

TRANSFERABILITY, UTILITY, AND TAXATION

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I. INTRODUCTION

Both in economics and in the law of taxation, the receipt of assets should not constitute income unless those assets are useful to the recipient. Since it is assumed that money is always useful to everyone,¹ it is only in the case of non-money assets that the question of utility must be raised. Even in the case of a non-money asset that is useless to the recipient in its present form, however, there is always the possibility that the recipient can trade that asset for one that is useful to him. Therefore, as long as an asset is useful to someone in the world and it is transferable, it ought to be treated as income even to one who does not want it. The utility, and therefore the taxable income generated by such an asset, ought not to be measured by the asset's objective fair market value in such cases, but rather by the value of the useful assets that can be acquired in trade, reduced by any transaction costs.

In the above discussion, transferability makes an otherwise useless asset useful. Similarly, transferability makes a useful asset more useful, and nontransferability

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¹ It is conceded that money is not equally useful to all. See W. BLUM & H. KALVEN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* 40-42 (1953) for a discussion of the marginal utility of money.

makes a useful asset less useful. When one is offered the choice of a useful, non-transferable asset, or the retail price of that asset in cash, one would choose the cash unless that asset happened to represent one's optimum expenditure of that amount of money.² Therefore, the taxable income generated by a useful, non-transferable asset ought to be less than its retail price, and ought to be measured by its subjective utility to the recipient.

The above analysis suggests four working assumptions with respect to the relationship of transferability and utility to taxable income: (1) the receipt of useless, nontransferable assets generates no taxable income; (2) the receipt of useful, transferable assets generates taxable income in the amount of the objective fair market value of the assets; (3) the receipt of useful, nontransferable assets generates taxable income in the amount of the subjective value of those assets to the recipient; and (4) the receipt of useless (in their present form), transferable assets³ generates taxable income only in the amount of the useful assets for which they can be traded, or their "transfer value". This Article will examine the implications of these four assumptions and analyze their interrelationship with current tax law.

II. USELESS, NONTRANSFERABLE ASSETS

The analysis of the assumption with respect to useless, nontransferable assets is the easiest of the four. If the asset were not transferable because no one else in the world wanted it, then even its objective fair market value would be zero. On the other hand, if the asset were nontransferable for some other reason, it still would not increase the material well-being of the recipient. The asset itself would be useless to him, and he would be unable to trade it for anything else. In fact, a rational person, when offered something that was neither useful to him nor transferable, would simply refuse to accept it. The case law is clear that one may avoid income taxes by refusing to accept proffered assets.⁴

III. USEFUL, TRANSFERABLE ASSETS

It should be equally clear that the receipt of useful, transferable assets generates some taxable income. Certainly, it generates income in at least the amount of the transfer value of the asset. If the recipient chooses to use the proffered asset rather than to sell it, he foregoes the sales proceeds. Therefore, the asset must be worth at least the amount of the sales proceeds foregone to the recipient, and should be taxable to him in that amount. Moreover, if the asset is useful to the recipient, it is probably useful to him for the same reasons that it is useful to others in the community. Therefore, he probably would have been quite willing to pay the objective fair market value for the asset, just as anyone else would have. Accordingly, the objective fair market value, rather than either subjective value or transfer value, should be the measure of taxable income.⁵

² This relationship is proved as a matter of economic theory in W. BAUMOL & A. BINDER, *ECONOMICS PRINCIPLES AND POLICY* 364-67 (1979).

³ Hereinafter, such assets shall be referred to as "useless, transferable assets."

⁴ *Commissioner v. Giannini*, 129 F.2d 638 (9th Cir. 1942); Rev. Rul. 581, 1974-2 C.B. 25; Rev. Rul. 167, 1966-1 C.B. 20; Rev. Rul. 282, 1965-2 C.B. 21; Rev. Rul. 515, 1958-2 C.B. 28; Rev. Rul. 220, 1958-1 C.B. 26.

⁵ The argument for taxing that portion of the fair market value that exceeds the transfer value is

The other two assumptions are more problematic, and furnish the basis for much of the discussion that follows.

IV. USELESS, TRANSFERABLE ASSETS

One cannot consider the category of useless, transferable assets without first determining when such assets might be conveyed. A rational person, when offered the choice of a useless, transferable asset or the cash amount of its transfer value, would almost certainly choose the cash. The non-cash asset would be comparatively undesirable in two respects. First, the recipient would be required to do some amount of work in order to convert the asset into something useful to him. Second, there is always some risk that the recipient would not be able to convert that asset into as much money as he thinks it is worth. Therefore, it is highly unlikely that useless, transferable assets would be received on the basis of an arm's length exchange, assuming comparable bargaining power on the part of the two parties to the transaction. Most useless, transferable assets are probably received at Christmas in the form of ties. However, such gifts are excluded from taxable income pursuant to section 102.⁶ The only other instances when one might receive useless, transferable assets would be the finding of treasure trove, or the receipt of a taxable prize.⁷

A. *Treasure Trove*

If a taxpayer were to discover treasure trove in the form of an asset that was not itself useful to him, but was useful to others, that taxpayer would probably take that treasure trove and sell it for cash. The cash amount, rather than the asset's retail value, ought to be the measure of taxable income. Moreover, if there were any transaction costs involved in the sale, those costs should reduce the taxable income. However, these transaction costs would not have to be a direct reduction of taxable income, as long as they were deductible under either section 162 or section 212, as an expense of producing income.

Unfortunately, the only case law on treasure trove deals with the finding of cash.⁸ Since cash is useful to everyone, cash does not fit into the category of useless, transferable assets. Revenue Ruling 61,⁹ however, deals with all types of treasure trove. The Ruling provides in its entirety: "The finder of treasure-trove is in receipt of taxable income, for Federal income tax purposes to the extent of its value in United States currency, for the taxable year in which it is reduced to undisputed possession."¹⁰ Unfortunately, the Ruling gives no hints as to what it means by the term "value."

admittedly not totally satisfying intellectually. However, it should be pointed out that useful, transferable assets constitute by far the largest of the four categories. Substitution of a subjective value would have disastrous effects upon the administration of the tax laws. In addition, see *Pfalzgraf v. Commissioner*, 67 T.C. 784 (1977), and *Cornelius v. Commissioner*, 56 T.C. 976 (1971), allowing valuations of household goods higher than resale value for the purpose of the casualty loss deduction.

⁶ References to sections of the Internal Revenue Code of 1954 are made to the section only.

⁷ Those prizes that are excludable from income pursuant to section 74(b) are omitted from this analysis.

⁸ *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970).

⁹ 1953-1 C.B. 17.

¹⁰ *Id.*

B. Prizes

Those taxable prizes that have been considered by the tax law can be broken down into the categories of quiz show prizes, prizes in the nature of employee fringe benefits, and trophies. As to quiz shows, one could easily win a useless, transferable asset in such a show, largely because the contestants often have no idea of the nature of the prize when they enter the contest. Clearly, if the value of such a prize to the quiz show contestant is only the amount for which he can sell it, then no more than that amount should be taxed to him. Such prizes are explicitly covered in Treasury Regulation section 1.74-1(a)(1): "Prizes and awards which are includible in gross income include (but are not limited to) amounts received in radio and television giveaway shows"

Treasury Regulation section 1.74-1(a)(2) provides: "If the prize or award is not made in money but is made in goods and services, the fair market value of the goods or services is the amount to be included in income." Again, as in the case of treasure trove, the Regulation is unclear as to the treatment of assets that are useless to the recipient. If "fair market value" means the value of the asset in the hands of the recipient, at which point the asset is no longer new but used, then the Regulation is correct. Although there is no case law on this fact category, the IRS has conceded on numerous occasions at the conference level that the taxable income in such situations can be no more than the sales proceeds actually realized in the transaction.¹¹ If this is indeed the consistent position of the Service, the Regulation should be changed to make the point clear.

