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Proposing a Single, Simpler Test for Cash Equivalency

Fred B. Brown
University of Baltimore School of Law, fbrown@ubalt.edu

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FRED B. BROWN*

Abstract

The cash method of accounting is a popular tax accounting method that is used by most individuals and many small business entities. Under the cash method, generally taxpayers include income items that are received in the form of cash, checks, and property, in the year in which they are received. Under the cash equivalency doctrine, a promise to pay an amount in the future, even though it is a property right, generally will be included upon receipt only if the promise to pay constitutes a cash equivalent. An example of the application of the cash equivalency doctrine is where a lessee gives her own promissory note to a cash method lessor for rent that is owed. Unless the promissory note is a cash equivalent, the lessor would not include income on the receipt of the note but instead when the note is paid.

Whether an obligation is a cash equivalent is generally determined based on common law standards developed by the courts with some assistance from the Service. As a consequence, the current approach to cash equivalency suffers from the lack of a uniform standard. There is also uncertainty in applying the particular tests, given the fact-intensive, imprecise inquiry that is required. In addition, the current standards for cash equivalency may also present liquidity difficulties for taxpayers.

To address these problems, this Article proposes a single test for determining whether an obligation calling for future payments is a cash equivalent. The proposed test would generally define a cash equivalent as an obligation that is readily tradable in an established securities market. By avoiding the aforementioned problems, the proposed test would promote the simplicity and liquidity policies that underlie the cash method of accounting. The proposed test would also create consistency with the results under the installment method of reporting when a taxpayer receives a deferred-payment obligation on the sale of property. To prevent possible abuses, the article also

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*Associate Professor of Law and Director of the Graduate Tax Program, University of Baltimore School of Law; B.S. with high honors 1982, Rutgers University; J.D. summa cum laude 1985, Georgetown University; LL.M. 1986, New York University. I thank Walter Schwidetzky and Arturo Estrada for their excellent feedback on a draft of this Article. I also thank the participants at the 2017 annual Law & Society meeting for their excellent comments on a presentation of this Article. I am very grateful to Stacey Morris for her excellent research assistance. I thank the University of Baltimore School of Law for supporting this Article with a summer research stipend. Any errors are solely the responsibility of the author.

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considers the adoption of certain measures that apply in connection with the installment method.

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I. Introduction

The cash method of accounting is a popular tax accounting method that is used by most individuals and many small business entities.[1] Under the cash method, generally taxpayers include income items that are received in the form of cash, checks, and property, in the year in which they are received.[2] Under the cash equivalency doctrine, a second-party promise to pay an amount in the future, even though it is a property right, generally will be included upon receipt only if the promise to pay constitutes a cash equivalent.[3] A second-party promise exists where the promisor or obligor is the party that transacts with the taxpayer. An example of the application of the cash equivalency doctrine is where a lessee gives her own promissory note to a cash method lessor for rent that is owed. Unless the promissory note is a cash equivalent, the lessor would not include income on the receipt of the note; instead, the lessor would include income when the note is paid.[4]

Whether an obligation is a cash equivalent is generally determined based on common law standards developed by the courts with some assistance from the Service.[5] As a consequence, the current approach to cash equivalency suffers from the lack of a uniform standard.[6] There are apparently different standards for obligations received for services and those received for non-services.[7] Moreover, different tests exist within the sub-categories.[8] There is also uncertainty in applying the particular tests, given the fact-intensive, imprecise inquiry that is required.[9] In addition, the current standards for cash equivalency may also present liquidity difficulties for taxpayers.[10]

To address these problems, this Article proposes a single test for determining whether an obligation calling for future payments is a cash equivalent, for purposes of determining when a cash method taxpayer is required to include income upon the receipt of such an obligation. The proposed test would generally define a cash equivalent as an obligation that is readily tradable in an

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[1] The cash method of accounting is authorized under section 446 and the regulations thereunder. *See* I.R.C. § 446(a), (b), (c)(1); Reg. § 1.446-1(a)(1), (c)(1)(i). All section references are to the Code of 1986 or the Treasury regulations issued thereunder. Certain large business entities are prevented from using the cash method of accounting. *See* I.R.C. § 448(a), (b) (prevents C corporations and partnerships with C corporations as partners from using the cash method unless a corporation is a qualified personal service corporation or a corporation or partnership (as the case may be) satisfies a $25 million average annual gross receipts test).

[2] *See infra* notes 20-22 and accompanying text.

[3] *See infra* note 22 and accompanying text.

[4] This assumes that section 467 does not apply to the situation. If applicable, section 467 can place both the lessor and lessee on a sophisticated accrual method for rent and imputed interest with respect to certain agreements for the rental of tangible property. *See* I.R.C. § 467.

[5] *See infra* Part III.C.

[6] *See infra* Part V.A.

[7] *See id.*

[8] *See id.*

[9] *See id.*

[10] *See infra* Part V.B.

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established securities market. By avoiding the aforementioned problems, the proposed test would promote the simplicity and liquidity policies that underlie the cash method of accounting.[11] The proposed test would also create consistency with the results under the installment method of reporting when a taxpayer receives a deferred-payment obligation on the sale of property.[12] To prevent possible abuses, the Article also considers the adoption of certain measures that apply in connection with the installment method.[13]

The Article proceeds as follows. Part II discusses the cash method of accounting in general, including its underlying policies of simplicity and preventing taxpayer illiquidity. Part III describes the cash equivalency doctrine (and its underlying policies), which involves non-uniform standards, and may include different tests for deferred-payment obligations received for services and non-services. Part IV addresses the general non-application of the cash equivalency requirement for dispositions of property not subject to installment method treatment, and the effective application of a cash equivalency test under the installment method of reporting that generally treats an obligation as a cash equivalent where the obligation is readily tradable in an established securities market. Part V examines the administrative and liquidity problems associated with the current approach to cash equivalency. To avoid these problems, Part VI proposes and analyzes a test for cash equivalency that basically adopts the standard used for installment method reporting purposes. Part VII considers adopting a pledging rule, as well as a related party, second disposition rule, to prevent taxpayer abuse of the proposed test, and Part VIII concludes the Article.

II. Cash Method of Accounting

A. *Basic Rule*

Under the cash method of accounting, taxpayers include items of gross income in the taxable year in which they actually or constructively receive the items.[14] Actual receipt occurs when a taxpayer has possession of an income item. Constructive receipt occurs when an item of gross income is credited to a taxpayer's account, set apart for her, or otherwise made available so that the taxpayer can draw upon it.[15] Cash method taxpayers also include amounts under the economic benefit doctrine when amounts are irrevocably set aside

[11] *See infra* Part VI.B.2.b.
[12] *See infra* Part VI.B.2.b.
[13] *See infra* Part VII.
[14] I.R.C. § 451; Reg. §§ 1.446-1(c)(1)(i), 1.451-1(a).
[15] Reg. § 1.451-2. An example of constructive receipt is where after having performed services for another person, a taxpayer is offered payment in cash on December 31, 2016, but the taxpayer refuses to accept the payment and instead instructs the other person to make payment on January 1, 2017. The taxpayer should be in constructive receipt of the income in 2016 because the cash payment was made available to the taxpayer then.

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for the sole benefit of a taxpayer in a trust or escrow account that is beyond the reach of the payer's creditors.[16]

Cash method taxpayers generally deduct allowable deductible items in the taxable year in which the items are paid.[17] This includes the payment of cash along with the delivery or mailing of a check.[18] As an exception, where an expenditure creates an asset (tangible or intangible) whose useful life extends substantially beyond the close of the taxable year, the taxpayer is generally required to capitalize the expenditure and deduct only a portion of this amount for the year of payment and the remainder in subsequent years.[19]

The items of gross income that cash method taxpayers include upon actual or constructive receipt need not be in the form of cash. A check can constitute income,[20] as can the receipt of property, such as a BMW received in exchange for services.[21] In contrast, an unfunded second-party promise to pay an amount in the future, even though it is a property right, generally will be taken into account only if the right to receive income constitutes a cash equivalent.[22] A second-party promise exists where the promisor or obligor is the party that transacts with the taxpayer. An example is where a service recipient gives her own promissory note to the taxpayer in exchange for services performed by the taxpayer. An unfunded second-party promise exists where the obligor has given her own note and does not irrevocably set aside amounts for the sole benefit of a taxpayer in a trust or escrow account that is beyond the reach of the payer's creditors—that is, where the economic benefit doctrine does not apply to the transaction.[23]

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[16] *See, e.g.*, Sproull v. Commissioner, 16 T.C. 244, *aff'd*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174; John F. Cooper, *The Economic Benefit Doctrine: How an Unconditional Right to a Future Benefit Can Cause a Current Tax Detriment*, 71 Marq. L. Rev. 217, 223 (1988). An example of an application of the economic benefit doctrine is as follows: to satisfy an obligation for rent owed to the taxpayer, on December 31, 2016 a lessee transfers cash to an escrow account that is beyond the reach of the lessee's creditors. Under the terms of the escrow account, the cash will be paid to the taxpayer on January 15, 2017, without any conditions. The taxpayer should have income in 2016 under the economic benefit doctrine because in that year the cash transferred to the escrow account was irrevocably set aside for the taxpayer's benefit in an account that was beyond the reach of the lessee's creditors.

[17] Reg. § 1.461-1(a)(1).

[18] *See* Rev. Rul. 54-465, 1954-2 C.B. 93; Witt's Estate v. Fahs, 160 F. Supp. 521, 523 (S.D. Fla. 1956).

[19] Reg. § 1.461-1(a).

[20] *See* Kahler v. Commissioner, 18 T.C. 31 (1952).

[21] *See* Reg. § 1.446-1(c)(1)(i) ("Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property or services) are to be included for the taxable year in which actually or constructively received.").

[22] *See, e.g.,* Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961).

[23] *See supra* note 16 and accompanying text.

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Cash method taxpayers include third-party promises to pay upon receipt without regard to whether the obligations constitute cash equivalents.[24] A third-party promise to pay exists where the party who transacts with the taxpayer gives another person's note to the taxpayer—for example, where a service recipient gives a promissory note made by another person to the taxpayer in exchange for services performed by the taxpayer. Funded second-party promises to pay are included by cash method taxpayers, irrespective of whether they are cash equivalents, under the economic benefit doctrine.[25]

As discussed in Part IV.A of this Article, the cash equivalency requirement apparently does not apply to notes and other obligations that are received in exchange for property. The definition of a cash equivalent is discussed in Part III of this Article.

B. *Policies Underlying the Cash Method*

The cash method is founded primarily on the policy of simplicity.[26] Generally, amounts are includable and deductible upon the actual receipt of income and the payment of expenses, respectively, which is typically easy for taxpayers to determine. This approach is to be contrasted with the accrual method of accounting, which generally requires taxpayers to ascertain when rights to receive income arise and liabilities are incurred.[27] Simplicity under the cash method is sacrificed to an extent by the constructive receipt doctrine, but this broadening of receipt has been justified to prevent taxpayers

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[24] *See* Gregg D. Polsky & Brant J. Hellwig, *Taxing Structured Settlements*, 51 B.C. L. Rev. 39, 54 (2010) [hereinafter Polsky & Hellwig, *Taxing Structured Settlements*]; George L. White, *Accounting Methods – General Principles*, 570-4th Tax Mgmt. Port. (BNA) IV.B(1)(c)(2) (2018); United States v. Christine Oil & Gas Co., 269 F. 458, 459-60 (W.D. La. 1920); Rev. Rul. 69-50, 1969-1 C.B. 140; *cf.* Don W. Llewellyn, *Promises to Pay in the Future—A Modest Proposal*, 31 U. Miami L. Rev. 1337, 1351 (1977) (stating that third-party promises are property for purposes of the cash method).

