically equivalent to other capital assets (such as real property, precious metals, etc.), Brandeis was free to seek other economic equivalencies. He examined the methods by which corporate managers use the issuance of additional shares to capitalize the corporation's retained earnings and discovered that corporations and the marketplace regard stock dividends and cash dividends accompanied by below market share offerings as equivalent transactions. Stock dividends compel shareholders to accept stock which they can resell to generate cash. Below market share offerings may not actually force shareholders to accept additional shares, but they do economically compel exercise of the purchase right, although the shareholder may sell the right itself rather than the underlying shares. Since the two transactions produce identical economic results, Brandeis concluded that it was unreasonable to tax them differently. Brandeis nowhere took issue with the majority's underlying proposition that "enrichment through increase in value of capital investment is not income in any proper meaning of the term."[51] Instead, his views differed from those of the majority principally in his approach to the anomaly created by the imposition of a tax on corporate earnings at both the corporate and the shareholder levels.[52]

Among the members of the *Macomber* court, Justices Holmes and Day are the only ones advocating views difficult to reconcile with the realization requirement recognized in the decision. In a terse dissent in which Justice Day concurred, Holmes, the author of the decision in *Towne v. Eisner*[53] upon which the majority in *Macomber* relied,[54] distinguished the earlier decision as resting

tion that shareholders could be taxed directly on their respective shares of corporate earnings does not support the conclusion that simple appreciation in share value in excess of corporate earnings could be taxed as well. Appreciation attributable to market perception of the value of shares, as opposed to the retention of earnings, does not differ from capital appreciation in other property.

[51] 252 U.S. at 214-15. See supra note 48 and accompanying text.

[52] See discussion supra note 39 and accompanying text. Brandeis does not disclose whether a decision to tax corporate earnings to shareholders would necessitate complete adoption of the flow-through system so that no tax would be imposed at the corporate level. In his comparison of the handling of undivided corporate profits with the undivided profits of partnerships, 252 U.S. at 230, Brandeis does not address that issue at all.

[53] 245 U.S. 418 (1918).

[54] See supra note 43 and accompanying text.

upon a statutory, rather than a Sixteenth Amendment, concept of income. Like *Macomber*, *Towne* involved the taxability of a stock dividend. However, the governing statute in the latter case,[55] unlike the statute involved in *Macomber*,[56] did not list stock dividends separately as one of the items to be included in net income. The Court in *Towne* held (without specifying whether it was interpreting the statute or the Constitution, both of which it considered to be properly before it) that the stock dividend was capital, not income.[57] Justice Holmes, dissenting in *Macomber*, would read the Sixteenth Amendment notion of income in "a sense most obvious to the common understanding at the time of its adoption."[58] Holmes continued:

> The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax.[59]

While Justice Holmes' rhetoric is powerful, as is characteristic of his judicial style,[60] he cites no authority to support his conclusion. Since Justice Holmes did not depart from his earlier conclusion in *Towne* that a stock dividend was capital, he appears to have expressed a willingness to read the Sixteenth Amendment sufficiently broadly to reach "enrichment through increase in value of capital investment."[61] It seems unlikely that "most people not lawyers would suppose"[62] that the Sixteenth Amendment would tax the appreciation in the value of their property in the absence of any disposition of it. Despite the various occasions upon which the Court has distinguished or limited the broadest reach of its deci-

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[55] Internal Revenue Act of 1913, Pub. L. No. 16, § II(A)(1) and (B), 38 Stat. 144 (1913), reprinted in Jacob Stewart Seidman, Seidman's Legislative History of Federal Income Tax Laws 1938-1861, 983 at 987-88 (1938). Section II(B) lists dividends among other items of income, but not stock dividends, and does not otherwise define income.

[56] Supra note 41 and accompanying text.

[57] 245 U.S. at 425-26.

[58] 252 U.S. at 220 (quoting Bishop v. State, 149 Ind. 223, 230 (1897); State v. Butler, 70 Fla. 102, 133 (1915)).

[59] Id. at 220.

[60] See Richard Posner, Law and Literature: A Misunderstood Relation 281-87 (1988), for a more extensive discussion of Justice Holme's rhetorical style.

[61] See supra note 48 and accompanying text.

[62] See supra note 59 and accompanying text.

sion in *Macomber*, the Court has never accepted Holmes' suggestion that appreciation in the value of capital, without more, is taxable, and has never retreated from its position that realization is a constitutionally-based requirement.

C. *Congressional Reactions to Macomber and the Constitutional Realization Requirement*

Congress reacted to the *Macomber* decision by modifying both the taxable dividend rules and the treatment of undistributed corporate earnings. Section 201(d) of the Revenue Act of 1921 specifically exempted stock dividends from taxation except in those cases in which "the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend."[63] The legislative history discloses that Congress considered *Macomber* to mandate the exemption of stock dividends from income.[64] Section 220 of the Revenue Act of 1918 imposed partnership treatment[65] on corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed."[66] Congress amended section 220 immediately following the *Macomber* decision to impose a penalty tax on the corporation itself because Congress doubted the constitutionality of the existing partnership model provision.[67] The Code has continued to impose the accumulated earnings tax on a corporation rather than its shareholders since 1921[68] so that the constitutional

[63] Pub. L. No. 98, 42 Stat. 277, 228-29 (1921). The Code abandoned this intent-based exception and substituted a more comprehensive network of dividend equivalency provisions. These provisions appear in §§ 302, 304 and 306.

[64] Seidman, supra note 55, at 782.

[65] In other words the statute imposed the tax on corporate earnings at shareholder rather than corporate level. Each partner would include her proportional share of corporate earnings in the shareholder's own income, presumably with the character of the income wherever relevant retained as the income flowed through the corporation. Compare the current partnership provisions contained in subchapter K of chapter 1 of the Code, § 701 et seq.

[66] Pub. L. No. 254, 40 Stat. 1057, 1072 (1919), reprinted in Seidman, supra note 55, 892, at 924-25.

[67] H.R. Rep. No. 350, 67th Cong., 1st Sess., at page 12-13, reprinted in Seidman, supra note 55, at 852.

[68] Currently, I.R.C. § 531 et seq.

permissibility of the earlier version of the statute was never tested.[69]

1. *Foreign Personal Holding Companies*

When it enacted the first personal holding company provisions in 1934,[70] Congress followed the surtax model of the accumulated earnings tax in accord with *Macomber* rather than taxing the shareholders directly. Three years later, however, Congress imposed a tax on United States shareholders of foreign personal holding companies based upon the corporations' earnings rather than the amount of distributions to the United States shareholders.[71] The legislative history of the foreign personal holding company provisions justifies breaching the constitutional barrier to a shareholder level tax to prevent the proliferation of foreign "incorporated pocketbooks" which lie beyond the taxing jurisdiction of

[69] Many years later, Helvering v. National Grocery Co., 304 U.S. 282 (1938), in upholding the validity of the accumulated earnings tax imposed on corporations, would lead one to wonder whether Congress' concern with *Macomber*'s effect on the original anti-accumulation of earnings provisions was necessary. In *National Grocery*, the Supreme Court, referring to the accumulated earnings tax, stated: "Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits." Id. at 288. The language, written by Justice Brandeis, a dissenter in *Macomber*, is dictum responding in part to the taxpayer's argument that the accumulated earnings tax is an impermissible penalty, rather than a tax on income, designed only to compel corporations to distribute their earnings so that the shareholders may be taxed. A footnote implicitly approving of the imposition of the tax on shareholders which Congress changed to the penalty tax in 1921 follows the quoted language. Brandeis does not mention *Macomber*.

[70] Section 351 of the Revenue Act of 1934, Pub. L. No. 216, 48 Stat. 680 (1934), reprinted in Seidman, supra note 55, at 394. The surtax at corporate level on the earnings of personal holding companies was designed to prevent individuals from avoiding the income tax by placing their passive investment type assets into closely-held corporations so that the passive income would be taxed only at the lower rates applicable to corporations. The legislative history indicates that the existing accumulated earnings tax was inadequate to combat the "incorporated pocketbook" problem, in that the corporation would seek to free itself of the accumulated earnings tax by making minimal distributions and demonstrating some need for accumulation for the future purposes of the corporation. This purpose made it difficult to prove that the corporation was being used to avoid the surtax on shareholders, an essential condition to imposition of the accumulated earnings tax. See H.R. Rep. No. 704, 73d Cong., 2d Sess., at 11 (1933), reprinted in Seidman, supra note 55, at 394. I.R.C. § 541 et seq., the current personal holding company provisions, continue this pattern.

[71] The Revenue Act of 1937, Pub. L. No. 75-377, § 201, 50 Stat. 813 (1937), reprinted in Seidman, supra note 55, at 188-94, added section 337 to the Revenue Act of 1936, Pub. L. No. 740, 49 Stat. 1648 (1936), reprinted in Seidman, supra note 55, at 206.

the United States.[72] Rather than employing the partnership model which it employed earlier with the accumulated earnings tax,[73] Congress elected to treat each United States shareholder's proportional share of the earnings of the foreign personal holding company as constructively distributed to the shareholder as a dividend.[74]

While taxpayers generally appear to have accepted the congressional position that there is no constitutional barrier to the foreign personal holding company provisions, the provisions have not been left altogether unchallenged. The case of *Eder v. Commissioner* involved the application of the foreign personal holding company provisions of the Code to the United States shareholders of a Columbian corporation which, owing to Columbian currency controls, could not distribute its income outside Columbia.[75] The court remanded the case to the Board of Tax Appeals for further proceedings to determine the value in United States money of the blocked Columbian income. In so doing, the court, citing, inter alia, *Heiner v. Mellon*,[76] held that the restriction on distribution of the income, whether as a function of law or by private agreement, did not prevent taxation of the income.[77] The court found that Congress, in enacting the foreign personal holding company provisions, intended to deal harshly with "incorporated pocketbooks" and to make them expensive. The court concluded that this purpose was valid and constitutionally permissible.[78] The opinion does not ad-

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[72] See Seidman, supra note 55, at 189-90.

[73] See discussion supra note 66.

[74] See Revenue Act of 1937, Pub. L. No 75-377, § 201, 50 Stat. 813 (1937).

[75] 138 F.2d 27, 27-28 (2d Cir. 1943).

[76] 304 U.S. 271 (1938).

[77] 138 F.2d at 28. Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), limits the reach of the decision to distribution, i.e., so-called "blocked" income, as opposed to earning of income. In *First Security Bank*, the government failed in its efforts to attribute income to the taxpayer from insurance commissions which it was instrumental in generating but which it legally could not receive. More recently in Proctor and Gamble Company v. Commissioner, 95 T.C. 23 (1990), aff'd, 961 F.2d 1255 (6th Cir. 1992), the Tax Court refused to uphold the government's use of § 482 of the Code to allocate royalty income from a Spanish subsidiary because, under Spanish law, it was illegal for the subsidiary to pay a royalty. The Sixth Circuit emphasized the distinction between "blocked" and illegal income in its affirmance. 961 F.2d at 1259-60. *Eder* is reconcilable with these later cases in that Columbian law did not prohibit distribution of the income to the shareholders. It only prohibited distribution outside Columbia. 138 F.2d at 27.

[78] *Eder*, 138 F.2d at 28-29.

dress the realization issue, and the court's string of "cf." citations to Supreme Court decisions in its second footnote does not include *Macomber*, but does include *Mellon.*[79]

Heiner v. Mellon[80] indirectly concerns a realization question of the type raised by *Macomber*. The taxpayers in *Mellon*, in liquidating their corporations, distributed their whiskey inventories to partnerships. The partnerships did not report their income from the sales of their whiskey stock, contending that they would not have reportable income from sales until they had recovered the entirety of their respective tax bases in the whiskey inventory. By analogy to the subdivision of real estate, the Court viewed the case as principally involving issues of annual accounting and held that the partnerships should allocate their bases among the units of whiskey stock in order to report income annually on gains from each year's sale of whiskey.[81] The Court also held that, in spite of the partnerships' technical dissolution under state law upon the death of one of the partners, the partnerships continued their operations in a liquidating mode, so that, for federal tax purposes, the remaining partners had to include their shares of the partnerships' income in their individual returns.[82] The court found it irrelevant that state law may have prevented distribution of the income until the partnerships had discharged all their debts.[83]

Mellon approached the issue of realization only insofar as it relied on section 220 of the Revenue Act of 1918[84] for its determination that the word "distributive," as used in section 218(a) of the Revenue Act of 1918,[85] meant "proportionate" rather than "cur-

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[79] Id. at 29 n.2. The court also cited Helvering v. National Grocery Co., 304 U.S. 282 (1938); Burnet v. Leininger, 285 U.S. 136 (1932); Corliss v. Bowers, 34 F.2d 656, 658 (2d. Cir. 1929), aff'd 281 U.S. 376 (1930); and Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46 (1940). *National Grocery Co.* and *Northwest Steel* address the constitutionality of the accumulated earnings tax imposed on corporations, not on their shareholders. See discussion of *National Grocery Co.* supra note 69. The other cases deal with assignment of income issues.

[80] 304 U.S. 271 (1938).

[81] Id. at 275-77.

[82] Id. at 277.

[83] Id. at 280-81.

[84] 40 Stat. 1057, 1072 (1919).

[85] Id. at 1070 (providing that, "There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year.").

rently distributable under state law."[86] But in *Mellon*, the Supreme Court was in no way confronted with the realization issue as framed in *Macomber*, nor did it approve of taxing corporate profits directly to shareholders.

2. *Controlled Foreign Corporations*

While there was little evident disagreement over whether the foreign personal holding company provisions could withstand constitutional challenge, the constitutional issue, even with respect to interests in foreign entities, was by no means dead. Although possibly overshadowed by the foreign policy and economic debates surrounding the enactment of the controlled foreign corporation provisions of the Code,[87] the constitutional issue was very much alive during the deliberations.

Congress modeled the controlled foreign corporation provisions after the foreign personal holding company provisions. Under section 951 of the Code, United States shareholders of a controlled foreign corporation include their respective shares of the corporation's current, but undistributed, income as if the corporation had distributed it to them as dividends. Shareholders actually or constructively owning less than ten percent of the voting stock of the controlled corporation are not subject to these rules[88] because of their inability to influence corporate decisions or compel distributions.

Senators dissenting from the Finance Committee report which approved the controlled foreign corporation legislation[89] quoted ex-

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[86] 304 U.S. at 280-81.

[87] I.R.C. §§ 951-64. These sections were added by the Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1006-27.

[88] I.R.C. § 951(a)-(b). Constructive ownership rules impute ownership of shares by one shareholder to certain other shareholders bearing specified relationships to the first shareholder. See I.R.C. §§ 958(b), 318(a). This prevents a shareholder from dispersing ownership among family members, for example, in order to avoid the ten percent ownership requirement.

Only certain types of corporate income are distributed constructively under the rules. The rules apply to, among other things, passive investment income, i.e., foreign personal holding company income, and active business income the corporation generates through activities in a jurisdiction which does not bear a direct relationship to the activity. See I.R.C. §§ 952(a), 954(a). An example of the lack of a direct relationship might be the sale by a United States controlled Mexican corporation of goods manufactured in Canada to buyers in Guatemala.

[89] S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962 U.S.C.C.A.N. 3304.

tensively from the brief opposing the legislation prepared by Joseph B. Brady, vice president of the National Foreign Trade Council.[90] The quoted section includes Brady's discussion of the constitutionality of the proposed provision and emphasizes the violation of the *Macomber* realization requirement.[91] The dissenting Senators also pointed out that the proposal lacked the tax avoidance justification of the foreign personal holding company provisions,[92] and that there was no constructive receipt by the shareholders of any distribution.[93]

Similarly, Republican members of the Committee on Ways and Means reminded the committee that counsel for the Joint Committee on Internal Revenue Taxation had "advised the committee that Congress cannot constitutionally tax shareholders on the undistributed income of foreign corporations, except in cases where such taxation is reasonably necessary to prevent evasion or avoidance of tax . . . ."[94] These Republican committee members predicted that "[t]he settlement of the question will produce long and costly litigation. Neither taxpayers nor the Government will know for years whether this unprecedented experiment in tax jurisdiction will be sustained by the courts."[95]

Despite the dire predictions of long and costly litigation, in 1973, the Second Circuit in *Garlock, Inc. v. Commissioner*[96] gave short shrift to the taxpayer's constitutional arguments:

> The argument that §951 . . . is unconstitutional we think borders on the frivolous in light of this court's decision in Eder v. Commissioner, 138 F.2d 27, 28 (1943). That case held constitutional the foreign personal holding provisions of the income tax laws upon which subpart F was patterned, permitting taxation of United States shareholders on the undistributed net income of Colombian

[90] Id. at 378-87, reprinted in 1962 U.S.C.C.A.N. at 3679-87.

[91] Id. at 382-83, reprinted in 1962 U.S.C.C.A.N. at 3683-84.

[92] Id. at 375, reprinted in 1962 U.S.C.C.A.N. at 3676. See discussion of the foreign personal holding company provisions supra text accompanying note 71.

[93] Id. Compare the justification for the mark-to-market system. See discussion infra part III.C.1.

[94] H.R. Rep. 1447, 87th Cong., 2d Sess. B-21 (1962) (citing President's 1961 Tax Recommendations: Hearings on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress on April 20, 1961, Before the House Committee on Ways and Means, 87th Cong., 1st Sess. 311-13 (1961)).

[95] Id.

[96] 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974).

corporations even though Colombian law made the taxpayer unable to receive such income in the United States in excess of $1,000 per month.[97]

Footnote 5 accompanies the quoted passage and reads:

> Appellant argues that the "constitutional" issues presented in *Eder* were in fact "apparently" waived in that case and that, therefore, *Eder* does not control our decision here. We disagree with appellant's reading of *Eder*, and note particularly Judge Frank's explicit reference to and paraphrase of Heiner v. Mellon, 304 U.S. 271, 281 (1938). Whatever may be the continuing validity of the doctrine of Eisner v. Macomber, 252 U.S. 189 (1920), as applied to the facts in this case it has no validity under Mellon. See also cases cited 138 F.2d at 29 n.2.[98] (parallel citations omitted)

The paraphrase to which the court referred in the footnote is the discussion in *Eder v. Commissioner*[99] of the permissibility of taxing income despite law or private agreement prohibiting distribution of the income.

The Tax Court's decision in *Garlock, Inc. v. Commissioner*[100] added little to the constitutional debate although it viewed the taxation of the corporate income to the shareholders as analogous to attribution of income from one taxpayer to another.[101] In a subsequent case, *Estate of Whitlock v. Commissioner*, the court dealt with the constitutional argument more completely.[102] In sustaining the constitutionality of the controlled foreign corporations provisions of the Code, the court distinguished *Macomber* as addressing neither the taxation of a corporation's current, rather than accumulated, earnings to its shareholders, nor the taxation of a corporation's earnings to its controlling shareholders who have the power to force a distribution.[103]

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97 Id. at 202-03.

98 Id. at 203 n.5.

99 138 F.2d 27, 28 (2d Cir. 1943).

100 58 T.C. 423 (1972), aff'd 489 F.2d 197 (2d Cir. 1973), cert denied, 417 U.S. 911 (1974).

101 Id. at 438.

102 59 T.C. 490, 506-10 (1972), aff'd in part and rev'd in part, 494 F.2d 1297 (10th Cir.), cert. denied, 419 U.S. 839 (1974).

103 Id. at 508-09. The Tenth Circuit approved the Tax Court's constitutional reasoning. 494 F.2d at 1301.

3. *Taxing Appreciation on Gratuitous Transfers*

Among President Kennedy's 1963 tax proposals was the recognition of gain and loss upon the gratuitous, non-charitable transfer of property.[104] The proposal intended to compensate in part for the revenue loss emanating from the contemporaneously proposed reduction in the rate of tax imposed on long term capital gains. The record indicates that Congress indeed was concerned with the constitutionality of imposing a tax at that juncture.[105] Treasury Secretary Dillon placed into the record a memorandum of opinion from the General Counsel to the Department of the Treasury confirming the constitutionality of the approach.[106] After discussing the post-*Macomber* cases, especially *Helvering v. Horst*[107] and *United States v. Davis*,[108] and the manner in which they limit the

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[104] President's 1963 Tax Message: Hearings on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress January 24, 1963, Before the House Committee on Ways and Means, 88th Cong., 1st Sess. 24 (1963) [hereinafter 1963 Hearings]. Cf. Jerome Kurtz & Stanley S. Surrey, Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal, 70 Colum. L. Rev. 1365, 1381-89 (1970) (arguing strongly for income taxation of appreciation at death); Michael J. Graetz, Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals, 59 Va. L. Rev. 830 (1973) (evaluating the merits of various proposals).

[105] See 1963 Hearings, supra note 105, at 595.

[106] Id. at 596-602.

[107] 311 U.S. 112 (1940); see infra note 199 and accompanying text. *Horst* involves the assignment of interest income rather than the realization of gain. Nevertheless, the opinion supports equating the intangible satisfaction of making a gift with the value of the gift and then treating that amount as the amount realized. In no case, however, has this intangible satisfaction caused a taxpayer to recognize gain, as opposed to including periodic growth in value in income as *Horst* requires.

Increase in value owing to the passage of time under a contractual arrangement is quite unlike appreciation of property in the market and raises different issues. Historically, accrual basis taxpayers include interest in income with passage of time whether or not paid by the obligor, while cash basis taxpayers include interest income only when paid to or set aside for the taxpayer. This lack of parallelism afforded accrual basis, corporate debt issuers the opportunity to deduct interest as it accrued on the issuers' discount obligations, while the debt holders on a cash basis were not required to include the amount in income until the bond was retired or sold. Ultimately, this led Congress to tax debt holders on the current accrual of interest from original issue discount obligations. For both accrual and cash basis taxpayers, appreciation in the value of property was not ripe for taxation until the taxpayer sold or exchanged it.