The second category of taxable prizes is prizes in the nature of employee fringe benefits. Here, there is some case law authority. In *McCoy v. Commissioner*¹² an automobile furnished by an employer as a prize in an annual sales contest constituted the unwanted, transferable asset. The prize was a 1957 Lincoln Capri two-door coupe, which had been purchased by the employer for \$4,452.54.¹³

The employee received the automobile on November 5, 1956, after which he drove it to his home in Knoxville, Tennessee. Within ten days, he traded the car to a dealer for 1,000 dollars cash and a 1957 Ford Country Squire station wagon, having a dealer's price of 2600 dollars. The petitioner included 3600 dollars in his adjusted gross income for the year of 1956 as a result of these transactions.¹⁴

The Tax Court found the following additional facts:

In 1956 the petitioners had 4 children. Over the 5-year period prior to the trial the petitioner's average annual income was about \$7,500 At the time he received the Lincoln automobile the petitioner did not own a car. He had not purchased an automobile since 1954 when he purchased a used Oldsmobile which he sold in 1955. Subsequent to selling his Oldsmobile, petitioner used automobiles furnished to him by his employer and, after receiving the Lincoln and trading for the Ford station wagon, he continued to use automobiles furnished by his employer. The Ford station wagon was used primarily by his wife. Except for the car in question, the petitioner has never owned a Lincoln car and has never con-

¹¹ Conversations with New York attorneys and accountants in January, 1980 (names withheld on request).

¹² 38 T.C. 841 (1962).

¹³ *Id.* at 842.

¹⁴ *Id.*

sidered purchasing one.¹⁵

The Commissioner asserted that the fair market value of the automobile was the employer's purchase price, or \$4,452.54. He argued that the difference between that figure and the 3600 dollar figure could be explained by ten days of depreciation. The court commented:

When the car was received by the petitioner it was a new car in the sense that it had not been actually used. However, we think it is common knowledge of which we may take notice, that when an automobile has been purchased from a dealer the purchaser cannot, on a sale of the car, normally realize the price which he paid for the car, even though it has not been actually used. We think that a substantial part of the reduction in value of the car in question is attributable to this fact. On the other hand, we cannot conclude that the full reduction in value to \$3,600 was attributable to this factor.¹⁶

The court ultimately concluded that the automobile had a fair market value of 3900 dollars at the time it was received by the petitioner, and was taxable to him in that amount.

The court in *McCoy* does seem to have recognized, at least in part, that transfer value in the hands of the recipient, rather than retail value, is the appropriate criterion. Yet the decision appears to go too far. The court was apparently willing to subtract 500 dollars from the taxable value of the automobile at the moment it was sold and driven off the dealer's lot. Presumably, if the employer had given his employee a check in the amount of \$4,452.54 made out to the Lincoln dealership, and the employee had picked up the automobile on the dealer's lot, he would have been taxed on the higher figure.

Does *McCoy* actually contemplate significant differences in tax treatment depending upon whether the recipient picks up the automobile at the dealership or at some other location? At first, the case seems to stand for this unfair proposition. However, it seems significant that the court took the trouble to recite the facts, as stated above, that the petitioner had never owned a Lincoln, had never considered purchasing one, and in fact did not own a car at the time of the receipt of the prize. In effect, the court was taking notice of the fact that the Lincoln was not as useful to the taxpayer as it was to the dealer. Apparently, the court used this fact to justify its decision to tax the petitioner at less than the automobile's retail value. It would be hoped that it was this utility factor, rather than the coincidence of whether or not the automobile was on the dealer's lot when ownership was transferred, that was the significant factor in the case. The Tax Court appeared to accept this premise in *McDonald v. Commissioner*,¹⁷ when it commented that "while we recognize the general validity of petitioners' premise that an item may have different values to different persons, see *Lawrence W. McCoy*"¹⁸

The only other category of prizes discussed in the case law is sports trophies. In *Wills v. Commissioner*¹⁹ the taxpayer received the S. Rae Hickock Belt award

¹⁵ *Id.* at 842-43.

¹⁶ *Id.* at 844.

¹⁷ 66 T.C. 223 (1976).

¹⁸ *Id.* at 234.

¹⁹ 48 T.C. 308 (1967), *aff'd*, 411 F.2d 537 (9th Cir. 1969).

for having been voted the outstanding professional athlete of 1962.

The S. Rae Hickock belt was jewel-studded, contained 27 one and one-half carat diamonds, simulated stones, and had a 3 1/2-pound gold belt buckle. It is stipulated that the value of the belt at the time of receipt was \$6,038.19. One of the gems in the belt was subsequently removed by and used in a ring for petitioner's wife.²⁰

The Tax Court dealt with the taxpayer's arguments about the utility and transferability of the award as follows:

Petitioner argues that the Hickock belt is nontaxable on the ground that the belt is a "trophy"; that section 74 is silent on the question of a trophy; and that the belt has no fair market value because recipients intend to treat it as a "trophy." Respondent counters this argument by noting that petitioner was not subject to any restrictions as to possible disposition of the belt after receipt and that it had an actual value of over \$6,000.

.....
Petitioner's position is equitable. The receipt of an award like the Hickock belt is not equivalent to the receipt of a car or any other like item which the recipient would ordinarily find useful in his daily affairs and which he might purchase on his own. The fact that a recipient of an award having utilitarian value would commonly purchase a similar item tends to mitigate the harshness of imposing a tax upon its receipt. Clearly, the Hickock belt, being large and cumbersome, made out of gold studded with gems, is of no utilitarian value. Its purpose is honorary and decorative. Although the Hickock belt is a valuable item, it is hardly one which the recipient would be likely to purchase in the absence of award. Thus, if taxable, the taxpayer-recipient would be required to pay for the privilege of retaining a trophy.

.....
Despite our solicitude for petitioner's position, we do not believe that the fair market value of the Hickock belt is excludable from gross income.²¹

The United States Court of Appeals for the Ninth Circuit affirmed, commenting that, "To agree, as the taxpayer does, the belt could be sold for some amount is to agree that the belt is the 'equivalent of cash' in which case it is taxable when received."²²

Unfortunately, it is difficult to fit *Wills* into the pattern. Fair market value here was stipulated. Therefore, it is impossible to tell whether it was retail value or transfer value. Moreover, although the Tax Court agreed that the award had no utilitarian value, it is still undeniable that the taxpayer chose not to sell it. Therefore, it had to be of some use to him, and was not an entirely useless, although transferable, asset.

*Hornung v. Commissioner*²³ was a similar situation. In *Hornung* the taxpayer received a Corvette for being named the outstanding player in the 1961 N.F.L. Championship game. The automobile was clearly not of much use to Hornung, because he sold it. Again, the question of retail price versus transfer value is moot. We are told that the fair market value of the automobile was \$3,331.04.

²⁰ 48 T.C. at 310 n.1.

²¹ *Id.* at 315.

²² *Wills v. Commissioner*, 411 F.2d 537, 543 (9th Cir. 1969).

²³ 47 T.C. 428 (1967).

We are also told that Hornung sold it for \$3,331.04.²⁴ Therefore, either the court accepted transfer value as fair market value, or Hornung managed to sell the automobile for its retail price. Either way, the decision to tax Hornung in this amount was correct.

C. Conclusion

Aside from an ambiguous decision in *McCoy* and some judicial solicitude in *Wills*, the authorities do not take a position as to whether the taxable income from useless, transferable assets ought to be limited to the transfer value of the assets involved. Yet, such a result is demanded by common sense and good economics. If the Service is already conceding this position at the conference level, it is time to come out of the closet and accept it in the full glare of the Treasury Regulations and published rulings.