[25] *See* Polsky & Hellwig, *Taxing Structured Settlements*, *supra* note 24, at 54-56. For a brief description of the economic benefit doctrine, see *supra* note 16 and accompanying text. As described by Professors Polsky and Hellwig, the unifying conceptual theme in requiring cash method taxpayers to be immediately taxable on third-party promises and funded second-party promises is that in both cases the taxpayer's right to payment is not subject to an insolvency risk of the party with which the taxpayer transacted. *See* Polsky & Hellwig, *supra* at 58. Professors Polsky and Hellwig view the inclusion of third-party promises and funded second-party promises as a sensible application of the cash method: it is easy to determine when they are created (unlike unfunded second party promises), and because they are almost always purchased for cash (in the case of third-party promises) or funded with cash (in the case of funded second-party promises), they do not raise valuation or liquidity concerns. *See* Polsky & Hellwig, *supra* at 58.

[26] *See, e.g.*, Note, *Checks and Notes as Income When Received by a Cash-Basis Taxpayer*, 73 Harv. L. Rev. 1199 (1960); Polsky & Helwig, *Taxing Structured Settlements*, *supra* note 24, at 52; Cooper, *supra* note 16, at 219.

[27] Reg. § 1.446-1(c)(1)(ii).

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from turning their backs on income and avoiding an inclusion,[28] as well as to reflect a more realistic conception of the realization of income.[29] And the capitalization requirement on the deduction side[30] is needed to match more properly income and related expenditures.

Preventing taxpayer illiquidity is apparently another policy concern that underlies the cash method.[31] By generally basing inclusions on the receipt of cash and checks, the cash method often ensures that taxpayers have liquid funds to pay the tax that is due.[32] While the receipt of illiquid property can generate an inclusion under the cash method, this does not occur that often given that such assets are typically not used as a means of payment,[33] except in the case of promissory notes and other obligations; and such obligations generally need to qualify as a cash equivalent to be included by a cash method taxpayer.[34]

III. The Cash Equivalency Doctrine

A. *Overview*

As discussed above, in general, a cash method taxpayer will include in gross income an unfunded second-party promise to pay an amount in the

[28] *See* Vander Poel, Francis & Co. v. Commissioner, 8 T.C. 407, 411-12 (1947); Jay A. Soled, *Taxation of Employer-Provided Health Coverage: Inclusion, Timing, and Policy Issues*, 15 Va. Tax Rev. 447, 478 (1996); Ridgeley A. Scott, *Rabbis and Other Top Hats: The Great Escape*, 43 Cath. U. L. Rev. 1, 16, 23 (1993); Cooper, *supra* note 16, at 228.

[29] *See Vander Poel*, *supra* note 28, at 412.

[30] *See supra* note 19 and accompanying text.

[31] *See* Polsky & Hellwig, *Taxing Structured Settlements, supra* note 24, at 52; Gary Quincy Michel, *The Doctrine of Cash Equivalency as Illustrated by Land Sale Contracts and Notes Received for Services Rendered*, 22 UCLA L. Rev. 219, 222 (1974) (contending that the policy of postponing taxation until the receipt of cash is the controlling force behind the cash method).

[32] A recent paper develops a framework for quantifying the hardship caused by illiquidity in connection with paying taxes. Andrew T. Hayashi, *The Quiet Costs of Taxation: Cash Taxes and Noncash Bases* (Va. Law & Econ. Research Paper No. 2017-15, 2017), https://ssrn.com/abstract=3011505.

[33] Nevertheless, it is not uncommon for stock or partnership interests to be used as payment for services rendered (or to be rendered).

[34] *See supra* note 22 and accompanying text. Furthermore, for most illiquid assets other than obligations for future payments, there really is no choice but to tax their receipt, because a subsequent sale for cash may never occur or may not occur for many years.

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future only where that obligation constitutes a cash equivalent.[35] To illustrate, assume that a cash method, calendar year taxpayer performs services for another person, and the service recipient compensates the taxpayer by giving her the service recipient's unfunded promissory note on December 31, 2016; the promissory note provides that the service recipient will pay the taxpayer $1,000 of cash on December 31, 2017. If the promissory note qualifies as a cash equivalent, the taxpayer will include in income in 2016 the fair market value of the note at the time of its receipt.[36] If the note does not qualify as a cash equivalent, the taxpayer will include no income upon the receipt of the note and instead include the cash received at the time the note is paid (in 2017, if payment occurs according to the terms of the note).[37]

The cash equivalency doctrine is a significant feature of the cash method of accounting.[38] While the cash equivalency doctrine apparently does not apply to sales of property,[39] it applies to many other types of transactions. These include unfunded second-party promises to pay that are received for

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[35] *See supra* notes 22-23 and accompanying text. The cash equivalency doctrine also has significance for accrual method taxpayers. Under the prepaid income doctrine, accrual method taxpayers generally include payments into income, even though the required services have yet to be performed. *See, e.g.,* Schlude v. Commissioner, 372 U.S. 128, 137 (1963). Thus, the Service has interpreted the all events test (which determines when accrual method taxpayers include amounts) as being satisfied on the earlier of when (1) the required performance occurs, (2) payment is due, or (3) payment is made. *See* Rev. Rul. 74-607, 1974-2 C.B. 149. Payment for this purpose includes the receipt of a cash equivalent. *See, e.g.,* T.A.M. 1986–39–006 (June 5, 1986). The Service has traditionally provided a procedure for deferring for a limited time period the inclusion of advance payments for services, goods, and other specified items, *see, e.g.*, Rev. Proc. 2004-34, 2004-1 C.B. 991, and the Tax Cuts and Jobs Act has codified the current procedure for a limited deferral of such advance payments. *See* I.R.C. § 451(c); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13221(b), 131 Stat. 2054, 2113.

[36] When the note is paid, the taxpayer will have to reconcile and account for any differences between the amount included on the receipt of the note and the payment received.

[37] This assumes that section 409A does not accelerate the time for income inclusion. *See generally* I.R.C. § 409A.

[38] Nevertheless, one commentator describes the cash equivalency doctrine as much more narrow than the two other doctrines applicable to cash method taxpayers—the constructive receipt doctrine, *see supra* note 15 and accompanying text, and the economic benefit doctrine, *see supra* note 16 and accompanying text—and thus much less significant than these other doctrines. *See* Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 Vill. L. Rev. 635, 651 n.6 (2012).

[39] *See infra* Part IV.

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services,[40] rent, royalties, bonuses on leases or licenses of property, judgments, and lottery winnings.[41]

While apparently not inconsistent with the regulations,[42] the cash equivalency doctrine is a creation of the courts, and consequently the standards for determining what constitutes a cash equivalent have been developed by the courts[43] with some assistance from the Service.[44] This Part first reviews the policies underlying the cash equivalency doctrine, and then discusses the standards used for determining cash equivalency.

B. *Policies Underlying the Cash Equivalency Doctrine*

The policies underlying the cash equivalency doctrine are to prevent cash method taxpayers from effectively being placed on the accrual method with respect to all rights to receive income,[45] while requiring such taxpayers to include obligations that function like cash in terms of easy valuation and

[40] While section 83 governs the transfer of property in connection with the performance of services, property for purposes of section 83 excludes an unfunded and unsecured promise to pay money. *See* I.R.C. § 83(a); Reg. § 1.83-3(e). Consequently, the cash equivalency doctrine should apply to unfunded and unsecured promises to pay money that are issued for services rendered. *See* Steven J. Willis, The Cash Equivalency Doctrine 10-11 (2008), http://nersp.osg.ufl.edu/~acadian/poland/2009/Top40Doctrines/Cash%20equivalence.pdf (citing several commentators and the Service for this proposition); Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 Minn. L. Rev. 1092, 1111 n.105 (2005) [hereinafter Polsky & Hellwig, *Taxing the Promise to Pay*] (stating that this proposition is widely recognized). In addition, the cash equivalency doctrine still applies to the nonqualified deferred compensation plans following the enactment of section 409A. *See* Notice 2005-1, 2005-2 C.B. 274. Thus, income that is not accelerated under section 409A could still be taxable in a year before payment in cash or check if the deferred compensation obligation is a cash equivalent. Moreover, section 409A generally does not apply to services performed by independent contractors. *See* Reg. § 1.409A-1(f)(2).

[41] *See* Willis, *supra* note 40, at 1-2.

[42] In this regard, Regulation section 1.446-1(c)(1)(i) provides that "[g]enerally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property or services) are to be included for the taxable year in which actually or constructively received." While a right to receive income should be viewed as property, at least under state law, the term "generally" would appear to permit some exceptions to income inclusions upon the actual or constructive receipt of property. Moreover, state law is not controlling in determining property rights for purposes of federal tax law. *See* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1112 (the fact that payment rights are property under state law is not dispositive in determining whether they are property for purposes of federal taxation).

[43] *See, e.g.*, Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961).

[44] *See, e.g.*, Rev. Rul. 68-606, 1968-2 C.B. 42.

[45] See Gordon T. Butler, *Economic Benefit: Formulating a Workable Theory of Income Recognition*, 27 Seton Hall L. Rev. 70, 83 (1996); Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1112-13; Polsky & Hellwig, *Taxing Structured Settlements*, *supra* note 24, at 51; Soled, *supra* note 28, at 468-69; Cooper, *supra* note 16, at 230 n.56; Note, *supra* note 26, at 1204.

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liquidity.[46] If not for the cash equivalency requirement, a cash method taxpayer who has a right to receive an amount of income would have to include the value of the income right when it arises, given that the income right is a property right and cash method taxpayers include income items in the form of property.[47] Thus, absent this requirement, cash method taxpayers would be treated in a manner similar to their accrual method counterparts, who generally include income items when the right to receive income becomes fixed and the amount is determined with reasonable accuracy.[48] Consequently, the cash equivalency requirement is necessary to maintain the essential difference between the cash method and accrual methods, that is, a cash method taxpayer should report income items on receipt rather than when the right to receive income items becomes fixed. Moreover, unlike the receipt of other non-cash items, it is not necessary to require cash method taxpayers to include obligations for future payments upon the receipt of the obligations; instead, taxation can wait until the obligations are paid.[49]

In maintaining this essential aspect of the cash method, the cash equivalency requirement also promotes the simplicity and liquidity concerns that underlie the cash method. Taxing cash method taxpayers on rights to receive income would require that taxpayers determine when such rights exist along with their value, which may be difficult,[50] as well as necessitate the added complication of having to reconcile and account for any differences between amounts included on the receipt of the rights and the payments ultimately received.[51] In addition, taxing cash method taxpayers on income rights could result in inclusions without the receipt of liquid assets.[52]

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[46] *Cf.* Theodore P. Seto, *When is a Game only a Game?: The Taxation of Virtual Words*, 77 U. Cin. L. Rev. 1027, 1050 (2009) (describing the two functions of the cash equivalency doctrine: an exception to the general rule of includability to prevent cash method taxpayers from being treated like accrual method taxpayers, and an exception to the exception for obligations that are the equivalent of cash).

[47] *See* Kahler v. Commissioner, 18 T.C. 31, 34-35 (1952); Reg. §1.446-1(c)(1)(i).