[108] 370 U.S. 65 (1962). *Davis* involves the transfer of appreciated property from husband to wife incident to a divorce. The case concludes that the transfer is not a gift, but rather an exchange of property in return for the recipient's inchoate marital property rights. These inchoate rights are difficult to value, but the Court concludes that the divorcing parties are bargaining at arm's length and therefore, under a rule of exchange equivalency, the marital

reach of *Macomber*, the memorandum concludes that any constitutionally-based realization requirement would not apply to gratuitous transfers because the transfer itself is an appropriate realization event: "The making of a donation, devise, or bequest is an affirmative act of control over property to obtain certain objectives of the taxpayer. In either case the taxpayer has control of the appreciation in value and it is transferred in accordance with his decision."[109]

While the proposal did not become part of the tax bill in 1963 or 1964, it was not dead. It surfaced, but was not adopted, in both 1969 and 1976.[110] In 1976, however, the administration opposed not only the gratuitous transfer proposal, but also the carryover basis and the additional estate tax proposals. Treasury Secretary Simon testified against all three proposals and said with respect to the recognition of gain at death:

> The event of death hardly qualifies as a tax realization transaction. During his lifetime, a taxpayer has a choice of realizing gain on sale of an asset, paying the tax, and keeping the net proceeds, or of retaining the asset and not realizing a gain on it. The occurrence of his death is hardly a voluntarily chosen event upon which to base the realization of gain. . . . We cannot tax a dead man for a sale he did not make no matter how hard we try.[111]

Secretary Simon assumes incorrectly that voluntary action by the

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rights must be equal in value to the property received for them.

Under current law, the result would differ. Section 1041 of the Code treats all transfers of property incident to divorce as gifts; therefore, the transferor recognizes neither gain nor loss. Unlike a true gift, the transferee succeeds to the transferor's basis regardless of whether the transfer involves gain or loss property. Compare § 1015 which, for purposes of determining a loss upon sale of the property, gives the transferee a basis equal to the lesser of either fair market value or donor's basis.

[109] President's Tax Message of 1963: Hearings Before the House Comm. on Ways and Means, 88th Cong., 1st Sess. 602 (1963).

[110] Tax Reform Studies and Proposals, U.S. Treasury: Joint Publication: House Comm. on Ways and Means, Senate Comm. on Finance, 91st Cong. (1969), reprinted in part in Background Materials on Federal Estate and Gift Taxation: House Comm. on Ways and Means, 94th Cong., 2d Sess (1976), reprinted in part in Tax Management, Inc., Series II Primary Sources, v.4, PS-37, PS-39-40. Proposals to tax gains at death surfaced again this year. See, for example, the testimony of Lawrence Zelnack before the Committee on Ways and Means reprinted as Lawrence Zelnack, Taxing Gains at Death, 59 Tax Notes 287 (April 12, 1993).

[111] Federal Estate and Gift Taxes: Public Hearings and Panel Discussion Before the House Comm. on Ways and Means, pt.2, 94th Cong., 2d Sess. 1188-89 (1976).

taxpayer is otherwise necessary to the realization of gain. Absent an election by the taxpayer under section 1033 of the Code[112] to defer the gain and reinvest the proceeds, the taxpayer recognizes gain when she receives compensation for any involuntary conversion, including the destruction, theft or, pursuant to a governmental unit's exercise of its power of eminent domain, condemnation of her property. In fact, until Congress added section 1231's predecessor to the Code in 1942,[113] gain from involuntary conversion was ordinary rather than capital gain.[114]

In 1976, Congress chose carryover basis rather than current recognition for transfers at death.[115] Carryover basis itself was none too popular. Outcry from taxpayers, tax professionals and banking communities led to its repeal in 1980.[116] While it is impossible to know what the Supreme Court would have done with a gratuitous transfer gain recognition provision, the transactions involved certainly would differ from the realization issue addressed by *Macomber*. Unlike taxing a stock dividend, the statute would not seek to tax a recipient of a distribution on something which was no different, except in a technical sense, from what she owned before the distribution. In fact, the recipient of the gift has something different from and in addition to what she owned before. Absent section 102 of the Code there would be no barrier to taxing the donee on the value of the gift received because of the clear and measurable benefit to the donee, the increase in wealth, and the receipt of

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[112] A provision similar to current § 1033 of the Code has been part of the tax laws since Congress enacted the Revenue Act of 1921, §§ 214(a)(12), 234(a)(14), 42 Stat. at 241-42, 257. According to the Congressional discussion, the provisions simply made the ongoing administrative practice statutory. See Mr. Hawley's comments reprinted in Seidman, supra note 55, at 840.

[113] Revenue Act of 1942, Pub. L. No. 77-753, § 151(b), 56 Stat. 798, 846 (1942) added subsection (j) to § 117 of the Internal Revenue Code of 1939, as amended. Section 117(j) classified gains and losses from property used in the taxpayer's trade or business or involuntarily converted in much the same way § 1231 classifies gains and losses today.

[114] See Helvering v. Flaccus Leather Co., 313 U.S. 247 (1941) (holding that an involuntary conversion is not a sale or exchange). Since current section 1222 and its predecessors define capital gain as the gain from the sale or exchange of a capital asset, involuntary conversions therefore produce ordinary gain.

[115] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), 90 Stat. 1520, 1872 (1976), added section 1023 to the Code. Section 1023 preserved the decedent's tax basis in property owned at the time of her death, thereby changing the longstanding fresh basis approach of section 1014.

[116] Crude Oil Windfall Profits Tax Act, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299 (1980), repealed section 1023 of the Tax Reform Act of 1976.

some distinct property. Nor would the statute seek to tax an owner of property on a simple increase in value without a change in the owner's relationship to the property. In the case of a gift, the owner relinquishes his ownership — disposes of the property — whether voluntarily or involuntarily. All commentators would agree that the taxpayer in *Macomber* should become subject to tax on the dividend shares at sale.

If there is a realization event defined by the gift, it becomes necessary to determine the amount realized in order to compute the amount of the taxpayer's gain. Unlike the husband in *United States v. Davis*,[117] the donor is not dealing at arm's length with the donee, and accordingly one may not assume that the donor will receive market value consideration in exchange for the gift. In order to constitute a gift, judicial decisions require that the transfer be made without the donor receiving or expecting consideration from the donee.[118] The proposed legislation did not assume the actual receipt of consideration. Instead, the proposal transformed all non-charitable, donative transfers into imputed gifts of cash equal in amount to the fair market value of the gift property followed by the donee using the hypothetical cash to purchase the property from the donor.

4. *Imputing a Circle of Cash*

The imputed circle of cash which the gift gain recognition legislation would have employed is no stranger to the tax law. Except in tax gross-up provisions, imputation historically has been implicit.[119] Recently, however, Congress adopted an explicit imputa-

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[117] 370 U.S. at 65 (1962). See supra note 108.

[118] Commissioner v. Duberstein, 363 U.S. 278 (1960), holds a donee to be taxable on the receipt of a "gift" whenever the donor lacks donative intent or motive or other facts and circumstances indicate that the transfer is something other than a gift. In most cases, the payment is compensation for past or future services and therefore not excludable from the recipient's income under § 102 of the Code. In *Duberstein*, the Court refused to promulgate a general legal definition of gift for tax purposes. Id. at 287-89. Instead, it identified the concept as one requiring a facts and circumstances inquiry peculiarly within the bailiwick of the trier of fact. The trier of fact would apply a conglomeration of the standards employed by the various courts over the years. Id. at 289-91.

[119] Section 666(b) of the Code, for example, deems a trust to distribute taxes it paid on accumulated income when it makes an accumulation distribution. Under section 83, however, the imputation is implicit. When an employer distributes appreciated property for services, the recipient is implicitly deemed to have received cash, which she then uses to

tion approach for low interest or interest-free loans under section 7872[120] and for distributions by corporations of appreciated property to their shareholders under sections 311 and 336 of the Code.[121]

The legislative history of section 7872 of the Code analogizes an interest-free or low-interest loan to a transfer by the lender of income from property, but not the income-producing property itself, to the borrower. The assignment of income case, *Helvering v. Horst*, supports taxation of income from the property to the owner of the income-producing property.[122] Under section 7872, the income producing property is money, and only a short step remains to conclude that the income produced by loan money equals the amount it would have produced had the lending transaction been at arm's length. The statute deems the interest to be paid at the market rate. Accordingly, failure to collect interest is an assignment of the income from the loan, but not the money lent, to the borrower as a gift, compensation or dividend as the case may be, as the income under *Horst* continues to be taxed to the owner of the income-producing property.

In the case of corporate current or liquidating distributions, the statute reversed the nonrecognition rule recognized in the *General Utilities*[123] decision. *General Utilities* lacked any constitutional foundation for the Court's holding that no sale or exchange occurred,[124] so imputation of a sale or exchange remained a matter

purchase the property from the employer. As a result the employer recognizes gain on the sale of the property. See Treasury Reg. § 1.83-6(b).

[120] DEFRA, § 172(a), 98 Stat. at 699, added section 7872 to the Code. Section 7872 imputes a payment of interest from the borrower of an interest-free loan to the lender and further imputes a transfer of the funds constructively paid as interest back to the borrower. The latter constructive payment may be deemed a gift subject to gift tax, or, in a non-gift context, a payment for services, a dividend, etc.

[121] Sections 311(b), 336 treat a corporation as having sold, at fair market value, all property distributed to its shareholders. While unstated in the statute, the source of the money the shareholders used to purchase the property from the corporation must have originated in a distribution from the corporation itself. See the discussion of these statutes supra note 7.

[122] H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1370 (1984). The House Report reads *Horst*, 311 U.S. 112 (1940), discussed infra text accompanying note 199, to hold that the donor of income from property "realizes the income upon the exercise of control over its disposition."

[123] 296 U.S. at 200 (1935).

[124] See supra note 6.

for the legislature. Inasmuch as the appreciated corporate property changes hands, the corporate taxpayer's relationship to the property terminates even though the corporation may not receive consideration for it. *Macomber* implies no barrier to treating the disposition of property, with or without consideration, as a realization event.[125] Taxpayers have not challenged imputation in the context of such loans and corporate distributions.

D. *Supreme Court Decisions Refining the Reach of Macomber*

Congressional consideration and statutory delimitation of the realization requirement demonstrate that the realization issue remained a matter of concern at least until 1976.[126] Despite the number of occasions on which Congress addressed realization issues, legislative history offers very little by way of clarifying the realization concept or its constitutional underpinnings. Supreme Court decisions subsequent to *Macomber*, on the other hand, provide a great deal of insight into the realization concept.

The Court has revisited *Macomber* and the realization issue many times. Notwithstanding the consistent evolution in the personnel and ideology of the Supreme Court, the basic realization concept has remained remarkably stable since the *Macomber* decision. The Court's post-*Macomber* decisions have refined the coarse definitions of realization and income offered in that case. Several decisions specifically pare the realm of stock distributions qualifying for exclusion from gross income.[127] Others extend the definition of gross income itself to reach beyond the strict confines of income from labor or capital.[128]

However, as the Court has decided each case, it has held to the principles that realization is essential to the imposition of tax and that alteration of the taxpayer's aggregate rights with respect to the property is a condition of realization. In simplest terms, a change in the value of the taxpayer's property without a corresponding change in the taxpayer's relationship to the property is

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[125] Compare discussion of death as a realization event supra note 109 and accompanying text.

[126] See the Secretary of the Treasury's comments concerning death as a realization event, supra note 111 and accompanying text.

[127] See infra notes 142-143 and accompanying text.

[128] See infra note 214 and accompanying text.

not realization because the Sixteenth Amendment does not view a mere change in value as income. The constitutional concept of income is narrower than the Haig-Simons formulation of the economic concept.[129] On the other hand, a change in the taxpayer's relationship to the property resulting in alteration of the taxpayer's rights in the property is realization. Whenever taxpayers' rights change, the constitutional barrier to taxation dissolves, and Congress is free to tax or not tax as it chooses. The post-*Macomber* decisions never abandon the realization requirement or concept; rather, they factually distinguish cases in which a change in the taxpayer's rights occurs from those in which no such change occurs.

1. *The Corporate Distribution Cases*

a. *Identity Reorganizations*

Three early corporate identity reorganization decisions, *United States v. Phellis*,[130] *Weiss v. Stearn*[131] and *Marr v. United States*,[132] follow on the heels of *Macomber* and illustrate that an exchange in and of itself does not support realization. These decisions establish that by exchanging identical properties, the taxpayer realizes no gain or loss. Accordingly, a stock split or recapitalization pursuant to which the shareholders surrender their old shares for new shares, but in which no redistribution among shareholders nor alteration of ownership attributes in the corporation occurs, is not taxable to the shareholders. In *Cottage Savings Ass'n v. Commissioner*,[133] however, the Court reads these early reorganization decisions for the converse rule that only minor modifications in aggregate rights, i.e., even a minimal change in the taxpayer's relationship to her property, suffice to trigger realization and recognition of gain.[134]

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[129] See the Haig-Simons classical formulation of the concept of income, supra note 11 and accompanying text.

[130] 257 U.S. 156 (1921).

[131] 265 U.S. 242 (1924).

[132] 268 U.S. 536 (1925).

[133] 111 S. Ct. 1503, discussed infra note 230 and accompanying text.

[134] See Richard L. Bacon and Harold L. Adrion, Taxable Events: The Aftermath of *Cottage Savings* (Part I), 59 Tax Notes 1227 (May 31, 1993). Bacon and Adrion argue that in *Cottage Savings*, the Court misses the point of these reorganization decisions. They would distinguish the issue of realization from whether an exchange is of materially different

In an identity reorganization the corporate enterprise does not change, but each shareholder exchanges her shares for shares of the new corporation. Neither corporate fusion nor fission occurs.[135] The reorganized corporation continues the same business activities as its predecessor. In the three cases cited in the preceding paragraph, following the reorganization, each common shareholder's ownership in the reorganized corporation was substantially unchanged relative to the other pre-reorganization common shareholders. According to the Court in *Cottage Savings*, all shareholders recognized their gain in *Phellis* and *Marr* because the reorganizations involved a change in the corporations' states of incorporation.[136] Because shareholders' rights differ from state to state, this resulted in a change of each shareholder's relationship to the corporation, and thus of the shareholder's aggregate rights. In *Stearn*, however, the corporation reorganized in its pre-reorganization state of incorporation, so no alteration of rights occurred, and realization of gain was deferred pending some future change in relationship.[137]

The Court's 1991 reading of these early reorganization cases in *Cottage Savings* may understate the true requirements for realization under the earlier cases. In *Helvering v. Griffiths*,[138] the Court viewed *Phellis*, *Marr* and *Stearn* as finding realization where the shareholder received a "different stock, or different proportionate interests, than before."[139] The reorganization in *Phellis* differed from a traditional identity reorganization in that the old corporation remained in existence and continued to hold a special class of debenture stock of the new corporation. It passed dividends from that stock on to its shareholders. Thus, even if one ignored the

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properties. Since these cases address the fundmental issue of realization, they are inapposite to the materially distinct question raised in *Cottage Savings*.

[135] Identity reorganizations are "E" and "F" type reorganizations (and some "D" type reorganizations), section 368(a)(1)(E), (F) and (D) respectively. Corporate fusion occurs on a tax deferred basis under "A", "B" and "C" type structures, section 368(a)(1)(A), (B) and (C) respectively. Section 355 generally governs tax deferred corporate fission.

[136] 113 L. Ed. 2d at 602.

[137] Note that the reorganization provisions of the Code expressly permit the changes in Stearn and Marr on a tax deferred basis. Rockefeller v. United States, 257 U.S. 176 (1921), and Cullinan v. Walker, 262 U.S. 134 (1923), frequently are included in discussion of the *Phellis, Stearn* and *Marr* line of cases. *Rockefeller* and *Cullinan* involve divisive reorganizations, however.

[138] 318 U.S. at 371 (1943), discussed infra text accompanying note 148.

[139] Id. at 374.

continuing existence of the old corporation, the common shareholders of the old corporation received not only common shares in the new corporation, but part of a class of debenture shares which also were distributed to the old corporation's preferred shareholders and debt holders. As a result, the old shareholders' priority position vis à vis creditors and preferred shareholders of the old corporation improved in the reorganization. The old shareholders gained rights they did not have before the reorganization.[140]

Stearn differs from *Phellis* not only in that the old corporation and the new corporation were incorporated in the same state, but also in that the old corporation ceased to exist following the reorganization. Each old shareholder received cash and proportionally half the interest in the new corporation as she owned in the old corporation. A new group of shareholders who came to own the other half of the new corporation provided the cash which the old shareholders received. The Court collapsed the steps and viewed the transaction as the sale by each old shareholder of half her shares for cash, and each old shareholder thus recognized gain on that sale. Unlike *Phellis*, the capitalization of the old and new corporations was essentially identical.

That *Marr* was a more difficult case for the Court than either *Stearn* or *Phellis* is reflected by the dissent of four of the nine justices. In addition to alterations in shareholders' rights arising from a change in the state of incorporation, *Marr* involved a change in capitalization affecting the preferred shares of the corporation. Shareholders owning seven percent, voting preferred stock of the old corporation received additional par value of the six percent, non-voting preferred stock of the new corporation. Modification of the preferred stock ownership altered the voting rights and economic position of the common shareholders but did not affect their rights relative to one another. The language of Brandeis' opinion for the majority suggests, however, that the changes in

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[140] Under current law, the transaction as a whole would not qualify for gain deferral at shareholder level under the tax-deferred reorganization rules because the transferor corporation failed to distribute the securities it received to its shareholders. I.R.C. § 354(b). At best the creation of the new corporation would qualify under § 351 for tax deferral, but the distribution of the stock and securities in the new corporation would constitute a distribution which § 301 governs and which probably would be dividend to the shareholders of the transferor because they retain their interests in the transferor, and the transaction, as a whole, does not qualify as a tax-deferred, divisive reorganization.

rights, other than those arising from the change in the state of incorporation, were only incidentally relevant to the decision.

In *Phellis*, *Marr* and *Stearn*, the corporate shareholders exchanged their shares in one corporation for shares in a new corporation. *Stearn* clarifies the realization requirement for fungible property. A taxpayer does not realize gain or loss by merely exchanging one property for another if those properties are identical, as fungible properties are by definition. The corporations and their shares in *Stearn* were identical, so the exchange of shares did not alter the shareholders' interests. *Phellis* and *Marr* demonstrate that minimal differences in the properties do render a tax consequence to their owners when they exchange one property for another. Appreciation or depreciation in value of property alone remains insufficient to trigger the realization of income absent other modifications in the property.

b. *Taxable Distributions of Stock*

Obedient to *Macomber*'s mandate, in 1921 Congress enacted a general exclusion from gross income of stock dividends.[141] This general exclusion gave taxpayers more than they were entitled to under subsequent refinements of the *Macomber* holding. *Koshland v. Helvering*,[142] involved the sale of preferred shares following a stock dividend of common on preferred. The selling shareholder successfully argued that the stock dividend was not capital under the Sixteenth Amendment because the receipt of common shares gave her additional rights in the corporation. Insofar as no statute expressly governed the allocation of basis between old and new shares in the event of a statutorily-excludable stock dividend, no portion of her basis in the preferred stock transferred to the common stock as it would in the case of a stock dividend which was capital. Thus, upon the sale of her preferred shares, she should recover her full historical basis. The Court agreed, holding that, while taxing the dividend would not be unconstitutional, the broad language of the statute excluded the dividend from gross income.

Helvering v. Gowran[143] reached the same allocation of basis re-

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[141] § 201(d) of the Revenue Act of 1921, supra note 62, became § 115(f) of the Revenue Act of 1928, and read in part: "[a] stock dividend shall not be subject to tax . . . ."

[142] 298 U.S. 441 (1936).

[143] 302 U.S. 238 (1937).

sult as did *Koshland* by examining the dividend rather than the original shares owned by the taxpayer. It also addressed the holding period of dividend shares which constitutionally could have been taxed.[144] In *Gowran*, the corporation distributed a dividend of preferred on common which was not taxable under the Revenue Act of 1928.[145] Writing for the Court, Justice Brandeis held that the distribution was not capital and therefore immune from taxation as in *Macomber* because it was of a class of shares different from those with respect to which it was made.[146] Since the dividend could have been taxed under the Constitution, it was not a capital distribution and no portion of old stock basis transferred to the dividend shares. The taxpayer's basis in the new shares was zero rather than market value at date of distribution. Congress had expressed its intent only to refrain from taxing stock dividends when distributed, not to exempt them from taxation altogether. Moreover, the taxpayer's holding period in the dividend shares commenced upon their receipt, so the gain on their subsequent redemption was ordinary income lacking the necessary holding period to qualify for preferred capital gain treatment.[147]

Helvering v. Griffiths[148] addressed the government's invitation to overrule *Macomber*. The case arose from the revision of the stock dividend provision that allowed the taxation of stock divi-

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[144] Id. at 244 n.2.

[145] Pub. Law No. 70-562, § 115(f), 45 Stat. 791, 822 (1928).

[146] The corporation had preferred shares outstanding at the time of the distribution, so the common shareholders had enhanced their rights in the corporation relative to the preferred shareholders. It is unclear whether the same result would inhere if no preferred shares had been outstanding, since the distribution in that event would not have altered the aggregate rights of the common shareholders.

In the companion case of Helvering v. Pfeiffer, 302 U.S. 247 (1937), facts similar to *Gowran* are involved, but the Court does not disclose whether or not the corporation had shares of preferred outstanding at the time of the distribution. Under the Act, the dividend is not taxable. The government failed to appeal the portion of the Board of Tax Appeals' decision which held that the redemption of preferred shares was not substantially equivalent to a dividend because the Board had held in its favor that the dividend was taxable currently. Reversal on current taxability shut the government out and prevented it from collecting anything.

Compare discussion of Marr v. United States, 268 U.S. 536 (1925), supra text following note 140. § 305(a) of the Code currently excludes preferred on common, as well as common on common stock dividends from gross income.

[147] This transaction is a paradigmatic preferred stock bailout now governed by § 306 of the Code.

[148] 318 U.S. at 371 (1943).

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ity of *Macomber*. It analyzed the legislative hist
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intent to pass legislation which would challeng
in *Macomber*.[149] Rather, the legislation accep
imposed by *Macomber* and sought only to reve
isting statutes in order to permit corporations
mulated earnings tax without having to distribu
of all stock dividends from taxation prevented
using stock dividends to eliminate their expos
lated earnings tax. Thus, the Court refused to
Macomber.

Helvering v. Sprouse[150] considered two case
volved a preferred on common dividend when
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the holding in *Griffiths* and *Macomber*, the sta
tax dividends in stock that were not previously
under the Sixteenth Amendment. In both ca
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remained unchanged.

