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Advance Trade Discounts: A Reprise

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Advance Trade Discounts: A Reprise

By Deborah A. Geier

Deborah A. Geier is a professor of law at the Cleveland-Marshall College of Law, Cleveland State University. While she unabashedly titles her article a "reprise" to an excellent column by Robert Willens, she notes that he has not reviewed this piece and should be absolved of all responsibility for anything with which he may disagree.

This report reviews the various possible conceptual approaches that can be applied to advance trade discounts. While concerns for administrative ease make conceptual purity unlikely in this context, the author believes that we can do a far better job than was done in two recent cases and a revenue procedure. The key inquiry that should be made (but was ignored in all three authorities) is whether the recipient of the cash advance trade discount paid market-rate interest for the time value of deferring inclusion.

Table of Contents

Robert Willens, as usual, has done an excellent job of parsing two recent cases on advance trade discounts,[1] *Westpac Pacific Food v. Commissioner*[2] and *Karns Prime & Fancy Food, Ltd v. Commissioner*.[3] While doing so was beyond the scope of his article, I would like to take an additional step and review how the courts' analyses and rhetoric in these cases depart from various conceptual approaches that have been advanced in the academic literature for measuring the income tax base properly. For that reason, I take the presumptuous step of adding "reprise" to my title.

While these ideas are not new,[4] perhaps those recent cases (and a recent revenue procedure, to boot) provide another excuse for exploring how we might better approach this issue. I am doubtful, from the point of view of administrative ease, that we can achieve conceptual purity in this context, but I nevertheless think that we clearly can do much better than the approaches evidenced in these recent authorities. In my view, the Ninth Circuit incorrectly allowed exclusion of an advance trade discount that should have been included, the Third Circuit incorrectly required inclusion of an advance trade discount that should have been excluded, and the IRS, in determining the appropriate tax treatment, inappropriately focused in its recent revenue procedure on how the taxpayer is reporting the matter for financial accounting purposes. The key fact in analyzing advance trade discounts properly is whether market rate interest is paid on the cash receipt.

The Bargain Purchase Rule Is Inapplicable

As a preliminary matter, a slight detour is necessary. There is one clearly wrong way to analyze these advance trade discounts: to analogize them to a tax-free bargain purchase, which typically does not result in gross income in the year of purchase but rather only in the later year when the purchased property is sold. The example that we use to illustrate this point in our textbook is as follows:

> Pilar, an art history professor, is browsing around an art gallery in Year 1 and notices a small Holy Family painting attributed to the minor Renaissance artist Lodovico da Bologna with a price tag of $2,000. Pilar recognizes this is a long-lost work (last seen in 1895 in the private collection of the Earl of Tweed) painted by the major Florentine master Andrea del Sarto, who was the subject of Pilar's doctoral dissertation. Pilar, who is familiar with the

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[1] *See* Robert Willens, "Accounting for Advance Trade Discounts?" *Tax Notes*, Sept. 3, 2007, p. 893, *Doc 2007-18820, 2007 TNT 172-40*.

[2] 451 F.3d 970, *Doc 2006-12073, 2006 TNT 120-10* (9th Cir. 2006).

[3] 494 F.3d 404, *Doc 2007-17050, 2007 TNT 141-54* (3d Cir. 2007).

[4] My analysis here is not entirely new. *See, e.g.*, Glenn E. Coven, "Redefining Debt: Of *Indianapolis Power* and Fictitious Interest," 10 *Va. Tax Rev.* 587 (1991); Coven, "And the Rebuttal," 11 *Va. Tax Rev.* 493 (1991); Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value," 15 *Am. J. Tax Pol'y* 17 (1998); Daniel I. Halperin, "Interest in Disguise: Taxing the 'Time Value of Money'," 95 *Yale L.J.* 506 (1986); George K. Yin, "Of *Indianapolis Power and Light* and the Definition of Debt: Another View," 11 *Va. Tax Rev.* 467 (1991).

trade in paintings of this period, thinks the work is worth at least $500,000, and so she purchases the painting for $2,000, barely concealing her glee. Pilar's attribution is confirmed by a panel of experts in Year 3, and in Year 4 Pilar sells the work to a museum for $800,000.[5]

Outside the compensation and dividend situations (in which a bargain purchase is made between related parties and is effectively a substitute for something else that clearly would have been taxable immediately: compensation or a dividend), the government has never argued that a bargain purchase between strangers produces immediate gross income equal to the bargain in the year of purchase. While Pilar is clearly wealthier for having purchased the painting for less than fair market value, the portion of the painting's value equal to the bargain is typically considered so closely analogous to unrealized appreciation in the underlying property that it is not considered clearly realized until later sold.