[48] *See* Reg. § 1.451-1(a); I.R.C. § 451(b). As a result of the Tax Cuts and Jobs Act, accrual method taxpayers will generally recognize gross income no later than the taxable year in which the income is taken into account as revenue in certain financial statements of the taxpayer. § 451(b); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13221(a), 131 Stat. 2054, 2113.

[49] *Cf.* Note, *supra* note 26, at 1199 (pointing out that the only possible value of checks and notes is their subsequent conversion into money or goods). In contrast, this is not the case for property other than obligations for future payments. *See supra* note 34 and accompanying text.

[50] *See* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1115 n.122; Note, *supra* note 26, at 1204.

[51] *See* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1115 n.122; Note, *supra* note 26, at 1204.

[52] *See* Butler, *supra* note 45, at 82; Soled, *supra* note 28, at 468; *cf.* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1115 n.122 (viewing liquidity as an incidental benefit of the cash equivalency doctrine); Patricia A. Cain, *Taxation of Promises to Pay*, 8 Ga. L. Rev. 125, 133 (1973) (viewing concerns over taxpayer liquidity as a possible rationale why some courts required a deferred-payment obligation to be a cash equivalent to be included in the seller's amount realized under section 1001(b)).

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On the other hand, disregarding all rights to receive income under the cash method, regardless of the nature of the rights, could permit taxpayers to postpone income inclusions even where the taxpayers have received deferred-payment obligations that function like cash in terms of easy valuation and liquidity, thus violating notions of substance over form.[53] Therefore, obligations that are viewed as functioning like cash generate income inclusions when received by cash method taxpayers.[54] The cash equivalency doctrine is a product of these competing policies.

C. *Standards for Determining Cash Equivalency*

1. *Cash Equivalence in General*

a. *The Cowden Test.* The courts and Service have used several different tests for determining cash equivalence. The most widely used of these tests is apparently the one announced by the U.S. Court of Appeals for the Fifth Circuit in *Cowden v. Commissioner*.[55]

Cowden involved a situation where the taxpayers made an oil, gas and mineral lease to Stanolind Oil and Gas Company, and in connection therewith, Stanolind agreed to make bonus payments as follows: $10,223.85 was payable on the execution of the lease in April, 1951; $250,484.31 was due in January, 1952; and $250,484.31 was due in January, 1953.[56] In November, 1951, the taxpayers assigned the right to the 1952 payment to a bank for an amount equal to the face amount of the amounts assigned less a small discount.[57] In November, 1952, the taxpayers assigned the right to the 1953 payment under terms similar to the previous assignment.[58] At issue were the timings of the income inclusions for the 1952 and 1953 payments under the bonus agreement. The taxpayers reported them in the years in which the taxpayers received payments from the bank pursuant to the assignments.[59] The Service determined that the bonus payments were includable in 1951 upon the creation of Stanolind's obligation to make the payments, based on the fair

[53] *Cf.* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* 40, at 1115 (stating that the cash equivalency doctrine is consistent with taxing the receipt of cash).

[54] *See* Cooper, *supra* note 16, at 230 n.56.

[55] Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961); *see* Butler, *supra* note 45, at 83; Polsky & Hellwig, *Taxing the Promise to Pay, supra* note 40, at 1113; Soled, *supra* note 28, at 469 (referring to *Cowden* as a seminal case); Cooper, *supra* note 16, at 230 (referring to *Cowden* as often cited); *cf.* Llewellyn, *supra* note 24, at 1340 (stating that although there is no unanimously accepted test for cash equivalency, it is generally agreed that the key factor is marketability at a reasonable discount, citing *Cowden* and a few other cases for this proposition).

[56] *Cowden,* 289 F.2d at 21.

[57] *Id.* at 22.

[58] *Id.*

[59] *Id.*

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market value of the obligations at that time.[60] Whether the obligations were taxable upon receipt depended on whether they were cash equivalents.[61]

In *Cowden*, the Fifth Circuit described a cash equivalent as follows:

> We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.[62]

Thus, to qualify as a cash equivalent under the *Cowden* test, a promise to pay must be: (1) assignable,[63] (2) unconditional[64] and not subject to set-offs, (3) by a solvent obligor, and (4) of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money.

There may also be a fifth requirement under the *Cowden* test: that the promise be evidenced in an instrument other than the contract. The *Cowden* court referred to another case espousing this requirement, and noted that

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[60] The character of the income was also at issue, with the taxpayer reporting the amounts received upon the assignments of the payments as long-term capital gains and the Service determining that the fair market value of the obligations was included as ordinary income. *Id.*

[61] In the decision, the Fifth Circuit had ruled that Stanolind's willingness to pay (and the taxpayers' unwillingness to receive) the entire bonus upon the execution of the lease did not by itself cause the entire bonus obligation to be taxable in the year that the lease was executed. By so ruling, the court rejected a constructive receipt basis for including the entire bonus in the year of execution. The taxpayers had claimed that the Tax Court included the face amount of the entire bonus in the year that the lease was executed on the basis of the constructive receipt doctrine. *Id.* at 23.

[62] *Id.* at 24.

[63] As a result of this factor, providing that an obligation is non-assignable should prevent cash equivalency. *See* Willis, *supra* note 40, at 3, 6. Specifically, to avoid cash equivalence treatment for deferred compensation plans, the plans normally prohibit a participant from transferring in any way her interest in the plan. *See* A. Thomas Brisendine, Elizabeth Drigatos & Thomas R. Pevarnik, *Deferred Compensation Arrangements*, 385-5th Tax Mgmt. Port. (BNA) VII.C (2018); Daniel S. Knight, *Income Tax Consequences of Nonqualified Deferred Compensation*, 21 Tax Law. 163, 178 (1967) (stating that while the finding of a cash equivalent with respect to the typical unfunded deferred compensation arrangement is remote because a regular market is likely lacking, it seems inadvisable not to have a non-assignment clause). Likewise, to increase substantially the likelihood that the obligation of a buyer of property is not a cash equivalent (assuming cash equivalence is relevant to property sales, *see* Part IV.A), commentators have recommended that the buyer's obligation not be transferable or assignable. *See* Martin D. Ginsburg, *Taxing the Sale for Future Payment*, 30 Tax L. Rev. 471, 566 (1975). Nevertheless, there may be an issue as to whether certain nonassignability clauses are legally valid. *See* Ginsburg, *supra,* at 564-65; Gary Friedhoff, *Reed v. Commissioner: A Case for the Economic Benefit Doctrine*, 46 Ohio St. L. J. 1001, 1014-15 (1985).

[64] This requirement raises the issue of whether an obligation that is conditional can be a cash equivalent once the condition is satisfied. *See* White, *supra* note 24, at IV.B(1)(c)(4) (stating that the application of the cash equivalency doctrine is unclear once income is earned).

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the test of that case was met on the present facts.[65] Additional support for a separate instrument requirement can be found in Revenue Ruling 60-31, which provides that a "mere promise to pay, not represented by notes or secured in any way, is not regarded as the receipt of income" under the cash method of accounting.[66] Given that a separate instrument requirement is rather formalistic, it is not clear whether it is, or should be, a requirement for cash equivalency.[67] Indeed, the *Cowden* court rejected a requirement that an obligation must be a negotiable instrument for it to qualify as a cash equivalent, because such a requirement, which concerns the form of the obligation, is inappropriate given that the tax law "deals in economic realities, not legal abstractions," and its reach should not be "delimited by technical refinements or mere formalism."[68] And subsequent case law may not view the existence of a separate instrument as a necessary requirement for cash equivalency.[69]

In *Cowden,* the Fifth Circuit remanded the case to the Tax Court to determine whether the bonus obligations were cash equivalents based on the test announced.[70] On remand, the Tax Court held that the bonus obligations were cash equivalents, and thus taxable upon their creation to the extent of their fair market value at that time.[71]

b. *The Test Used in Rev. Rul. 68-606.* The Service apparently has adopted the *Cowden* test for cash equivalency, or at least a test quite similar to the one in *Cowden*. In Revenue Ruling 68-606,[72] on facts that are nearly the same as in *Cowden*, the Service stated that "a deferred-payment obligation which is readily marketable and immediately convertible to cash" is a cash equivalent, citing *Cowden* for this proposition (although *Cowden* does not use this specific language).[73] In determining that the obligation addressed in the ruling met this standard, the Service pointed out that the deferred payments called for under the obligation "are unconditionally payable by a solvent obligor whose credit is unquestioned" and that the rights under the obligation "are freely transferable and readily saleable."[74] The facts highlighted by the Service are basically the same as the factors in the *Cowden*. Although the Service does not determine whether the particular obligation has a discount that is not substantially greater than the generally prevailing premium

[65] *Cowden,* 289 F.2d at 24.

[66] *See* Rev. Rul. 60-31, 1960-1 C.B. 174, 177; Willis, *supra* note 40, at 14.

[67] *See* Willis, *supra* note 40, at 13-15 (questioning whether *Cowden* supports a separate instrument requirement for cash equivalency, and disagreeing that this should be a requirement for cash equivalency).

[68] *Cowden,* 289 F.2d at 24; *see* Soled, *supra* note 28, at 470 (stating that under *Cowden* the substance of the obligation controls and the form does not matter).

[69] *See* Perelman v. Commissioner, 41 T.C. 234, 239 (1963), *acq*. 1965-2 C.B. 6.

[70] *Cowden,* 289 F.2d at 25.

[71] Cowden v. Commissioner, 20 T.C.M. (CCH) 1134, T.C.M. (P-H) ¶ 61,229 (1961).

[72] Rev. Rul. 68-606, 1968-2 C.B. 42.

[73] *Id.*

[74] *Id.*

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for the use of money, it does state that the obligor has unquestioned credit.[75] It seems safe to assume that an obligation issued by a person with such credit should only have a discount equal to the generally prevailing premium for the use of money, not substantially greater than such. Thus, in the ruling the Service appears to use the "unquestioned credit" factor as a surrogate for the "no substantial discount" factor.[76]

c. *Other Readily Marketable Tests.* Besides the tests mentioned above, other tests have also been used. Courts and commentators have stated that to constitute a cash equivalent, a deferred-payment obligation needs to be reflected in an evidence of indebtedness that, like money, commonly and readily changes hands in commerce.[77] In this regard, some authorities presume that negotiable notes are cash equivalents because they freely pass from hand to hand in commerce, whereas non-negotiable notes are not normally cash equivalents, in the absence of a specific indication of marketability.[78] Similarly in Revenue Ruling 73-173,[79] the Service ruled that a cash method taxpayer was required to include upon receipt the fair market value of breeding rights in thoroughbred stallions, received as compensation for services, where the breeding rights were "freely transferable, readily marketable, and immediately convertible to cash." While the Service cited to *Cowden* and Revenue Ruling 68-606 in the ruling,[80] the Service did not refer to all of the factors set forth in *Cowden* or Revenue Ruling 68-606—in particular, the "no substantial discount" factor in *Cowden* or the "unquestioned credit" factor in Revenue Ruling 68-606. Perhaps the Service considered these factors inapplicable given the circumstances that involved breeding rights as opposed to a deferred-payment obligation.

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[75] *Id.*

[76] However, in other guidance, the Service has used or referred to the *Cowden* test for cash equivalence. *See, e.g.,* P.L.R. 2000–31–031 (May 5, 2000) (applying the *Cowden* test to lottery prize payments in the form of an annuity); P.L.R. 1996–39–016 (June 17, 1996) (same); P.L.R. 1996–24–009 (Mar. 12, 1996) (same); T.A.M. 1986–39–006 (June 5, 1986) (referring to the *Cowden* test).