Opinions of the Supreme Court in corporat
subsequent to *Macomber* adhere firmly to that
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Distribution of common on preferred shares or
mon shares, when preferred is currently outsta

[149] Id. at 380.
[150] 318 U.S. at 604 (1943).

shareholder's rights in the corporation. Accordingly, Congress may choose to tax such distributions.

2. *Decisions not Involving Corporate Distributions*

While the corporate distribution cases refine and limit, but never abandon, the realization requirement insofar as corporate distributions are concerned, other decisions distill the requirement as it pertains to transactions not involving corporation-shareholder income issues. Yet, as the discussion below demonstrates, all the cases assume that realization is essential to taxation. While realization occasionally surfaces under circumstances which may have surprised contemporary tax experts, no decision permits taxation without realization. Absent a change in the taxpayer's relationship to property, mere appreciation, as opposed to periodic increase, in value of the property never generates a taxable event.

a. *Confusion from Integrating Separate Transactions and Economically Discrete Interests*

Among the earliest realization decisions which do not involve dealings in corporate shares is *United States v. Kirby Lumber Co.*,[151] which addressed corporate debt. Applying the legislative reenactment doctrine to sustain the validity of treasury regulations directly on point, the Court treated repurchase by a corporation of its outstanding bonds on the market at a discount from their issue price as income to the corporation in the amount of the discount.[152] The taxpayer unsuccessfully argued that the transaction was capital and thus required a sale by the corporation to constitute realization.

The two most obvious ways of viewing the Court's rather summary handling of the case both can be reconciled comfortably with a constitutional realization requirement. On the most basic level, the corporation received something of value which it did not have previously. Under the Sixteenth Amendment, receipt of a benefit,

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[151] 284 U.S. 1 (1931).

[152] Id. at 3. The Court failed to note the significance of the nature of the consideration the corporation received for the debt. Instead, the Court considered the face amount of the debt to have been the issue price. For a discussion of consideration received by corporations, see Boris I. Bittker, Income From the Cancellation of Indebtedness: A Historical Footnote to the *Kirby Lumber Co.* Case, 4 J. Corp. Tax'n 124 (1977).

absent a statutory exclusion, is income.[153] Since the corporation had an obligation to repay the borrowed funds, it derived no net benefit which could be taxed when it issued its debt.[154] Once the corporation's obligation to repay is diminished without payment, the corporation has a net benefit from the earlier receipt which may be taxed. Whether the year of borrowing or the year of discharge without payment is the correct year of inclusion may remain unclear, but both annual and transactional accounting would place the enhancement to wealth in the year of discharge.[155]

Viewed as a capital transaction, the result should be no different. The corporation indeed sold property, specifically its own obligations.[156] It realized no gain on the sale because it had an unconditional obligation to repurchase its debt instruments at their face value and a basis in them equal to the amount of that unconditional obligation.[157] Repurchase of the obligations for less than face

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[153] At the time of the decision, doubt may have existed with respect to receipts which were not payments for capital, labor or both combined, as required under the definition of income of Doyle v. Mitchell Bros. Co., 247 U.S. 179, cited in *Macomber*. However, Irwin v. Gavit, 268 U.S. 161 (1925), views the exclusion of gifts of property from income as statutory, not constitutional. Id. at 166. It cites *Macomber* for the proposition that Congress intended to use its full taxing power, except as it specifically provided to the contrary, but not for the proposition that there would be a constitutional barrier to taxation of the gift of property itself — although such a statement would have been dictum in any event. The decision in Commissioner v. Glenshaw Glass, 348 U.S. 426 (1958), discussed infra in text accompanying note 214, resolved the issue of includibility of payments which were not "gain from capital or labor." Id. at 429-31.

[154] The government has never sought to tax debtors when they borrow. In view of its difficultly with taxing embezzlers in part because of their unconditional obligation to repay, Commissioner v. Wilcox, 327 U.S. 404 (1946), overruled by James v. United States, 366 U.S. 213 (1961), it seems unlikely that the Supreme Court would have permitted the taxation of funds voluntarily borrowed from a creditor as income. Crane v. Commissioner, 331 U.S. 1 (1947), which includes nonrecourse indebtedness encumbering property in the amount realized on the sale of the property, assumes that borrowed funds are not includable in income when borrowed.

[155] Note that Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1930), adopts annual, rather than transactional, accounting as the norm.

[156] This analysis suffers from the flaw that treating the issuance of debt as a sale of a capital asset might cause the gain to become short term capital rather than ordinary income from cancellation of indebtedness.

[157] The basis of an issuer in its own debt remains an open question. Rev. Rul. 68-629, 1968-2 C.B. 154, and a line of cases beginning with Alderman v. Commissioner, 55 T.C. 662 (1971), hold that an issuer has a zero basis in its own debt for purposes of § 357(c) of the Code. § 357(c) causes a taxpayer to recognize gain if the taxpayer contributes property to a corporation in an otherwise tax-deferred transaction under § 351, but the transferred liabilities exceed the taxpayer's adjusted basis in the property it contributes. Lessinger v. Com-

value reduced the corporation's basis in its own debt and yielded a net gain on the earlier sale of the debt. Timing is reversed since the sale took place in a year prior to the reduction of basis which caused gain to be recognized. Accordingly, some uncertainty may arise as to the correct year in which to include the gain, but a similar issue arises whenever a purchase price is reduced, whether as the result of litigation or otherwise, after the buyer has resold the property. The buyer's basis for purposes of determining gain on the resale was a function of the buyer's purchase price as it was reduced owing to events taking place after the resale.

Because of both the brevity and the manner in which the Court distinguished it from *Bowers v. Kerbaugh-Empire Company*,[158] the decision in *Kirby Lumber* is confusing. It suggests that under appropriate, but unspecified, circumstances, a taxpayer might integrate repurchase of debt at a discount with the investment of the borrowed funds in order to diminish or eliminate income from cancellation of indebtedness, or perhaps postpone the event of realization until the integrated transaction was complete. After summarizing with approval *Kerbaugh-Empire*, which favors transactional over annual accounting for currency gains and losses, the Court stated: "[h]ere there was no shrinkage of assets and the taxpayer made a clear gain."[159] Then the Court cited the leading annual accounting case, *Burnet v. Sanford & Brooks Co.*,[160] in holding for the government.

In *Kerbaugh-Empire*, the taxpayer borrowed and obligated itself to repay in German marks, converted the borrowed funds into United States dollars and transferred the funds to its subsidiary. The subsidiary's investment of the funds failed, and the subsidiary deducted the loss. The taxpayer repaid the loan in depreciated German marks such that the United States dollar equivalent of the borrowed funds was significantly greater than the amount repaid. The government sought to tax the corporation on its currency gain, but the Court held the borrowing and investment to be a single transaction on which the corporation lost money:

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missioner, 872 F.2d 519 (2d Cir. 1989), is to the contrary and holds that an issuer's debt has a basis equal to its face amount. See generally, Bittker & Eustice, supra note 6, at ¶3.06 and articles cited therein.

[158] 271 U.S. 170 (1926).

[159] *Kirby Lumber*, 284 U.S. at 3.

[160] 282 U.S. 359 (1930).

> The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit or income.[161]

Transactional accounting retains its vitality for purposes of the tax benefit rule[162] and nonrecourse borrowings[163] but has fallen into disfavor as an approach to foreign currency gain and loss. Under current law, the investment, borrowing and foreign currency transactions remain separate in most cases. Section 988 of the Code isolates the foreign currency aspect of the transaction from the borrowing and the investment. Likewise, recourse loans from parties other than the seller of the investment remain separated from the underlying investment of the borrowed funds. A foreclosure sale of the property securing the debt is treated as a sale of the property by the debtor who is then deemed to use the proceeds to pay the debt.[164] If the proceeds are inadequate and the lender forgives part or all the remainder of the debt,[165] the borrower has forgiveness of indebtedness income, subject to the insolvency exception in section 108 of the Code.[166] On the other hand, *Tufts v. Commissioner*[167] integrates losing investments and the nonrecourse loans financing them. Upon foreclosure or abandonment to the lender, the borrower is treated as having sold the investment to the lender for the outstanding balance of the nonrecourse indebtedness encumbering the investment even if the property securing the nonrecourse indebtedness is worth less than the amount of the debt.

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[161] *Kerbaugh-Empire*, 271 U.S. at 175. See Louis A. Del Cotto, Debt Discharge Income: Kirby Lumber Co. Revisited under the 'Transactional Equity' Rule of Hillsboro, Tax Notes 761 (February 18, 1991), for a more extensive discussion of the transactional accounting issues in *Kerbaugh-Empire* and *Kirby Lumber*.

[162] § 111 of the Code and Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), discussed infra note 218 and accompanying text.

[163] See Tufts v. Commissioner, 461 U.S. 300 (1983), and § 7701(g) of the Code (codifying *Tufts*).

[164] Helvering v. Hammel, 311 U.S. 504 (1941) (establishing that a foreclosure sale is a sale by the debtor/owner of the property securing the debt).

[165] Lenders need to be cautious that they do not jeopardize their bad debt deductions by bidding in the foreclosed property at the amount owed. See Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216, 224 (1937).

[166] However, § 108(e)(5) of the Code integrates the transactions where the lender is also the seller and treats reduction in the loan amount as a purchase price adjustment.

[167] 461 U.S. 300 (1983).

There is no forgiveness of indebtedness income. Integration under *Tufts* appears conceptually unsound.[168]

Similar confusion concerning integration of transactions may have led Surrey[169] to overestimate the significance of *Helvering v. Bruun*.[170] For Surrey, the decision marks the turning point in realization jurisprudence from a constitutional concept to an administrative convenience rule under which legislators and administrators determine when it is appropriate to end the postponement of taxation. But, as evidenced by the Supreme Court's unwillingness to overrule *Macomber* three years later in *Helvering v. Griffiths*,[171] Surrey had prematurely sounded the death knell for the constitutional realization requirement. *Bruun* did refine the realization requirement and drew a fundamental distinction between market appreciation and other enhancements to value; yet, the Court in no way relegated realization to the realm of administrative convenience.

Under state law, from the moment of its construction, the building in *Bruun* became part of the land and not severable from it. The lessee owned a term interest in both the land and the building. Since the term interest disappeared, or merged with the fee upon forfeiture of the lease, it is not surprising that commentators, including Surrey, viewed the decision as permitting taxation of appreciation without realization. Although his fee interest increased in value as a result of the lease forfeiture, Bruun received no asset separate from what he had owned previously. Earlier cases such as *Macomber* and *Doyle v. Mitchell Bros. Co.*[172] adopted definitions of income which implied that gain from capital had to be separable from the capital in order to be taxed. Accordingly, it was arguably inappropriate to tax Bruun at the time of forfeiture of the

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[168] Cf. Crane v. Commissioner, 337 U.S. 1 (1947) (holding recourse and nonrecourse debt to be the same so long as the value of the property exceeded the amount of the debt because the owners of the property would treat the debt as their personal debt in order to protect their equity in the property). *Tufts* treats recourse and nonrecourse debts dissimilarly whenever the value of the property securing the debt is less than the amount of the debt. Justice O'Connor, concurring in *Tufts*, 461 U.S. at 317, identified the conceptual flaw in *Tufts*' holding. For an excellent discussion and critique of *Tufts*, see Deborah Geier, Tufts and the Evolution of Debt Discharge Theory, 1 Fla. Tax Rev. 115 (1992).

[169] Surrey, supra note 1, at 783-84.

[170] 309 U.S. 461 (1940).

[171] 318 U.S. at 371, discussed supra note 148 and accompanying text.

[172] 247 U.S. at 185 (1918).

leasehold.

As in *Kirby Lumber*,[173] the *Bruun* Court refused to be bound by the definitions employed in previous cases. When the lessee of Bruun's land forfeited the lease and abandoned the building it erected on the land, Bruun realized income to the extent of the building's value.[174] It seems obvious that Bruun owned something he had not owned previously — a new building — despite the fact that his ownership of the fee included any structures affixed to the land. He received a valuable asset which was appropriately taxed.[175]

Bruun's land increased in value as the result of direct action affecting the property, not through the indirect and generalized impact of market forces. Its value was enhanced as contemplated by the lease between Bruun and the tenant. The parties may not have viewed the tenant's building as consideration for the use of the landlord's property, as they expected the value of the building to be consumed if the lease went to term. They certainly understood, however, that the landlord would take possession and reap the benefit of the building upon termination of the lease whether at term or earlier. Change in value resulting from the leasing bargain resembles rent. It was part of the price the tenant was willing to pay for use of the property and quite different from the effects of the marketplace on the value of property. Even under the definition employed in *Macomber*, the new building is part of the gain derived from the capital, not the growth in value of the capital.

Integration of the capital and the rent it produces confuses the issue. Had the tenant forfeited some personal property he pledged to secure performance of the obligation to pay rent, there would

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[173] 284 U.S. 1 (1931), discussed supra note 151 and accompanying text.

[174] In the case, the government agreed that the amount of income should be diminished by Bruun's unrecovered basis in the building the tenant demolished in order to erect the new building.

[175] Congress chose to permit taxpayers to defer their income from the erection of buildings by tenants upon leased land. Section 109 of the Code and its companion basis provision § 1019 of the Code, adopted by section 115(a) of the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 812 (1942), in response to the holding in *Bruun*, is somewhat misleadingly codified with the exclusions from income provisions of the Code since it is actually a deferral provision. As the lessor receives a zero basis in the building under § 1019 of the Code, the lessor will be taxed on the full proceeds upon sale of the building and during operations has no allowance for depreciation to diminish the income generated from rent. A lessor normally would have such an allowance for depreciation in the case of a purchased or constructed building.

have been no doubt that the value of the personal property was income to the lessor. Had one person built a building on another's land as payment for services provided to the former by the latter, or in exchange for other property, real or personal, or as rent for the use of other property, there would have been no doubt that the value of the building was income to the recipient even though it became part of and enhanced the value of the land upon which it was erected.

As in *Kirby Lumber*, the correct timing of the inclusion in income adds uncertainty to the analysis. The lessor may have realized income when the tenant erected the building, as the lessor owned the reversion in the building following the lease term.[176] That value in *Bruun* would have been quite small. During the term of the lease, most of the economic value of the building would be consumed, and its residual value, discounted to present value, probably would have been insignificant, as the term of the lease was ninety-nine years. Unless one accepts the independent significance of the landlord's and the tenant's varying temporal interests, it is easy to fall into the trap of seeing Bruun receiving nothing more than he already owned when the tenant forfeits its interest.

The Supreme Court has been unwilling, in tax cases, to acknowledge the existence and economic complexity of discrete temporal interests held by a taxpayer in a single piece of property. In *Hort v. United States*,[177] decided a year after *Bruun*, the Court held that a lease, to which land and building received by the taxpayer from his father's estate was subject, was inseparable from that land and building. Accordingly, a lease cancellation payment was a rent substitute rather than payment received in exchange for the taxpayer's interest in the lease, viewed as a discrete asset. Had Hort prevailed, his aggregate basis in the land, building and lease probably would have been the same as his basis in the land and building alone under the decision, i.e., the fair market value of the whole on the date of his father's death (or alternate valuation date).[178] His

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[176] But see *Bruun*, 309 U.S. at 465-467 (discussing history of the case law and the treasury regulation addressing the timing issue).

[177] 313 U.S. 28 (1941).

[178] I.R.C. § 1014. "Probably" implies that the aggregate basis may not have been the same. The lease may have had premium value, which did not become included in the date of death valuation if the rental required under the lease were greater than the current market rentals. A good appraiser, however, would have taken such premium rental into account in

basis in the separate leasehold asset would have been its present value, and the land and building would have had a smaller basis — roughly the present value of their worth at the end of the lease term. As a result of the allocation of basis, Hort would have recognized a loss since the cancellation payment was less than the present value of the stream of rental payments. Instead, Hort had ordinary income and no capital gain or loss because he had not sold the land and building. The issue in *Hort* was fundamentally a matter of accepting separate assets and allocating basis between two interests in the same property which were owned by one person and delineated along temporal lines, rather than according to traditional, legal property definitions.[179] Note, however, that the impact of such analysis upon *Hort* may have resulted in little, if any, change in the overall tax payable. The value of Hort's reversion increased as the reversion became possessory, due to the lessee's cancellation of the lease, and, like Bruun, perhaps Hort should have been taxed upon that increase in value.

Under a discrete temporal interests analysis, upon forfeiture of the lease, the lessor in *Bruun* receives an interest in the building not previously owned, i.e., the possessory interest during the remainder of the lease term. That interest has a value distinct from

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determining the fair market value of the land and building, so, separately or as a single asset, the value of the whole should equal the sum of its parts. Note, however, that section 13261(b)(2) of the 1993 Tax Act adds § 167(c)(2) to the Code prohibiting allocation of any portion of the adjusted basis of property acquired subject to a lease to the leasehold. Accordingly, the entire basis is taken into account in determining the allowance for depreciation of the leased property.

[179] The Court similarly missed arguments concerning the true nature of temporally divided, economic interests in its earlier decision in Irwin v. Gavit, 268 U.S. 161 (1925), discussed infra note 192 and accompanying text. Consider also the economic inconsistency which arose when the Eighth Circuit missed the economic significance of a premium lease. It had to permit both the lessor and lessee to own depreciable interests in the same building which the lessee constructed on the lessor's land at the lessee's sole expense. World Publishing Co. v. Commissioner, 299 F.2d 614 (8th Cir. 1962). And the inability to carve up interests into economically sensible packages for tax purposes occasionally compels taxpayers to sell parcels of appreciated property for development, rather than developing the parcels themselves, in order to prevent their long-term appreciation from becoming reclassified as ordinary income. See Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976), in which classification of property held "primarily for sale to customers in the ordinary course of . . . business," as a non-capital asset under § 1221(1) of the Code, results in all the gain on the sale of subdivided land being taxed as ordinary income rather than capital gain, even that gain resulting from the long-term appreciation of the land while it was used for farming.

the underlying fee interest. Its value is equal to the present value of the income which the building will generate during the remaining lease term. Income in this case is the excess of the rental value of the land with the building over the rental value of the land without the building (or with the demolished building still on it). The tenant has transferred that value to the landlord in full or partial exchange for the tenant's release from its obligation to continue paying rent under the lease.

In the meantime, the lessor's residuary interest, which should have been taxed upon receipt, might have appreciated or depreciated in value. The taxpayer has not yet realized that appreciation or depreciation. In order to produce an economically consistent tax result, the lessor ought to separate appreciation or depreciation of the residuary interest in the building from receipt of the possessory interest in order to defer taxation on the appreciation.

Although the Supreme Court may not have expressed these distinctions between indirect market change in value and direct enhancement in these terms, it has distinguished cases involving one from cases involving the other. Thus, in both *Kirby Lumber* and *Bruun*, the Supreme Court prevented taxpayers with gain from closed transactions from exploiting the broad language of *Macomber* to defer or eliminate inclusion of the gain. As transactions are closed out, the taxpayer realizes income or gain, even if the transaction's termination seems only to increase the value of property the taxpayer already owns rather than providing the taxpayer with new property. A clearer understanding of the economics of temporal interests in property may have enabled the Court to better express its rationale. In turn, economically sound decisions may have aided the tax law in developing according to consistent economic principles rather than the sometimes obscure views of traditional property interests.[180]

Generalized market appreciation and depreciation emerge from the decisions as the changes in value which require alteration of the taxpayer's relationship to the property as a condition of realization. Enhancement of property value resulting from contractual relationships differs materially from market appreciation. Directly

[180] And it may have produced a different outcome for cases like Tufts v. Commissioner, 461 U.S. 300 (1983), discussed supra text accompanying notes 167-168; and Cottage Savings 111 S. Ct. 1503, discussed infra note 230 and accompanying text.

or indirectly, the enhancement forms part of the consideration under the contract and becomes realized and taxable no later than the moment the property owner secures a present interest in the enhancement. The income so realized is not from the sale of the property which the original owner continues to own but is payment for (i) use of the property, (ii) release from an obligation, (iii) transfer of other property, or (iv) services the owner performs for the benefit of the other party.

When, for example, the taxpayer transfers other property for the enhancement of the retained property, she measures the gain with respect to the relinquished property and not with respect to the retained property. If the taxpayer pays for the enhancement either with property which has not appreciated in value or with cash, she, of course, will have no income or gain. Other direct enhancements to the taxpayer's property for which the owner has no obligation to pay, e.g., windfalls, are similarly realized and taxable when they inure to the owner's benefit,[181] but statutory rules may defer or exclude such items from income, e.g., gifts.[182]

Yet, the issue is still more complicated as unrealized appreciation from market forces is also economically distinguishable from growth in value attributable to the mere passage of time. Growth with time may be present along with both market fluctuation and direct enhancement. Confusion reigns in the area of taxation of time based value augmentation.

b. *Market Versus Time-Based Value Enhancement*

Gain attributable to the operation of market forces differs qualitatively from periodic increase in value as a function of time. The former is subject to market risk; the latter is not. While both generally are present whenever possession of property is postponed, time based value enhancement enjoys certainty, and tax rules applicable to it should, but do not always, differ from those governing market risk value increase. Under *Macomber*'s constitutionally based definition, realization occurs when the taxpayer sells the property, exchanges it for "other property differing materially in

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[181] See discussion of Commissioner v. Glenshaw Glass Co., 348 U.S. 426, infra note 214 and accompanying text.

[182] I.R.C. § 102.

kind or extent,"[183] or, possibly, when the taxpayer changes her relationship to the property in some other way.[184]

Consistent tax treatment for time-based increases has proven elusive.[185] Depending upon the underlying transaction, and unless the owner sells or exchanges the property interest in question thereby closing out the transaction and triggering realization and recognition of gain or loss, the growth in value solely based upon passage of time may be taxed (i) as it accrues economically, (ii) when the interest becomes possessory in the underlying property, (iii) when the owner of the interest sells or exchanges the underlying property or (iv) not at all.

The first category, economic accrual, governs debt instruments issued at a discount and stripped preferred stock.[186] Market discounted debt and purchased remainder interests in trusts holding cash or cash equivalents illustrate the second category. Upon expiration of the fixed term of market discounted debt and following the term interest or interests preceding purchased remainders, the owner of the interest receives cash. Section 1271 treats cash received on retirement of debt as an amount received in exchange for the debt, so the holder recognizes gain includible as ordinary income equal to excess of the amount so realized over the holder's

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[183] Treas. Reg. § 1.1001(a). See Cottage Savings 111 S. Ct. at 1503, discussed infra text accompanying note 230, rejecting economic equivalence as a method for avoiding realization.