In the context of volume trade discounts not involving an upfront receipt of cash, for example, the government has never argued that the discount represents gross income to the buyer in the year of purchase. Thus, if Wholesaler normally prices widgets at $10 each but Retailer negotiates a volume discount price with Wholesaler of $9 each because Retailer is purchasing a large number of widgets for resale to Consumers, the government has never argued that Retailer realizes $1 of gross income in the year of purchase for each widget purchased for $9 (rather than the usual price of $10). Rather, Retailer will achieve the benefit of deferral regarding this bargain purchase; the benefit of the bargain ($1 per widget) will not be taxed to Retailer until the year in which the widgets are sold to Consumers at a cost of goods sold of only $9 instead of $10. In that scenario, however, Retailer is not in receipt of *cash* during that interim that could be invested and earn a return, a crucial factual distinction that makes all the difference.

In general terms sufficient for this discussion, the cases litigated by the government involve an upfront transfer of cash in year 1 from Wholesaler to Retailer equal to $1 per widget (the discount) multiplied by the number of widgets Retailer is expected to purchase from Wholesaler under the volume discount contract. On the actual purchase of widgets from Wholesaler, Retailer pays the full price of $10 per widget (rather than $9). If the volume required to be purchased by Retailer is not achieved, Retailer will be expected to return a pro rata portion of the cash received in year 1 that represents the $1-per-widget volume discount, and Retailer never includes the amount returned in gross income. If the cash is retained (because the required volume has been purchased during the relevant period), Retailer effectively includes the amount in income only when it sells the widgets (by reducing its cost of goods sold from $10 to $9).

The upfront receipt of cash distinguishes these "discounts" from the usual bargain purchase situation, where the issue is whether the bargain is "clearly realized" in the year of purchase or only in the later year of sale. But that does not necessarily mean that the cash should always be includable in full (and then deducted if later repaid), either. Rather, the key inquiry for tax purposes is whether market rate interest was paid by the recipient of the cash for the period between receipt and either repayment or inclusion for tax purposes. How the taxpayer accounts for the cash receipt under financial accounting principles should not be relevant, because financial accounting rules often do not take adequate account of the time value of money. Moreover, application of financial accounting rules can result in consumption tax treatment rather than income tax treatment. While Congress can and does insert consumption tax provisions in the Internal Revenue Code, the default norm absent an explicit consumption tax rule should be that Congress intends the tax base to be comprised of income.

Because these points can be made most plainly in the context of *Indianapolis Power & Light*,[6] I next revisit that Supreme Court decision.

Indianapolis Power & Light

Indianapolis Power & Light (IPL) required customers with poor credit histories to deposit cash (generally equal to the expected electric bill for two months) as a condition of selling electricity to them. IPL would repay the money to the customer after timely payments for 9 consecutive months (or after timely payments for 10 of 12 consecutive months if the 2 delinquent months were not consecutive). If the customer failed to pay an electric bill, however, the cash advance would be retained and applied to the customer's outstanding balance due. Thus, by the time that one year passed, the cash would usually either be repaid or credited against a bill.

IPL did not pay interest to the customers on this cash for the first 12 months, paying 6 percent interest thereafter in the unlikely event that it continued to hold the cash. Taken together with the interest-free rate for the first 12 months, the 6 percent rate surely was below market. That is to say, if the customers were in the market to invest this same cash, they surely could have obtained a greater interest return elsewhere. But they had no choice. If they wanted to purchase electricity from IPL, they were forced to lend it money at below-market rates. By the same token, IPL may not have been able to borrow money from banks or other conventional sources at such a favorable rate.

The government argued that IPL should include the cash on receipt as advance payments for electricity. If IPL paid the money back to the customer in the future, it could then take a deduction. IPL argued successfully that the cash receipt should instead be treated as excludable loan proceeds, despite the involuntary nature of the transaction on the part of the "lenders." To the extent actually repaid to the customer/lenders, the amounts would never be included by IPL. To the extent the cash

[5]Joseph M. Dodge, J. Clifton Fleming Jr., and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure & Policy*, 423-424 (3d ed. 2004).

[6]*Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

was applied to a customer's bill, IPL would include the amounts at that later time as a payment for electricity.