[77] *See* Reed v. Commissioner, 723 F.2d 138, 147 (1st Cir. 1983) (citing other cases); Mertens, Law of Federal Income Taxation § 12A:37 (2018 ed.) (referring to a cash equivalent as a negotiable instrument that is commonly traded in commerce like money); Cain, *supra* note 52, at 137 (stating that under the cash equivalency doctrine, it is generally accepted that a promise to pay that is capable of being readily converted into cash would be included into income); Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in its Proper Season*, 67 Ohio St. L. J. 347, 357 (2006) (stating that an unfunded promise to pay that is readily tradable would be subject to tax).

[78] *See* Ginsburg, *supra* note 63, at 564-65 (1975) (citing cases supporting these propositions); William R. Skinner, *Earn-Outs in Public Company Acquisitions: New CVRS Raise Unsettled Tax Issues*, 113 J. Tax'n 360, 362 (2010) (same); *cf.* Barnsley v. Commissioner, 31 T.C. 1260, 1263 (1959) (negotiable promissory note treated as cash equivalent and includible in income to the extent of its fair market value).

[79] Rev. Rul. 73-173, 1973-1 C.B. 40.

[80] *Id.*

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d. *Intended as Payment Test.* Some courts have used a decidedly different cash equivalency standard that focuses on whether a note received in connection with salary owed was intended as payment and therefore includable upon receipt, or whether it was merely evidence of the obligation and not so includable.[81] As discussed below,[82] a similar, "received in payment" standard for cash equivalency seems to be called for by Treasury regulations for obligations that are provided as compensation for services. Some authorities use a combined test for cash equivalency that requires an obligation to be both readily transferable and intended as payment.[83]

e. *Ascertainable Fair Market Value Test.* Despite the apparently wide acceptance of the *Cowden* test, some commentators have staked out the much less taxpayer-friendly position that any obligation with an ascertainable fair market value is a cash equivalent, regardless of whether the obligation has a deep discount.[84] Such an approach would seem problematic in that it may often tax cash method taxpayers on the receipt of deferred-payment obligations, and thus blur the distinction between the cash and accrual methods

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[81] *See, e.g.*, Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938); Note, *supra* note 26, at 1208 (referencing *Schlemmer* and another decision using this test). The court in *Schlemmer* determined that the note was not intended as payment and therefore not a cash equivalent. *Schlemmer,* 94 F.2d at 78. One commentator describes an "accepted as payment" rule for cash equivalency as a more nearly accurate statement of the general rule for cash equivalency (as compared to a negotiability test). *See* Henry Brandis, Jr., *The Treatment Accorded Promissory Notes Under the Federal Income Tax*, 52 N.C. L. Rev. 93, 94-95 (1973).

[82] *See* discussion *infra* Part III.C.2.

[83] *See* Reed v. Commissioner, 723 F.2d 138, 147 (1st Cir. 1983) (citing other cases and a commentator); Carter G. Bishop & Marion McMahon Durkin, *Nonqualified Deferred Compensation Plans: A Review and Critique*, 17 Wm. Mitchell L. Rev. 43, 117 (1991); Scott, *supra* note 28, at 37; John H. Davies, *Public Stock, Private Stock: A Model for the Corporate Income Tax*, 124 U. Pa. L. Rev. 299, 323 (1975); Patricia Ann Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 Tax L. Rev. 525, 554 (1974).

[84] *See* White, *supra* note 24, at IV.B(1)(a)(3) ("[C]onsensus appears to be that the standards of 'property with ascertainable fair market value' and 'cash equivalent' are the same."). The Ninth Circuit's decision in *Warren Jones v. Commissioner* may provide some support for this view, as there the court stated that the *Cowden* language regarding cash equivalency was written principally as a description of the obligation involved in the *Cowden* case. 524 F.2d 788, 794 n.9 (9th Cir. 1975). Some commentators, however, disagree with the view that the *Warren Jones* court rejected the *Cowden* test for cash equivalency. *See* Llewellyn, *supra* note 24, at 1341; Richard L. Meives, *Revenue Ruling 79-292 and Deferred Reporting*, 36 U. Miami L. Rev. 175, 201 (1982) (stating that the *Warren Jones* court's analysis of the legislative history of section 1001(b) strongly indicates that the court did not reject the no substantial discount factor announced in *Cowden*).

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of accounting,[85] which is at odds with the crucial policy underlying the cash equivalency doctrine.[86]

2. *Cash Equivalency Test for Obligations Received for Services*

For deferred-payment obligations received for services, there may be a separate test for cash equivalency that looks to whether the obligation was "received in payment" for the services.[87] While the regulations under section 61 provide for this test, they do not provide any guidance on how to determine whether a given obligation was received in payment for services.[88] In *Williams v. Commissioner*, where the court found that a note was not received in payment for services,[89] but instead as evidence of indebtedness, the court looked at the intent of the parties, relying primarily on the taxpayer's testimony that the particular note was not given to him in payment of the obligor's indebtedness.[90] The court also took into account the taxpayer's testimony that the note was not payable until the obligor sold the property that was located by the taxpayer.[91]

A few commentators, however, appear to take the position that the regulations under section 61 embrace the *Cowden* test for cash equivalency, and that a note or other evidence of indebtedness received for services would be includable upon receipt if it satisfied the *Cowden* factors.[92] Another commentator similarly contends that whether a note is intended as payment is determined in large part based on the form and nature of the obligation, including whether it be freely assignable and the existence of a ready market involving reasonable discounts.[93]

Some court decisions are difficult to reconcile with any of the standard tests for cash equivalency. For example, in *Goldsmith v. United States*, the United

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[85] *See Reed,* 723 F.2d at 148 n.7 (citing commentators for this proposition); Warren Jones v. Commissioner, 60 T.C. 663, 668-70 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975) (in rejecting an ascertainable fair market value for purposes of including an obligation in the seller's amount realized under 1001(b), stating that such treatment would blur the distinction between cash and accrual methods, as well create liquidity problems for the seller); *see also* Skinner, *supra* note 78, at 363 (describing the Tax Court's reasoning in *Warren Jones*).

[86] *See supra* notes 45-48 and accompanying text.

[87] *See* Reg. § 1.61-2(d)(4); Llewellyn, *supra* note 24, at 1351 n.60 (stating that with respect to promises to pay for services, the only test appears to be the one under Regulation section 1.61-2(d)(4) that looks to intent).

[88] *See* Brisendine et al., *supra* note 63 (pointing out that the regulation has created some confusion for practitioners).

[89] The court in *Williams* refers to the predecessor of Regulation section 1.61-2(d)(4) and a few prior decisions for the applicable legal standard. Williams v. Commissioner, 28 T.C. 1000, 1001 (1957).

[90] *Id.* at 1002.

[91] *Id.* at 1001.

[92] *See* Brisendine et al., *supra* note 63; *cf.* Polsky & Hellwig, *Taxing the Promise to Pay*, *supra* note 40, at 1115 n.121 (applying the *Cowden* test to a promise to pay for services rendered without mentioning Regulation section 1.61-2(d)(4)).

[93] *See* Llewellyn, *supra* note 24, at 1352-53.

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States Court of Claims determined that a taxpayer who received promises to pay death benefits under a deferred compensation arrangement was taxable on the value of the promises in the years that the promises were made.[94] The promises to pay these benefits were not, however, represented by any notes or other writing that was assignable,[95] which would apparently preclude a finding of cash equivalency.[96] Indeed, the court does not discuss at all whether the promises were intended as payment or readily marketable. And while the employer did purchase an insurance policy to fund the death and disability payments, the employer was the owner of the policy, which was thus subject to claims of its creditors;[97] this should have prevented the application of the economic benefit doctrine.[98]

IV. Obligations Received on Sales of Property

Where a taxpayer sells property and receives a deferred-payment obligation of the buyer, the taxpayer-seller is generally permitted to recognize any gain on the sale by using the installment method of reporting.[99] Very generally, under the installment method, the seller recognizes gain on the sale as payments on an installment obligation are received.[100] The amount of gain recognized per payment is equal to the amount of the payment multiplied by the gross profit ratio, which is equal to the ratio of the gross profit on the sale to the contract price.[101] If the installment method does not apply either because of an exception[102] or because the seller elects not to use it,[103] the seller has to recognize any gain in the year of sale as determined under section 1001.[104]

A. *Sales Not Subject to Installment Method Reporting*

For purposes of recognizing gain or loss under section 1001 on a sale of property in the year of the sale, it seems that notes or other obligations received by a cash basis seller are taken into account in determining the amount realized on the sale, regardless of whether the obligations are cash

[94] *See* Goldsmith v. United States, 586 F. 2d 810, 821 (Ct. Cl. 1978).

[95] *See id.* at 820. In this regard, although the court was specifically addressing promises to pay retirement and severance benefits, these benefits were part of the same deferred compensation agreement that contained the death and disability benefits, and there is no indication that the taxpayer was given a separate writing reflecting the death and disability benefits. *See id.*

[96] This is unless a nonassignable note can still be viewed as received in payment for services rendered.

[97] *See Goldsmith,* 586 F. 2d at 817-18.

[98] *See supra* note 16 and accompanying text. One commentator refers to *Goldsmith* as an isolated departure. *See* White, *supra* note 24, at IV.B(1)(c)(1).

[99] *See* I.R.C. § 453. As mentioned below, there are some significant exceptions to the use of the installment method. *See infra* note 114 and accompanying text.

[100] *See* § 453(a), (c).

[101] *See* § 453(c); Reg. § 15A.453-1(b). This generally allows basis to be recovered in a ratable manner as payments are received.

[102] *See infra* note 114 and accompanying text.

[103] *See* § 453(d).

[104] *See* I.R.C. § 1001(a), (b).

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equivalents. This is the apparent holding by the Ninth Circuit in the seminal case of *Warren Jones v. Commissioner*, where the court held that the seller should include the fair market value of a deferred-payment obligation in the amount realized under section 1001(b), even though the fair market value of the obligation reflected a deep discount from the obligation's face amount.[105] In reaching this holding, the court relied heavily on the legislative history of section 1001, which indicated that Congress had replaced the requirement that the property received have a readily realizable market value with a requirement that it merely have an ascertainable fair market value.[106] Based on this legislative history, the court concluded that Congress intended to establish the rule that if the fair market value of property received in a disposition is ascertainable, the fair market value of the property is included as an amount realized.[107] Thus, the apparent basis for the court's holding is that cash equivalency is irrelevant for purposes of determining the amount realized under section 1001(b).[108] Nevertheless, because the court also stated that the *Cowden* language regarding cash equivalency was written principally as a description of the obligation involved in the *Cowden* case,[109] *Warren Jones* can possibly be read as endorsing the view that cash equivalency *is* relevant for purposes of section 1001(b), but that a cash equivalent is any obligation with an ascertainable fair market value. The latter appears to be a strained reading of the case.[110]

The regulations also provide that the amount realized on a sale of property includes obligations of the buyer irrespective of whether the obligations constitute cash equivalents.[111] Nevertheless, there appears to be some contrary authority in the Fifth Circuit, where subsequent to the *Warren Jones* decision,

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[105] *See* Warren Jones v. Commissioner, 524 F.2d 788 (9th Cir. 1975). Likewise, the Service does not apply the cash equivalency doctrine to dispositions of property. *See* Skinner, *supra* note 78, at 363.