V. USEFUL, NONTRANSFERABLE ASSETS

The assumption with respect to useful, nontransferable assets is potentially the most disastrous to the system of tax administration, in that it contemplates a subjective, rather than an objective, valuation. Subjective standards require laborious, unpredictable, case-by-case determinations. Furthermore, subjective valuation is virtually incapable of being proved by the adversary process. All of the facts, such as they are, are in the hands of the recipient; none are available to the tax administrators through external means.²⁵

In view of the valuation problems, there are three alternative tax treatments of the receipt of useful, nontransferable assets. The first is to exclude such assets from taxation. The second, equally simple, though kinder to the federal revenues, is to refuse to take nontransferability into account, and tax such assets at their objective, fair market value. The third is to tax such assets on the basis of their subjective value to the recipient.

A. Early Statutory Treatment

The earliest response to the problems raised by the receipt of nontransferable assets was statutory. That response was to exclude nontransferable assets from taxation. The 1918 Revenue Act provided: "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, *if any*."²⁶ Clearly, a nontransferable asset has no fair market value, in that there cannot be a willing buyer and a willing seller. According to case law interpretations of the 1918 provision, the receipt of assets having no fair market value did not produce any taxable gain or loss.²⁷ However, the basis of the asset given up was carried over to the asset received. Therefore, the tax was only deferred, not avoided.

²⁴ *Id.* at 431.

²⁵ For an expression of a similar concern with respect to a different body of law, see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), which states: "The jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant." *Id.* at 746.

²⁶ Revenue Act of 1918, § 202(b), 40 Stat. 1057 (1919) (emphasis added).

²⁷ See notes 37-43 *infra*.

Shortly after the enactment of the 1918 Revenue Act, *Eisner v. Macomber*²⁸ was decided. In *Eisner* Justice Holmes began with the definition of income adopted in two early cases arising under the Corporation Tax Act of 1909: "Income may be defined as the gain derived from capital, from labor, or from both combined."²⁹ Holmes expanded upon that definition as follows:

Here we have the essential matter: *not* a gain *accruing* to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and *coming in*, being "*derived*," that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description.³⁰

The phrase "exchangeable value," which appears in the opinion, clearly suggests a requirement that assets be transferable before they constitute income. Although this phrase has not been discussed at length by the modern commentators, it was clearly significant at the time.³¹ In the Revenue Act of 1921, enacted one year after the *Eisner* case, the "fair market value, if any" language of the 1918 Act was replaced with the phrase, "no gain or loss shall be recognized unless property received in exchange has a readily realizable market value."³²

The House Ways and Means Committee report to the Revenue Act of 1921 began by quoting the 1918 provision and commented:

Probably no part of the present income tax law has been productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions. Under existing law the presumption is in favor of taxation. The proposed bill modifies that presumption by providing that on exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a definite and readily realizable market value.

The preceding amendments, if adopted, will, by removing a source of grave uncertainty, not only permit a business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.³³

If there is any doubt as to the import of the word "realizable" in the 1921 Act, the following colloquy that occurred in the Senate should put it to rest:

Mr. Walsh: I would like to ask the acting Chairman if it would not be better to insert the word "ascertainable" in lieu of the word "realizable," on line 21, page 11?

Mr. McCumber: I can see no reason for making the change suggested. It reads, "has a readily realizable market value." If we are to get the money out of the property and out of the sale, there must be a realizable value, and a realizable value is what it can be sold for, what can be realized.

Mr. Walsh: I did not know that it is particularly important, but it has

²⁸ 252 U.S. 189 (1920).

²⁹ *Id.* at 207 (citation omitted).

³⁰ *Id.* (emphasis in original).

³¹ See R. MAGILL, *TAXABLE INCOME* 200 (1936).

³² Revenue Act of 1921, § 202(c), 42 Stat. 227.

³³ H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921).

been suggested to me that "ascertainable" would be more effective in the administration of the law than "realizable."

Mr. McCumber: "Ascertainable" would be nothing more than a mere measurement to ascertain the value. It seems to me what we want to get at is what could actually be realized on the sale. It may be worth a certain amount, and yet it may not be salable for that amount.

Mr. Walsh: I do not know that it is particularly important.

Mr. McCumber: I think it is very important to the taxpayer.

Mr. Walsh: I do not care to press the suggestion.³⁴

In rejecting the alternate word "ascertainable," the Senate was clearly requiring more than measureability. In fact, it was requiring that the asset be transferable for cash. In addition, in light of the Ways and Means Committee's comment as to the presumptions, it appears clear that if the asset had no readily realizable value in cash, there would be no tax whatsoever.

This statutory language was short-lived, however. In the Revenue Act of 1924, the formula of fair market value was revived, but this time, the phrase "if any" was deleted.³⁵ This change was supported by the Treasury Department, which favored a presumption in favor of taxation.³⁶

The focus of these early statutes was on marketability rather than transferability. Assets that are nontransferable solely because they are unmarketable furnish a relatively easy problem for the system. As long as the assets are useful, unmarketability must be a temporary phenomenon, probably caused by a lack of sufficient information. Therefore, when the system excludes unmarketable, though useful, assets from taxation, it is really only deferring the taxable event until such time as the assets become marketable again. An analysis of the cases that came up under the early statutes and of the later reflection of some of these case law patterns in the new statutes makes this point.

B. Early Case Law

The early cases fall into two major fact patterns: the transfer of assets into a new corporation, and the receipt of rights to future income.

1. Transfers to New Corporations

The transfer of assets into a new corporation was generally viewed as an exchange. The amount received upon the exchange was the stock of the new corporation. The issue was whether that stock had either fair market value or readily realizable market value, so that gain or loss could be computed.

Normally, the situation was the incorporation of an existing business. Since the assets transferred into the corporation had value, the stock representing ownership of these assets had a certain intrinsic value. However, these corporations were usually closely held, and since they were brand new, there was no earnings history upon which to make a valuation. Therefore, there was insufficient information to allow the market to form a judgment as to the value of the corporate

³⁴ 61 CONG. REC. 6549 (1921).

³⁵ Revenue Act of 1924, § 203, 43 Stat. 253.

³⁶ *Revenue Revision of 1925: Hearings Before the House Comm. on Ways and Means, 69th Cong., 1st Sess. 152 (1925) (statement of Joseph Klein).*

stock, and the stock was unmarketable. Since the stock had no market value, such transfers were held not to trigger a taxable exchange.

However, it was equally clear that, over time, the stock would acquire an earnings history, become more generally known, and thus ultimately become marketable. In fact, in the many instances in which it was held that such stock had no market value at the moment of the exchange, the basis in the transferred assets was carried over.³⁷ Therefore, when that stock was later sold to third parties, the tax was ultimately paid. This early tax deferral treatment was later codified for corporations in section 351 and for partnerships in section 721. These statutes merely expanded upon the tax deferral treatment given very early on to corporate reorganizations.³⁸

2. *Rights to Future Income*

The other basic category of cases concerned the receipt of rights to future income. In some of these cases, the amount of the income, and therefore the value of the right, was dependent upon profitability. Since future profitability could not be predicted, the rights were held to have no market value.³⁹ However, one needed only to wait in order to find out how much profit there would be. These cases led to the development of the open transaction doctrine, by which a transaction is not closed until all of the income has been earned and paid.⁴⁰ Again, initial nontransferability was solved by tax deferral.