Now for some relevant doctrine. In *James v. United States*,[7] the Supreme Court had previously stated that, to be considered a loan for federal income tax purposes, there must be a "definite, unconditional [that is, absolute] obligation to repay"[8] the amount received, and this obligation to repay must be consensual and recognized by both parties at the time of the original receipt.[9] In contrast, if the obligation to repay is only *contingent* on some future event, the cash is immediately includable on receipt under *North American Oil Consolidated v. Burnet*.[10] If the contingency ripens and repayment actually occurs, the repayment would raise a deduction issue (or a credit issue under section 1341) in the repayment year.[11]

On the face of things, the government might have argued (although it did not) that IPL's repayment obligation was merely contingent (and thus immediately includable) because the utility sometimes kept the payment if the customer failed to pay an electric bill. In other words, whether repayment would occur was contingent on future events. Even if the argument had been made, however, it would not likely have carried the day in any event. Justice Blackmun characterized the facts under the substance-over-form doctrine as involving an absolute obligation to repay to the customer/lender in every case. In the cases in which no actual repayment was made, there could be said to be a deemed payment to the customer (under IPL's *absolute* obligation to repay) and a deemed payment back to the utility as a payment for electricity. Justice Blackmun said:

> The problem with [the government's] argument perhaps can best be understood if we imagine a loan between parties involved in an ongoing commercial relationship. At the time the loan falls due, the lender may decide to apply the money owed to him to the purchase of goods or services rather than to accept repayment in cash. But this decision does not mean that the loan, when made, was an advance payment after all. The lender in effect has taken repayment of his money (as was his contractual right) and has chosen to use the proceeds for the purchase of goods or services from the borrower. Although, for the sake of convenience, the parties may combine the two steps, that decision does not blind us to the fact that in substance two transactions are involved.[12]

Some might observe that the involuntary nature of the lending transaction (with utility customers being forced to lend money to IPL as a condition of being permitted to purchase electricity from it) is so far removed from a more conventional lending transaction that the Court should not have struggled to recast the transaction from one involving only a contingent obligation to repay to one involving, under the substance-over-form doctrine, an absolute obligation to repay.[13] But that is quibbling, as Justice Blackmun's characterization of the transaction as one involving an absolute obligation to repay in every case is not clearly wrong.

Nevertheless, the conclusion that there was an absolute obligation to repay the cash on the part of IPL should not have been the end of the analysis — at least, as a conceptual matter. A crucial fact in the case was that IPL paid below-market interest to its customer/lenders for the cash in its possession, which it could invest for the interim between receipt and repayment (or application against an outstanding electric bill). In other words, the key fact is that IPL did not pay market rate interest for the time value of deferral.

The One-Party Approach

There are two competing conceptual views regarding how the transaction in IPL should be analyzed. The first, discussed in this section, views IPL alone, without regard to the taxation of IPL customers. The question under this view is simply whether IPL realized a wealth accession when it obtained the cash deposits from its customers.[14]

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[7]366 U.S. 213 (1961).

[8]*Id.* at 215-216.

[9]*See id.* at 219.

[10]286 U.S. 417 (1932).

[11]While the *North American Oil* Court noted that the taxpayer received the amounts at issue in that case under a "claim of right," even though the amount might later need to be repaid, the claim of right language was later rejected in *James* itself. The taxpayer in *James* argued, in effect, that because his embezzled funds were *not* received under a claim of right (indeed, the taking was unlawful), he need not include the embezzled funds immediately on receipt. The Supreme Court had previously come to this conclusion in *Commissioner v. Wilcox*, 327 U.S. 404 (1946), but the *James* Court explicitly overturned *Wilcox*. The *James* Court apparently recognized (correctly, in my view) that the important point in *North American Oil* was not that the receipt was held under a claim of right, but rather only that it was subject to a *contingent* (rather than absolute) obligation to repay. Moreover, the *James* Court added that the absolute obligation to repay that is required to exclude an amount as the proceeds of a loan must be consensually recognized by the parties themselves at the time of the transfer. A legal obligation to repay imposed by law if an embezzler is caught is not sufficient. Thus, the claim of right language in *North American Oil* should have no continuing legal force today. The crucial question is only whether the obligation to repay is absolute (excludable as a loan, if the repayment obligation was recognized by the parties at the original transfer) or contingent (immediately includable, with repayment, if it occurs, raising a deduction issue).

[12]493 U.S. at 211-212.

[13]His language to the effect that the lender "*may* decide to apply the money owed to him to the purchase of goods or services" and that he has "*chosen* to use the proceeds for the purchase of good or services" seems far from the facts of the case.

[14]Justice Blackmun, as well as the judges in *Westpac Pacific Food* and *Karns Prime & Fancy Food, Ltd.*, discussed whether the cash recipients had "dominion" over the cash receipt. This reference, of course, is to *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), in which the Supreme Court construed the residual clause in section 61 ("gross income means income from whatever source derived") as encompassing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Properly conceptualized, however,

(Footnote continued on next page.)