[184] Compare the discussion of taxing appreciation upon gratuitous transfer supra part II.C.3.

[185] Consider the enormous effort that has gone into distinguishing debt from equity. The Department of the Treasury promulgated and revised proposed regulations under § 385 of the Code during the 1970s, but ultimately withdrew the proposals for failure to clarify the distinction adequately. More recently, Treasury has struggled with contingent payments under its proposed § 1274 regulations in seeking to distinguish interest from risk equity returns and with separating the interest payments from other types of payments under notional principal contracts. Proposed treasury Reg. § 1.446-3 (7/10/91). See also discussion infra note 318 and accompanying text.

[186] I.R.C. §§ 1271-1288 governs original issue discounts on debt and I.R.C. § 305(e), added by section 13206(c)(1) of the 1993 Tax Act, treats separation of the dividend and principal elements of preferred stock as the creation of an original issue discount debt instrument. From 1969 to 1984, under § 1232(a)(3) original issue discount on corporate bonds was includible ratably in income rather than on an economic accrual basis. Before mid-1969, inclusion in income awaited sale, exchange or retirement of the debt, so original-issue discount debt fit into the second rather than the first category. United States v. Midland-Ross Corp., 381 U.S. 54 (1965), established that original issue discount was an interest substitute taxable as ordinary income when bonds were retired by the issuer.

adjusted basis in the debt.[187] Receipt of cash when a remainder interest in a trust becomes possessory triggers recognition of gain to the interest holder to the extent that the amount of cash received exceeds the holder's adjusted basis in the interest.[188]

Purchased remainder interests in trusts holding and distributing in kind, non-cash property serve as examples of the third category. Inclusion in gross income awaits sale of the property received from the trust. Presumably, the purchaser's adjusted basis in the remainder interest becomes her adjusted basis in the properties the trust distributes in kind,[189] thereby preserving the purchaser's gain for future recognition. However, absent an election by the trust to recognize gain on the distribution, section 643(e)(1) of the Code gives the beneficiary an adjusted basis in property distributed in-kind by the trust equal to the trust's basis in the property. Under that statute, the purchaser's adjusted basis in the remainder interest becomes irrelevant to the computation of gain or loss. Accordingly, in kind distributions with respect to purchased remainders, in some cases, may fall into the fourth category of non-taxed time-based gain.[190]

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[187] Section 1276 of the Code classifies the market discount as ordinary income rather than capital gain for instruments issued after mid-1984. Section 1286 requires the immediate accrual of the market discount if the holder of the debt strips all or part of the right to collect interest from the debt and sells that part or the underlying debt separately. See discussion of § 1286, infra text accompanying note 348.

[188] See Jones v. Commissioner, 40 T.C. 249 (1963), remanded, 330 F.2d 302 (3d Cir. 1964), on remand, 25 T.C.M. 701 (CCH) (1966). The court held that a portion of the gain the taxpayer recognizes on sale of purchased, contingent remainder interests resembles and should be taxed as ordinary income. The decision assumes that if the taxpayer had collected the proceeds of the remainder, he would have had income equal to the excess of the cash received over the purchase price of the interest. The income would have been ordinary because there was no sale or exchange.

This result is logical but questionable under the provisions of subchapter J of the Code. A beneficiary receiving a distribution from the corpus of a trust has income only to the extent that the distribution is either out of distributable net income under § 662 of the Code or an accumulation distribution of undistributed net income under § 667.

[189] See Howard Zaritsky, Bits and Pieces: Sales of Remainder Interests and Split Purchases, 38 Major Tax Plan. 16-1, 16-16, 16-17 (1986); Walter Blum, Amortization of a Retained Terminable Interest After Transfer of a Remainder, 62 Taxes 211, 218 (1984).

[190] Section 81(a) of the Deficit Reduction Act of 1984, P.L. 98-369, 98th Cong., 2d Sess. (July 18, 1984), added what is now subsection (e) to § 643 of the Code. The legislative history explains that the provision was designed to prevent beneficiaries from receiving a fair market value basis in trust assets distributed in kind without the trust recognizing gain. The provision was not intended to alter the uniform basis rules of the Code. H.R. Conf. Rep. No. 4170, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. (June 22, 1984), as reprinted 71

Remainder interests received as both testamentary and inter vivos gifts exemplify the fourth category consisting of time-based gains which are never taxed. Over time, the adjusted basis of postponed interests in property receive an increasing share of the uniform basis of the property.[191] This rule eliminates the taxation of the time-based enhancement of the remainder's value while preserving the taxability of increases in the value of the underlying property.

Ongoing reallocation of uniform basis follows from the early case of *Irwin v. Gavit*.[192] *Gavit* interpreted the first income tax statute under the Sixteenth Amendment which included income from gifts of property but excluded the value of the property from net income.[193] The taxpayer in *Gavit* argued unsuccessfully that periodic payments from a testamentary gift of an income interest were gifts of property, not income. Rather than analyzing the issue on the basis of the economic substance of the temporal interests and holding the income beneficiary to be taxable on a portion, but not all, of each periodic payment,[194] the Court held each periodic payment to be fully taxable to the income beneficiary. Implicitly, the Court also held that only the remainder interest was an excludable gift of property and must receive all the adjusted basis.[195] Uniform basis allocation and reallocation became necessary to prevent a remainder beneficiary from claiming a loss on the sale of her interest solely because the present value of the interest is less than the basis of the underlying property, as it often would be during the term

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CCH Standard Federal Tax Reports, No. 27 at 194, 2d column (June 26, 1984). Congress, in all likelihood, did not intend the provision to offer the purchaser of remainder interests an opportunity to secure a tax free step up in basis.

[191] Treas. Reg. §§ 1.1014-5, 1.1015-1(b).

[192] 268 U.S. 161 (1925).

[193] Section 2. B. of the Act of 1913, Public. No. 16, 38 Stat. 114, 63rd Cong., 1st Sess., ch. 16 (October 3, 1913) reprinted in Seidman. Seidman's Legislative History of Federal Income Tax Laws 1938-1861 (1938) at 983, 987-88, excluded gifts (now excluded under § 102 of the Code) and life insurance proceeds (now excluded under § 101 of the Code) from net income.

[194] Compare an annuity governed by § 72 of the Code.

[195] But c.f. McAllister v. Commissioner, 157 F2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947) (permitting an income beneficiary to recover her actuarially determined share of the uniform basis upon sale of her life estate to the remainder beneficiary). Currently, § 1001(e) of the Code treats the seller of an income interest received by gift as having a zero basis in that interest unless the income and remainder beneficiaries sell their interests at the same time. Section 273 prevents a donee income beneficiary from amortizing her share of the uniform basis.

of the preceding income interest.[196]

Time-based growth resembles, and in many instances is, the consideration which a contractual relationship requires. It raises accounting, not realization, issues. Replete with historical, enduring inconsistencies in treatment, time-based growth is realized and taxable as it accrues. Unlike market appreciation requiring the owner to change her relationship to the property before realization occurs, time-based growth is certain and not subject to the principal risk of the marketplace — positive and negative fluctuation. As time passes, the increment permanently attaches to the property. Subsequent loss in value of the property is independent of the time-based growth. It is a function of the marketplace, not the passage of time, and affects the underlying property as enhanced by the time-based growth. While early in the development of the income tax, the Supreme Court missed its opportunity to create economically sensible rules for temporal interests,[197] the Court identified no constitutional barriers to the immediate taxation of time-based increments in value. Ultimately, the Court acknowledged that original issue discount is equivalent to interest.[198]

c. *Income Shifting Not Realization*

Helvering v. Horst[199] is not a realization decision but the classical income shifting case. The *Horst* taxpayer removed interest coupons from his bonds just before maturity and gave them to his son.[200] His son collected the interest, but the Court held that the income from the coupons was taxable to the donor.[201] In the companion case of *Helvering v. Eubank*,[202] a taxpayer assigned to his wife his right to renewal commissions on life insurance which he

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[196] Section 1015(a) of the Code arguably would limit the remainder beneficiary's basis in the remainder to its fair market value at the time of the gift for purposes of determining a loss. However, § 1015's loss basis rule is not clearly applicable, as the donor owned the underlying property, not the remainder, so its fair market value properly should be the subject of § 1015.

[197] See Irwin v. Gavit, 268 U.S. 161 (1925), discussed supra note 192 and accompanying text; Hort v. United States, discussed supra note 177 and accompanying text.

[198] United States v. Midland-Ross Corp., 381 U.S. 54 (1965).

[199] 311 U.S. 112 (1940).

[200] Id. at 114.

[201] Id. at 120.

[202] 311 U.S. 122 (1940).

placed while acting as a sales agent.[203] The Court held the commission income taxable to the donor when his wife collected the income several years later.[204]

Although the *Horst* opinion speaks of the donor realizing income through the intangible satisfaction he received by transferring the right to his son,[205] that discussion sheds no light on the constitutional realization requirement established in *Macomber*. *Macomber* seeks to define when, not to whom, income is realized, and *Horst* concerns itself only with the latter issue.[206] In the broader context of the economic benefit and constructive receipt doctrines, *Horst* identifies the continuing owner of the income producing property as the taxpayer to whom the realized income is taxable. Read with *Eubank*, the issue of who is taxed arises after the income is realized. In both cases, the donors are not taxed until their respective donees collect the income.[207]

While income shifting is impermissible without an accompanying transfer of the income producing property and is impossible for income produced by the performance of services,[208] transfer of the

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[203] Id. at 124.

[204] Id. at 125.

[205] Id. at 117.

[206] In Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954), the government unsuccessfully sought to persuade the court that a charitable gift of cattle was a realization event. The taxpayer had a zero basis because the taxpayer had deducted all the expenses of raising the cattle. The Fifth Circuit distinguished the assignment of realized income to which Helvering v. Horst would apply from transfer of property which required a sale or exchange as a condition to realization of income. The Supreme Court cited *Prothro* with apparent approval in Hillsboro National Bank v. Commissioner, 460 U.S. 370, 386 n.20, viewing it as a realization rather than a tax benefit rule case.

[207] In *Horst*, the donee collected the income in the same taxable year as the donor made the gift, so the possibility that the donor would be taxed in the year of the gift inheres for gifts of income from property as might follow from the "intangible satisfaction" language. *Eubank*, however, strongly suggests that taxation to the donor would await collection or would occur concurrently with accrual of income by the donee.

[208] Shifting of income from services is possible, however, when the services have produced tangible property such as works of art and perhaps such intangible properties as copyrights. Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959), provides that donees of patents, not the donor, should be taxed on the royalties. Similarly, in the case of transfers to entities as receivables, income from services may be shifted to entities even if the services already have been performed at the time the service performer makes the transfer. In the case of a partnership, however, under I.R.C. § 704(c)(1)(A), the partnership would allocate the income from the receivable to the contributing partner. Moreover, the recent decision of Schneer v. Commissioner, 97 T.C. 643 (1991), in which an attorney turned income received through a prior affiliation over to his new firm, indicates that it is necessary to draw a distinction between income with respect to which services remain to be performed and income with

right to collect income is not the realization event.[209] In *Eubank*, the transaction remained open to the donor until the donee realized the income by collecting the money. Presumably, if the taxpayer in *Horst* had removed several years' worth of the coupons and given them to his son, he would have been taxed on the interest each year as his son collected the interest proceeds. In neither case does the government challenge the *Macomber* principle and seek to tax appreciation in the value of the underlying property before its disposition.

The *Horst* decision suffers from the same economic infirmity as the *Hort* and *Gavit* cases. The Court's refusal to acknowledge the income interest as distinct property following its separation from the principal leads to long term conceptual confusion.[210] Ideally, the rule in section 1286 of the Code would have been more sensible for gifts of income from property.[211] Such a rule was unnecessary in *Horst* because the taxpayer did not transfer coupons until immediately before maturity. Under section 1286 of the Code, the *Horst* taxpayer would accrue the interest to the date of transfer and allocate his basis between the bond and the coupons (or registered right to interest payments as debt instruments must be issued in registered form under current law in order for the interest to be deductible to the issuer[212]) relative to their respective fair market values. As the donee collects the interest payment, he would be taxed on the excess of the amount collected over the donor's basis as allocated to that payment at the time of the gift. At the same time, the bond would be treated as an original issue discount instrument, and the donor taxed on the interest accrual while he continues to hold the bond.[213]

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respect to which all services already have been performed at the time of the transfer. The former, but not the latter, category of income is assignable, for tax purposes, to the new firm.

[209] Although it remains unclear whether or not a donor could be taxed on the appreciation in the value of property which is the subject of the gift. See supra part II.C.3.

[210] On the bright side, it has provided wonderful hypothetical questions for generations of law teachers. What happens if the *Horst* taxpayer clips all the coupons, gives them to his son and the son sells the coupons? Presumably, the full sale proceeds are taxed to the donor. But what if immediately before the son's sale, the donor gives the bond to his daughter?

[211] See infra note 348 and accompanying text.

[212] I.R.C. § 163(f).

[213] And law teachers would have lost a source of teaching hypotheticals (see supra note 210) since subsequent sale of coupons by the donee would not be taxable to the donor nor

d. Further Definitional Refinement

The taxpayer conceded in *Commissioner v. Glenshaw Glass Co.*[214] that there was no constitutional barrier to taxing punitive damages.[215] Receipt of the damages did not represent appreciation in the value of the taxpayer's capital which, under *Macomber*, must await disposition by the taxpayer before it becomes realized. With that key, correct concession, the taxability of punitive and treble damages in antitrust actions involved only definitional issues. Except insofar as *Macomber* employed the *Doyle v. Mitchell Bros. Co.* definition of income, "the gain derived from capital, from labor, or from both combined,"[216] *Macomber* was not pertinent to the case. The Court rejected *Macomber*'s definition of income, but not the constitutional principle underlying the decision.[217] The windfall of punitive damages is income.

The *United States v. Bliss Dairy, Inc.* portion of *Hillsboro National Bank v. Commissioner*[218] incidentally addressed some realization issues but added little to the realization concept. By permitting the tax benefit rule to override the nonrecognition of section 336 of the Code, the Court implicitly held that a sale or exchange was unnecessary to realization.[219] The taxpayer's distribution of its cattle feed inventory to its shareholders was "fundamentally inconsistent"[220] with the deduction it claimed in its prior tax year. The distribution triggered inclusion of the cost of the grain distributed in the taxpayer's income. While acknowledging the "inherent tension"[221] between its formulation of the tax benefit rule and nonrecognition provisions of the Code,[222] the Court was unwilling to

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would a subsequent transfer of the bond change the identity of the person receiving income from the coupons.

[214] 348 U.S. 426 (1955).

[215] Id. at 429.

[216] Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918).

[217] *Glenshaw*, 348 U.S. at 430-31.

[218] 460 U.S. 370 (1983). The Supreme Court decided *Hillsboro* and *Bliss* in a single decision.

[219] Id. at 402. The Court cites with approval the depreciation recapture provisions of I.R.C. §§ 1245, 1250, which trigger recognition of gain without a sale or exchange and override former I.R.C. § 336. *Hillsboro*, 460 U.S. at 397-98. I.R.C. § 336 now forces recognition of gain by corporations on liquidation. Under the holding in *Hillsboro*, new I.R.C. § 336 is constitutional.

[220] *Hillsboro*, 460 U.S. at 385.

[221] Id.

[222] It is interesting to note that the Court's example, taken from the government's brief,

adopt the principle that the tax benefit rule always overrides nonrecognition provisions.[223] Conversions to personal use and gifts of property already expensed by a non-corporate taxpayer caused the Court particular concern.[224] It declined to take a position on those cases which were not before it.

As a matter of constitutional jurisprudence emanating from *Macomber*, gifts of expensed property raise somewhat different realization issues than those raised by conversions to personal use. In the case of a gift, the taxpayer's ownership in the property has changed. While neither Congress nor the courts have adopted such a rule, change in ownership, albeit by gift, might suffice as a realization event.[225] Change in use affects some tax characteristics of property, but not ownership. For example, business use property which is converted to personal use no longer generates an allowance for depreciation.[226] However, ownership of the property remains unchanged unless the taxpayer acting as the sole proprietor of a business differs from the same individual acting in a non-business capacity. Absent the change in ownership, no event would trigger realization.

Strong, if not compelling, arguments exist for taxing the change in use under the tax benefit rule. If the expense deduction arose from the use of the property in the business, and the property was not used up in the business, the full expense was unjustified. The expense deduction was allowed in anticipation of business use; the expense was accelerated. Once it becomes certain that the property will not be exhausted in the business, the earlier deduction should be reversed by including it in income to the extent of the unexhausted portion of the property deducted.[227] No realization

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Id. at 386 n.20, of a sole proprietor making a gift of an expensed asset does not represent a conflict between tax benefit principles and nonrecognition provisions of the Code. The Code does not provide expressly for nonrecognition of gain by a donor. The rule is not statutory although various Code provisions assume the validity of the rule. For example, I.R.C. § 1015 causes the donee to continue the donor's adjusted basis and I.R.C. § 170(e) limits a charitable donor's deduction for ordinary income property to adjusted basis. See discussion of gift as a recognition event, supra part II.C.3.

[223] Id. at 385-86.

[224] *Hillsboro*, 460 U.S. at 386 n.20 (citing Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954), with apparent approval).

[225] See discussion of gift as a recognition event, supra part II.C.3.

[226] I.R.C. § 167(a).

[227] Justice Blackmun would amend tax returns for open years and limit transactional reporting to those instances in which the statute of limitations has expired. *Hillsboro*, 460

question arises.[228] The tax benefit rule simply adjusts for the unearned deduction by restoring it to income.

e. Economic Fungibility

The Supreme Court's policy of determining tax consequences based upon traditional property concepts rather than more complex economic notions[229] compelled its decision in *Cottage Savings Association v. Commissioner*.[230] Although realization does not occur when a taxpayer exchanges identical properties,[231] classification of such identical properties depends on legal, rather than economic, characteristics. In holding that the exchange of one portfolio of residential mortgages for an economically equivalent portfolio enables the exchanging party to realize and recognize its tax loss on the first portfolio, *Cottage Savings* does not alter this rule.[232] Were economic features determinative of the fungibility issue, the early identity reorganization decisions, *United States v. Phellis*,[233] *Weiss v. Stearn*[234] and *Marr v. United States*,[235] all should have resulted in the Court finding no realization of gain. While a change in the state of incorporation may have altered the shareholders' aggregate rights under state corporate laws,[236] their economic interests remained unchanged.[237]

U.S. at 425-26 (Blackmun, J. dissenting). See supra note 151 and accompanying text discussing repurchase by a corporation of its outstanding bonds as a realization event.

[228] Campbell v. Prothro, 209 F.2d 331, 335 (5th Cir. 1954).

[229] See discussion supra notes 170, 177 and 192 and accompanying text.

[230] 111 S. Ct. 1503 (1991).

[231] Weiss v. Stearn, 265 U.S. 242 (1924) establishes that a taxpayer realizes no gain in an exchange of identical properties. Treas. Reg. § 1.1001-1(a) reads in part: "the gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." The regulation appears to mean that realization does not occur when identical properties are exchanged. On the other hand, it may imply that realized gain is not income if the properties are identical.

[232] 111 S.Ct. at 1511 (1991). The Federal Home Loan Bank Board which regulated the taxpayer considered the portfolios to be economically identical and consequently did not require the taxpayer to account for the loss on its balance sheet or income statement. The tax loss improved the taxpayer's financial position for Federal Home Loan Bank Board accounting purposes by increasing its cash assets by the amount of tax savings and refunds from the operating loss carryback.

[233] 257 U.S. 156 (1921).

[234] 265 U.S. 242 (1924).

[235] 268 U.S. 536 (1925).

[236] See supra note 136 and accompanying text.

[237] But see discussion supra note 139 and accompanying text.

Whether or not one agrees with the *Cottage Savings* decision, acceptance of a nonrealization principle for exchanges of economically fungible properties would have added uncertainty to the tax system and would have placed a formidable burden on both the Internal Revenue Service and the courts. In some investment industries, various packages of diverse properties or types of properties may be considered economically fungible because of the predictable manner in which they fluctuate in value relative to one another. Options on specific equity indices, for example, change in value along with baskets of the underlying equities. Relationships between various options and baskets are economically regular and interrelated. For some investors, purchases of an option or a basket or various options are equivalent, so that the opposite result in *Cottage Savings* would permit those investors to exchange baskets for options without realizing gain or loss. Moreover, such investors could elect the most favorable timing for inclusion of gain or deduction of loss by selling for cash, rather than exchanging for like-kind property, at the desired moment.[238]

The language of *College Savings* is troublesome from the perspective of a continued constitutional foundation for the realization requirement. The opinion cites *Helvering v. Horst*,[239] defining realization as a rule of administrative convenience rather than constitutional jurisprudence.[240] It is the first and only Supreme Court decision to apply, albeit in dictum, the language of *Horst* to the context of gain from the sale or exchange of property. *Horst* itself used administrative convenience language in relation to realization when it referred to accounting methods for ordinary income which permit the cash basis taxpayer to defer inclusion of earned income pending the receipt of payment.[241]

Despite its troublesome language, *Cottage Savings* offers noth-

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[238] Such a system is not necessarily undesirable. Adherents of consumption-based tax systems would favor the alternative system. But the opportunity should be available universally, without the need for fact-intensive inquiry into the characteristics of the specific investment industry, and should follow a legislative decision to adopt a consumption tax. Currently, § 1092 requires such inquiry into complex economic relationships as it prevents taxpapers from deducting losses which unrealized gains offset. Similarly, new § 1258, added by section 13206(a)(1) of the 1933 Tax Act, will require analysis of financial packages as it prevents taxpayers from converting ordinary income into long term capital gain.

[239] *Horst*, 311 U.S. 112.

[240] *Cottage Savings*, 499 111 S.Ct. at 1510.

[241] *Horst*, 311 U.S. at 116.

ing new. It does not alter the basic rule that a change in the taxpayer's relationship to property is essential to realization and to the tax consequences of market appreciation or depreciation in the value of a taxpayer's property. The decision indicates that the Court might be favorably disposed to upholding the constitutionality of a statute violating that realization condition, but *Cottage Savings* presented no such opportunity. If squarely confronted with the issue, the Court seems equally likely to adhere to precedent, as in *Cottage Savings*, as it is to relegate the traditional rule to the realm of administrative convenience.