In other cases, the right to future income was in the form of a promissory note. While in other open transaction cases the contingency was profitability, in the promissory note cases the contingency was ultimately the ability to pay. Additionally, promissory notes can be negotiable or non-negotiable. Clearly, non-negotiable promissory notes are nontransferable. Only if the maker of the note is good for his obligation will the note have taxable value.⁴¹

Negotiable promissory notes, though legally transferable, can be unmarketable. Such notes furnished the fact situations for many early cases. Most of the early cases arose out of the Florida land boom of 1925. Land was sold at highly inflated prices for very little cash and very large mortgages. When the inflated values of the land burst within a year, it became apparent that the value of the collateral was nowhere near that of the face value of the notes. No financial

³⁷ *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481 (1937); *Champlin v. Commissioner*, 71 F.2d 23 (10th Cir. 1934); *O'Meara v. Commissioner*, 34 F.2d 390 (10th Cir. 1929); *Bourn v. McLaughlin*, 19 F.2d 148 (N.D. Cal. 1927); *Dohrmann v. Commissioner*, 19 B.T.A. 507 (1930), *rev'd per curiam on stipulation*, 56 F.2d 1081 (9th Cir. 1932); *Ault & Wilborg Co. v. Commissioner*, 17 B.T.A. 665 (1929); *Burley Tobacco Co. v. Commissioner*, 13 B.T.A. 892 (1928); *Saeger v. Commissioner*, 9 B.T.A. 90 (1927).

See also *Mailloux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963) (partial restriction justifies partial discount; dictum that total restriction could destroy fair market value); *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934) (partnership).

For cases holding that the intrinsic value of the underlying assets should be used to value the stocks, see *Ambassador Petroleum Co. v. Commissioner*, 28 B.T.A. 868 (1933), *rev'd on other grounds*, 81 F.2d 474 (9th Cir. 1936); *Holmby Corp. v. Commissioner*, 28 B.T.A. 1092 (1933), *aff'd*, 83 F.2d 548 (9th Cir. 1936); *Belridge Oil Co. v. Commissioner*, 26 B.T.A. 810 (1932), *rev'd on other grounds*, 85 F.2d 762 (9th Cir. 1936).

³⁸ Revenue Act of 1918, § 202(b), 40 Stat. 1057 (1919).

³⁹ *Compare* *Walls v. Commissioner*, 60 F.2d 347 (10th Cir. 1932) *with* *Commissioner v. Moore*, 48 F.2d 526 (10th Cir.), *cert. denied*, 284 U.S. 620 (1931).

⁴⁰ *Burnet v. Logan*, 283 U.S. 404 (1931).

⁴¹ *Ennis v. Commissioner*, 17 T.C. 465 (1951).

institution would either purchase such mortgage notes or accept them as collateral.

Although the open transaction doctrine was used on occasion, the more common response of the system was to close the transaction, either putting a discounted value upon the note, or declaring that the note had no value whatsoever.⁴² If later events proved that the notes were worth either more or less than the value found by the tax courts upon their receipt, there were adjustment devices, such as the bad debt deduction on the loss side and the simple device of taxing additional income on the gain side. This deferred treatment led to possible unfair characterizations as between ordinary income and capital gain, but it did ensure that the proper amount of income would ultimately be taxed.

The early law, therefore, focused upon marketability. As long as the assets in question were useful, unmarketability was a temporary phenomenon. Therefore, even if the system excluded unmarketable assets from taxation, that exclusion in reality functioned as deferral. These responses of the system are still with us in the areas of corporate transactions by statute; streams of income by the open transaction doctrine; and promissory notes, by a combination of the open transaction doctrine and the installment sale provisions.⁴³

An analysis of the remaining situations in which a useful, nontransferable asset might be received reveals that most fall into the category of arm's length transactions, in which valuation problems are easily resolved. The remainder of transactions create varying degrees of difficulty, and must be analyzed separately.

C. Arm's Length Transactions

Perhaps the greatest number of potentially difficult cases are resolved in a fairly simple manner because most assets, whether transferable or not, are received on the basis of an arm's length exchange. It is implicit in the notion of an arm's length exchange that the assets on both sides of the exchange will be equal in value. If the asset given up in trade is susceptible to valuation, that value can be assigned to the asset received as well. Therefore, even though the nontransferable character of the asset received requires that it be taxed at its subjective value to the recipient, there are no problems in determining that value. The recipient pinpoints his subjective value of that asset by purchasing it in an arm's length exchange.⁴⁴

The arm's length exchange doctrine works well as long as one of the two items exchanged is capable of valuation. However, when nontransferable assets are exchanged as compensation for services rendered, it is quite possible that neither the assets nor the services are capable of valuation. This problem is addressed by section 83, added to the Internal Revenue Code in 1969.

⁴² Florida land cases: *Wells Amusement Co. v. Commissioner*, 70 F.2d 208 (4th Cir. 1934); *Walter W. Rose Inv. Co. v. Commissioner*, 24 B.T.A. 215 (1931); *Burman v. Commissioner*, 23 B.T.A. 639 (1931); *Ives Dairy, Inc. v. Commissioner*, 23 B.T.A. 579 (1931), *aff'd*, 65 F.2d 135 (5th Cir. 1933); *Georgia-Florida Land Co. v. Commissioner*, 16 B.T.A. 1253 (1929); *Miami Beach Improvement Co. v. Commissioner*, 14 B.T.A. 10 (1928).

Other cases: *Whitlow v. Commissioner*, 82 F.2d 569 (8th Cir. 1936); *Chambers v. Commissioner*, 19 B.T.A. 1110 (1930); *Sullivan v. Commissioner*, 2 B.T.A. 1012 (1925).

⁴³ I.R.C. § 453.

⁴⁴ *See* *United States v. Davis*, 370 U.S. 65 (1962); *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

D. Section 83

Section 83(a) provides:

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

- (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
- (2) the amount (if any) paid for such property—shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

It should be apparent that section 83 deals with two aspects of the taxable income generated by the receipt of restricted assets. First, it deals with the valuation of property to be recognized as income. Second, it deals with timing of the recognition. As to valuation, the statute appears to provide that a temporary restriction will not be considered, but one which by its terms will never lapse will be considered. Arguably, permanently nontransferable assets are subject to a restriction which by its terms will never lapse. However, Treasury Regulation section 1.83-3(h) provides:

For purposes of Section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "non-lapse restriction") is a permanent limitation on the transferability of property—

- i) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and
- ii) Which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).

Accordingly, pursuant to the Regulation, any restriction, even a permanent one, that does not contain a formula resale clause is not a restriction which by its terms will never lapse. Therefore, permanent nontransferability will not be considered in valuation.

This definition was clearly not contemplated by the Congress. In the House Report, the Ways and Means Committee made the following comment:

Restrictions which by their terms never lapse, *for example*, a requirement that an employee sells the stock back to the employer at book value or a formula price if he terminates his employment, are not, in your Committee's opinion, tax-motivated and should be distinguished from restrictions designed to achieve a deferral for tax saving purposes.⁴⁵

Two points are apparent in the Committee report. First, by use of the phrase "for example," the Committee makes it clear that formula resale provisions are but one example of a nonlapse restriction; they are not the only example. Second, it is clear that the essential quality of nonlapse restrictions in the eyes of the Committee is their absence of tax motivation. Clearly, the nontransferability dis-

⁴⁵ H.R. REP. NO. 413, 91st Cong., 1st Sess., *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1735 (emphasis added).

cussed here is not something that is necessarily consciously imposed. Often, it results from the nature of the asset, rather than from anyone's intentions. Since nontransferability generally is not tax-motivated, it fits into that category of nonlapse restrictions which Congress would have taken into account in valuing the transferred assets. Accordingly, the Regulation is incorrect.⁴⁶

The timing provisions of section 83, however, make the problems in the Regulations moot for some categories of nontransferable assets. Regardless of their valuation, the income from the receipt of the restricted assets is not taxable to the recipient until such time as they are transferable, or are not subject to a substantial risk of forfeiture. As to permanently nontransferable assets, if the penalty for transfer is forfeiture, then the taxable event contemplated by section 83 will never arise. Therefore these items will never be taxed.