Under traditional analysis,[15] a borrower is not considered to have realized a wealth accession on the receipt of loan proceeds because the offsetting obligation to repay negates any present wealth accession. Moreover, regarding most loans, we engage in this analysis simply by comparing the cash received with only the *face amount* of the principal repayment to be made in the future. So, for example, assume that Lender transfers $100,000 to Borrower in year 1 and that Borrower must pay 5 percent interest, compounded annually (which we shall assume is the prevailing market rate of interest), to Lender over the 10-year duration of the loan, after which he must repay the $100,000 principal. The total interest payments over 10 years add up to $63,000. Ignoring the interest payment, however, we typically say that Borrower's $100,000 cash receipt is not a wealth accession in year 1 solely because Borrower must repay that $100,000 principal in the future; Borrower is not any wealthier for having received the $100,000 in cash because of the offsetting obligation to repay it.

But there is a more discerning explanation for why Borrower does not realize a wealth accession on the receipt of the $100,000 loan proceeds, which is that the *present value* of his *aggregate principal and interest* payment obligation equals the amount received in year 1. In our example, the *present value* of the borrower's obligation to pay $100,000 of principal in year 10 added to the *present value* of his obligation to pay aggregate interest of $63,000 over the loan term equals $100,000, which is the amount received in year 1, thus negating any wealth accession in year 1.[16]

If a borrower is paying market rate interest, the decision whether to look only at the face amount of the principal repayment obligation or to look at the present value of the repayment obligation of both principal and interest should make no difference in determining whether the borrower realizes a wealth accession on the receipt of borrowed funds; he realizes no wealth accession under either approach. In contrast, if a borrower is paying below-market interest for the use of borrowed cash, the choice of analytical construct makes all the difference in the world.

Assume, for example, that Borrower receives $100,000 in year 1 and must repay that $100,000 in year 10, as above. Further assume that, unlike above, no interest is paid. If we look only at the face amount of the principal repayment obligation, the Borrower realizes no income on the receipt of the borrowed funds because of the repayment obligation. If, however, we look to the present value of the repayment obligation of both principal and interest, the Borrower will have realized an immediate wealth accession of $38,600 (using a 5 percent discount rate, compounded annually) on the receipt of the $100,000 of borrowed funds because the present value of his aggregate repayment obligation is only $61,400. In effect, this approach bifurcates the $100,000 receipt into two amounts: (1) a loan with the "real principal" of only $61,400, which is excludable on receipt because of the offsetting repayment obligation, and (2) an immediate wealth accession under section 61 equal to $38,600, because that amount is not subject to an offsetting repayment obligation.

It would be cumbersome to apply the present value approach to every loan in the economy, and current law does not require it. If, however, the relationship of the parties demonstrates that they are not bargaining at arm's length regarding the terms of the loan — by itself — perhaps we should apply it. This may be true whenever a "loan" is required as a condition of doing business with the borrower, where the primary relationship between the parties is not that of lender and borrower but of buyer and seller. In *IPL* the primary relationship between IPL and the credit risk customers was not that of borrower and lender. Rather, their primary relationship was that of seller of electricity to buyer of electricity. IPL demanded, however, that these customers lent IPL money (at a below-market rate of interest) as a condition of selling electricity to them. If the credit risk customers refused to lend IPL money (at a below-market rate of interest), IPL would not sell electricity to them.

In that case, perhaps it would be reasonable to apply the more discerning present value approach to the question of whether a borrower realizes a wealth accession on the receipt of loan proceeds rather than the more common face amount approach, using the applicable federal rate to discount to present value. If we did that, notice that IPL would not have been made to include the entire face amount of the deposits in gross income (as the government argued), nor would it have been entitled to exclude 100 percent of the deposits from gross income (as IPL argued and the Court held). Neither result — the only two possibilities presented to the Court — is conceptually correct under this reasoning. Only the difference between the amount received in year 1 and the present value of the repayment obligation (both principal and interest) would properly be included in year 1. Faced with the Hobson's choice of either overtaxing IPL or undertaxing IPL, perhaps the Court cannot be faulted too harshly for choosing to undertax by recasting what appeared to be only a contingent obligation to repay into an absolute obligation to repay under the substance-over-form doctrine. The conceptually correct result (at least under this approach) was not an option presented to the Court.

Similarly, in the case of advance trade discounts, the primary relationship between Wholesaler and Retailer is not that of lender and borrower. Their primary relationship is that of seller of goods to buyer of goods. Retailer demands, however, that Wholesaler lend it money (typically at no interest) as a condition of buying goods from

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loan analysis raises only the first part of that equation: whether the receipt is a wealth accession. Loan analysis really has nothing to do with dominion and control. That portion of the *Glenshaw Glass* language is most usefully deployed in the assignment of income area, for example, where the question is "whose gross income is it?" In short, loan analysis is wealth accession analysis.