E. Intermediate Conclusion: Faltering Constitutionality?

In *Macomber*, the Supreme Court recognized a fundamental realization principle in the Sixteenth Amendment. Over the years, that principle has required refinement. Yet, each clarification left the foundation of the principle intact. Although, alternative formulations of the constitutional rule exist, the following principle has remained: a change in the value of a taxpayer's property which is attributable to market forces, as opposed to activity affecting the specific property directly, may not be taxed until the relationship between the taxpayer and the property is altered.

Changes in value resulting from direct enhancement or diminution of the property may be taxed when they occur. As a matter of administrative convenience, tax accounting rules frequently permit the taxpayer to defer the moment of taxation following accrual of the income until the taxpayer has secured the full benefit of or converted the item of income into an exchangeable medium which enables the taxpayer to use the income to pay the tax. To prevent taxpayers from suffering from a lack of liquidity, Congress reversed the result in *Helvering v. Bruun*,[242] and permitted lessors to defer the income resulting from a lessee's improvement of the leased land past the termination of the lease.[243]

As commentators began to assert that the Supreme Court had abandoned realization as a constitutional requirement, the Court neither confirmed these suspicions nor expressly affirmed the constitutional principle.[244] Nevertheless, except for allowing the taxa-

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[242] 309 U.S. 461 (1940).
[243] I.R.C. §§ 109, 1019.
[244] See supra note 169 and accompanying text.

tion of United States shareholders on the income of certain offshore corporations,[245] neither Congress nor the courts permitted the taxation of the market appreciation in the value of a taxpayer's property absent a change in the taxpayer's relationship to the property until 1984.[246] Accordingly, considerable doubt inheres as to the constitutionality of any statute which would tax market appreciation without disposition.

Furthermore, not every disposition gives rise to a taxable event. Historically, corporations recognized no gain when they distributed appreciated property to their shareholders. Reversal of that rule by statute seems to have been permissible although the Court has not addressed the issue.[247] In *Hillsboro National Bank v. Commissioner*,[248] the Court expressly permitted the tax benefit rule to override the general rule of nonrecognition.

Similarly, donors do not include in their incomes the appreciation in the value of property they transfer gratuitously.[249] While such transfers might seem to resemble corporate distributions, key differences in current tax rules exist, and the Court's attitude toward taxation of such transactions remains uncertain. Neither the tax benefit rule[250] nor depreciation recapture[251] overrides the nonrecognition of gain by donors on gratuitously transferred property, as they did for corporate distributions. Termination of installment reporting upon the gratuitous, inter vivos transfer remains the unique inclusion provision governing gifts.[252] Only recently has decisional law established conclusively that a donor recognizes gain when he receives consideration for the gift through relief from an obligation.[253] Even then, the donor recognizes gain only to the extent that liabilities assumed (or subject to which he takes the

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[245] See supra notes 70-93 and accompanying text.

[246] Congress enacted I.R.C. § 1256 as a part of ERTA, supra note 15, requiring futures contracts to be marked to market for tax purposes.

[247] See supra note 6 and accompanying text.

[248] 460 U.S. 370 (1983).

[249] Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954). See I.R.C. § 1015.

[250] *Hillsboro*, 460 U.S. at 386 n.20 (citing Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954)).

[251] I.R.C. §§ 1245(b)(1) and 1250(d)(1) exempts gifts from their respective operative rules.

[252] I.R.C. § 453B.

[253] Diedrich v. Commissioner, 457 U.S. 191 (1982).

property) exceed the donor's adjusted basis in the property.[254] While deferral of taxation on gratuitous transfer may lack the constitutional foundation of the general realization principle, it nevertheless may be as firmly entrenched in the tax law as that principle and remain, like the realization requirement, far more than a simple matter of administrative convenience.

III. Mark To Market Taxation and The Constitutional Realization Requirement

Despite the death knell Surrey sounded fifty years ago,[255] part II of this article demonstrates that "the reports of [the constitutional realization requirement's] death have been greatly exaggerated."[256] Although undermined by commentary and the dicta of decisions like *Cottage Savings Association v. Commissioner*,[257] realization as a constitutional principle, while perhaps lethargic, subsists. Its continuing vitality surrounds legislation which approaches or crosses the longstanding limits of realization with an aura of uncertainty.[258] Although the history of section 1256 of the Code suggests the contrary,[259] such uncertainty imperils serious congressional consideration of accretion taxation models. Adoption of accretion taxation, in turn, might be a desirable means to end the income tax law's dissimilar treatment of the commodities industry relative to other investment industries, and to halt Congress' piecemeal enactment of accretion taxation as a revenue enhancer.[260] This latter objective might compel Congress to return to principled policymaking in the tax legislative process rather continue than its current system of trading targeted benefits for offsetting revenue en-

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[254] Id. The rule is different for charitable gifts. Section 1011(b) of the Code requires a charitable donor to allocate her basis in the property in proportion to the ratio the consideration the donor receives from the charitable donee, including the relief of liability, bears to the value of the property, and to recognize gain equal to the excess of the consideration over such allocated portion of the donor's adjusted basis.

[255] Surrey, supra note 1.

[256] John Bartlett, Familiar Quotations 763 (Little Brown 1968) (quoting Mark Twain's cable from London to the Associated Press in 1897).

[257] 111 S.Ct. 1503 (1991).

[258] See, e.g., infra note 262.

[259] See discussion infra Part III.A.

[260] Extension of mark-to-market taxation to securities dealers is characterized as "Offsetting Revenue Increases" in the committee reports to the 1992 Tax Proposals. Supra note 17. Section 13223 of the 1993 Tax Act added § 475 to the Code.

hancements. Accretion taxation is too important an issue for Congress to address in such a haphazard manner.

In order to gain an understanding of the special treatment of the commodities industry under the Code this part explores the following questions:[261] How does Congress support its departure from the traditional handling of asset appreciation in the absence of a sale or exchange? Does the industry differ sufficiently from other investment activities to justify accretion taxation? Why has there been virtually no outcry within the industry nor any effort to test the validity of the rules Congress began to apply to it in 1981? Are the rules perhaps more favorable to the industry than unfavorable? Will the securities industry be similarly complacent when Congress applies the concept of mark to market to it?[262]

A. *Enactment and Expansion of Section 1256*

Congress added section 1256 to the Code as part of its comprehensive effort during 1981 to overcome the tax sheltering impact of certain commodity futures trading strategies.[263] Although both houses sought to eliminate the commodity tax shelter,[264] the House of Representatives proposed to do so with the loss deferral rule alone and did not include section 1256's mark-to-market mechanism in its bill. As the discussion of that loss deferral rule will establish,[265] section 1256 of the Code is unnecessary to combat the

[261] Among the few articles offering more than explanation of the operation of I.R.C. § 1256 is John J. Washburn, The New Penalties on Speculators: The Current Status of the Tax on Unrealized Gains under Section 1256, 8 B.U. J. Tax Law. 163 (1990), which argues that § 1256 unduly penalizes participants in the commodities trading industry.

[262] See letter dated June 4, 1992 from the Securities Industry Association to Treasury Secretary Nicholas F. Brady, 92 TNT 131-44, opposing provisions of H.R. 4210, 102d Cong., 2d Sess., (1992), which would apply the mark-to-market rules to securities dealers. The letter emphasizes that the legislation "represents a substantial departure from the most fundamental principle of our income tax law — that income should be taxed only when it is realized by the taxpayer." See also Report of the Committee on Financial Transactions, Section of Taxation, American Bar Association, Presidents Proposal to Require Mark-to-Market Inventory Accounting for Dealers in Securities, 92 TNT 209-28.

[263] See H.R. Rep. No. 201, 97th Cong., 1st Sess. 212 (1981).

[264] Id.

[265] See discussion of I.R.C. § 1092 infra note 361 and accompanying text. Interestingly, § 1092 itself may have been unnecessary to prevent the shelter schemes. Judicial decisions following enactment of §§ 1092, 1256 apply pre-enactment law to disallow losses in most of the litigated straddle cases. For example, Smith v. Commissioner, 78 T.C. 350 (1982), aff'd without op., 820 F.2d 1220 (4th Cir. 1987), held various artificially priced silver future straddles to be transactions not engaged in for profit. Thus such losses are not deductible under

perceived abuse.[266] Yet, section 1256 of the Code treats the commodity investment industry differently, and less favorably,[267] than other investment industries by placing it on an accretion basis of taxation.

Originally section 1256 of the Code applied only to regulated futures contracts. It required taxpayers who held such contracts at the close of their taxable year to mark those contracts to market and to recognize the unrealized appreciation or depreciation[268] in the value of the contracts. The Senate Finance Committee Report to the Economic Recovery Tax Act of 1981[269] explained that the provision was designed in accordance with the system applied by the commodity exchanges in the United States and justifies current inclusion in income of unrealized appreciation under the rubric of constructive receipt:

> The committee bill adopts a mark-to-market system for the taxation of commodity futures contracts. This rule applies the doctrine of constructive receipt to gains in a futures trading account at year-end. The application of this rule in present law means, for example, that taxpayers must include in their income any interest which has accrued during the year, even though they may not have withdrawn the interest from their savings accounts. Because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, the committee believes it appropriate to measure the taxpayer's futures' income on the same

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§ 165. Similarly, in the consolidated, London Metal Exchange cases, Glass v. Commissioner, 87 T.C. 1087 (1986), aff'd sub nom. Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (1989), the Tax Court held straddles constructed to generate tax losses to be sham transactions having no economic substance so that such losses were not deductible.

[266] In the early stages of discussion, some proposals would have applied mark-to-market taxation only to taxpayers with a substantial volume of futures transactions, as it would be difficult for them to determine the gain or loss incurred on each offsetting pair of futures contracts. Commodity "Tax Straddles": Hearings on S. 626 Before the Subcomm. on Taxation and Debt Management and the Subcomm. on Energy and Agricultural Taxation of the Senate Committee on Finance, 97th Cong., 1st Sess. 50-51 (1981) (Statement of John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy).

[267] Washburn, supra note 261.

[268] Use of the "unrealized appreciation or depreciation" terminology of course reflects the bias that, notwithstanding the statute, the traditional indicia of realization are absent. The mark-to-market system is explained, infra Part III.B.3.d.

[269] Report on Economic Recovery Tax Act of 1981, S. Rep. No. 144, 97th Cong., 1st Sess. 156-57 (1981).

basis for tax purposes.[270]

The legislative history offers no hint that the statute might violate long-standing tax doctrines governing realization of gains. Legislators did not make even a passing reference to potential constitutional barriers identified in *Macomber*.[271]

This is not to say that the realization issue never surfaced during the discussion of the mark-to-market provisions. One commentator noted that the proposal violated the *Macomber* rule and argued that any departure from the traditional realization rule should not apply selectively to a single industry. While he welcomed rejection of realization as a controlling taxation concept, he viewed its rejection as appropriate only in the context of an overall change in the tax rules governing dealings in other property as well.[272] Others commented that relief would be necessary in the first year in order to avoid bunching of income which might accompany marking to market.[273] Representatives of the commodities industries expressed concern that taxation of their industries on paper gains derived from commodities trading while other industries were not so taxed was an unfair violation of long-standing tax rules.[274]

Subsequent extensions of the mark-to-market system, first to foreign currency contracts[275] and later to nonequity options and dealer equity options,[276] lack the constructive receipt foundation which underlies the treatment of regulated futures contracts. Nev-

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[270] Id. at 157. See infra discussion Part III.C.1. Cf. discussion infra in text accompanying note 310 (Comparison of increase in the value of commodities contracts to interest accrual on savings accounts is particularly inapposite).

[271] See supra note 33 and accompanying text.

[272] Commodity "Tax Straddles": Hearings on H.R. 1293 Before the House Comm. on Ways and Means, 97th Cong., 1st Sess. 162-68 (1981) (Statement of Glenn Willett Clark, Former Professor of Law at Drake University).

[273] Id. at 198-99 (Statement of Martin D. Ginsburg, Professor of Law at Georgetown University Law Center); Id. at 203 (Statement of Donald Schapiro, New York, N.Y.). Donald Schapiro also recommended long term gain and loss for all positions marked to market. Id. at 203.

[274] Commodity "Tax Straddles": Hearings on S. 626 Before the Subcomm. on Taxation and Debt Management and the Subcomm. on Energy and Agricultural Taxation of the Senate Comm. on Finance, 97th Cong., 1st Sess. 67 (1981) (Testimony of Robert K. Wilmouth, President, the Chicago Board of Trade). Participants in the industry objected to the proposals at a time before 60-40 long term/short term capital gain became part of the proposed mark-to-market rule. See discussion infra part III.F.

[275] Technical Corrections Act of 1982, Pub. L. No. 97-448, § 105(c), 96 Stat. 2385.

[276] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 102(a)(2), 98 Stat. 620.

ertheless, the legislative history does not indicate that congress recognized the possibility that the provisions might be unconstitutional.

B. The Commodities Industry[277]

The commodities industry involves products far less familiar to the investing public than those available in the securities markets. Rather than the mundane, stable world dominated by blue chip stocks and bonds, this exotic realm of futures, forwards and options suggests risk, volatility and the potential for vast rewards and devastating losses. Nonetheless, blue chip stocks and bonds share the securities markets with more speculative products, such as initial public offerings and junk bonds. So, while the contrast is not as stark as it appears at first blush, significant differences exist between the two industries. Regulatory distinctions, margin restrictions, and the nature of the underlying products all contribute to these differences. For example, regulated investment companies, which pool investment securities, may not buy securities on margin and must buy long. On the other hand, commodity pools characteristically trade futures contracts which always employ margin leverage, and these pools invest both long and short.[278] Moreover, rela-

[277] Materials in this Section have been adapted from the following sources: various documents offering to sell interests in commodities pools; textbooks, including, R.W. Kolb, Understanding Futures Markets (3d. Ed. 1991), Hans R. Stoll & R.E. Whaley, Futures and Options Theory and Applications (1993), and J.O. Grabbe, International Financial Markets (2d Ed. 1991); and a leading treatise in the area of commodities regulation, Thomas A. Russo, Regulation of the Commodities Futures and Options Market (1983), supplemented (1992).

[278] The Investment Company Act of 1940, Pub. L. No. 768, 54 Stat. 789, 808-09 (1940) as amended by 15 U.S.C. § 80a-12(a)(1), (3). Subsection (1) prohibits purchasing on margin by investment companies, and subsection (2) prohibits short selling by investment companies. Since the short seller is not buying securities currently, margin limitations do not apply to such transactions. In effect, subsection (2) extends the prohibition on the purchase of securities on margin to short sales by making such sales by investment companies illegal. This margin prohibition prevents leveraging by investment companies. Leverage can significantly enhance profitability when prices rise because the leveraged investor captures the profit on the borrowed, as well as the investor's own, funds. By the same token, however, leverage magnifies loss in a falling market, since the leveraged investor must repay the borrowed funds without regard to the value of the property acquired through borrowing.

A short position obligates the holder to deliver a security or commodity in the future at a pre-determined price. Short positions anticipate decreases in market price for the underlying property. If the market falls, the holder of the short position profits, because she can buy the property to cover the short position at a lower price than that at which the resale tive to the fifty percent margin requirement for the purchase of stocks and bonds,[279] investment in futures is highly leveraged with margins as low as two to three percent.[280]

Differences in product mix aside, both securities and commodities investing are important to the domestic and global economies. While the securities markets offer industry a source of capital with which to operate and expand, the commodities markets facilitate certain business operations, such as those which depend upon the availability and price predictability of agricultural products and precious metals, and those which operate in an international market and must deal in various world currencies. As explained infra, investors who speculate in commodities bear the hazards of price shifts which the businesses would otherwise have to carry at the risk of operational destabilization. Commodities investors provide ongoing stability to international and domestic markets, so that their participation has a continuous value, whereas securities investors lose their significance once the needed capital has been raised. Thus, no justification for treating commodity investing less favorably than securities investing lies in the nature of the industries.[281]

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occurs. A long position is the current purchase of a security or the obligation to accept delivery of a commodity at a pre-determined price. Long positions anticipate increases in the market prices for the subject of the position. If the market increases, the holder resells the property at a profit, but if the market falls, the holder may resell only at a loss.

[279] Section 7 of the Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881, 886-87 (current version at 15 U.S.C. § 78g (1982)), limits the maximum allowance of margin on non-exempt securities to the greater of (1) 55% of the current market price of a security or (2) 100% of the lowest market price of the security during the preceding 36 calendar months (or 75% of current market price, if less), and delegates authority to the Board of Governors of the Federal Reserve System (hereinafter "the Fed") to prescribe rules and regulations governing margin. The Fed has exercised this rule-making authority and promulgated Regulation T, 12 C.F.R. § 220.18 (1992), Regulation U, 12 C.F.R. § 221 (1992), Regulation G, 12 C.F.R. § 207 (1992), and Regulation X, 12 C.F.R. § 224.1 (1992) (listed in order of adoption) governing initial margins only. Since 1974, the Fed has retained the margin ratio at 50%. The self-regulatory organizations, including the exchanges and the National Association of Securities Dealers, under oversight of the Securities Exchange Commission, control maintenance margins.

[280] Margins in the commodities industry are not subject to control by the Federal Reserve System. Margin practices developed with the commodities industry and were reasonably well-established before enactment of the Securities Exchange Act of 1934. Board of Governors of the Federal Reserve System, A Review and Evaluation of Federal Margin Regulations (1984) 54-57. See discussion infra note 329 and accompanying text.

[281] Even the Service acknowledged recently that commodities positions were an appropriate part of the investment portfolio of a private foundation so that such investments would

1. *Commodity Market Traders: Hedging and Speculating*

Hedging plays a far more prominent role in the commodities markets than it does in the securities markets. The concept of hedging encompasses the realm of protective procedures and investment strategies which businesses employ to minimize the potentially adverse impact of price fluctuations in raw materials, foreign currencies or interest rates. A manufacturer may purchase futures contracts to guarantee the supply and price of raw materials required for the manufacturing operation, while a business operating offshore may purchase or sell currency futures or forwards to fix the rate of exchange on payments it will receive or make in currencies other than the dollar.

Rather than trading commodities to protect operating profits from erosion attributable to price and currency fluctuations, speculators assume and profit from the very risks hedgers seek to avoid. Since the speculator may take either a long or short position in a commodity, correct prediction of market fluctuations enables the speculator to profit and incorrect prediction causes the speculator to incur losses.

2. *The Commodities Markets*

a. *Futures Contracts*

Commodity futures contracts involve the future delivery of, and payment for, specified quantities of various commodities at a designated price. The commodities exchange selects the commodities which will trade on its floor from among various agricultural and tropical commodities (wheat, sugar, etc.), precious and industrial metals, financial instruments and indices, and foreign currencies, and standardizes the terms of the contracts. Open outcry on the floor of the exchange when the contract is created establishes the future delivery pricing of the underlying commodity.

While the buyer and seller may discharge their contractual obligations under the futures contract by accepting delivery and delivering respectively an approved grade of commodity as the terms of the contract require, delivery of the physical commodity rarely oc-

not jeopardize its tax exempt purpose under I.R.C. § 4944. See Priv. Ltr. Rul. 92-37-035 (June 16, 1985).

curs.[282] Customarily, each party sells or purchases, as the case may be, an offsetting futures contract on the same exchange prior to the expiration of trading in the contract, thereby closing out the transaction.[283] For example, the contractual obligation arising from the sale of one contract of December 1993 wheat on a commodity exchange may be fulfilled at any time before trading in the contract ceases by the purchase of one contract of December 1993 wheat on the same exchange. The difference between the price at which the investor purchases or sells the futures contract and the price she pays for the offsetting sale or purchase, after allowance for brokerage commissions and transaction costs, constitutes the investor's gain or loss.

Changes in the value of a futures position coincide with movement in the spot price[284] of the underlying commodity. When the spot price fluctuates, the value of the futures position tends to fluctuate as well. In the case of a financial index, the position's value fluctuates with the difference between the contractual index level and the current index level. This direct relationship in pricing arises in the case of a futures contract for a physical commodity because the holder of the short position could hedge her position perfectly by buying the physical commodity needed to cover currently and storing it until delivery was due. Consequently, the future delivery price at the inception of a futures contract equals the sum of the spot price for the commodity and the carrying costs.[285] If the spot price advances, the short leg of futures in the commodity decreases in value and the long leg increases. Because commodities interest transactions always have two parties, overall gains on commodities contracts match overall losses.[286]

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[282] Stock and other financial or economic indices have no physical existence. Thus, futures contracts for such indices must settle in cash rather than delivery of any physical commodity.

[283] Purchase of an offsetting contract with a counterparty closes the open position and terminates the overall transaction. Closeout is possible because the clearinghouse becomes the counterparty to all contracts trading on the exchange for which it is acting as clearinghouse. See discussion of the clearinghouse infra part III.B.3.a.

[284] Spot price is the current market price for physical delivery of the commodity.

[285] Arbitrageurs are likely to serve the function of protecting the validity of the pricing model by intervening whenever pricing fails to follow the normal formula. The model oversimplifies pricing by disregarding the effects of anticipated price movements in spot. When perishable commodities are involved, for example, pricing follows the market's expectation of the future spot price so the price is more subjective.

[286] This analysis ignores the impact of transaction costs including brokerage commissions.

b. Forward Contracts

Forward contracts resemble futures contracts insofar as they constitute the contractual right to purchase or sell a commodity at or before a specified date at a specified price. The standardized terms and exchange trading characteristic of futures contracts is absent for forward contracts. Rather, forward contracts are subject to individual negotiation between the parties; the market mechanism of immediate offset and profit (or loss) taking is not available to holders of such contracts. A trader desiring to close out a forward contract position will establish an opposite position in the contract but will settle and recognize the profit or loss on both positions simultaneously on the delivery date.[287]

Forward contracts in currencies trade primarily in the interbank market. Major currencies — United States dollars, British pounds, German marks, etc. — trade both in the interbank market and on designated commodity exchanges such as the International Monetary Market of the Chicago Mercantile Exchange, while many other currencies trade only in the interbank market.[288] This market is an informal network of trading relationships among participants worldwide, primarily consisting of major commercial banks. The market also includes investment banks, securities and commodities brokers and dealers, pension funds, insurance companies, commodity pools, multinational corporations and sophisticated individuals. Banks facilitate the market by maintaining essential, active currency trading operations.