A recent Treasury Department discussion draft of proposed regulations on fringe benefits would purport to exclude fringe benefits from the coverage of section 83. In the discussion draft, Treasury Regulation section 1.83-1(a)(3) would provide in part as follows:

Cross references. For rules concerning the taxation of income from restricted property transferred in connection with the performance of services, see section 1.61-2. For special rules concerning the taxation of property transferred or used in connection with the performance of services, commonly known as fringe benefits, see sections 1.61-17 - 1.61-20.⁴⁷

Treasury Regulation section 1.61-2 is amended in the discussion draft, and Treasury Regulation sections 1.61-17 through 1.61-20 are added by the discussion draft. These portions of the proposed regulations provide generally that such items of income will be taxed at their fair market value. These sections will be discussed later.⁴⁸

It is immaterial whether useful, nontransferable assets are dealt with in section 61 or in section 83, as long as the nontransferability is taken into account. Of course, if the language of section 83 is to be ignored, so that items which would otherwise come within its provisions will be treated elsewhere, then this decision ought to be made by Congress and not the Treasury Department.

The bulk of useful, nontransferable assets are either unmarketable, and therefore resolved by tax deferral, or the product of an arm's length exchange, and therefore can be valued by the sale price, or compensation, for purposes of section 83. However, there are other useful, nontransferable assets that fall into none of these categories. These can be grouped as nontransferable rights and nontransferable services.

E. Nontransferable Rights

Rights are often nontransferable. Although most nontransferable rights are

⁴⁶ See generally Battagline, *The Final Treasury Regulations Under Section 83* (pts. 1-2), 65 A.B.A.J. 274, 476 (1979).

⁴⁷ Proposed Treasury Regulations §§ 1.83-1(a)(3), 1.61-17(c) [1981] STAND. FED. TAX. REP. (CCH) ¶ 8991. The Tax Treatment Extension Act of 1977, § 3, 92 Stat. 3097, provided that no final regulations on fringe benefits would be promulgated before July 1, 1978. The moratorium was extended to December 31, 1979 by Act of Oct. 7, 1978, § 1, 92 Stat. 996; to May, 1981 by Act of Dec. 29, 1979, § 1, 93 Stat. 1275; and again to December 31, 1983 by § 801 of the Economic Recovery Act of 1981.

⁴⁸ See notes 67-69 and accompanying text *infra*.

either compensation or the product of an arm's length exchange, it is conceivable that some rights are neither. These rights could be professional rights or social rights.

A professional franchise, such as the right to practice law, is clearly an example of a useful, though nontransferable, asset. It is virtually impossible to conceive of a right to practice law being awarded on a basis other than an arm's length exchange, at least when viewed from the eyes of the recipient. The candidate "buys" the franchise with the payment of tuition, expenses, and, hopefully, work. Unfortunately, this arm's length exchange is not helpful to valuation in two respects. First, the work performed is virtually impossible to value, since there is no particular employer who is receiving benefits from the work. Second, though the relationship between the student/candidate and the law school and bar admission committee is presumably at arm's length, it does not necessarily follow that the value of the payment is equal to the value of the professional franchise. The greater number of applicants to law school than there are places in the first year classes, and the greater number of applicants for admission to the bar than there are admittees, suggests that the value of the professional franchise exceeds the costs involved. If not, it would be presumed that demand and supply would create an equilibrium.⁴⁹

Finally, if the awarding of a professional franchise were valued and taxed upon receipt, that value would have to be amortised over the professional career of the recipient to avoid double taxation. This requirement would pose a problem because there is an extreme reluctance to amortise human capital.⁵⁰

Fortunately, the value of a professional franchise is the future income that it can generate. The amount of this income depends upon the talent and industry of the franchisee, and it is clearly more accurate to tax such income when received. Thus, professional franchises are prime candidates for deferred taxation, and, in fact, they are treated that way.

Social rights differ from professional rights in two respects. First, professional rights are comparable to streams of income in that they will eventually be converted into cash, which can be taxed at that time. Social rights, in contrast, can never be converted into anything else. Therefore, deferral is not helpful. Second, the value of social rights, especially such rights as those inherent in the membership in an exclusive club, would decline if such rights were made freely transferable. These rights have many of the problems associated with imputed income. Neither category is taxed.

F. Nontransferable Services and the Rent Free Use of Property

The worst problem for the system arises upon the receipt of either nontransferable services or the rent free use of property. If there is no arm's length exchange,

⁴⁹ See generally Leibowitz & Tollison, *Earning and Learning in Law Firms*, 7 J. LEGAL STUD. 65 (1978); Pashigian, *The Market For Lawyers: The Determinants of the Demand for and Supply of Lawyers*, 20 J. LAW & ECON. 53 (1977).

⁵⁰ See *Sharon v. Commissioner*, 591 F.2d 1273 (9th Cir. 1978); Treas. Reg. §§ 1.262-1(b)(9), 1.162-5(b) (1980); accord, 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 43 (1966); R. GOODE, *THE INDIVIDUAL INCOME TAX* 92-93 (rev. ed. 1976); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1145-46 (1974); McNulty, *Tax Policy and Tuition Credit Legislation*, 61 CAL. L. REV. 1, 16 (1973); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L.J. 1081, 1113-17 (1980).

such exchanges are similar to social rights in that there is no event which will occur in the future which will make their valuation easier than it is upon their receipt. Therefore, tax deferral does not help. Yet, they are different from social rights, in that transferability does not decrease their value, and, if transferable, they would have a readily ascertainable fair market value.

One might ask when, if ever, the problems arise. Even these forms of income are not normally received for nothing. Therefore, there usually would be an arm's length exchange. When there is not an arm's length exchange the transaction would most likely be a non-taxable gift. However, these forms of income can be received when they are neither a gift nor the product of an arm's length exchange. The situation arises in three instances. The first is the receipt of a prize on a quiz show. The second is the receipt of certain employee fringe benefits, and the third is imputed income.

1. Quiz Show Prizes

Service income from quiz shows is covered by Treasury Regulation section 1.74-1(a)(1) and (a)(2). This Regulation, found to be ambiguous as to the timing of the valuation in the analysis of useless, transferable assets,⁵¹ is also ambiguous on the issue of subjective versus objective valuation. However, this issue is resolved by *Turner v. Commissioner*.⁵²

In *Turner* the taxpayer was telephoned at random by a radio quiz show. Upon successfully answering the questions asked, the taxpayer was given two round trip first class steamship tickets for a cruise between New York City and Buenos Aires. The tickets were not transferable and were good only for one year. Turner negotiated with the steamship company, however, and managed to exchange his two first class tickets and a nominal amount of cash for four round trip tourist steamship tickets between New York City and Rio de Janeiro, his wife's birthplace. The retail price of the tickets was 2220 dollars. Turner argued that he never would have paid that amount for the tickets. In fact, he argued that he never could have afforded to pay that amount. Accordingly, the Turners reported only 520 dollars as income from the award of the tickets. The Tax Court apparently accepted the taxpayers' argument at least in part, splitting the difference between 2220 dollars and 520 dollars and holding the petitioners taxable on 1400 dollars. The court commented:

The winning of the tickets did not provide them with something which they needed in the ordinary course of their lives and for which they would have made an expenditure in any event, but merely gave them an opportunity to enjoy a luxury otherwise beyond their means. Their value to the petitioners was not equal to their retail cost.⁵³

The most interesting aspect of the *Turner* case is that it is the only case of its type. Many television game shows offer trips as prizes, and most, if not all, of those trips are nontransferable.⁵⁴ Moreover, all airline tickets are

⁵¹ See discussion at notes 12-14 *supra*.

⁵² 13 T.C.M. (CCH) 462 (1954).

⁵³ *Id.* at 463.

⁵⁴ The author has been given release forms from a major television game show. In this form, potential contestants must promise not to transfer any travel or lodging accommodations. The author has not been authorized to publish the form or to reveal his source.

nontransferable.⁵⁵

Given the significant number of prizes in the form of nontransferable trips, and the ambiguity of Treasury Regulation section 1.74-1(a)(2), why has the issue not been litigated more often? There is some reason to believe that *Turner* stands alone because the IRS has routinely accepted the taxpayers' subjective valuations at the conference level, thereby eliminating the need for litigation that would appear in the reported cases.⁵⁶ If this hypothesis is correct, the system is clearly being unfair to those taxpayers who interpret the Regulation as requiring objective, retail value, and therefore never get to the conference level. If the IRS is routinely acquiescing in the *Turner* result, it should acknowledge this fact in revenue rulings, if not in the Regulations themselves.