[106] *See Warren Jones*, 524 F.2d. at 791-92; *see also* Skinner, *supra* note 78, at 363.

[107] *See Warren Jones*, 524 F.2d at 792. The court also viewed section 453's installment method of reporting as evidence in support of the court's holding, in that the installment method provides taxpayers "relief from the rigors of section 1001(b)." *See id.*

[108] *See* Campbell v. United States, 661 F.2d 209 (Fed. Cl. 1981) (stating that *Warren Jones* rejected the application of the cash equivalency doctrine in determining the amount realized under section 1001(b), and holding the same); *cf.* Meives, *supra* note 84, at 201 (stating that the *Warren Jones* court's analysis of the legislative history of section 1001(b) strongly indicates that the court did not reject the no substantial discount factor announced in *Cowden*).

[109] *See Warren Jones*, 524 F.2d at 794 n.9.

[110] *See supra* notes 106-108 and accompanying text.

[111] The previously applicable regulations under section 453 provide that obligations are taken into account regardless of whether they are cash equivalents. *See* Reg. § 15A.453-1(d)(2)(i). The currently applicable regulations under section 1001 imply that cash equivalency is irrelevant for purposes of 1001(b), as the regulations simply require a seller to take into account a value associated with a deferred-payment obligation (which is usually the issue price of the obligation determined under the OID rules). *See* Reg. § 1.1001-1(g)(1), (3).

courts have required that an obligation needs to be a cash equivalent to be included under section 1001(b).[112]

B. *Sales Subject to Installment Method of Reporting*

1. *In General*

As mentioned above, section 1001, and the concomitant rule that treats obligations as part of the amount realized regardless of whether they are cash equivalents, only applies to determine the timing of any gain where the sale is not subject to the installment method of reporting.[113] In general, a seller is able to use the installment method of reporting when the seller receives obligations of the buyer on a sale of property; nevertheless, there are significant exceptions to the use of the installment method for sales of inventory, dealer property, publicly-traded stocks and securities, property with recapture income, and depreciable property to controlled entities.[114] Under the installment method, the seller recognizes gain on the sale as payments on an installment obligation are received.[115]

For purpose of recognizing income under the installment method, payments do not include the buyer's obligation to make future payments unless the obligation is in a form designed to render it readily tradable in an established securities market, is payable on demand,[116] contains interest coupons, or is in registered form[117] (except for those that the taxpayer establishes will not be readily tradable in an established securities market).[118] Payment for purposes of the installment method also includes an obligation that is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of

[112] *See* Watson v. Commissioner, 613 F.2d 594 (5th Cir. 1980); Bright v. United States, 926 F.2d 383 (1991); *see also* Skinner, *supra* note 78, at 363.

[113] *See supra* part IV.A.

[114] *See* I.R.C. § 453(b), (i), (g), (k).

[115] *See supra* notes 100-101 and accompanying text.

[116] According to the regulations, an obligation will be treated as payable on demand only if it is payable on demand pursuant to state or local law. *See* Reg. § 15A.453-1(e)(3).

[117] An obligation is considered to be in registered form if it is registered as to principal, interest or both, and if its transfer must be effected by the surrender of the old instrument and either the reissuance of the old instrument to the new holder or the issuance of a new instrument to the new holder. *See* Reg. § 15A.453-1(e)(1)(i).

[118] *See* § 453(f)(3)-(5); Reg. § 15A.453-1(e). As originally enacted, the aforementioned obligations (except those that are payable on demand) were treated as payment only if they were issued by a corporation or a government or political subdivision thereof. *See* § 453(f)(4)(B) (prior to American Jobs Creation Act of 2004). The American Jobs Creation Act of 2004 amended the statute to treat these obligations as payments regardless of the nature of the issuer. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 897(a), 118 Stat. 1418.

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deposit or Treasury note.[119] Thus, a seller who is reporting gain on the installment method would not recognize gain on the receipt of the buyer's obligations unless the obligations met one of the above-mentioned conditions.

Congress's reason for including the aforementioned obligations as payments in applying the installment method is that taxpayers receiving such obligations have liquidity to pay tax on gains to the same extent as if they had received cash.[120] Indeed, the legislative history refers to such obligations as the equivalent of cash.[121] As a result of these rules, there is a cash equivalency standard for sales of property subject to installment reporting that treats an obligation as a cash equivalent where the obligation is designed to render it readily tradable in an established securities market,[122] payable on demand, containing interest coupons, or in registered form (except for those that the

[119] Reg. § 15A.453-1(b)(3)(i). An example in the regulations illustrates this rule. *See* Reg. § 15A.453-1(b)(5), Ex. (8) (concluding that payment occurred to the extent of cash and Treasury bills deposited in an escrow account as security for buyer's note, where seller could look directly to escrowed collateral upon buyer's default). The meaning of cash equivalent for this purpose seems quite limited and relegated to the items mentioned or other similar third-party obligations. If the common law meaning of cash equivalent applied for this purpose, the receipt of a buyer's obligation that is not a payment under section 453(f)(3)-(5), but is a common law cash equivalent, would not be a payment for installment method purposes; however, the same obligation that is secured by a common law cash equivalent issued by the buyer would be a payment—a seemingly odd and unjustifiable result.

[120] *See* S. Rep. No. 91-552, at 111-12 (1969) (viewing such obligations as a "close approximation of cash"); H.R. Rep. No. 91-413, at 107-08 (1969).

[121] S. Rep No. 91-552, at 111-12; H.R. Rep No. 91-413, at 107-08. Congress apparently felt that obligations containing interest coupons are in a form that makes it possible to readily trade them in an established securities market, and thus the equivalent of cash. In this regard, the Senate Finance Committee amended the House bill to provide that obligations in registered form that the taxpayer establishes will not be readily tradable in an established securities market are not to be treated as payments, because they lack marketability and thus are not essentially similar to cash. *See* S. Rep. No. 91-552, at 111-12 (1969). A similar amendment was not made with respect to obligations containing interest coupons, thus suggesting the view that such obligations are in a form that renders them readily tradable in an established securities market. Nevertheless, the regulations provide that obligations containing interest coupons are treated as payment regardless of whether the obligation is readily tradable in an established securities market, thus acknowledging that such obligations may in fact not be readily tradable in an established securities market. *See* Reg. § 15A.453-1(e)(1)(i)(A).

[122] Such obligations are described in more detail in the next subsection of this Article.

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taxpayer establishes will not be readily tradable in an established securities market).[123]

2. *Obligations Designed to Be Readily Tradable in an Established Securities Market*

Whether an obligation is considered to be in a form designed to render it readily tradable in an established securities market and thus considered a payment for purposes of applying the installment method is determined pursuant to the Treasury regulations under section 453.[124] Under these regulations, obligations are deemed to be so designed if (1) the obligation is part of an issue or series of issues that are readily tradable in an established securities market, (2) the obligations are certain convertible obligations, (3) the issuer has other obligations of a comparable character that are readily tradable in an established securities market, or (4) steps necessary to create a market for the obligations are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding that existed at the time of issuance).[125] The regulations elaborate on these categories and terminology, as described immediately below.

An obligation is treated as readily tradable if brokers or dealers making a market in the obligation regularly quote the obligation or if it is part of an issue that is in fact traded in an established securities market.[126] An established securities market includes (1) a national securities exchange that is registered under the Securities Exchange Act of 1934, (2) a securities exchange that is exempt from registration because of its limited volume of transactions,

[123] *See* Metzer, *supra* note 83, at 555-56 (stating that with such obligations, Congress had determined that the cash equivalency doctrine should prevail over the installment method); Michel, *supra* note 31, at 236 (stating that the Code apparently defines a cash equivalent as only the obligations that are considered as payments for purposes of section 453). According to the legislative history, ordinary promissory notes are not included within the types of obligations that are treated as payments for purposes of the installment method, even though these notes may be assignable. *See* S. Rep. No. 91-552, at 111-12 (1969). One commentator describes these rules as relaxing the common law cash equivalency doctrine for purposes of section 453 by creating a scaled-down version of the doctrine. *See* John P. Steines, *Taxation of Corporate Distributions—Before and After TEFRA*, 68 Iowa L. Rev. 937, 962 n.106 (1983); *see also* Estate of Silverman v. Commissioner, 98 T.C. 54, 63-64 (1992) ("[W]hile Congress has created an exception to installment reporting based on the cash equivalence characteristics of certain obligations, it specifically enumerated the type of debt obligations which fell within the exception.").

[124] *See* Reg. § 15A.453-1(e).

[125] *See* Reg. § 15A.453-1(e)(4)(i), (ii).

[126] Reg. § 15A.453-1(e)(4)(iii).

and (3) any over-the-counter market, which is reflected by the existence of an interdealer quotation system.[127]

Under the convertible obligation category, an obligation is considered in a form designed to render it readily tradable in an established securities market if the obligation contains a right that allows the holder to convert the obligation either into (1) another obligation that would be treated as a payment under the regulations (*i.e.,* designed to render it readily tradable on an established securities market, payable on demand, containing interest coupons, or in registered form (except for those that the taxpayer establishes will not be readily tradable in an established securities market)) or (2) stock that is treated as readily tradable or designed to be readily tradable in an established securities market. If, however, the obligation is convertible only at substantial discount, the obligation will not be treated as designed to be readily tradable in an established securities market under this category.[128] A substantial discount is considered to exist if at the time of the issuance of the convertible obligation the fair market value of the obligation or stock into which the convertible obligation is convertible is less than 80% of the fair market value of the convertible obligation.[129] A substantial discount also exists if the right to convert the obligation into stock or an obligation that is readily tradable in an established securities market cannot be exercised within a period of one year from the date the convertible obligation is issued.[130] Other than these situations, whether a substantial discount exists depends on the particular facts and circumstances.[131]

Under the comparable obligations category, the determination of whether the issuer has other obligations of a comparable character that are readily tradable in an established securities market is based upon the particular facts and circumstances.[132] Factors to be considered include (but are not limited to) substantial similarity with respect to the security for the obligation, the

[127] Reg. § 15A.453-1(e)(4)(iv). An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer. *Id.*

[128] Reg. § 15A.453-1(e)(5)(i). One commentator has criticized the inclusion of this category of obligations as not supported by the statute and inconsistent with the legislative history. *See* Ginsburg, *supra* note 63, at 508-09.

[129] Reg. § 15A.453-1(e)(5)(ii).

[130] *Id.*

[131] *Id.*

[132] Reg. § 15A.453-1(e)(4)(ii)(B).

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number of obligations issued, the number of holders of such obligation, and the principal amount of the obligation.[133]

With regard to the final category of obligations designed to be readily tradable in an established securities market, the regulations provide no guidance on what it means to take steps necessary to create a market for obligations.[134] The Service has taken the position in a trial memorandum and field service advisory that "steps taken to create a market" need not involve an established securities market, but can be steps necessary to replicate the features of an organized market by ensuring liquidity;[135] however, the scant judicial authority interpreting this provision indicates that there need to be price quotes for the particular obligations that are set by a market.[136] Moreover, the Service's interpretation appears to be in conflict with the statutory language, which refers to obligations issued in a form designed to render such obligations "readily tradable in an established securities market."[137] Thus, it would seem

[133] *Id.*; *see* T.A.M. 1984–25–007 (Mar. 9, 1984) (analyzing facts and circumstances and concluding that two types of certificate issued by a purchaser were not comparable because of significant differences in the number of obligations issued, the total amount of each obligation, and the number of holders, and one certificate was registered, issued with coupons and publicly sold, while the other certificate was unregistered, without coupons and privately placed, which were characterized as major differences).