[15] *But see* Dodge, "Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated," 26 *Va. Tax Rev.* 245 (2006) (exploring, in part, whether a cash flow approach to borrowing is conceptually superior).

[16] *See generally* Dodge, Fleming, and Geier, *supra* note 5, at 285-291.

Wholesaler. If Wholesaler refuses to lend Retailer money, Wholesaler will not buy goods from Retailer. In that case, once again I believe that it would be reasonable to apply the more discerning present value approach to the repayment obligation. The difference between the amount received in year 1 and the present value of the repayment obligation (both principal and interest) would properly be includable by Retailer in year 1 as a conceptual matter.

The immediate rejoinder, of course, is that this conceptually correct result would be impossible to implement as a practical matter, however, because we do not know beforehand when the cash received in year 1 will either be actually repaid (if Retailer fails to purchase the required volume from Wholesaler) or deemed repaid and then effectively included in income (typically through a later reduction in the cost of goods sold by Retailer after the purchase of goods at full cost). Regarding advance trade discounts in particular, if our only realistic choices are full exclusion on receipt (with later inclusion only if not repaid and only when the goods are later sold) or full inclusion on receipt (with later deduction only to the extent actually repaid for failure to meet the volume quota), I would argue for full inclusion when no interest is paid. As mentioned above, this treatment would apply only if the primary relationship between the parties is not that of lender and borrower but that of buyer and seller of services or property, where the purported loan is embedded in the transaction at no interest (or significantly below market rates) as a condition of doing business — an adhesion contract, of sorts. Moreover, it would apply only if section 7872 (described in the next section) is not extended to apply to this situation. In form, these transactions deal only with a contingent obligation to repay (if the volume discount quotas are not met). As I hinted above, I see no reason to struggle to recast these transactions into ones involving, in substance, an absolute obligation to repay (and, thus, an excludable "loan") when no interest is paid for the time value of the deferral.

Forcing Retailer to include advance trade discounts in gross income on receipt when no interest is paid for the use of the cash should not require congressional legislation. I think it should be enough for Treasury to issue a regulation under section 61 that requires this result. Indeed, we could reach this same result by judicial decision if more judges resisted Justice Blackmun's characterization of these transfers as involving, in substance although not in form, an absolute obligation to repay rather than only a contingent obligation to repay.[17]

The reason it is important, for tax purposes, to do better at this analysis is that allowing Retailer to defer inclusion of the cash received until the later year of sale of the purchased inventory (without having effectively paid for this deferral privilege by paying market rate interest) effectively provides Retailer with consumption tax treatment of the investment return that it earns on the cash between the receipt and the inclusion. Although Retailer nominally includes the investment return in income, that return is effectively free from tax because it was earned with pretax dollars.

The Two-Party Approach

The one-party approach focused only on the proper tax treatment of the cash recipient, viewed alone, without regard to the tax consequences to the other party to the transaction. Under that approach, the goal was to avoid consumption tax treatment on the investment return (that is, effectively no tax on that return) between the time when the cash was received and when it was either returned to the other party to the transaction or included in income. Stated differently, the goal was to accurately measure the wealth accession realized by the cash recipient in view of the fact that the repayment obligation putatively justifying exclusion of the cash receipt was, in present value terms, less than the cash received.

The two-party approach, in contrast, focuses on the tax consequences of the transaction for both parties, but its goal can be seen as the same as in the one-party analysis: to ensure that investment income that should be

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[17]We actually could make the taxpayer who ends up having to repay part of the cash (for failing to achieve the required volume quota) whole by allowing an *augmented* deduction (which takes into account the time value of money between the original inclusion and the repayment) rather than merely a face amount deduction. Prof. George Yin suggested a similar solution, although it differs in important respects. His initial inclusion would be less than 100 percent of the cash receipt, equal to the difference between the amount received and the present value of the aggregate repayment obligation of both principal and interest. In other words, his analysis regarding the amount that should be included was of the pure sort suggested above, which may not be administratively feasible, in my view. He then

(Footnote continued in next column.)

suggested that if this lesser amount that was included is repaid, the taxpayer could be allowed an augmented deduction to take account of the time value of money. *See* Yin, *supra* note 4, at 488-489.