Participants in the interbank market contract by telephone with follow-up, written confirmation. Absent the standardization of exchange trading, the parties to the forward contract establish its term or maturity which may range from several days to several years. Similarly, quantity of a currency trade and the exchange rate are subject to negotiation rather than the competitive bidding of an exchange floor. As payment or settlement awaits contract ex-

[287] In recent years, the terms of forward contracts have become more standardized, and in some instances such contracts now provide a right of offset or cash settlement as an alternative to making or taking delivery of the underlying commodity. See Russo, supra note 277, § 9.02. In addition, the holder of a position might acquire the offsetting position from the same counterparty thereby closing out the position.

[288] Those currencies traded in the interbank market but not on designated commodity exchanges are called "exotics".

piration, as opposed to the daily marking to market which characterizes futures trading,[289] successful operation of the market depends upon the financial stability of its participants.

c. Options

An option gives its holder the right to buy or sell a specified amount of the contractually designated property at the option price at any time before the option expires.[290] Unlike a futures contract, an option imposes no obligation to purchase upon its holder. Call options describe the right to purchase, and put options the right to sell, the option property. In exchange for the option right, the initial purchaser of an option pays the seller a purchase price referred to as a premium.

Possibilities for the property underlying an option are unlimited and may have the effect of pyramiding existing products. For example, in addition to traditional options to buy or sell shares of stock or debt instruments, options on stock indices and futures contracts also trade regularly.

Options enable their purchasers to capture the benefit of favorable price changes from greater quantities of the underlying property than the purchaser could acquire directly with the same investment. The investor uses such option leverage to enhance her return on investment if the price of the underlying property moves in a direction favorable to the option by advancing in the case of a call and retreating in the case of a put. If the price of the underlying property moves to an unfavorable position during the life of the option, the investor loses her investment in the option. As the holder has no obligation to exercise the option, potential loss is limited to the amount of the premium.[291]

When an exchange lists an option for trading, it standardizes terms, including the exercise price and the expiration time.[292] Standardization enables options exchanges to provide a market in which holders or writers of options can close out their positions by

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[289] See infra part III.B.3.d.

[290] An option can have any type of property as its subject although this article addresses primarily options on securities and commodities. See Russo, supra note 277, § 7.02. Unlike so-called American options described in the principal text, European options are exercisable only on their maturity date. See Grabbe, supra note 277, at 113-114.

[291] See supra part III.B.2.a.

[292] 17 C.F.R. § 240.9b-1(a)(4) (1992).

offsetting sales and purchases. By selling an option with the same terms as the one purchased, or by buying an option with the same terms as the one sold, an investor can liquidate an option position at any time. Upon liquidation, the investor's gain or loss is the difference between the option prices the investor paid and received respectively.

The intrinsic value of an option is the difference between the market price for the underlying property and the option price. Options usually trade at a premium above their intrinsic value because the option trader is speculating on or hedging against future movements in the price of the underlying property. As an option nears its expiration date, the market and intrinsic value typically coalesce. The difference between an option's intrinsic value and its market value is referred to as the time value of the option.

3. *Commodity Exchanges*

In the United States, futures contracts, options on futures contracts and certain physicals trade almost exclusively on commodity exchanges designated by the Commodities Futures Trading Commission (hereinafter "CFTC"),[293] including the Chicago Board of Trade, the Chicago Mercantile Exchange (including the International Monetary Market), the New York Cotton Exchange and the Commodity Exchange, Inc. Futures markets are auction markets in which floor brokers having customer orders and floor traders trading for their own account meet on the floor of the exchange and, through the bid and offer process known as "open outcry," determine the price at which orders will be filled.

With limited exceptions (for example, the exchange of futures for physicals), all orders are filled on the floor of the exchange and priced competitively through the auction market process. Block trades and small trades which utilize special procedures on the securities exchanges have no counterparts in the futures markets. Exchange rules do not permit kerb trading (trading before the opening bell or after the closing bell).[294] In further contrast to the

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[293] The Commodities Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended at 7 U.S.C. § 2 (1988)), created the CFTC to replace the Commodity Exchange Commission and to be "an independent agency of the United States Government," 7 U.S.C. § 4a.

[294] See, e.g., Chicago Board Options Exchange, Inc., Chicago Board Options Exchange

securities markets, futures markets have no specialists whose duty it is to make a market in a particular contract. Liquidity is provided by members trading for their own accounts. The exchanges keep the members' transaction costs low in order to encourage trading. Because of their willingness to "scalp" or take the smallest of profit margins, floor members tend to keep prices in line and provide needed volume.

a. The Clearinghouse

Each commodity exchange in the United States has an associated clearinghouse. The clearinghouse insures the integrity of trades by becoming substituted for each buyer and seller following confirmation of a trade, so that each party to a trade looks only to the clearinghouse for performance. In order to protect its central position, the clearinghouse requires margin deposits[295] and continuously marks positions to market[296] to provide some assurance that its members will be able to fulfill their contractual obligations. In addition, the clearinghouse generally establishes a security or guarantee fund which is intended to permit the clearinghouse to meet its obligations as the substituted counterparty to contracts initiated by an insolvent clearing member despite the failure of the insolvent clearing member to honor its contracts. Further, the clearinghouse imposes net limits on the number of positions that a member (representing a customer or itself) may hold overnight and establishes financial minimums that clearing members must maintain.

b. Daily Limits and Limited Liquidity

Most United States commodity exchanges limit the highest and lowest price, measured from the previous day's close, at which a contract can trade. Once the daily price fluctuation limit or "daily limit" has been reached in a particular commodity, no trades may be made at a price beyond the limit. Positions in the commodity may then be taken or liquidated only by traders willing to do busi-

Guide ¶ 2131 (1990 & Supp. 1993) (prohibiting any member of the Exchange from "mak[ing] any bid, offer, or transaction on the Exchange before or after [business] hours").

[295] See infra part III.B.3.c.

[296] See infra part III.B.3.d.

ness at or within the limit during the trading period on such day. A "limit up" or "limit down" market may be a particularly costly event because it may prevent the liquidation of unfavorable positions. Domestic futures prices occasionally have moved the daily limit for several consecutive trading days, thus preventing prompt liquidation of positions and subjecting the trader to substantial losses for those days.

c. *Margin*

Original or initial margin represents the minimum amount of capital a commodity trader must deposit with her commodity broker in order to initiate futures contract trading or to maintain an open position in futures contracts. Maintenance margin is the amount (generally less than the original margin) to which a trader's account may decline before she must post additional margin. Margin helps assure the commodity trader's performance of the futures contracts that she purchases or sells.

The exchange on which a particular futures contract trades determines the level of margin required in connection with the contract. Margin levels reflect an assessment of risk.[297] In setting levels, an exchange will attempt to evaluate two related factors: contract volatility and the likelihood of limit moves. Margin on futures contracts ranges from less than 2% of the value of the contract to as much as 20%.[298] The exchange requires such low margin levels because it recalculates the amount of maintenance margin owed on each position daily and requires the holder to deposit additional margin as needed. Failure to post additional margin when the exchange makes a margin call results in liquidation of the position holder's open position.

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[297] Major United States futures and securities options exchanges have recently obtained regulatory approval to initiate a cross-margining arrangement where futures and options positions held in certain accounts would be aggregated and margin requirements assessed on a portfolio basis, measuring the total risk of the combined positions. See, e.g., Exchange Act Release No. 34-26,153, 53 Fed. Reg. 39,567 (1988) (approving cross-margining for the Options Clearing Corporation). Without cross-margining, if a trader posted big profits in trading stock index options on one exchange and took big losses on corresponding stock index futures positions on another exchange, the amount of margin she would be required to pay on the futures exchange would not take into account the profit on the related options positions. With the cross margining system, the two exchanges, working together, will determine a margin level that reflects the total positions. Id.

[298] Fed Margin Study, supra note 280, at 58.

d. *Mark to Market*

At the close of each trading day, the clearinghouse marks each position to the market, that is, it determines the gain or loss on the position from the prior day's close. Those positions that have declined in value must pay this loss to the clearinghouse to be transferred to those positions that have advanced in value. While marking to market is conceptually distinct from margin maintenance, it is tied closely to margining. Generally, the loss is charged and the gain credited automatically to the position holder's margin account; thus, a loss in value may bring the account below the exchange's maintenance margin level. In such case, the exchange makes a margin call on the position holder who must post additional maintenance margin. Position holders may withdraw from their margin accounts any net daily increase[299] or may have to pay into their margin accounts the net daily decrease in the value of their open positions.[300] Section 1256 of the Code mimics the margin maintenance of the regulated futures market by requiring taxpayers to mark the section 1256 contracts that they own to market at the end of their taxable years.

C. *Section 1256 of the Code and Taxation of Unrealized Appreciation*

1. *Constructive Receipt and Mark to Market*

The legislative history to section 1256 of the Code supports mark-to-market accounting for tax purposes under the doctrine of constructive receipt.[301] One commentator describes the doctrine as follows: "[b]riefly stated, the constructive receipt doctrine prescribes that a taxpayer may not postpone income that is available to him merely by failing to exercise his power to collect it."[302] Since the clearinghouse marks commodity futures positions to

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[299] Unless the exchange has increased the maintenance margin level.

[300] Brokerage firms carrying accounts for traders in futures contracts may not accept lower, and generally require higher, amounts of margin as a matter of policy in order to afford further protection for themselves.

[301] Supra note 270 and accompanying text.

[302] Marvin A. Chirelstein, Federal Income Taxation ¶ 11.01 (6th ed. 1991). See Treas. Reg. §§ 1.446-1(c)(1), 1.451-1(a), 1.451-2(a) (requiring the taxpayer to include all items of gross income constructively received in the year of constructive rather than actual receipt whenever the two differ).

market daily and credits the daily gains to the position holder's account, the constructive receipt doctrine seems apposite. The position holder needs only to withdraw the gain from her account in order to possess it. Failure to withdraw the available funds should not affect the incidence of taxation.

Recently the Ninth Circuit accepted this rationale and held the mark-to-market provisions to be constitutional.[303] In a case argued by a pro se plaintiff, the court examined this legislative history and reasoned that the doctrine of constructive receipt justifies current taxation, as it does in the case of interest income not withdrawn by the taxpayer. Concluding that the fact "[t]hat the investment remains at risk is inconsequential; so do loaned or deposited funds," the court failed to distinguish payments for the use of money (interest) from appreciation in the value of property unrelated to the passage of time. The court viewed the "unique accounting method governing futures contracts" as permitting differential taxation of such contracts. It reserved broader realization conclusions: "[w]e need not, and do not, decide the broader issue of whether Congress could tax the gains inherent in capital assets prior to realization or constructive receipt." Thus, the court considered constructive receipt and realization to be independent bases upon which to support current taxation rather than viewing constructive receipt as an alternate accounting method for cash basis taxpayers which in itself is dependent upon realization. Of the leading realization decisions, the court cites only *Helvering v. Horst* for the proposition that the power to direct income to another is enjoyment and realization of the income.

Despite this apparent applicability of the constructive receipt doctrine to regulated commodity futures, the government never sought to apply the doctrine to commodity trading until Congress enacted section 1256 of the Code. The government has not endeavored to exercise its taxing jurisdiction to reach all income,[304] adopting non-statutory exclusions from income that reflect underlying concerns about taxing the income, such as the extreme difficulty of

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[303] Murphy v. United States, 1993 USApp LEXIS 10154, 71 AFTR 2d 93-1862 (May 4, 1993).

[304] For example, until the late 1970s, the government did not seek to tax many fringe benefits, including travel passes the airlines gave their employees, even in the absence of a statutory exclusion. Today, I.R.C. § 132 excludes much of such air travel by airline employees. Similarly, no statutory exclusion exists for governmental welfare benefits.

measuring value or the risk that taxation would obstruct an activity giving rise to income.[305] Such reasons for electing not to recognize income do not apply to the tax gain on commodities positions marked to market. The clearinghouse regularly measures value based on a public market, and speculation in property hardly offers a sympathetic argument for eliminating or deferring taxation of its gains. Traditionally, however, the gain from dealing in property has been taxed at favorable rates when the speculator holds the property for a sufficient period.[306] That rate differential has been available for all property which is a capital asset, not just commodities positions.

It is possible that the government simply missed an opportunity to enhance revenues. On the other hand, insofar as the issue of marking commodities positions to market to tax gains seems to relate to timing rather than to inclusion in gross income, the government may have permitted commodity traders to defer income they already had realized economically. Historically, such deferrals were common in a variety of business contexts. Until 1969, for example, taxation of economically accrued, original issue discount on debt instruments awaited sale or retirement of the debt before the holder included it in gross income.[307] Similarly, taxpayers customarily have deferred taxation of a portion of their income by mismatching expenditures and the income to which they relate.[308] The legislative history of the mark-to-market provisions indicates that mark-to-market transactions may be compared to the constructive receipt of interest income.[309] Extension of that comparison to the original issue discount manifestation of interest income to discover the historical reason for not taxing the commodity gain follows logically. Morever, it lends credence to the argument that earlier fail-

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[305] Certain fringe benefits raised difficult questions of valuation, while taxing welfare benefits might undermine the function of the payment and render the provision of the benefit, net of tax, more costly.

[306] It may be more accurate to describe the long term capital gain advantage as an exclusion of a portion of the gain from taxation because before 1986, the statute provided a net capital gain deduction rather than a rate differential. See Int. Rev. Code of 1954, § 1202. The effect of a partial deduction and a rate differential are substantially identical. Current law provides a rate differential for individuals but only at the top three marginal rates of tax. See §§ 1(h) of the current Code.

[307] See supra note 186 and accompanying text.

[308] See, e.g., United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983).

[309] See supra note 270 and accompanying text.

ure to tax was permissive rather than a governmental oversight.

However, closer examination of the legislative history's comparison of mark-to-market gains with interest income discloses that the two differ materially. Mark-to-market taxation addresses gain from the sale of property rather than a return on the use of property such as interest or rent. An account holder constructively receives the interest income which a depository institution credits to her account because she has only to withdraw the interest to possess it. Where subsequent events such as early withdrawal penalties may affect the amount of the credited interest the account holder may retain, the government requires the account holder to include in income only so much of the interest as is permanent and not subject to potential forfeiture.[310]

Commodity positions, on the other hand, continue their exposure to the vicissitudes of the marketplace until liquidated by sale, offset or delivery. A loss may counterbalance the gain the position holder captured on the previous day. If the position holder withdrew the proceeds of the previous day's marked-to-market gain, she must restore the loss to the margin account to be paid over to positions which gained on that day. Failure to meet the margin call arising from a marked-to-market loss results in liquidation of the position with the position holder liable for any shortfall following liquidation. So long as the position remains open, the "realized" gain from marking to market lacks permanence.

The doctrine of constructive receipt operates in the presence of taxable income to control the timing of inclusion by preventing artificial deferral. Absent realization the doctrine is inapplicable, as it does not create taxable income which otherwise would not exist. As a concept, marking to market under the Code precedes constructive receipt by a major step to supply the taxable income without which constructive receipt cannot function. Marking to market measures and requires the taxpayer to include in income the gain or loss a taxpayer would realize if the taxpayer sold or exchanged the underlying property. We might characterize marking to market better as the doctrine of constructive sale or constructive realization rather than constructive receipt. If we accept the validity of the doctrine to create a sale where none actually

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[310] Treas. Reg. § 1.451-2.

occurs,[311] we still might need the doctrine of constructive receipt to complement the constructive sale and to force the taxpayer to include in income those constructive sale proceeds which the taxpayer does not withdraw from her margin account.

2. *Payments under Commodities Contracts as Advance Payments for Performance—Payment without Accrual*

Failure of the constructive receipt doctrine to explain adequately current inclusion in income of commodity future gains and losses under the mark-to-market system does not mean that the system is flawed. A taxpayer holding commodity positions which the clearinghouse marks to market has the cash proceeds from the change in the position's value available to her currently. Withdrawal or the unexercised right to withdraw the money is an appropriate time to impose a tax because the taxpayer has the money available with which to pay the tax: "The entire process of government depends on the expeditious collection of tax revenues. Tax accounting therefore tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax, as manifested by his current cash flow . . . ."[312]

A commodity position holder's continuing obligation to pay if the market reverses vaguely resembles the continuing obligation which the receipt of an advance payment for goods or services imposes on a taxpayer to deliver the goods or perform the services in the future. Generally, a taxpayer who receives such an advance payment must include the income when the payment is received, not when it is earned.[313] While such a taxpayer usually is not obligated to refund the amount paid, she is potentially liable to respond in damages for failing to provide the contracted goods or services.[314] Since the commodities markets view margin as a deposit to assure performance of an executory contract to purchase

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[311] See infra part III.C.3.

[312] RCA Corp. v. United States, 664 F.2d 881, 888 (2d Cir. 1981), cert. denied, 457 U.S. 1133 (1982).

[313] American Automobile Ass'n v. United States, 367 U.S. 687 (1961), holds that the taxpayer must include in income payments for membership in the year received rather than the year in which the taxpayer provides the membership services — i.e., the year in which it earns the income.

[314] This is not a question of claim of right. The taxpayer's claim to the payment is not in dispute, only performance or adequacy of performance might be at issue.

or sell the underlying commodity, failure to deposit additional margin following a margin call constitutes an anticipatory breach of the contract.[315] The counterparty, in this case the clearinghouse which was substituted for the original counterparty, has the right to damages.

The tax treatment of advance payments lacks consistency. Not all contractual arrangements calling for payment in advance of performance result in immediate inclusion in income. Taxpayers found the government eager to depart from the longstanding precedents requiring current inclusion of advance payments[316] when taxpayers began to structure notional principal contracts[317] with large initial payments. Taxpayers hoped to generate income which they could utilize to exhaust expiring net operating loss carryovers, but the government quickly responded by requiring amortization of the initial payments in order clearly to reflect income.[318]

Moreover, closer scrutiny reveals that the analogy of a commodity contract to a executory contract for the provision of goods or services is inapposite. Under a customary executory contract, one party has an obligation to pay, the other an obligation to deliver goods or provide services.[319] Funds should flow to one party to the

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[315] Federal Margin Study, supra notes 280, at 16-17. No actual breach of the commodity contract technically occurs until the delivery date, although there is an independent obligation arising from dealing on a commodities exchange which requires each party to meet the ongoing obligation of margin calls and which the party breaches by failing to meet the call. See discussion of margin, supra part III.B.3.c, and the differences between securities and commodities margins, infra text accompanying note 329.

[316] E.g., *American Automobile Ass'n*, 367 U.S. 687.

[317] Under a notional principal contract, the parties swap payments based upon a notional principal amount which never changes hands. For example, parties may swap floating for fixed rate debt payments without swapping the debt principal. For a good general introduction to swaps and other notional principal contracts, see Mark D. Young and William L. Stein, Swap Transactions under the Commodity Exchange Act: In Congressional Action Needed?, 76 Geo. L.J. 1917, 1927-31 (1988); S.K. Henderson, Swap Credit Risk: A Multi-Perspective Analysis, 44 The Business Lawyer 365, 366-373 (1989); Grabbe, supra note 277, at 87-89, 345-366. For analysis and critique of the proposed treasury regulations governing tax accounting for notional principal contracts, see N.Y. State Bar Ass'n. Tax Section Committee on Financial Instruments, Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts, 54 Tax Notes 1127 (March 2, 1992). See also George C. Howell, III and Cameron N. Cosby, Exotic Coupon Stripping: A Voyage to the Frontier Between Debt and Option 12 Va. Tax Rev. 531 (1993).

[318] Treas. Reg. § 1.863-7; I.R.S. Notice 89-21 C.B. 651; I.R.S. Notice 87-4, 1987-1 C.B. 416.

[319] In a barter transaction, each party is obligated to deliver differing goods or provide differing services.

contract, goods or services to the other.[320] A party delivering goods or providing services anticipates profit primarily from such delivery of goods or rendition of services. Only incidentally does the change in the market price for the goods contribute to the profit. Under an exchange-traded commodities contract which is marked to market, funds may flow to or from either party to the contract without regard to whether the party's contractual obligation is to deliver or pay. Although the contract includes the indicia of an executory contract for the delivery of goods, the actual mark to market payments are unrelated to performance of the underlying contractual obligation. In fact, the parties customarily do not anticipate actual performance of the contract.[321] Rather money follows the fluctuation in the value of the contract as intangible investment property.

3. *Constructive Sale and Mark to Market*

Since the parties to a commodity futures contract rarely make or accept delivery of the underlying property but tend to close out the contract by purchasing an offsetting position, a taxpayer holding a commodities position expects to profit from the movement in the value of the position rather than from performance of the underlying contractual obligation. As the foregoing sections of this article demonstrate, marking to market is neither a form of constructive receipt nor an advance payment for goods to be delivered. Taxpayers realize their gains and losses from dealings in commodities futures contracts as discrete, intangible, traded property, rather than from performance of the contract.

Realization of gain or loss from dealing in property historically and traditionally occurs first when the property owner disposes of the property and not as the property fluctuates in value. Consequently, in order for section 1256 of the Code to operate consistently with established tax principles, it must impute, as it does,[322] a sale of the contract at its market value in order to compel the

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[320] If a barter transaction is involved, goods or services flow to each contracting party, but the same goods or services are not the subject of both sides of the transaction.

[321] See supra part III.B.2.a.

[322] I.R.C. § 1256(a)(1) reads: "[E]ach section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year . . . ."

current inclusion of gains and losses in income. Stated differently, a constructive sale occurs under the Code accompanied, to the extent of commodity market's mark-to-market debit or credit for the last business day of the year, by the actual or constructive receipt of the sale proceeds. While constructive sale of property is not a new concept in the tax law, only section 1256 and new section 475 of the Code impute a sale in the absence of fundamental change in the taxpayer's incidents of ownership of the property.