2. *Employee Fringe Benefits*

One of the best and earliest examples of employee fringe benefits as income is suggested by Kleinwachter:

Imagine two officers of the same rank, both without independent means, one of whom serves with the troops and therefore has to pay for all of his needs and entertainment out of his salary, while perhaps the second has the position of flugeladjutant to his sovereign. The flugeladjutant occupies an apartment in the princely residence which obviously is free of charge; heating and lighting, understandably, are also free; one or two servants are assigned to the flugeladjutant from the princely household; he takes his meals daily at the princely table; every evening he sits in the box at the theatre with his sovereign; he rides in the carriage and rides on the horses of his master; he accompanies the ruler on all excursions and trips and takes part in all festivities at court. In short, he leads a life as if he himself were a prince at the cost of the princely bureaucracy; and therefore—after the expenses for his toilet articles and a few other small items are taken care of—he can carry his entire pay to the bank. In contrast, his comrade, serving with the troops, perhaps has barely enough to live on the level required by his rank. Even a child could understand that our flugeladjutant finds himself in an incomparably better material situation—that is, translated into the language of the national economist, he has a much greater “income” (or, if one wants to be more exact, he has far greater “receipts”) than the troop officer.⁵⁷

If these fringe benefits are income to the flugeladjutant, they are nontransferable. Assuming that the prince has chosen the flugeladjutant whom he finds to be most congenial, the officer in question is not in a position to sell his opera tickets to another, nor can he rent out his apartments in the princely residence.

As nontransferable services, these benefits must be valued subjectively. This valuation can be extremely difficult:

However, what then, if the supposed “pleasures” are not pleasures to the person in question, but rather on the contrary actually a torture; if those trips, which he must take accompanying his master cause him difficulties;

⁵⁵ Local and Joint Passenger Rules, No. 100(D), issued by Airline Tariff Publishing Co., Agent.

⁵⁶ Conversations with New York attorneys and accountants in January, 1980 (names withheld on request).

⁵⁷ F. KLEINWACHTER, *DAS EINKOMMEN UND SEIN VERTEILUNG* 6 (1896) [hereinafter cited as *KLEINWACHTER*] (the translation of the Introduction by H. McDowell is available in the Wake Forest University Law School Library).

if the continuing visits to the theatre, concerts, balls, evening parties (and so on) are a great bore; if all of this is exceedingly burdensome official duty to him?⁵⁸

Other employee fringe benefits are equally nontransferable and equally difficult to value. Some are nontransferable by contractual agreement, such as free trips on a space-available basis to airline employees. Many others are practically, rather than legally nontransferable. For example, it is not realistic to expect a businessman to rent out the services of his secretary to third parties when she is not busy typing for him, or his office furnishings when he is not using them. Nor is it likely that an employee would be able to sell his free lunch to a third party if he were not hungry.⁵⁹

The inherent valuation problems have been recognized by the Treasury Department:

What is the value to a stewardess of riding in an otherwise empty seat? In most cases the privilege would not be worth to her the retail price of a ticket, i.e., she would not make the trip if she had to pay for it (The Report then cites *Turner* with approval). Similarly, how would one tax free or subsidized medical and recreational services and facilities for employees? Or company cafeteria meals provided at prices at less than prices prevailing in the restaurants? Valuation of such items, comes very close to valuing working conditions as such, an undertaking that would encounter almost insurmountable difficulties.⁶⁰

The most telling aspect of many employee fringe benefits is that, if they were not furnished by the employer, they would have to be provided by the employee. If they were so provided, the consequent expenses to the employee would be deductible under section 162. If imputed interest income on an interest-free loan can be set off against an imputed deduction for interest paid,⁶¹ then the imputed income from many employee fringe benefits ought similarly to be set off against section 162 deductions. This argument is relevant in part to Kleinwachter's flugeladjutant, and to the business executive with office furnishings, typists included. However, it is of no help to the airline employee who receives free trips, nor is it helpful to any employee fringe benefit that is not ordinary and necessary to the business.

One might argue that fringe benefits are the product of an arm's length exchange. Therefore, the valuation problems ought to disappear. But do they?

⁵⁸ *Id.* at 8.

⁵⁹ In *Commissioner v. Kowalski*, 434 U.S. 77 (1977), in-kind meals furnished on the premises were held to be excludable pursuant to section 119, while cash allowances for such meals were not. Clearly, one significant difference between the in-kind meal and the cash allowance is that the in-kind meal is practically nontransferable, while the cash is clearly transferable. The cash is therefore capable of valuation and taxation, while the meal is not. See also Rev. Rul. 58, 1959-1 C.B. 17, which excludes from taxable income the value of a turkey, ham, or other item of merchandise distributed by employers at Christmas, but does not exclude distributions of cash, gift certificates, and similar items of readily convertible cash value. The rule of Revenue Ruling 58 has been applied in the new Proposed Regulations on Fringe Benefits in Proposed Regulation § 1.61-19(b)(3) [1981] STAND. FED. TAX REP. (CCH) ¶ 8991.

⁶⁰ See 40 Fed. Reg. 41,118 (1975); withdrawn, 41 Fed. Reg. 56,334 (1976). The Tax Treatment Extension Act of 1977, § 3, 92 Stat. 3097, provided that no final regulations on fringe benefits would be promulgated before July 1, 1978. The moratorium was extended to December 31, 1979 by Act of Oct. 7, 1978, § 1, 92 Stat. 996; to May, 1981 by Act of Dec. 29, 1979, § 1, 93 Stat. 1275; and again to December 31, 1983 by § 801 of the Economic Recovery Act of 1981.

⁶¹ *Dean v. Commissioner*, 35 T.C. 1083 (1961); see Proposed Regulations on Fringe Benefits § 1.61-18(c), [1981] STAND. FED. TAX REP. (CCH) ¶ 8991.

Here, the exchange would be services for compensation in the forms of cash plus fringe benefits. Presumably, the value of the fringe benefits would equal the value of the services minus the cash compensation. The difficulty lies in the valuation of the services.

The problem may be addressed only by determining the fair market compensation of a comparable job that offers no fringe benefits. This task has two enormous hurdles. First, in this era of complex job descriptions, it is increasingly difficult to find one job that is exactly comparable to another. Second, almost every job has some fringe benefits. Therefore, it would be very difficult, even if a comparable job were found, to find one without fringe benefits that could be used as an easy measuring rod. Comparing two comparable jobs with different fringe benefit packages is unhelpful, because it is virtually impossible to compare the values of different fringe benefits. Who can say how the value of a free airplane ride to a clerk in an airline company compares to the value of free use of a gym to a clerk in a university? The comparison is especially difficult when, due to the nontransferability of the fringe benefits, it is the subjective value to the recipients that must be compared. Therefore, the arm's length exchange solution does not work in the case of employee fringe benefits, and all of the problems of subjective valuation remain. Further, deferral will not solve anything.

Arguably, most employee fringe benefits should be resolved under section 83.⁶² However, the section 83 nontransferability problem is rarely mentioned. In fact, the latest Treasury proposals would specifically exclude fringe benefits from the coverage of section 83.⁶³

Currently, most employee fringe benefits are excluded from taxation, either because their value is minimal, or because they fit into the category that the recent Treasury discussion draft calls working conditions:

The value of any property, service or facility provided with the specific intent either to enable or facilitate the performance of employment services is excludable from the recipient's gross income as a working condition. Generally, a working condition is provided at the recipient's place of employment for use during normal working hours. The fact that a particular item is not required for the performance of employment services does not necessarily negate the characterization of the item as a working condition.⁶⁴

Presumably, working conditions have been excluded because the benefit to the employee is only a minor incident to the benefit to the employer.