Congressional legislation obviously would be required to allow an augmented deduction (regardless of whether the original inclusion is equal to 100 percent of the cash received or only a lesser amount equal to the difference between the cash received and the present value of the aggregate repayment obligation). An argument against providing a special augmented deduction for advance trade discounts that are actually repaid is that current law does not allow such an augmented deduction for other taxpayers who must include an amount in gross income in year 1 because it is subject to only a contingent (rather than an absolute) obligation to repay and who must repay it because the contingency ripens. In *North American Oil*, for example, the taxpayer received cash under a trial court judgment in year 1, but the decision was appealed, which meant that the cash might have to be returned. Because the receipt was subject to only a contingent, rather than an absolute, obligation to repay, the taxpayer had to include the amount in year 1 when received. The appeals were not successful, which meant that North American Oil was not required to disgorge the money after all. If the contingency had ripened, however, and the amount actually returned, the taxpayer would have been entitled only to a face amount loss deduction under section 165 (or perhaps a credit under section 1341); the time value of money loss would not be taken into account. Because that is the treatment under current law for amounts repaid that were previously included because the receipt was subject only to a contingent obligation to repay, I think it is defensible to apply that current rule to advance trade discounts and *IPL*-type transactions, as well.

taxed to someone does not fall through the cracks and not get taxed to anyone, as would happen under a consumption tax. This value is encapsulated in section 7872.[18] The primary targets of section 7872 for income tax purposes are compensation-related loans and corporation-shareholder loans. To illustrate, return to the numbers previously described. Assume that CEO Sue borrows $100,000 from the corporation for whom she works. The term of the loan is 10 years, and she pays no interest over the loan term. In essence, section 7872 provides that only the present value of CEO Sue's future repayment obligation, or $61,400, is the real principal of the loan, while the remaining $38,600 is an immediate accession to wealth (in the nature of compensation for services rendered under section 61(a)(1)) because it's not subject to an offsetting obligation to repay (assuming that 5 percent interest, compounded annually, is the applicable federal rate used for this analysis under section 7872). The corporation may generally deduct the $38,600 compensation as a business expense under section 162. Over the 10-year term of the loan, the corporation will accrue $38,600 of deemed interest payments under the original issue discount rules, and CEO Sue will be deemed to pay that interest. If CEO Sue used the loan proceeds to purchase a home or investment property, the interest may be deductible under section 163(h) or (d). If, however, the $100,000 loan proceeds were used to fund other living expenses, CEO Sue would not be permitted to deduct the interest deemed paid. Thus, while the transaction may effectively be a wash on the corporation's side, it may result in net income for CEO Sue.

It may not be a wash for the corporation if the loan is a corporation-shareholder loan. For example, assume the same facts as above, except that Sue is not the CEO of the corporation (or any sort of employee) but only a shareholder. The corporation lends Sue $100,000 for 10 years at no interest (because Sue controls the corporation through her stock ownership and can force it to do anything she wants). The $38,600 income inclusion for Sue in year 1 will be a dividend, which is nondeductible to the corporation. The corporation's inclusion of $38,600 of deemed interest payments will therefore not be a wash. And, just as with the compensation-related loan, it may not be a wash for Sue, depending on how she uses the loan proceeds. If the loan proceeds are used for living expenses, her year 1 income inclusion will not be offset by her deemed interest payments.

Finally, even if the amounts are includible and deductible on both sides, which can occur with a compensation-related loan (if the loan proceeds are used by the borrower in a way that generates deductible interest), there will be a time-value-of-money difference for both parties. The $38,600 year 1 inclusion for the borrower will be offset by $38,600 in aggregate deemed interest deductions over the 10-year term under the OID rules, and the $38,600 year 1 deduction for the lender will be offset only by $38,600 deemed interest inclusions over the 10 years.

We could (but do not) apply section 7872 principles to IPL and its credit risk customers. Because we cannot know the term of the loan, the rules governing demand loans, under which two steps are deemed to occur, would presumably have to apply. Under the first step, the credit risk customers would be deemed to pay an amount equal to the forgone interest (using the applicable federal rate as a benchmark of how much interest was forgone) to IPL each year that the loan was outstanding. This deemed transfer would presumably be nondeductible for those customers purchasing electricity for their personal residences rather than for their business premises, but it could be deductible for those purchasing electricity for business or investment property. (This payment could be characterized as a premium required for their electricity purchases in view of the credit risk.) IPL would have to include the same amount in gross income as a wealth accession. Under the second step, IPL would then be deemed to pay precisely that same amount back to the credit risk customers as interest. That deemed payment by IPL would be deductible as business interest under section 163, while the customers would have to include the deemed interest receipt in gross income under section 61(a)(4). When the dust clears, the wealth accession deemed received by IPL (equal to the forgone interest) would be precisely offset by an interest deduction in the same amount. In other words, IPL would *not* effectively be taxed on the forgone interest. There is not even a time-value-of-money difference, because the OID rules cannot be used. Rather, the *customers* would include this amount in their gross incomes, and it would be offset by a deduction only if the electricity were purchased for business or investment property. If the electricity were purchased for a personal residence, the deemed interest income (equal to the forgone interest) would not be offset by any deduction and, thus, would effectively be taxed to the customers.