[134] Reg. § 15A.453-1(e)(4)(i)(A).

[135] *See* Respondent's Trial Memorandum at 54, Saba P'ship v. Commissioner, 78 T.C.M. (CCH) 684, 1999 T.C.M. (RIA) ¶ 99,359 (Nos. 1470-97, 1471-97), 1998 WL 35249371; F.S.A. 001968, 1996 WL 33320975 (Dec. 6, 1996). It should be noted that for purposes of private letter rulings, the Service has accepted the following types of representation as sufficient for apparently concluding that steps necessary to create a market for obligations have not been taken: the parties do not intend to seek the establishment of a securities market in which the particular obligations would be readily tradable, *see* P.L.R. 1980–49–078 (Sept. 12, 1980), the obligations will not be listed or traded on a national securities exchange or over-the-counter market, taxpayer does not believe that obligations will be regularly quoted by brokers or dealers, and it is anticipated that there will be no established trading market for the obligations, *see* P.L.R. 1986–35–009 (May 22, 1986). These rulings seem to suggest that the Service viewed a market for purposes of the "steps taken to create a market" as one that needs to be established in some form.

[136] *See* Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298, 384-86 (D.D.C. 2001), *rev'd on other grounds*, 314 F.3d 625 (D.C. Cir. 2003). In *Boca Investerings*, the agreement pertaining to the notes provided that the parties "agree (i) not to engage any broker or dealer to make a market" in the notes "and (ii) not to offer or list" the notes "in an established securities market." *Id.* at 385. The court concluded that this language confirmed the parties' intention not to take steps necessary to create a market for the notes. *Id.* at 386. The court further stated that the evidence demonstrates that the sale of the notes "was in no way consistent with the presence of an 'established securities market' or an 'over-the-counter market'" for the notes. *Id.* The court found that the sales of the notes "were negotiated with the buyers and there was no market to set the price," which is necessary for steps to be taken to create a market. *Id.*; *see also* Applegate v. Commissioner, 94 T.C. 696, 701 (1990) (stating that it is clear that the obligations were not readily tradable for purposes of sections 453(f)(4)(B) and 453(f)(5) based on the stipulation of the parties, which provided "[t]here is no established secondary market by which 'price later contracts' are bought and sold").

[137] *See* I.R.C. § 453(f)(5).

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that this category should only apply where there are steps taken to trade the obligations in either an established securities market or a market that involves price quotes.

V. Problems with Current Approach for Cash Equivalency

As detailed below, the cash equivalency doctrine presents both administrative and potential liquidity problems, which run counter to the key policies underlying the cash method. This Part examines these difficulties.

A. *Administrative*

The current cash equivalency doctrine suffers from several administrative problems.[138] First, as the discussion in Part III illustrates, a uniform standard is lacking for determining whether an obligation constitutes a cash equivalent.[139] There are apparently different standards for obligations received for services and those received for non-services.[140] Moreover, different tests exist within the sub-categories.[141] In particular, for non-service transactions, while the *Cowden* test may be the most popular formulation of cash equivalency, the courts and the Service have used other standards as well.[142] Furthermore, the proper test for the services situation also lacks clarity.[143]

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[138] *See* Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv. L. Rev. 1575, 1642 n.188 (1979) (noting that the cash equivalency doctrine has produced considerable litigation); Cain, *supra* note 52, at 125 (stating that "the taxation of promises to pay is a particularly difficult area" of federal tax law; while most of the difficulties involve sales of property, problems also occur in other transactions); *cf.* Soled, *supra* note 28, at 468 (stating that under the cash equivalency doctrine, courts have the greatest challenge in determining the taxation of instruments with transferability features and some value to third parties).

[139] *See* Llewellyn, *supra* note 24, at 1337 (stating that the test for cash equivalency has not been clearly articulated); Note, *supra* note 26, at 1202 (stating that the treatment of notes received by cash method taxpayers is much less uniform than the treatment of checks).

[140] *See supra* Part III.C; Michel, *supra* note 31, at 227 (stating that adding to the confusion, one definition of cash equivalency is used in the services context and another is used for all other situations); *cf.* Michael B. Lang et al., Federal Tax Accounting 55 (2d ed. 2011) (describing Regulation section 1.61-2(d)(4), which applies a "received in payment" standard to obligations received for services as "making things murkier").

[141] In this regard, Judge Tannenwald, who dissented in the Tax Court's decision in *Warren Jones*, criticized the majority for escalating the no substantial discount element into a governing criterion and thus ignoring prior Tax Court decisions where the existence of a substantial discount did not prevent the court from finding that an obligation was marketable. *See* Warren Jones v. Commissioner, 60 T.C. 663, 671 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975).

[142] *See supra* Part III.C.1. Indeed, in F.S.A. 2001–51–003, (Dec. 21, 2001), the Service referred to the *Cowden* test, intended as payment test, and negotiability test in discussing the cash equivalency doctrine.

[143] *See supra* Part III.C.2; Brisendine et al., *supra* note 63, at VII.C (stating that the exclusion of unfunded and unsecured notes from the definition of property under section 83 along with Regulation section 1.61-2(d)(4) without explanation has created some confusion and a lack of clarity as to the applicable cash equivalency standards for notes given for services).

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There is also uncertainty in applying the particular tests, which involve imprecise criteria and require fact-intensive inquiries.[144] For example, the *Cowden* test requires a determination of whether an obligation is of a kind that is frequently transferred at a discount that is not substantially greater than the generally prevailing premium for the use of money.[145] Whether transfers are frequent enough, or discounts not substantial enough, to satisfy this criterion is far from clear.[146] Moreover, facts aside from the particular transaction may need to be evaluated to apply this criterion. This evaluation may include determining what is the generally prevailing premium for the use of money, and comparing the subject obligation to similar obligations with known discount rates to determine whether the subject obligation is of the same kind. Whether obligations of the same type are being frequently transferred at standard discount rates would also need to be determined. For example, in three private letter rulings, the Service concluded that lottery prize payments in the form of an annuity were not cash equivalents because there were no prevailing market rate discounts applied to such obligations, but rather discounts were negotiated on a case-by-case basis, based on evidence of sales of similar obligations in other states.[147] In addition, the solvency of the obligor needs to be determined.[148] The *Cowden* test also has legal uncertainties, such as whether a separate instrument is required,[149] and whether an obligation that is conditional can be a cash equivalent once the condition is satisfied.[150]

Likewise, a test that looks to whether an obligation is readily marketable and immediately convertible to cash raises serious uncertainties, given the need to examine the facts and circumstances to make this determination. Indeed, as discussed by the Ninth Circuit in *Warren Jones v. Commissioner*, the legislative history to section 1001 indicates the administrative difficulties associated with a readily marketable standard.[151] As a result of the Revenue Act of 1921, the predecessor to section 1001(b) provided that for gain or loss to be recognized on an exchange of property, the property received in the exchange,

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[144] *See* Llewellyn, *supra* note 24, at 1337 (stating that determining the tax consequences of promises to pay requires the resolution of complex marketability and valuation issues).

[145] *See supra* note 62 and accompanying text.

[146] *See* Willis, *supra* note 40, at 8 (stating the meaning of "substantial" is not clear).

[147] *See* P.L.R. 2000–31–031 (May 5, 2000); P.L.R. 1996–39–016 (June 17, 1996); P.L.R. 1996–24–009 (March 12, 1996).

[148] *See supra* note 62 and accompanying text.

[149] *See supra* notes 65-69 and accompanying text.

[150] *See supra* note 64. Another legal question of sorts under the *Cowden* test is the treatment accorded to a so-called junk bond that is regularly traded in an established securities market. Because of its status as a junk bond, its value reflects a large discount below its face amount and thus seems not to qualify as a cash equivalent under the *Cowden* test. Nevertheless, because it is regularly traded in an established securities market, the bond is highly liquid, and thus seems to be able to function like cash. I thank David Elkins for raising this question on the TaxProf listserv.

[151] *See* Warren Jones v. Commissioner, 524 F.2d 788, 791-92 (9th Cir. 1975).

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which included a buyer's note, had to have a readily realizable market value.[152] The regulations interpreting this provision provided that property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property.[153] In the Revenue Act of 1924, however, Congress amended the statute to provide in effect that the amount realized on the disposition of property is the fair market value of the property received.[154] In connection with this change, the report of the Senate Finance Committee stated the following: "The question whether, in a given case, the property received in exchange has a readily realizable market value is a most difficult one, and the rulings on this question in given cases have been far from satisfactory. . . . The provision can not be applied with accuracy or consistency."[155] Thus, Congress has recognized the administrative problems caused by using a readily marketable standard.

The "intended as payment" standard raises similar concerns. In this regard, courts have considered several factors in determining the intent of the parties, including the testimony of the parties,[156] whether the notes would be negotiated or used as security, the nature of the documents, the debtor's ability to pay, and subsequent actions by the parties. [157] Indeed, as one commentator points out, because the obligor on the note must ultimately pay off the note, the difference between a note intended as payment and one that is not is elusive.[158]

B. *Liquidity*

Depending on the particular standard used, the current cash equivalency doctrine may present liquidity difficulties for taxpayers. The *Cowden* test's "frequently transferred at no substantial discount" criterion should avoid such problems. With this requirement, taxpayers needing cash to fund the tax liability that results from taxing the receipt of the obligation should be able to readily dispose of the obligation, and do so without incurring substantial losses on the sales vis-à-vis the face value of the obligation, which

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[152] Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230; *Warren Jones,* 524 F.2d at 791-92.

[153] Reg. 62, art. 1564 (1922); *Warren Jones,* 524 F.2d at 791.

[154] *See Warren Jones,* 524 F.2d at 792.

[155] *Id.* (quoting S. Rep. No. 68-398 (1924)).

[156] *See* Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1939); Williams v. Commissioner, 28 T.C. 1000, 1000-02 (1957).

[157] *See* Scott, *supra* note 28, at 37, 38.

[158] *See* Willis, *supra* note 40, at 3.

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arguably prevents unfairness.[159] In contrast, under the "intended as payment" standard, an obligation may be viewed as so intended and therefore treated as a cash equivalent, even though the obligation may be difficult to sell, or the taxpayer may only be able to sell the obligation at a substantial discount, and thereby be forced to sacrifice a portion of her right to collect income.[160] Some commentators, however, would only find intent where there is marketability with reasonable discounts.[161] This version of an intent test could avoid liquidity difficulties.

VI. Proposal to Use "Readily Tradable in an Established Securities Market" Standard to Determine Cash Equivalency

A. *Proposal*

1. *Definition of Cash Equivalents*

To avoid the problems created by the current approaches to defining cash equivalents, this Article proposes that a cash equivalent be defined as an obligation that is designed to be readily tradable in an established securities market.[162] Under this approach, in situations where the cash equivalency doctrine

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[159] *See* Willis, *supra* note 40, at 7 (viewing the *Cowden* "no substantial discount" requirement as preventing this arguable unfairness); *cf. Warren Jones*, 524 F.2d at 790 (stating that the Tax Court, in determining that the particular obligation was not a cash equivalent because of its substantial discount, observed that requiring the taxpayer to include the particular obligation in income in the year of sale could create substantial hardships for the taxpayer, because this might require the taxpayer to sell the obligation at its fair market value, which otherwise might not be necessary or advantageous).