In other contexts, constructive sale takes place, for example, when the taxpayer transfers tax, but not legal, ownership to another by shifting the economic incidents of ownership while retaining title.[323] For example, under a land sale contract, the seller retains title until the buyer completes payment of the purchase price. From the moment of execution of the contract, the buyer economically owns the property, bears the risk and enjoys the benefit of market fluctuations in value, and customarily assumes the burden of maintaining the property. Although the contract remains executory until title transfers upon completion of payment, the tax law treats the buyer as the owner and awards her the tax incidents of ownership such as the right to depreciation allowances.[324] Some incidents of ownership appear more significant than others in establishing tax ownership. Potential to capture market appreciation, for example, must take precedence over bearing the economic risk of loss; otherwise, borrowing nonrecourse in the absence of substantial equity would qualify as a tax transfer of ownership.

Similarly, statutes governing corporate distributions of appreciated property to shareholders treat the corporation as having sold the property at its fair market value at the time of distribution.[325] Although the corporation receives no proceeds from the sale, it does relinquish ownership of the property. Other constructive sale

[323] Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959), recharacterizes a lease as an installment sale when the property leased, for all practical purposes, cannot be reused by the lessor, and the rental payments after the initial term become negligible. Conversely, Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), disregards a nominal sale of property when the combination of a minimal downpayment, nonrecourse, seller financing and an inflated sale price lead to the conclusion that the buyer has no economic ownership of the property. At best the buyer has an option to buy.

[324] Rev. Rul. 69-89, 1969-1 C.B. 59.

[325] I.R.C. §§ 311, 336. See also supra note 6 and accompanying text.

transactions involve the payment for services with property rather than cash. Case law[326] and regulatory pronouncements[327] impute a sale of the property to the service provider for an amount equal to the compensation plus any cash the service provider pays. The service recipient, like other constructive sellers, has relinquished ownership of the subject property.

Although it limits the scope of the characteristics necessary to define ownership, marking to market does not fit the foregoing model of constructive sale. The position holder continues to own the position, enjoying the economic benefit of appreciation while being forced to bear the economic burden of depreciation in the position's value. Thus, marking to market does not generate a constructive sale in any traditional tax sense. If it is based in a constructive sale concept at all, marking to market must impute its sale into the naked receipt of funds without the relinquishment of the property for which the funds are paid.

In that context, mark-to-market imputation of a sale is unique. Secured borrowing also provides funds without the owner relinquishing the property which generates the funds. Nonetheless, secured borrowing does not impute a sale of the property used as security. In some respects, secured, nonrecourse borrowing offers a more sympathetic opportunity for the constructive sale than does marking to market. Unlike the commodity position holder, who remains personally liable to provide money if the position declines in value, the owner of the property securing nonrecourse indebtedness does not even have the personal obligation to repay the borrowed funds. If the value of the property securing the nonrecourse indebtedness declines, the owner may abandon the property without repayment of the money previously borrowed. Nevertheless, taxpayers do not realize gain from the sale of property they employ to secure borrowed funds. Realization of the borrowed funds as sale proceeds awaits voluntary or involuntary termination of the

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[326] See International Freighting Corp., Inc. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (holding that a corporation recognizes gain when it distributes appreciated shares of its parent to its employees as bonuses); cf. United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), cert. denied, 365 U.S. 843 (1961) (holding that a corporation recognizes gain on appreciated realty contributed to an employee's pension trust and that the gain is determined as if the corporation sold the realty for its fair market value at the time of contribution).

[327] Treas. Reg. § 1.83-6(b).

borrower's interest in the property, whether by transfer of the property to the lender or to a third party who assumes or takes the property subject to indebtedness.[328]

The funds from marking to market of commodities positions are not borrowings: any analogy to debt may be misleading. Unlike securities transactions employing margin, margined commodities transactions involve no borrowing. Commodity margins secure performance of a contractual obligation; securities margins are true borrowings accompanied by the pledge of the underlying securities.[329] However, discussion of margin may miss the point completely because the existence of margins is by no means an essential element of mark-to-market taxation. While the industry employs the margin account as its vehicle to receive and pay mark-to-market gains and losses, the system could function without margin. For example, the position holder would pay any losses and receive any gains on her open positions each day if no margin account were maintained. Absence of margin would render commodities markets riskier since the market would depend fully upon the financial stability of the market participants.[330]

Since marking to market is independent of margin, comparisons of securities and commodities margins add little to the discussion of realization. Moreover, a securities customer could theoretically establish a relationship with a broker which would mimic mark-to-market for commodities positions. Under such an arrangement, the customer would maintain maximal leverage by instructing the broker to lend the maximum margin amount with each advance in the value of the customer's portfolio. Consequently, each retreat in the value of the portfolio would necessitate a margin call. Nonetheless, the customer would realize gain or loss only upon sale or exchange of the underlying securities, not upon receipt of a borrowing or payment of a margin call.[331]

Other analogies are inappropriate for understanding mark to

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[328] See supra note 167 and accompanying text.

[329] Federal Margin Study, supra note 280, at 16-17.

[330] Compare forward contract markets which lack the mark-to-market margin adjustments of the regulated futures markets.

[331] Following the 1986 Act, supra note 7, some lenders offered revolving credit lines employing a similar concept pegged to home equity in order to provide individuals an interest deduction under I.R.C. § 163(h) limiting non-business interest deduction to home mortgage interest.

market. Although installment sales[332] involve multiple payments similar to mark-to-market contracts, the installment seller relinquishes ownership of the property when entering into the installment sale, and the buyer captures appreciation and risks depreciation in the value of the property from the inception of the sale. Furthermore, an installment seller receives, but does not make, payments, and the amounts of the payments are unrelated to changes in the value of the property.

Sellers of covered call options[333] receive payments without terminating their ownership in the optioned property. The seller continues to bear the economic risk of depreciation in the value of the underlying property because the buyer of the option will not exercise the option if the value of the property falls below the exercise price. The buyer, however, owns the benefit of economic appreciation during the option period since the buyer will generally exercise the right to buy if the value of the optioned property exceeds the exercise price at expiration of an option.[334] Although sale of the option involves relinquishing more incidents of ownership than does the marking to market of a futures position, the optioner realizes no gain or loss on the option or the underlying property until the option transaction terminates.[335] Such termination results when the buyer exercises the option, (in which case the option premium becomes part of the sale proceeds of the underlying property for tax purposes) or when the option lapses without exercise (at which time the optioner realizes gain on the option equal to the premium received).[336] Nonrealization of gain on receipt of the op-

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[332] I.R.C. § 453 governs the taxation of installment sales.

[333] A covered call option is a option to sell property which the option seller owns.

[334] Whenever an option is "in the money," meaning that the optionee may buy the option property for less than the current resale value of the property, the optionee is economically compelled to exercise the option. Even if exercise and resale of the property will not permit the optionee to recapture the full option premium, it nevertheless will improve the optionee's economic position and permit recapture of at least part of the premium.

[335] See, e.g., Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938), cert. denied 307 U.S. 630 (1939) (holding that option premiums are not income to the optioner until the option transaction closes); Koch v. Commissioner, 67 T.C. 71 (1976) acq., 1980-1 C.B., acq., 1980-2 C.B. (confirming the result in Virginia Iron Coal & Coke Co. even if the option premiums do not reduce the ultimate exercise price).

[336] Rev. Rul. 78-182, 1978-1 C.B. 265, analyzes the effects of writing, purchasing and closing option transactions. Treas. Reg. § 1.1234-1(b) causes the income to the optioner from the premium received on an unexercised option to be ordinary income, not capital gain, because no sale or exchange occurred. I.R.C. § 1234(b), however, treats gain or loss to the

tion premium is the rule despite the fact that the optioner is not required to return the option premium. Conversely, although the gain may disappear or even become an overall economic loss in the next day's marking to market, the futures position holder realizes and recognizes such transitory gain at the close of the last business day of the taxable year.[337]

4. *Taxing Unrealized Gain*

Lacking a constructive sale (i.e., a shifting of the economic incidents of ownership) to accompany marking to market, the gain which section 1256 of the Code includes in income must be unrealized unless it falls within a category of income requiring no sale or exchange of property to support realization. Taxpayers undoubtedly realize income from services and property (rents, royalties) without a sale or exchange occurring. Moreover, cash basis taxpayers occasionally must include such income as it accrues rather than when they receive payment.[338]

A fundamental dichotomy exists in the tax law between income from use of property, which is realized without a sale or exchange, and gain from property, which requires termination of the taxpayer's ownership of the property as a condition of realization. While many differences in tax treatment depend upon that characterization as income from use of property or gain from the disposi-

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grantor of an option from closing of options and gain from lapses of options with respect to securities and commodities positions as short term capital gain.

Section 1234A, added to the Code by ERTA, supra note 15, classifies gain or loss from cancellation, lapse, expiration or other termination of options on personal property subject to §§ 1092, 1256 contracts as capital gain or loss if the subject of the option would be a capital asset in the holder's hands upon exercise of the option.

DEFRA, supra note 14, added § 1234(c). Section 1234(c)(1) forces the recognition of gain or loss on the exercise of an option to acquire a § 1256 contract. Since options on § 1256 contracts are subject to mark-to-market regulation under § 1256(b)(3), this provision appears to be unnecessary. However, if the option is excluded from § 1256 because it is part of a mixed straddle with respect to which the election under § 1256(d) is in effect, § 1234(c)(1) operates to force recognition of gain or loss upon exercise. In addition, § 1234(c)(2) causes cash settlement options to be treated as options on property for purposes of § 1234(a)-(b) so that gain or loss on such options in most cases is capital.

[337] I.R.C. § 1256(a).

[338] Section § 467 of the Code, governing certain rental agreements which result in the deferral of income, § 707(c) which places the recipient of a guaranteed payment from a partnership in which she is a partner on the same basis of accounting as the partnership, and § 1271 et seq., which require the economic accrual of original issue discount, all place or may place cash basis taxpayers on an accrual basis for specific payments.

tion of property (including ordinary income or capital gain,[339] recovery of investment[340] and the ability of the taxpayer to shift the tax liability for the income to a third party[341]), the distinctions between those characterizations are frequently neither obvious nor determinate. Often identical transactions involving the same property interest change character with the taxpayer and the other interests the taxpayer may own in the same underlying property.

In *Hort*,[342] the taxpayer received from the lessee a payment for cancellation of a lease. Since the taxpayer received his lessor's interest in the leasehold from his father's estate, the taxpayer argued that his adjusted basis in the leasehold was its fair market value on the date of his father's death.[343] Accordingly, the taxpayer averred that he realized and recognized a loss equal to the excess of his adjusted basis over the amount of the cancellation payment because he sold the leasehold interest in the transaction.[344] If the taxpayer had received only the leasehold from his father's estate, that result would have obtained.[345] Unfortunately for the taxpayer, he also received the fee interest from his father's estate, so the Court characterized the payment so as to cancel the lease as income from the underlying fee rather than treating it as proceeds from the sale of a separate property interest.[346] Hort realized ordinary income to the full extent of the cancellation payment and recovered none of his basis in the property received from his father's estate.

Our confusion about the underpinnings of mark-to-market taxation may emanate from a similar indeterminacy in characterization. Perhaps income from marking to market is not gain from the disposition of property but rather income from the use of property.

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[339] See supra note 177 and accompanying text; see also infra note 342 and accompanying text.

[340] Id.

[341] Compare Helvering v. Horst, 311 U.S. 112 (1940) (holding that a taxpayer who transferred the right to the income from the property to his son, but retained the income-producing property itself, should be taxed on the income) with Blair v. Commissioner, 300 U.S. 5 (1937) (holding that the taxpayer only owned the right to income and was not taxed following gifts of interests in that income where the term of the gifts was co-terminus with the taxpayer's income interest).

[342] *Hort*, 313 U.S. 28.

[343] I.R.C. § 1014.

[344] *Hort*, 313 U.S. at 30.

[345] I.R.C. § 1001(e). Section 1001(e) would compel the taxpayer to disregard his adjusted basis if a fee interest in the property passed to another distributee of the estate.

[346] *Hort*, 313 U.S. at 31-32.

It resembles income from use of property in that, following receipt of the mark-to-market proceeds, the owner's interest in the income producing property remains undiminished. The owner continues to own the same property as she owned before the mark-to-market payment. Even if we accept this depiction on the gain side of marking to market, we need to explain the loss side as well. Therefore a more thorough analysis of tax concepts is needed to discover a suitable explanation.

One theory which may justify mark-to-market taxation is "claim of right." Under this approach a taxpayer's right to retain mark-to-market payments is always subject to revision; thus a taxpayer who receives too large a payment may have to restore all or part of the payment in a subsequent period. However appealing the analogy may be, it simply does not comport with reality. The position holder may have to pay before receiving any payment; in fact she may never receive a payment.

Moreover, there is no transfer of the use of property. The payor is not paying for current use of property, possession and use of which ultimately will revert to a payee as generally occurs in a leasing arrangement. If the payor is paying for anything, it is for the future, unrestricted ownership of the underlying property. The payment is a deposit toward future ownership, and an impermanent deposit at that. This divergence from reality forces us back to a sale requiring transfer of the incidents of ownership as a condition to realization. Section 1256 and new section 475 of the Code are unique in taxing gain from market fluctuation in value before the gain is realized.[347]

Even the stripped bond rules, as they apply to market discount bonds,[348] which resemble mark-to-market taxation, are readily distinguishable from mark-to-market taxation. The resemblance derives from the stripped bond requirement that sums, which are not payment for the use of money or property, are includible in an owner's income before she disposes of the property. This deceptive similarity understandably flows from the disorderly state of the tax law concerning time-based appreciation in value.[349]

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[347] I.R.C. § 1361. Section 1361 allows taxpayers under some circumstances to recognize gain before they realize it in the *Macomber* sense, e.g., the S corporation provisions.

[348] I.R.C. § 1286(b)(1)(B).

[349] See supra Part II.D.2.b.

Specifically, if the owner of a market discounted debt instrument separates the ownership of the periodic interest payments from the ownership of the principal of the debt and sells one interest but not the other, she must include the full, accrued market discount in her income and not just that portion of the discount which she would allocate to the interest she sells.[350] Unlike original issue discount which represents a deferred payment for the issuer's use of the borrowed funds, market discounts result from interest rate advances which generate losses to the previous owners of the debt.[351] Market discounts are not issuer payments for the use of the borrowed funds, and they have no effect upon the issuer's obligation under the debt instrument.

Yet there is a contrast between the market discount and mark-to-market taxation in that the former does not suffer the latter's doubtful permanence. Unless the debtor becomes unable to pay its obligations, a risk present whenever payments are deferred, the issuer will pay the face amount of the debt instrument when it matures. Accordingly, in order to receive the market discount, the owner need only hold the instrument to maturity. By holding the instrument to maturity, the owner is entitled to the periodic payments of interest and the recovery of her investment, thereby realizing her gain in the amount of the market discount. Future market fluctuations in value have no impact upon the right to those payments,[352] in contrast to the holder of a commodity position who must close out or dispose of the position to render the income permanent under the mark-to-market rules.

Market discount gain belongs to the world of time-based increases in value, not the world of market fluctuation, and is ripe for taxation as time passes.[353] If current inclusion is permissible for

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[350] I.R.C. §§ 1286(b)(1)(B) - (b)(3). Section 1286(b)(3) requires the seller to allocate her basis between the interest sold and the interest retained relative to the respective fair market values of the interests.

[351] Interest rate advance may be specific to the debtor. For example, it may result from a decreased bond rating. Alternatively, the advance may be general as a function of an increased rate of inflation.

[352] See I.R.C. § 1272(d)(2). Future market fluctuation will of course affect the resale value of the debt instrument as opposed to the amount due at maturity. But that characteristic is common to original issue discount obligations as well, and the original issue discount provisions seek to isolate the market gain or loss from the accrual of original issue discount by adjusting the holder's basis by the amount of the original issue discount she accrues.

[353] See supra Part II.D.2.b.

original issue discount obligations, it is also permissible for market discount obligations. From the owner's perspective, the two are economically indistinguishable. The market discount rules postpone the moment of taxation until maturity, not because they must, but because the opportunity for abuse of the market discount rule is absent. Current inclusion of original issue discount is essential to reflect income correctly and to prevent the mismatching of issuer deduction and holder inclusion. The rules place both the issuer and the holder on an accrual basis of taxation. Yet where no issuer receives an interest deduction the potential for abuse does not compel current inclusion.[354] Thus, unlike the way the mark-to-market provisions violate the principle of realization, requiring the holder to include the accrued market discount when she strips the coupon does not violate a fundamental tax principle.

D. *Commodities and Tax Shelter*

Traditional tax jurisprudence provides no intelligible explanation of marking to market as a taxable event. Historical departures from fundamental tax principles sometimes find their justification in a need to defend the integrity of the taxing system from avoidance and abuse. For example, Congress has enacted statutes in the foreign tax realm that violate the realization requirement in order to combat specific tax abuses such as unlimited deferral.[355] Although the Supreme Court has never passed upon the validity of those statutes, they have withstood the test of time. If Congress designed mark-to-market taxation under section 1256 of the Code to address a problem of taxpayer manipulation of existing tax rules as with the anti-deferral rules in the foreign tax provisions, disregard of the realization limitation on inclusion in income may be justified.

During the 1970s, the practice of investing to shelter income

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[354] Although the seller of the obligation does realize a loss on the sale. Arguably, the seller's creation of a market discount is an interest substitute. The seller receives money currently in exchange for the obligation to repay a greater sum in the future and substitutes the issuer's obligation (the debt instrument) for the seller's obligation. In this view of the transaction, the market discount is no different from an original issue discount and should be accrued in the same manner.

[355] I.R.C. §§ 551, 951. The foreign personal holding company provisions, § 551 et seq., are discussed supra text accompanying note 71, and the controlled foreign corporations provisions, § 951 et seq., are discussed supra text accompanying note 87.

from taxation became increasingly popular.[356] Commodities investing constituted part of the burgeoning tax sheltering industry, as methods were devised to exploit futures contracts to defer income artificially. These deferral techniques rolled income into the next year by employing variations on commodities straddles.

In their simplest form, straddles presented an opportunity to control the timing of gains and losses with limited risk to the investor. The taxpayer would purchase a long futures position in a commodity and sell a short futures position in the same commodity for a different delivery month. These straddled positions move in tandem:[357] one leg of the straddle declines in value, and the other leg advances by the amount of that decline. At the end of the year, the taxpayer closes out the loss leg, recognizes her loss and uses it to offset capital gains recognized earlier in the year.[358] The taxpayer then holds the remaining leg of the straddle, the value of which exceeds its cost by an amount equal to the loss the taxpayer recognized on the other straddle leg. At the first trading moment of the new year, the taxpayer closes out the gain position and thus moves the capital gain from one year to the next, possibly recognizing a long term gain rather than the short term gain realized the prior year. While the straddle occurs, the investor has been exposed to market fluctuation in the value of the commodity for only a short period of time. The taxpayer could reduce risk further by

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[356] By 1982, 284,828 returns with tax shelter issues were under audit and during 1982, the Internal Revenue Service closed 71,793 returns after examination with recommended tax and penalties of $954.2 million. Staff of Joint Comm. on Tax'n, 98th Cong., 1st Sess., Background on Tax Sheltering, 11. Available in LEXIS, LEGIS Library, ESTCH file, citing 1982 Annual Report, Commissioner and Chief Counsel, Internal Revenue Service. Taxpayers invested $8 billion in 1981, $9 billion in 1982 and were expected to invest $11 billion during 1983 in tax advantaged investments other than individual retirement accounts and tax exempt bonds. Id. at 11.

[357] See supra note 285 and accompanying text.

[358] Some trading strategies may have permitted the sheltering of ordinary income as well as capital gain. Until ERTA, supra note 15, added § 1234A to the Int. Rev. Code of 1954, lapse, cancellation or abandonment of a commodity position lacked a sale or exchange, so any loss would have been ordinary. Moreover, under the Int. Rev. Code of 1954, §§ 162, 163, or 212, the taxpayer could deduct carrying costs of physical commodities until ERTA added subsection (g) to § 263 requiring capitalization of carrying costs. Accordingly, the taxpayer could control the character of the gain and loss and effectively convert ordinary income into capital gain if the taxpayer structured the straddle and closings of its positions properly. See H.R. Rep. No. 201, 97th Cong., 1st Sess. 212 (1981); Michelle P. Scott, Sheltering of Income Through Tax Straddles Greatly Restricted by 1984 Tax Law Changes, 62 J. Taxation 28 (1985).

matching the close out of the loss position with the purchase of the same side of the commodity straddle for a different delivery month.[359]

Section 1256 of the Code is not a solution to this tax deferral technique, but it does compel taxpayers to modify the scheme. Since taxpayers must mark all futures contracts to market and recognize their gain or loss, section 1256 of the Code would prevent taxpayers from straddling two or more futures positions. However, the statute does not address straddles composed of futures and spot. Like offsetting futures contracts, a direct correlation exists between the price of a long futures contract and its underlying commodity, and an inverse correlation exists between the short futures and its underlying commodity. Thus, a mixed straddle of spot and short futures permits a deferral whenever the spot advances in value. The short futures contract becomes the loss leg of the straddle and the taxpayer recognizes loss from marking to market. In fact, marking to market simplifies the practice of straddling since the taxpayer continues to hold both the spot and the futures, as well as remaining fully protected against economic loss.[360] Although mark-to-market taxation does not eliminate all the tax sheltering opportunities with which Congress was concerned, its departure from traditional tax principles still might be supportable if it were one of several provisions operating in concert to combat unreasonable tax deferral.

Marking commodities futures contracts to market became part of the tax law at the same time as the provision addressing straddles.[361] The straddle rules govern transactions in which a taxpayer

[359] I.R.C. § 1233(e)(2)(B). For tax purposes, identical commodity positions having different delivery months are not identical property for purposes of the short sale rules which prevent the conversion of short term into long term gain by selling property short. The transactions sold by major investment banking houses were far more complex, utilized multiple positions to minimize risk, and, in some cases, exploited a somewhat artificial pricing mechanism to guarantee the desired result even if the value of the underlying commodity did not move sufficiently to generate the desired loss on one side of the straddle. Smith v. Commissioner 78 T.C. 350, 366-67, aff'd without opinion, 820 F.2d 1220 (4th Cir. 1987).

[360] I.R.C. § 1256 increases transaction costs, as the taxpayer may require several mixed straddles to produce one in which the short futures contract becomes the loss leg. Section 1092(d)(5) brings such arrangements under the straddle, loss deferral rules and prevents it from being effective. See infra note 371 and accompanying text. For mixed straddles generating the opposite result, the taxpayer must dispose of the spot to offset the mark-to-market gain.