Because it would not be administratively feasible to tax these credit risk customers on their deemed interest payments, Prof. Daniel Halperin might say that we could tax IPL as a surrogate for taxing the customers to ensure that this income does not slip through the cracks and not get taxed to anyone.[19] I would add that we can do this simply by adopting the one-party analysis described above. That is to say, we could ignore the customers and simply require IPL to include the deposits when received and then allow a deduction if and only if the amounts were actually repaid to the customers instead of retained.

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[18]This value is also encapsulated in sections 83(h), 267(a)(2), and 404(a)(5), each of which delays the deduction of an accrued expense by an accrual method taxpayer until the payment is included by a related cash method recipient. Failing to defer the deduction for the accrual method taxpayer when the cash remains in hand and can earn a return means that the investment income earned on that cash is not taxed to anyone. It's not taxed to the accrual method taxpayer because the investment would be made with pretax dollars (as described in the part above) if the amounts are expensed before the cash is actually paid, and it's not taxed to the cash method taxpayer because he never actually or constructively receives that investment return until (and if) it is paid.

[19]*See* Halperin, *supra* note 4.

This approach, however, would collect too much tax *if* we believe that the two-party analysis is actually the correct one (and are applying the one-party approach only as a second-best surrogate for the conceptually correct two-party approach) to the extent that the credit risk customers were purchasing electricity for business or investment property, where the deemed payment to IPL would be deductible and precisely offset the deemed interest payment made from IPL to the customers. Similarly, if we used the one-party approach *only* as a surrogate for what is considered the superior two-party analysis for advance trade discounts, we would collect too much tax to the extent that the deemed payment from Wholesaler to Retailer in step one would be a deductible business expense, offsetting the deemed interest receipt in step two, which would likely be the case.

The Crucial Question

Thus, we finally arrive at the real crux of the matter: is it defensible to apply the pure one-step approach not as a surrogate for the two-step analysis but in its own right? In that instance, we are interested only in properly measuring the income of the cash recipient — Retailer — viewed alone. Or would we be applying the one-step approach *only* to tax Retailer as a surrogate for taxing Wholesaler? If the former, then it should not matter that Wholesaler would not be effectively taxed on the forgone interest — *if* we applied section 7872 principles. If the latter, then it would not be defensible to tax Retailer as a surrogate because most Wholesalers would, in fact, not be effectively taxed if we applied section 7872 principles to the transaction. Their income inclusion from the forgone interest would be precisely offset by a business expense deduction in the same amount. Thus, we would have no need to strive to tax Retailer as a surrogate for taxing Wholesaler.

In this regard, Prof. Charlotte Crane's observation may be helpful. She notes:

> It is the exception when we seek to relate a taxpayer's tax consequences with those of another, and we are apt to do so only when the taxpayers have a special ongoing relationship, or when the treatment for both can be dictated in a single statute.
>
> We seem to be much more willing to tolerate errors in the aggregate tax base than in the individual tax base.[20]

Indeed, that section 7872 does not, in fact, extend to the relationships described in this article is reason enough, in my view, to conclude that the usual default rule of measuring the income of each taxpayer properly, as an individual and without regard to the taxation of those with whom it engages in transactions, should control. Prof. Crane's insight is that we do not typically consider the tax consequences to the other party to a transaction in determining the first party's tax consequences *unless* Congress specifically requires us to do so in an explicit statutory provision.

If this observation is convincing, then it should not matter how section 7872 could theoretically apply to advance trade discounts treated as below-market loans if Congress were, in fact, to extend section 7872 to reach them. Rather, our concern under current law would be with properly measuring Retailer's wealth accession, viewed alone, on receipt of the cash. Under that view, I think it would be defensible to require Retailer to include cash advance trade discounts when received (unless market rate interest was paid for the use of the money). If the money were actually repaid to Wholesaler, then Retailer would deduct the repayment. Under current law, the deduction would be at face amount.