Some fringe benefits are taxed at full retail value. Usually, they are large and do not fit into the category of working conditions. The most common categories in the cases are rent free company cars and rent free yachts. More often than not, the taxpayer receiving the benefit is a shareholder as well as an employee, so the IRS chooses to argue for a constructive dividend rather than constructive salary, thus avoiding the deduction to the employer corporation. However, whether salary or dividend, the issues relating to the valuation of the benefit to the recipient are the same.

One would hardly expect one with the rent free use of a company car or yacht

⁶² See *Cohn v. Commissioner*, 73 T.C. 443 (1979) for an expansive interpretation of section 83.

⁶³ See note 47 and accompanying text *supra*.

⁶⁴ Proposed Regulation § 1.61-18(a) [1981] STAND. FED. TAX REP. (CCH) ¶ 8991.

to be allowed to sublet that asset to a third party. Hence, the cars and yachts in these cases are essentially nontransferable. Yet, nontransferability is never mentioned. These cases uniformly tax the recipient on the fair rental value of the assets, usually with very little discussion of valuation issues.⁶⁵ The only subject of controversy has been the relevance of the corporation's cost.⁶⁶

The recent Treasury Department discussion draft of Proposed Regulations on fringe benefits confirms the fair market value approach of the case law. The proposed changes that are most relevant to this discussion are found in Proposed Regulation section 1.61-20, which deals with the valuation of taxable fringe benefits. Section 1.61-20(a) provides that the value of taxable fringe benefits shall be their fair market value. Subsection (b) defines fair market value as follows:

Generally, fair market value is the amount that the recipient would have to pay in an arm's length transaction to purchase the same or equivalent item or its use. The determination of fair market value will depend on the facts and circumstances of each case. The relevant factors to be considered include, but are not limited to, the following:

- (1) Conditions and restrictions based on the purchase and use of the item.
- (2) The price charged for the item for its use to customers who are not employees, independent contractors or otherwise providing services to the employer.
- (3) Whether an equivalent item or its use is ordinarily purchased by the general public on an arm's length basis and, if so, at what price.⁶⁷

The definition creates an objective, retail standard, unless the "conditions and restrictions based on the purchase or use of the item" language can be interpreted to include transferability. The only example in the discussion draft that deals with such conditions and restrictions does not seem to deal with nontransferability.

Example (4) in Proposed Regulation section 1.61-20(c) is as follows:

T is a ticket agent in the employ of A, an airline company. A has a policy whereby any of its employees may take a number of personal flights annually, on a space available basis, for a nominal charge. Early in 1984, T takes advantage of this policy and flies round trip between New York and Los Angeles. The value of the round trip is includable in T's gross income at its fair market value, less the nominal charge actually paid. Under these circumstances, a relevant factor in determining value is the air fare which would be charged commercial passengers for a comparable flight (*considering restrictions as to reservation requirements, seating priority, cabin selection, etc.*). Generally, the cheapest air fare for a comparable flight available to the general public will be considered acceptable evidence of value.⁶⁸

⁶⁵ Ireland v. United States, 621 F.2d 731 (5th Cir. 1980); Loftin and Woodward, Inc. v. United States, 577 F.2d 1206 (5th Cir. 1978); Commissioner v. Riss, 374 F.2d 161 (8th Cir. 1967); Walker v. Commissioner, 362 F.2d 140 (7th Cir. 1966); United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963); Keeter v. Commissioner, T.C.M. (P-H) ¶ 77,251 (1977); Gardner v. Commissioner, T.C.M. (P-H) ¶ 76-349 (1976), *aff'd per curiam*, 613 F.2d 160 (6th Cir. 1980); Karp v. Commissioner, T.C.M. (P-H) ¶ 76-325 (1976); Whipple Chrysler-Plymouth v. Commissioner, T.C.M. (P-H) ¶ 72-55 (1972); Challenge Mfg. Co. v. Commissioner, 37 T.C. 650 (1962).

⁶⁶ Ireland v. United States, 621 F.2d 731 (5th Cir. 1980); Loftin and Woodward, Inc. v. United States, 577 F.2d 1206 (5th Cir. 1978); United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963).

⁶⁷ Proposed Regulations § 1.61-20(b) [1981] STAND. FED. TAX REP. (CCH) ¶ 8991.

⁶⁸ *Id.* at § 1.61-20(c).

There is virtually no difference between the stewardess mentioned in the Treasury Department's 1975 proposals⁶⁹ and the ticket agent mentioned in the current discussion draft. However, in the 1975 proposal, the Treasury Department recognized that the privilege of riding in an otherwise empty seat is not worth the retail price of the ticket to the stewardess, because the stewardess would not have made the round trip if she had had to pay for it. In making this comment, and in citing *Turner*, the 1975 proposal was clearly recognizing the impact of nontransferability. In light of the Treasury's recognition of this factor in 1975, it would appear that their treatment of the example in the current proposal, which recognizes restrictions as to reservation requirements, seating priority, and cabin selection, but not nontransferability, was a conscious decision to ignore nontransferability. This is especially likely since nontransferability would probably have a far greater impact upon valuation than any of the restrictions mentioned in the example.

In light of the position taken here, the apparent failure of the discussion draft to consider nontransferability overtaxes recipients of nontransferable fringe benefits, in that they are taxed on an objective retail value which is greater than the actual subjective value of the fringe benefits to the recipient.

3. *Imputed Income*

There are three categories of imputed income relevant to this analysis: employee fringe benefits, income from services performed for one's self, and income from the use of one's assets. Employee fringe benefits are discussed above. As to imputed income from services, Kleinwachter describes them as follows:

The mother who daily washes and combs her little wild rascals earns with this an "income", for either she could have washed and combed other children for money or she would have had to pay a bathing servant and hairdresser who would have performed this service for her and her children. And, unquestionably, the wilder the little rascals are the greater the "income" of this hypothetical woman will be, and that is to say the more often they have to be washed and combed a day If the wife does the cooking and washing herself, if the daughters quite often scrub the floor themselves, if the husband takes care of as many errands as possible for his wife and if he keeps the children himself, in short, if the people do all sorts of services and favors for each other, and if then in addition the heavens are as merciful as to send a few long and hard illnesses into their home, during which time the children are being nursed by the mother with self-sacrifice of her own health, and if—which is the main point—the people did not forget to register all of those services in their ledger as receipts because every service could have been performed by strangers for money or, the reverse, would have had to be bought for money from strangers—thus, the ledger will easily show a sum of "receipts" of several tens of thousands at the end of the year.

. . . . [I]t follows from this that the income of a shoemaker or a tailor is the more advantageous and therefore a man has to pay more income tax the busier his children are tearing apart their shoes or clothes respectively. The wine dealer is in no danger whatsoever of bankruptcy. He only needs

⁶⁹ 40 Fed. Reg. 41,118 (1975); withdrawn 41 Fed. Reg. 56,334 (1976); see note 60 and accompanying text *supra*.

to drink up his wine himself, and his ledger will show the fastest turnover of his product. The doctor and the pharmacist find themselves in an envious position as their "business"—according to the law—is the brisker, the more illness, the more serious and the more difficult the illnesses their families suffer. The happiest of all, however, is the owner of a funeral parlor if he can bury all of his relatives in one year!⁷⁰

There are three standard explanations for the exclusion of these items of imputed income from taxable income. First, it is often stated that these items are impossible to value. This problem is, of course, shared by all nontransferable assets. Second, it has been argued that, once personal service imputed income is taxed, there is no convenient stopping place. If the concept is followed to its ultimate conclusion, then the system is faced with a ridiculous problem of valuing the worth of absolutely everything that one does in a day, including taking a bath, shaving, and dressing.