[361] Section § 501(a) of ERTA, supra note 15, added § 1092 to the Int. Rev. Code of 1954.

disposes of personal property at a loss while continuing to hold personal property, the value of which fluctuates inversely to the value of the loss property. Such other property constitutes an offsetting position to the loss property. To the extent the taxpayer would realize a gain if she disposed of the offsetting position or positions, the taxpayer must defer her recognition of loss on the disposition of the loss property until she also disposes of and recognizes gain on the offsetting position.[362] Constructive ownership rules prevent the taxpayer from avoiding the straddle provision by constructing the straddle between related individuals, entities or individuals and entities.[363] These straddle rules were part of both the bill passed by the House of Representatives[364] and the bill passed by the Senate.[365] Only the Senate bill included the mark-to-market provision for which the Conference Committee opted.[366]

The mark-to-market and straddle provisions serve somewhat the same purpose, so it is necessary to coordinate the two. If the taxpayer must recognize gain and loss on all positions governed by the mark-to-market rules, simultaneous application of the loss deferral provision makes no sense. Similarly, if the taxpayer holds offsetting positions, but mark-to-market provisions govern the loss position and forces recognition of loss while the gain position is outside the mark-to-market regime, the two provisions operate at cross-purposes.[367] To avoid such conflicts, the mark-to-market provision alone governs straddles composed solely of positions the taxpayer must mark to market.[368] There will be no unrecognized gain against which to measure the loss which the straddle rules require the taxpayer to defer; thus, the taxpayer defers no loss.[369]

Contracts which include mark-to-market positions and non-mark-to-market positions, that is, mixed straddles, receive espe-

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[362] I.R.C. § 1092(a).

[363] I.R.C. § 1092(d)(4).

[364] H.R. 4242, 97th Cong., 1st Sess. (1981).

[365] H.R. 4242. Text of H.R.J. Res. 266, 97th Cong., 1st Sess. (1981).

[366] ERTA, supra note 15, § 503(a).

[367] See supra note 360 and accompanying text.

[368] I.R.C. § 1256(a)(4). However, § 1092, not § 1256, applies to all contracts composing an identified straddle.

[369] I.R.C. § 1092(a)(1) allows deduction of recognized loss to the extent it exceeds the unrecognized gain. Since § 1256 compels recognition of gain and loss, there is no unrecognized gain for purposes of § 1092. Section 1256(d) is unnecessary to this result but does make this conclusion clear.

cially unfavorable tax treatment designed to protect the loss deferral rules. Unless the taxpayer identifies the straddle and elects to exclude the mark-to-market positions from the mark-to-market tax regime,[370] the taxpayer must include mark-to-market gain in income. The loss on the non-mark-to-market positions is not available to offset the recognized gain because the taxpayer has not disposed of the loss positions. No realization and recognition event has occurred. However, if the taxpayer realizes a loss on the mark-to-market leg of the straddle, the loss deferral rules apply to the mark-to-market loss and defer the recognition of the loss until the taxpayer recognizes the gain on the offsetting, non-mark-to-market positions.[371]

Coordination of the two provisions would have been unnecessary if Congress had followed the House of Representative's approach to the straddle shelter and not enacted mark-to-market provisions. Moreover, it would appear that mark-to-market itself was unnecessary to combat the straddle shelter. Since the issue concerned taxpayers recognizing loss before gain on balanced positions, either a loss deferral rule or a mark-to-market rule, properly structured to include all possible offsetting positions, would eliminate the problem. Unlike a mark-to-market rule, however, adoption of a loss deferral rule required no departure from traditional principles of taxation. Loss deferral pending the genuine economic closure of a unified transaction finds its roots deep in the history of tax jurisprudence. Statutory[372] and case law[373] both demand closing of the loss transaction as a condition to recognition of loss.[374] While the straddle rules extend tax integration of transactions for determining genuine loss to a broader field, they break no new tax ground.

Marking to market, on the other hand, although simple to ad-

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[370] Such an election for identified straddles is permitted by I.R.C. § 1256(d).

[371] I.R.C. § 1092(d)(5) causes § 1256 contracts to be governed by the straddle loss deferral rules and the mark-to-market rules simultaneously.

[372] For example, I.R.C. § 1091 defers the recognition of loss on wash sales of stock, while § 267 disallows losses on related party sales but allows the deferred loss to the purchaser to the extent of her gain on resale.

[373] McWilliams v. Commissioner, 331 U.S. 695 (1947), applies related person loss disallowance to transactions involving an unrelated third party intermediary such as a stock exchange.

[374] Moreover, deductibility of loss is generally conditioned upon the presence of a transaction engaged in for profit. I.R.C. § 183.

minister[375] and administratively appealing because the taxpayer has or has had access to the cash, violates the constitutionally based tax doctrine of realization. Additionally, mark-to-market taxation lacks the rationale of a foreign personal holding company regime because it is neither essential to nor well-designed for combatting the tax deferral schemes which gave it life.

E. Liquidity as a Basis for Taxation: Forwards, Non-equity Options, Dealer Equity Options

So we are left with taxpayer liquidity to explain mark-to-market taxation. The traditional argument that we must capture the tax dollars when the commodities exchange marks the position to market lest the taxpayer dissipate the funds and become unable to pay the tax upon realization and recognition of the gain lacks merit. If liquidity supports taxation, we should tax each taxpayer who borrows against the appreciation in the value of property she owns.[376] Moreover, the advance in the value of the commodity position may occur early in the year with no subsequent movement in value. Since taxpayers are not required to include the daily mark-to-market receipts in their base for computing their estimated tax payment liability,[377] they may dissipate the funds during the year in any event. In fact, under some circumstances, mark-to-market taxation may undermine the smooth operation of the commodities markets by rendering some of its participants illiquid as they have to make tax payments on mark-to-market gains only to find they must meet a margin call because those same positions decline suddenly following the tax payment.

Even if liquifaction were to suffice as a taxable event, we still would not have concluded our quest to comprehend the tax principles and policies underlying mark-to-market taxation. Several markets are subject to the mark-to-market regime although those markets do not mark positions to market. In the interbank market for currency forwards and the options markets, both for non-equity

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[375] The futures markets already produce the records required.

[376] Cf. Woodsam Associates v. Commissioner, 198 F.2d 357 (2d Cir. 1952).

[377] Marking to market occurs on the last business day of the taxable year. I.R.C. § 1256(a)(1). Accordingly, a taxpayer annualizing income under § 6654(d)(1)(C)(iv) or § 6654(d)(2) will include § 1256 gain for estimated tax purposes no earlier than her fourth installment due January 15 of the next year (or December 15 in the case of a corporation).

options and dealer equity options, cash does not change hands on a daily basis with respect to open positions, yet contracts in those markets are subject to the mark-to-market regime.[378]

Extension of the mark-to-market rules to the interbank market for currency futures piggybacks upon the first group of mark-to-market rules under the auspices of treating similar transactions in different markets alike. Since only forward contracts in currencies for which there are also regulated futures contracts become subject to the mark-to-market regime,[379] the statute prevents taxpayers from avoiding mark-to-market taxation by purchasing forward contracts, rather than regulated futures contracts.[380] Dissimilarities such as lack of contract standardization and, more importantly, absence of daily cash margin settlement, take a subordinate position to the ready availability of price information upon which mark-to-market taxation depends.[381] Notions of constructive receipt and taxation based upon liquidity disappear as controlling principles almost immediately from the mark-to-market scene.

Inclusion of non-equity options and dealer equity options under the mark-to-market umbrella emerges without policy discussion of the appropriateness of taxing such products before realization of gain or loss.[382] The discussion centers rather on uncertainties arising from enactment of the previous mark-to-market rules. Doubt concerning the application of those rules to the tax treatment of other products created a realm of ambiguity in which taxpayers could whipsaw the government as to the proper tax treatment. Taxpayers could claim the benefit of mark-to-market provisions —

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[378] Under I.R.C. § 1256(b), contracts subject to marking to market under § 1256(a) include foreign currency contracts, nonequity options and dealer equity options.

[379] I.R.C. § 1256(g)(2).

[380] H.R. Conf. Rep. No. 986, 97th Cong., 2d Sess. 24, reprinted in 1982 U.S.C.C.A.N. 4149, 4212; S. Rep. No. 592, 97th Cong., 2d Sess. 26, reprinted in 1982 U.S.C.C.A.N. 4149, 4172; H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982).

[381] "Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available." H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982) at 23.

[382] The legislative history offers no explanation in terms of traditional tax jurisprudence for including such contracts under mark-to-market rules as it did for regulated futures contracts in 1981. H.R. Rep. No. 432, 98th Cong., 2d Sess. 1265-71 (1984), does not include discussion of constructive receipt as did the reports offering the original mark-to-market provision. See supra note 270 and accompanying text.

60 percent long term and 40 percent short term capital gain[383] — while avoiding the same treatment on the loss side by reporting short term capital loss outside the mark-to-market rules.[384] At the same time, dealers in options could claim ordinary gain or loss from their transactions in the ordinary course of business.[385] Congress was concerned about the disparity in treatment of options market makers on securities exchanges and professional traders on commodity exchanges: options market makers on securities markets were viewed as having ordinary income and loss whereas professional traders on commodities exchanges were viewed as having capital gain or loss.[386]

Clarifying that options lay outside the mark-to-market system would not solve the problem for such non-equity options as options on regulated futures contracts. Taxpayers having a gain could exercise the option, acquire the underlying futures contract and mark it to market, whereas taxpayers holding loss positions would recognize their loss on the option itself. To prevent this whipsaw effect, Congress brought non-equity options under the mark-to-market system. Thereafter, professional traders in non-equity options became subject to mark-to-market regulation. In order to treat options dealers in the securities markets the same as professionals in the commodities markets, dealer equity options became mark-to-market contracts as well.[387]

While the inclusion of such contracts fills a gap, linking options to other contracts under the mark-to-market system is unprincipled. Constructive or actual receipt of proceeds, which, as a general principle, served to explain mark-to-market regulation, became unnecessary to support its further growth. Although the markets themselves do not mark the contracts to market, as in the case of forward contracts in currencies, mark-to-market taxation again fed upon its own questionable existence to fuel its further growth. The commodities industry became subject to special accretion taxation rules requiring current taxation of unrealized gains while other investment industries remained free of taxation before realization.

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[383] I.R.C. § 1256(a)(3).

[384] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1267, reprinted in 1984 U.S.C.C.A.N. 697, 928.

[385] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1263, reprinted in 1984 U.S.C.C.A.N. 697, 924.

[386] Id. at 1267.

[387] H.R. Rep. No. 432, supra note 357, at 1267.

For example, listed equity options are traded principally on exchanges regulated by the Securities and Exchange Commission, rather than the Commodities Futures Trading Commission, and are not subject to mark-to-market regulations.[388] Having been accepted by the affected industries, mark-to-market taxation needed no further explanation of its policy. There has been no debate about the policies behind imposing mark to market taxation on the commodities industry, nor has there been discussion of the eroding constitutional realization requirement.

F. *Mark to Market as Consensual Inclusion of Unrealized Gain*

In examining the mark-to-market system, the discussion in this article has focused on the current status of *Macomber*'s realization rule. The commodities industry is insufficiently distinguishable from other investment industries to support taxing it differently and less favorably than other industries. Mark-to-market taxation lacks a foundation in tax policy and violates the constitutional realization requirement, yet to date, with a single exception[389] neither commentators nor participants in the commodities industry have challenged mark-to-market taxation. The absence of commentary is less surprising than the absence of industry challenge. Academic commentators generally have accepted Surrey's conclusion[390] that realization is a matter of administrative convenience or have simply overlooked this issue.[391] Practitioner commentary tends to follow the affected industry's lead rather than theoretical issues, but the industry has not objected to marking to market.[392] Without challenges, the government has no reason to question the propriety of taxation without realization in this instance.

Until 1993 the Code required marking to market only in the commodities industry.[393] New legislation now imposes mark to

[388] However, dealers in equity options on securities exchanges are subject to mark-to-market regulation. I.R.C. § 1256(b)(4).

[389] Supra note 303 and accompanying text.

[390] See supra note 1 and discussion following.

[391] See supra note 10 and accompanying text.

[392] But see Thomas A. Russo, Regulation of the Commodities, Futures and Options Market § 15.03 (1983 & Supp. 1992), for the broad outlines of the argument that marking-to-market taxation violates the realization rule of *Macomber*.

[393] I.R.C. § 1256(b)(1).

market taxation on one segment of the securities industry.[394] Under the legislation, securities dealers have to mark their inventories to market annually.[395] Threat of expansion of the mark-to-market regime to the inventories of securities dealers drew a sharp reaction from the Securities Industry Association.[396]

Through the rhetoric of the Securities Industry Association's adverse reaction to expanding mark-to-market taxation comes an obvious explanation for the failure of the commodities industry to object when Congress imposed mark-to-market taxation upon it: there was a quid pro quo. The industry, especially participants who generally held their open positions for only short periods, received a material capital gains benefit. Instead of long term capital gains being dependent on the taxpayer meeting long term holding period requirements, all mark-to-market gains, regardless of the taxpayer's holding period in the position being marked to market, became 60 percent long term and 40 percent short term capital gain. Accordingly, the maximum effective rate of taxation imposed upon marked-to-market gains was 32 percent until 1987.

This 32 percent maximum rate was the sum of 50 percent of 40 percent (20 percent) and 20 percent of 60 percent (12 percent). Short term gains were taxed as ordinary income which was subject to a maximum rate of tax of 50 percent, and non-corporate taxpayers received a deduction in computing adjusted gross income for net capital gains of 60 percent which lowered the maximum effective rate on net capital gain to 20 percent.[397] With this clean 18

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[394] Section 13223 of the 1993 Tax Act added § 475 to the Code.

[395] IRC § 475.

[396] Letter dated June 4, 1992 from the Securities Industry Association to Treasury Secretary Nicholas F. Brady, 92 TNT 131-44, opposing provisions of H.R. No. 4210, 102d Cong., 2d Sess., which would apply the mark-to-market rules to securities dealers, emphasizes that the legislation "represents a substantial departure from the most fundamental principle of our income tax law—that income should be taxed only when it is realized by the taxpayer."

[397] Before repeal by the 1986 Act, the Internal Revenue Code of 1954, § 1202, allowed taxpayers other than a corporation to deduct from gross income 60% of net capital gain. As defined by § 1222 of the Internal Revenue Code of 1954, net capital gain is the excess of net long term capital gains over net short term capital losses. The 1986 Act repealed the net capital gain deduction, thereby eliminating the differential in rates between long term gains and ordinary income.

In addition, the 1986 Act classified all foreign currency gains and losses from futures, forwards and options as ordinary income and loss. I.R.C. § 988. However, an election to treat foreign currency gain and loss as capital is available if the taxpayer holding a position which is a capital asset in her hands identifies the transaction and elects capital treatment percent tax reduction in their pockets, commodities market participants were willing to accept mark to market as a trade-off.[398] In fact, award of the 60/40 capital gain benefit to option dealers writing options in the ordinary course of their business accompanied extension of the mark-to-market rules to non-equity options and dealer equity options.[399]

Were we interested in locating a challenger with a deep economic interest in resisting mark-to-market taxation, we might look in vain to the commodities markets. In volatile markets, such as the commodities markets, holding periods tend to be short and trading strategies customarily involve mixing of long and short positions[400] because one group of market participants, speculators, prefer volatility to gradual increases in price levels. As a result, it is likely that the mark-to-market regime converts a substantial amount of what would be short term capital gain into long term capital gain. Moreover, the impact of the timing differential resulting from marking to market on such participants may be insubstantial. Frequent trading means that marking to market affects relatively few positions that a taxpayer has held for any meaningful period, so the benefit of 60/40 would seem to far outweigh the detriment from those few positions. At the same time, another major group of participants in the market, hedgers, may exclude themselves from mark-to-market rules,[401] so neither principal group of participants has an interest in challenging mark to

before the close of the day on which she enters into the position. I.R.C. § 988(a)(1)(B).

Section 11101 of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, 1403-05 (codified at I.R.C. § 1(h)), introduced a rate differential between ordinary income and net capital gain for non-corporate taxpayers at the highest rate bracket when the top marginal rate was increased from 28 to 31 percent. Sections 13201(a) and 13202(a) of the 1993 Tax Act each added a marginal bracket to IRC §1(a)-(e) thereby increasing the diffential between the top marginal rate on ordinary income and the IRC §1(h) 28 percent rate limit on net capital gain.

[398] Subsequent repeal of the net capital gain deduction has left the commodities industry without the benefit it received in exchange for accepting mark-to-market taxation. And as Washburn, supra note 242, illustrates, repeal of the capital gain deduction has transformed I.R.C. § 1256 into a penalty provision for speculators in commodity positions.

[399] H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1270-71 (1984). The regulated futures market has brokers, called futures commission merchants, and traders, but no market makers and dealers as the securities markets have. As no one carries inventories in regulated futures contracts, under I.R.C. §1221 such contracts always may have been capital assets in the hands of even regular participants in the markets.

[400] Reference to buy and sell as opposed to holding periods is intended.

[401] I.R.C. § 1256(e).

market.

Marking to market in the commodities industry resembles consensual arrangements for taxation without realization such as the S election.[402] As taxpayers elect to pay tax currently at the shareholder level on corporate profits in order to avoid the payment of a corporate level tax, taxpayers who trade commodities positions elect mark to market in order to receive the capital gain benefit of 60/40. The similarity is severely limited because the decision to elect or not elect does not belong to the individual taxpayer. In the commodities industry, the individual taxpayer or group of taxpayers has no choice. Rather, the industry in effect has made an election which binds all participants in the industry. If the realization requirement finds its origin in the Constitution, even a super-majority of the participants in an industry should not have the authority to waive the requirement for all others.[403]

G. *Toward Accretion Taxation*

If the foregoing observations about holding periods for commodity positions are correct, we must wonder why Congress bothered with marking to market in the first instance. Although it accelerates the receipt of a small amount of revenue, it does little to combat the tax sheltering that concerned Congress at the time of enactment.[404] Subsequent developments, however, give cause for reflection as to whether a broader effort to erode the realization requirement and to move gradually toward accretion taxation was involved. The commodities industry's acceptance of mark-to-market regulation paved the way for taxation without realization embedded in selective tax rules for discrete industries.

Although the strategy of negotiating an acceptable exchange of tax benefits and detriments with the affected industry makes good sense, it also may produce unsound tax policy which may later impact other industries. Mark-to-market taxation is just such a case. Even ignoring the unconstitutionality of such accretion taxation,

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[402] The S election is provided for in I.R.C. § 1362.

[403] Some argue, for example, that the community standards limitation on allegedly obscene material raises precisely this issue with respect to the First Amendment. See Miller v. California, 413 U.S. 15, 24 (1973) (defining obscenity by contemporary community standards).

[404] See discussion supra Part III.D.

other problems exist. In seeking to expand mark-to-market regulation to dealers in securities, Congress did not study the potentially adverse effect of the tax change on that industry carefully enough. Congress assumed that marking to market was an acceptable taxing method. It then applied it to dealers in securities as they were already required to account for their inventories on an accretion basis.[405]

Conditions in the securities industry, however, may not be identical to conditions in the commodities industry; nor is the use of a specific accounting method a necessary and sufficient rationale for a specific tax rule. Reporting positions for financial accounting purposes at fair market value does not affect the liquidity of the holders of those positions; reporting in such manner for tax purposes frequently requires cash to pay the tax and may strain the taxpayer's resources. Under the tax law, financial accounting rules have never determined the tax outcome. Generally, the courts have agreed with the Internal Revenue Service that accounting rules do not always make the best tax rules.[406] Thus, Congress again chose to impose constitutionally questionable tax rules on an industry without fully considering the theoretical implications or real world impact of such differential treatment.

Proposed application of the mark-to-market regime to passive foreign corporations[407] would have raised fewer objections than its application to securities dealers. Investors in passive foreign corporations choose the offshore investment from among available products, including similar domestic entities, with knowledge of the tax ramifications. The investment is likely not to be their principal livelihood as is the case with securities dealers, so they can avoid

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[405] Congressional understanding of the accounting rule appears flawed. See the Report of the Committee on Financial Transactions, supra note 262.

[406] Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), in which a taxpayer sought to carry its inventory of obsolete replacement parts at zero for tax purposes as it did for accounting purposes. The Court refused to accept the accounting rule as determinative of the tax outcome and held that the inventory must have a non-zero value since the taxpayer had not abandoned it. Similarly in American Automobile Assoc. v. United States, 367 U.S. 687 (1961), the Court held that a permissible accounting method under which the taxpayer, an automobile club, included advance payments of membership dues ratably in income as it performed the membership services was not acceptable for tax purposes. The club had to accrue the dues upon receipt and not ratably over the duration of the membership.

[407] 1992 Tax Proposals, supra note 17, § 4402.

any adverse tax consequences. In addition, taxing foreign income before realization has a long tradition under the Code.[408] Nevertheless, such treatment is a cause for concern insofar as it represents further impairment of the realization requirement.

IV. Conclusion

The Supreme Court's holding in *Macomber* remains valid today. Through a thorough analysis of Supreme Court decisions, this article has demonstrated that realization remains a constitutional prerequisite for the taxation of gains from property. Although the contours of realization may undergo further refinement, realization is a principle which threatens to undermine recent movements toward accretion taxation.

To date, the commodities industry is unique in having become subject to accretion taxation on a broad scale. Mark-to-market taxation lacks a solid foundation in tax jurisprudence. The identified rationales for mark-to-market taxation do not withstand analysis. Nonethless, the commodities industry has not challenged the governing statutes, presumably because it received tax benefits to compensate for its acceptance of the new tax model. The commodities industry's counterparts in the securities industry may not prove quite so inactive. If they challenge application of accretion models to their industry, they may well compel resolution of the permissibility of taxation without realization.

Without certainty concerning the vitality of the realization requirement, we cannot undertake any broad-based transition to accretion taxation. Congress seems likely to continue its current course: it will further erode the realization requirement in order to secure revenue and produce revenue neutral legislation. The better course would be to engage in a principled deliberation over the merits of a particular model of taxation. Congress must address theoretical inconsistencies in its decision making process before capturing revenues.

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[408] See supra Parts II.C.1., 2.