[160] *Cf.* Butler, *supra* note 45, at 85 (pointing this out as a problem with a readily ascertainable fair market value approach to cash equivalency, which would ignore the presence of significant discounts). Besides the costs of illiquidity in terms of the costs associated with selling property to pay taxes, illiquid taxpayers may alternatively raise cash to pay taxes in other ways, such as by reducing consumption or using savings. *See* Hayashi, *supra* note 32, at 11.

[161] *See supra* notes 92-93 and accompanying text.

[162] Other proposals have been made to reform the cash equivalency doctrine. One commentator has proposed that a single definition be used for purposes of a cash equivalent, property under section 1001(b), and payment under section 453. *See* Michel, *supra* note 31, at 243. This would be an obligation that is readily marketable or immediately convertible into cash, which would be determined based on the following characteristics with respect to an obligation: security, personal liability, obligor's financial status, time to maturity, size of the discount, and transferability. *See* Michel, *supra,* at 244-50. Another commentator has recommended that the intent of the parties should be paramount in determining cash equivalency. *See* Llewellyn, *supra* note 24, at 1351-53. Under this approach, whether a promise is intended as payment should be based largely on objective evidence, such as the marketability of the obligation at reasonable discounts. *See* Llewellyn, *supra*. Another commentator has recommended that the doctrine (which, according to him, defines a cash equivalent as an obligation accepted in payment) be eliminated in favor of a rule that taxes cash method payees when they actually receive payments on the obligations, subject to the constructive receipt doctrine (which he feels is more rational, realistic and sufficient to prevent unwarranted deferral of income inclusions). *See* Brandis, *supra* note 81, at 124-25.

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applies, a cash method taxpayer who receives an obligation of her counterparty would include into income the obligation's fair market value if the obligation is designed to be readily tradable in an established securities market. These obligations should include the categories of obligations described in the regulations under section 453: (1) obligations that are readily tradable in an established securities market, (2) certain convertible obligations, (3) obligations that are of a comparable character to other obligations of the issuer that are readily tradable in an established securities market, or (4) obligations with respect to which steps necessary to create a market for the obligations are taken.[163] The rationale for the proposed definition of a cash equivalent is provided below.[164]

To be consistent with the definition of payment for purposes of section 453, we should give consideration to including other obligations within the definition of cash equivalents, that is, obligations with interest coupons, obligations in registered form (except for those that the taxpayer establishes will not be readily tradable in an established securities market), as well as obligations that are secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or Treasury note.[165] In addition, while the section 453 definition of payment also includes obligations that are payable on demand, it may not be necessary to include demand obligations within the definition of cash equivalents, given that the receipt of such obligations should result in inclusions to cash method taxpayers in any event under the constructive receipt doctrine.[166] Note, however, that payments for purposes of the installment method also include amounts constructively received,[167] and it may be advisable to include demand obligations within the definition

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[163] *See supra* Part IV.B.2.

[164] *See infra* Part VI.B.

[165] *See supra* notes 116-119 and accompanying text.

[166] *See* Reg. § 1.451-2; Denver & Rio Grande W. R.R. Co. v. United States, 318 F.2d 922, 924 (Ct. Cl. 1963) (finding constructive receipt where taxpayer received a "car note" that called for the payment of cars at a fixed value that could be obtained immediately or anytime up to a certain date); White, *supra* note 24, at IV.B(1)(a)(1) (pointing out that in the case of demand obligations, the doctrines of cash equivalence and constructive receipt overlap); *cf.* Michel, *supra* note 31, at 237 n.73 (stating that while notes payable on demand could be taxed under a constructive receipt theory, the legislative history to section 453(f)(4) supports a cash equivalence basis for taxing these notes).

[167] Reg. § 15A.453-1(b)(3)(i).

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of cash equivalents to create a bright-line rule for inclusion, rather than subject such obligations to the constructive receipt doctrine.[168]

The proposed test for cash equivalency would likely be more restrictive than the current standard, and thus some obligations that would be cash equivalents under current law would not be under the proposed test.[169] For example, assume that a cash method taxpayer performs services for another party, and in return receives an unsecured obligation of that party that calls for a future payment. The obligation is negotiable and freely assignable, but the obligation is not designed to be readily tradable in an established securities market (as described above), does not have interest coupons, is not in registered form, and is not payable on demand. Although the obligation may be a cash equivalent under the current common law approach because it is negotiable and freely assignable,[170] it will not be a cash equivalent under the proposed

[168] Whether Treasury would have the authority to promulgate regulations adopting the proposed definition of a cash equivalent is not completely clear. On the one hand, section 451 appears to provide such authority by stating that "[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." *See* I.R.C. § 451(a). Treasury has used this authority, for example, in prescribing detailed rules for the constructive receipt of income items. *See* Reg. § 1.451-2. And as discussed previously, the Service has published revenue rulings addressing the cash equivalency of obligations. The definition of payment that is used for purposes of the installment method is, however, contained in the statute, *see* I.R.C. § 453(f)(3)-(5), which may suggest that Congress would need to similarly act to extend the use of this definition for cash equivalency.

[169] *Cf.* Davies, *supra* note 83, at 320 (discussing how some negotiable and marketable obligations that would be cash equivalents under the common law standards would not be payments for purposes of the installment method under the more lenient test for payment (from a taxpayer's perspective) contained in section 453, because the obligations are not readily tradable in an established securities market); Steines, *supra* note 123, at 962 n.106 (referring to the rules defining payment for purposes of section 453 as a scaled-down version of the common law cash equivalency doctrine); Estate of Silverman v. Commissioner, 98 T.C. 54, 63-64 (1992) ("[W]hile Congress has created an exception to installment reporting based on the cash equivalence characteristics of certain obligations, it specifically enumerated the type of debt obligations which fell within the exception.").

[170] *See supra* Part III.C.

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definition.[171] A stricter test for cash equivalency produces some administrative benefits and raises some concerns, which are discussed below.[172]

2. *Scope of Cash Equivalency Doctrine*

As a part of this effort to clarify the cash equivalency doctrine, Congress should also clarify the scope of the doctrine. To this end, Congress should specify that cash equivalency is irrelevant for purposes of section 1001(b) and that a deferred-payment obligation is taken into account in determining the amount realized on the disposition of property regardless of whether the obligation is a cash equivalent.[173] While this is apparently the holding of the seminal case of *Warren Jones v. Commissioner*,[174] and is implied under the current regulations under section 1001, there is some uncertainty based on contrary authority in the Fifth Circuit.[175] The rationale for making cash equivalency irrelevant for purposes of section 1001(b) is that otherwise, cash method taxpayers who receive deferred-payment obligations that are not cash equivalents on dispositions of property not subject to section 453 would nonetheless be able to defer the recognition of gain until the taxpayer's basis in the property was fully recovered. This is to be compared to the ratable recovery of basis that occurs under the installment method of reporting gain.[176] Since deferred-payment obligations would typically not be cash equivalents under either current law or this Article's proposal, cash method sellers would typically receive more generous deferral of gain recognition by either electing out of section 453 or not qualifying for installment method treatment, a result that conflicts with the current Congressional scheme under section 453 of prescribing a certain method for basis recovery and exceptions to the use of this method.[177]

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[171] *Cf.* Reg. § 15A.453-1(e)(4)(v), Ex. (1) (addressing an obligation with similar features in connection with the sale of property and concluding that the obligation is not a payment for purposes of the installment method); S. Rep. No. 91-552, at 111-12 (1969) (in connection with the adoption of the definition of payment for purposes of the installment method, stating that ordinary promissory notes are not intended to be included within the category of indebtedness that is treated as payments, even though it is possible for these notes to be assignable).

[172] *See infra* Parts VI.B.2.b.ii, VI.B.2.b.iii, VI.B.2.d. Another effect of the proposed definition of cash equivalents is that taxpayers and their advisers may be more willing to structure second-party promises to pay that permit assignments. As mentioned previously, commentators and practitioners recommend that second-party promises be non-assignable to prevent cash equivalency. *See supra* note 63. To the extent that the proposed definition causes parties to refrain from making second-party promises non-assignable, the proposal would produce efficiency benefits by removing a tax impediment to achieving the parties' non-tax objectives.

[173] *See* Llewellyn, *supra* note 24, at 1341 (urging the adoption of the view that cash equivalence is not required under section 1001(b)).

[174] Warren Jones v. Commissioner, 524 F.2d 788 (9th Cir. 1975).

[175] *See supra* note 112 and accompanying text.

[176] *See supra* notes 100-101 and accompanying text.

[177] *See supra* notes 114-115 and accompanying text. *But cf.* Skinner, *supra* note 78, at 363 (stating that it seems harsh to require cash method taxpayers to include in the amount realized the value of certain highly contingent, nonassignable obligations that are not eligible for installment method reporting).

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B. *Rationale for Proposed Definition of Cash Equivalents*

1. *The Benefits of a Single Test*

A single test for cash equivalency would have clear administrative benefits over the multiple tests that exist under current law. First and foremost, a single test for cash equivalency would eliminate the current confusion over the applicable test.[178] A single standard would also result in less of a burden for all of the parties involved in tax administration—the taxpayers (and their advisers), the Service and Treasury, and the courts—because these parties would only have one standard to know and apply.[179] In this regard, the Joint Committee on Taxation, in a simplification study of the federal tax system, acknowledged the added complexity caused by having duplicative rules.[180]

Moreover, there does not appear to be any reason for using different tests to determine whether an obligation is a cash equivalent. Certainly, using different standards for obligations received for the same type of items lacks any justification. The reason that the tests vary somewhat under current law is that different courts and the Service have developed and used different tests in the absence of a statutory or regulatory standard. And the apparently separate test for obligations received for the performance of services does not seem founded on any principled basis. The policy considerations involved—mainly simplicity and liquidity—seem to call for the same standard regardless of whether the obligations are received for the performance of services, the use of tangible property, or any other item.

Given the administrative advantages of using a single test for cash equivalency and the lack of any justification for using different tests for different situations, a single test should be used. The next section evaluates the competing tests and makes the case for defining a cash equivalent as an obligation that is designed to be readily tradable in an established securities market.

2. *Selecting the Single Test for Cash Equivalency*

a. *Criteria for Evaluating Tests for Cash Equivalency.* The criteria for evaluating a test for cash equivalency should of course be based on the relevant policies involved. These should include the following: the need to prevent the blurring of the cash and accrual methods with regard to rights to receive income;[181] the objective to limit cash equivalents to obligations that

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[178] *See supra* Part III.C.

[179] See Fred B. Brown, *Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Polices: A Simpler, More Rational, and More Unified Approach*, 67 Mo. L. Rev. 705, 728 (2002).

[180] *See* Brown, *supra* note 179, at 728 (citing Staff of Joint Committee on Taxation, Study of the Overall State of the Federal Tax System & Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (2001)).