Finally, it has been argued that if one decides not to create a given item of imputed income, one thereby creates the same amount of leisure income. For example, if one chooses not to mow one's lawn, but rather to hire someone else to mow the lawn, then presumably one has made that decision because it is worth the price of hiring someone else to do the work in order to have that amount of leisure time. Therefore, the leisure time is itself income to the recipient. Accordingly, everyone builds up an enormous amount of imputed income during his lifetime that will be in the same amount, whether one performs services for one's self, or whether one relaxes while someone else does the work. Unless leisure time is to be valued differently for different persons, then arguably this imputed income concept would add the same amount of income to everyone, and, therefore, would not change relative tax burdens at all.⁷¹

Personal service imputed income, however, might be treated more neatly if it were recognized as nontransferable income. Whether one is considering a housewife performing household chores, a man mowing his lawn, or a mortician performing his services for his own family, these services, once performed, can be enjoyed by no one but the recipient. If the income is said to be derived from the savings for not having to hire a third party to perform the work, the savings are enjoyed by the recipient alone; no one else enjoys the savings. If the income is a result of the enjoyment of a neat lawn or a clean house, it is only the family in question that enjoys these benefits. The enjoyment cannot be transferred. Therefore, personal service imputed income is nontransferable service income.

One might argue that the services are indeed transferable. If one is capable of mowing one's lawn, then one is equally capable of mowing someone else's lawn for pay. Therefore, the service of mowing one's lawn is as transferable to another as it is transferable to one's self. The same argument could be made equally for any service. However, the argument misses a crucial point as to the timing of the income. The income is not created until after the service has been performed. After one's lawn has been mowed, or after one's house has been cleaned for the day, one is no longer capable of transferring that particular service to a third

⁷⁰ KLEINWACHTER, *supra* note 57, at 10-11, 15.

⁷¹ See generally W. HEWETT, *THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION* ch. II (1925); H. SIMONS, *PERSONAL INCOME TAXATION* 51-54 (1938); W. VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* 44-52 (1947); Marsh, *The Taxation of Imputed Income*, 58 *POL. SCI. Q.* 514 (1943).

party. The income from that service at the point of its creation is in the form of savings or satisfaction, which are nontransferable. To say that one's potential for performing services for others makes those services transferable would be to shift the taxable event to the time before services are performed. This theory would tax every individual at birth for all potential income to be earned during life, notwithstanding the fact that no services have yet been performed. Clearly, our taxing system does not work this way. Again, at the time that the income has been created, it is clearly nontransferable.

The final category of imputed income is the category of income from the use of one's belongings. Here, the most telling example is the rental value of a house. In a fashion similar to imputed income from services, the argument is that, if one did not own a house, one would have to rent it. Therefore, the ownership of the house creates income in the amount of its rental value, either from the enjoyment of the house per se or from the savings created by not having to pay rent.⁷² Again, once one accepts the premise, the concept rushes pell-mell into absurdity. The concept would require not only that the rental value of houses be included in taxable income, but also the rental value of paper clips, pencils, and virtually every other nonconsumable asset. Moreover, if these assets are to create income by virtue of their ownership, their depreciation should also be deductible.

Again, unless one is willing to argue that the purchase or other acquisition of an asset immediately generates income in the amount of the potential rental value of that asset for its entire useful lifetime, the taxable event for such imputed income would not occur until the asset had been used by its owner. Therefore, one month's rental value of a home is not imputed income to its owner until he has resided in that home for the month. At that point, that rental value is not transferable income.

G. Conclusion

According to the above analysis, useful, nontransferable assets are not all taxed alike. Some are totally excluded from taxation, some are deferred from taxation, some are taxed at a subjective value, and some are taxed at fair market value. This discrepancy in treatment must be analyzed from two perspectives: tax administration and tax equity.

The discrepancies appear to make considerable sense in terms of tax administration. Those categories that present the most insoluble problems are excluded from taxation. Those whose valuation problems can be resolved by deferral are deferred. Those that, by virtue of an arm's length transaction, can be valued subjectively without great administrative costs and uncertainty, are so valued. Finally, as to that category for which an objective fair market value exists, but for which neither deferral nor an arm's length transaction makes any other form of valuation possible, the objective fair market value is used, unless the taxpayer is clever enough to prove another alternative exists. In sum, the IRS appears to do whatever is easiest in each case.

When tax equity is considered, however, the system has apparent deficiencies.

⁷² See generally R. GOODE, *THE INDIVIDUAL INCOME TAX* 139-43 (1976); W. VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* 18-34 (1947); *The Constitutionality of the Taxation of Imputed Income*, 9 VAL. L. REV. 221 (1974).

Even tax deferral must be justified. No one would be willing to pay tax immediately, given an option to pay it later. Perhaps, however, the advantages of deferral can be justified on the ground that, absent deferral, there would be no way of arriving at a tax valuation that even approached fairness to the recipient.

The real problems, however, arise when cases of tax exclusion are juxtaposed with cases of immediate taxation. Some might argue that it is inappropriate to lump all useful, nontransferable assets together and to demand equal treatment for all. Perhaps the real problems are caused not by nontransferability, but by the problems of imputed income and employee fringe benefits, problems which have vexed the system for many years. Perhaps the factor of fringe benefit or the factor of imputed income is in itself justification for different treatment. However, the factor of nontransferability clearly runs through these categories, and might conceivably furnish a basis for rational analysis that has not existed before.

The better analogy to nontransferability is the concept of realization. It should be remembered that the two standard reasons for not taxing unrealized appreciation are: (1) valuation is highly speculative until the appreciated asset has been sold; and (2) a tax on unrealized appreciation is a tax levied when the taxpayer has no liquid assets with which to pay the tax.⁷³ Both of these reasons apply in general to the receipt of useful, nontransferable assets. First, nontransferable assets can be very hard to value. Secondly, since they are nontransferable, they cannot be converted into cash. Therefore, once again, the recipient is not in a liquid position.

Yet, the hallmark of realization is severability. In actuality, it is the lack of severability that makes unrealized appreciation unrealized. Yet, a useful, nontransferable asset is clearly severable from the pool of assets that the recipient owned before receipt. Therefore, one cannot resolve transferability problems by translating them across the board into realization problems.

Perhaps severability should be ignored, and nontransferability, whenever permanent, should be grounds for exclusion from taxation. This solution, however, would furnish grounds for easy tax avoidance. Anyone who wanted to lessen his tax burden could request payment in the form of nontransferable assets rather than cash, whenever those assets were equivalent in value to him. For this reason, it is suggested that the arm's length transaction doctrine be maintained. That doctrine could be applied in cases of compensation and in cases of exchanges of goods, to avoid tax abuse. Furthermore, otherwise unequal treatment could be justified at least in part because, in an arm's length transaction, each side enters the transaction voluntarily, presumably in full knowledge of the tax law. In other areas, however, it is submitted that the taxation of useful, nontransferable assets should be deferred when the nontransferability is temporary, and excluded when the nontransferability is permanent.

VI. CONCLUSION

Assets can be either useful or not; either transferable or not. An analysis of the response of the income tax laws to these four permutations reveals that the response to two of the four is simple and predictable, while the response to the

⁷³ *But see*, Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967).

other two is not. Useful, transferable assets should be, and are, taxed at their full, objective, fair market value; useless, nontransferable assets should be, and are, excluded from taxation. On the other hand, useless, transferable assets appear to be taxed at their transfer value only if the taxpayer is willing to fight. Moreover, useful, nontransferable assets can be taxed in any number of ways, or not at all. Much, but not all of the disparity in treatment of the various receipts of useful, nontransferable assets can be justified. Some of the relatively advantageous tax effects are, again, available only if the taxpayer is willing to fight.

It is submitted that at least the information gap, and perhaps the underlying inconsistencies, could be lessened if transferability would be recognized as a factor that is as significant as realization to income taxation.