In sum, payment of market rate interest should clearly result in 100 percent exclusion of the cash advance trade discount. Failure to pay interest should clearly result in 100 percent inclusion of the cash advance trade discount. In the latter case, if the cash is, in fact, repaid (for failure to meet the agreement's volume terms), the repayment should be deductible. This leaves the most difficult transaction: the advance trade discount agreement that requires the cash recipient to pay interest, albeit at a below-market rate (perhaps by reference to the applicable federal rate or a percentage of it, say, 75 percent or less). While I know of no decision involving advance trade discounts with those facts, the situation should be addressed. And I come down on the side of inclusion on receipt when any interest paid is substantially below market rates. As I have written before:

> With overtaxation as the penalty for failing to pay a market rate of interest, the recipient might be encouraged to pay market interest, resulting in an income inclusion on the [other] side that also avoids taxation absent application of section 7872. Overtaxation is the lesser evil from an institutional standpoint, as the mere threat of overtaxation would perhaps encourage a change in behavior that leads to correct taxation of both parties. Undertaxation would encourage the opposite response.[21]

Conclusion

In *Westpac Pacific Food v. Commissioner*, the taxpayer entered into several advance trade discount agreements with various suppliers. Retention of the cash was conditioned on the purchase of a certain product volume from the various suppliers. If the required volume was not purchased, a pro rata portion of the cash had to be returned to the supplier. The taxpayer did not include the cash when received; rather, it reduced its cost of goods sold with respect to the products for which the required volume had been purchased. When the required volume was not purchased, the taxpayer had to repay a pro rata portion of the cash, and no adjustment to cost of goods sold was made. Thus, the taxpayer achieved deferral for the cash retained between the time of receipt and effective inclusion (through a reduction to cost of goods sold)

[20] Charlotte Crane, "Matching and the Income Tax Base: The Special Case of Tax-Exempt Income," 5 *Am. J. Tax Pol'y* 191, 225-226 (1986).

[21] Geier, *supra* note 4, at 136.

for tax purposes. From the reported decision, it does not appear that Westpac had to pay interest on the cash received under any of its agreements. The government argued that the cash should be included in the year received, but the Ninth Circuit held otherwise, saying:

> Because the taxpayer here has to pay the money back if the volume commitments are not met, it is not an "accession to wealth" as required under Glenshaw Glass. Westpac either has to buy a specific volume of goods for more than it would otherwise pay or pay the money back. . . . Thus the cash advance discounts are, like a loan or customer security deposit, liabilities rather than income when received.[22]

In *Karns Prime & Fancy Food Ltd. v. Commissioner*, the taxpayer entered into two agreements, under which it received $1.5 million and $300,000, respectively, from its supplier. Loan agreements were executed, and what looks to be significant interest payments were required (prime plus 1 percent on the first loan and 10.7 percent on the second loan). In companion agreements, the taxpayer agreed to purchase a certain product volume from the supplier by certain dates. If the required volume was purchased by the required dates, a portion of the loan repayments was forgiven. The taxpayer did not include the $1.5 million and $300,000 cash receipts but rather included as section 61(a)(12) debt discharge income the amounts that were forgiven as the various volume requirements were achieved (rather than reducing its cost of goods sold). As in *Westpac*, the government argued for inclusion of the cash on receipt, and the Third Circuit agreed, saying:

> The logic of the Supreme Court's holding in *Indianapolis Power* applies here. According to that decision, if the taxpayer has some guarantee that it will be allowed to retain the funds, then it has complete dominion over the money. . . . Such is the case here. Karns, and Karns alone, was at all times in control of whether it would meet the Supply Agreement. Therefore, the funds provided to Karns were in substance a projected rebate for products to be supplied, analogous to an advance payment, and as such were taxable income.[23]

In Rev. Proc. 2007-53,[24] the IRS said it will follow *Westpac Pacific Food* (and thus allow deferral) for accrual taxpayers who agree to reduce the cost of goods sold by the amount of the excluded cash, consistent with generally accepted accounting principles, as long as they report the transaction in this same manner for financial accounting purposes. The revenue procedure never mentions the word "interest."

All three of these authorities reached the wrong result, in my view. The taxpayer in *Westpac Pacific Food* should have been required to include the cash receipt in gross income because it did not pay any interest. The investment return earned with these pretax dollars between the time of receipt and inclusion (or repayment) is thus not effectively taxed to the taxpayer, although it is nominally included in gross income. The taxpayer in *Karns Prime & Fancy Food, Ltd.* should have been entitled to exclusion, as it paid what appears to be market rate interest between the cash receipt and either repayment or inclusion as debt discharge income. Finally, the revenue procedure is wrong to focus solely on whether the taxpayer is also deferring the income for financial accounting purposes, as well. Nowhere does it mention whether interest is paid on the amount excluded as a loan, which properly should be at the heart of the analysis.

While the analysis suggested here is also not conceptually pure (but rather errs on the side of administrative ease), it is, I believe, far closer to the ideal than the analytical approaches evidenced in these three recent authorities.

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[22] 451 F.3d at 976.
[23] 494 F.3d at 410.
[24] 2007-30 IRB 233, *Doc 2007-15698, 2007 TNT 128-6.*