[181] *See supra* notes 45-48 and accompanying text.

sufficiently function like cash;[182] the need to promote the simplicity policy that underlies the cash method;[183] and the need to promote the liquidity policy that underlies the cash method.[184]

Finally, while not previously articulated as a policy that relates to the cash method or cash equivalency, it is sensible to consider whether the standard for cash equivalency is consistent with application of section 453's installment method of reporting. Otherwise, a cash method taxpayer may have an inclusion on the receipt of a certain deferred-payment obligation in exchange for the use of property or provision of services, while a cash method taxpayer or (even) an accrual method taxpayer may not have to recognize income upon receiving the same obligation under the installment method on the sale of property. The application of each of these criteria to the proposed test, as well as to competing tests, is addressed below.

b. *Evaluating the Proposed Test.*

i. *Preventing the Blurring of the Cash and Accrual Methods for Rights to Receive Income.* Under the proposed test, a cash method taxpayer would be taxed on the receipt of a second-party promise to pay only if the promise to pay was embodied in an obligation that is designed to be readily tradable in an established securities market, contains interest coupons, is in registered form (generally), or is payable on demand. Consequently, the proposed test, limited to these discreet obligations, would certainly prevent cash method taxpayers from effectively being placed on the accrual method with respect to all rights to receive income, and thus satisfy a crucial policy underlying the cash equivalency doctrine.

ii. *Limit Cash Equivalents to Obligations that Sufficiently Function Like Cash.* For the most part, the use of the proposed definition should ensure that obligations that sufficiently function like cash are treated as cash equivalents. As previously mentioned,[185] Congress included obligations meeting the proposed definition as payments in applying the installment method based on the view that taxpayers receiving such obligations have liquidity to pay tax on gains to the same extent as if they had received cash. Furthermore, the section 453 regulations, which are incorporated in the proposed definition of cash equivalents,[186] guard against manipulation by including obligations that are comparable to, or convertible into,

[182] *See supra* notes 46, 53-54 and accompanying text.
[183] *See supra* notes 26-30 and accompanying text.
[184] *See supra* notes 31-34 and accompanying text.
[185] *See supra* notes 120-121 and accompanying text.
[186] *See supra* note 164 and accompanying text.

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obligations[187] that are readily tradable in an established securities market.[188] In addition, the "steps taken to create a market" category of obligations also prevents manipulation where the parties plan to take steps to trade the obligations in markets involving price quotes.[189]

Nevertheless, the proposed definition may be somewhat underinclusive in covering obligations that can function like cash. For example, a given obligation, although not readily tradable in an established securities market, may be of such a quality that it is readily accepted in the market place with no discount from its face amount, as a result of its interest rate and the credit worthiness of the obligor.[190] Thus, a particular obligation may function like cash, and not to treat it as a cash equivalent seems at odds with the principle that the substance rather than the form of a transaction should control.[191] Nonetheless, the proposed definition's bright-line approach to cash equivalency clearly has administrative benefits (addressed below), which appear to outweigh any under inclusiveness in treating obligations that function like cash as cash equivalents.[192]

iii. *Promotes the Simplicity Policy Underlying the Cash Method.* The use of the proposed definition would promote simplicity in the operation of the cash method, the key policy that underlies this tax accounting method.[193] A single standard for cash equivalency would obviously avoid the uncertainty that currently exists regarding the applicable test in a given situation. Moreover, a cash equivalency standard that requires an obligation to meet one of the prescribed categories of obligations should avoid the imprecise criteria and fact-intensive inquiry that exist with the current cash equivalency tests.[194]

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[187] Under the section 453 regulations, obligations convertible into stock that are traded in an established securities market are also included. *See supra* note 128 and accompanying text. Obligations convertible into readily tradable obligations or stock are not included if the holder would incur a substantial discount upon the conversion. *See supra* notes 128-132 and accompanying text.

[188] *See supra* notes 128-133 and accompanying text.

[189] *See supra* notes 134-137 and accompanying text.

[190] *Cf.* Warren Jones v. Commissioner, 60 T.C. 663, 669 (1973) (stating that the *Cowden* test as it pertains to the discount is very practical, in that it eschews a bright line in favor of a case-by-case approach for determining the amount of risk discount for a finding of cash equivalence).

[191] This may raise equity issues as well, given that taxpayers in similar situations may be treated differently, assuming an obligation that is readily tradable in an established securities market is sufficiently similar to one that otherwise can function like cash, for example, by satisfying the *Cowden* test.

[192] Moreover, to prevent taxpayers from borrowing against obligations that are not cash equivalents and avoiding inclusions on the loan proceeds received, the pledging rule that applies to certain installment obligations can be extended to obligations received by cash method taxpayers. *See infra* Part VII.

[193] *See supra* notes 26-30 and accompanying text.

[194] *Cf.* Brown, *supra* note 179, at 729-32 (discussing the administrative advantages of using a categorization approach versus a facts-and-circumstances approach in determining the standard for replacement property under the like kind and involuntary conversions rules).

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With the use of the precise definitions of established securities markets[195] and standards for determining readily tradable[196] contained in the section 453 regulations, whether an obligation meets the proposed standard usually should be fairly straightforward.

That said, fact-intensive inquiries would be necessary in some situations. Specifically, where an obligation is convertible into other obligations or stock that is readily tradable in an established securities market, the existence of substantial discount upon conversion would prevent the obligation from being a cash equivalent.[197] Determining the existence of a substantial discount is generally based on the facts and circumstances, although a few safe harbors are available for making this determination.[198] Another situation requiring a fact-intensive inquiry is where the issuer has other obligations that are readily tradable in an established securities market, which would then necessitate determining whether the issued obligation is comparable to the readily tradable obligations; this would require an examination of the facts and circumstances pertaining to the obligations.[199] Although these fact-specific inquiries involve administrative costs, they would only be necessary in limited situations. Finally, the "steps taken to create a market" category could create uncertainty if it is interpreted not to require an established securities market but only to require steps necessary to replicate the features of an organized market by ensuring liquidity, as the Service has contended.[200] In contrast, the limited case law interpreting this rule has required price quotes that are set by a market,[201] an interpretation that should avoid administrative difficulties in applying this rule.

As previously mentioned, the proposed test for cash equivalency is narrower than the current common law standard, [202] and this should produce some additional administrative benefits. With a narrower test, there would be fewer situations where obligations are treated as cash equivalents, and thus fewer situations where the fair market value of the obligations needs to be determined. And in these situations, the fair market value determination is likely to be easier as compared to current law, because the value is likely determinable based on a market price for the obligation.[203] In addition, with fewer instances of cash equivalency, taxpayers would be called upon less often to

[195] *See supra* note 127 and accompanying text.
[196] *See supra* note 126 and accompanying text.
[197] *See supra* note 128 and accompanying text.
[198] *See supra* notes 129-131 and accompanying text.
[199] *See supra* notes 132-133 and accompanying text.
[200] *See supra* note 135 and accompanying text.
[201] *See supra* note 136 and accompanying text.
[202] *See supra* notes 169-171 and accompanying text.
[203] This follows from the fact that most obligations treated as cash equivalents under the proposed test would be readily tradable in an established securities market.

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reconcile and account for any differences between amounts included on the receipt of the rights and the payments ultimately received.[204]

vi. *Promotes the Liquidity Policy Underlying the Cash Method.* The proposed definition would also avoid any liquidity problems for taxpayers, which potentially arise under the current cash equivalency doctrine. As the legislative history to section 453 indicates, payment in the section 453 context includes obligations that are designed to be readily tradable in an established securities market because taxpayers are liquid to the extent of such obligations.[205]

v. *Brings on Consistent Treatment Between the Cash Method and Section 453.* Finally, the proposed test for cash equivalency would bring on consistent treatment between the cash method and section 453 with regard to the receipt of two-party obligations. Currently, a cash method taxpayer who receives a second-party obligation that meets the governing cash equivalent test,[206] but is not designed to be readily tradable in an established securities market (and not containing interest coupons, in registered form, payable on demand, or secured directly or indirectly by cash or a cash equivalent) would have to include into income the fair market value of the obligation upon receipt.[207] In contrast, a taxpayer reporting gain under the installment method who receives the same obligation would not be treated as receiving a payment for purposes of recognizing gain. Given that sales of property are generally subject to section 453 (albeit with significant exceptions for sales of inventory, dealer property, publicly-traded stocks and securities, property with recapture income, and depreciable property to controlled entities),[208] cash method taxpayers are generally subject to markedly different standards on the receipt of obligations for sales of property versus other transactions, a distinction without any apparent policy justification. Indeed, the current inconsistency is quite pronounced in that under section 453 an accrual method taxpayer would not have a payment (and therefore the recognition of gain) on the receipt of an obligation that satisfies the governing cash equivalency test yet is not readily tradable in an established securities market,[209] but a cash method taxpayer would have an income inclusion where the same obli-

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[204] *See supra* note 51 and accompanying text.

[205] *See supra* notes 120-121 and accompanying text. As mentioned previously, Congress included these obligations as payments in applying the installment method based on the view that taxpayers receiving such obligations have liquidity to pay tax on gains to the same extent as if they had received cash. *See supra* notes 120-121.

[206] This could be the *Cowden* test, the "received in payment" test, or some other standard. *See supra* Part III.C.

[207] *Cf.* Davies, *supra* note 83, at 320 (pointing out that a note that is not readily tradable in an established securities market can still be a cash equivalent if legally negotiable and marketable).

[208] *See supra* note 114 and accompanying text.

[209] *See* I.R.C. § 453(f)(3), (4). This assumes that the obligation does not contain interest coupons, is not in registered form, is not payable on demand, and is not secured directly or indirectly by cash or a cash equivalent.

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gation is received in a transaction other than the sale of property. Presumably, the cash method taxpayer needs the benefits of liquidity and simplicity to a greater extent than an accrual method taxpayer receiving an obligation in exchange for property, given that compared to cash method taxpayers, accrual method taxpayers tend to be larger and more sophisticated financially,[210] and accustomed to including amounts prior to the receipt of cash, checks, or cash equivalents under the all events test.[211]

Of course, because of significant exceptions, not all deferred-payment sales receive the benefit of the installment method.[212] Thus, for transactions involving inventory, dealer property and publicly-traded stocks and securities, taxpayers are not eligible for the installment method and are apparently required to include deferred-payment obligations in their amount realized under section 1001(b) regardless of whether the obligations are cash equivalents.[213] Therefore, this may slightly weaken the argument that consistency between the definitions of cash equivalents and payments for purposes of the installment method is important, because many deferred-payment sales of property do not benefit from the section 453 definition of payment.

For the most part, however, the taxpayers who are denied installment method treatment presumably can manage their liquidity—dealers with respect to the property involved and sellers of publicly traded stocks and securities.[214] On the other hand, the taxpayers who are permitted to use the installment method would presumably experience liquidity difficulties on deferred-payment transactions in the absence of relief. Consequently, rather than consider all sellers of property in comparing the treatment to cash method taxpayers with respect to deferred-payment obligations, considering only taxpayers eligible for installment method reporting is more appropriate because they are similar to cash method taxpayers with regard to perceived liquidity. Stated differently, horizontal equity supports using the same definition for both cash equivalents and payment for purposes of section 453

[210] In this regard, section 448 generally prevents C corporations and partnerships with C corporations as partners from using the cash method unless a corporation is a qualified personal service corporation or a corporation or partnership (as the case may be) satisfies a $25 million average annual gross receipts test. *See* I.R.C. § 448(a), (b).

[211] Reg. § 1.446-1(c)(1)(ii). Similar sentiments originally led Congress in 1999 to prevent accrual method taxpayers from using the installment method, although Congress reversed itself one year later and reinstated retroactively the availability of the installment method for accrual method taxpayers. *See* S. Rep. No. 106-201, at 38 (1999) (stating that the installment method is inconsistent with the accrual method in that income be reported in the period it is earned, rather than the period it is received); I.R.C. § 453(a)(2) (prior to 2000); Installment Tax Correction Act of 2000, Pub. L. No. 106-573, 114 Stat. 3061.

[212] *See supra* note 114 and accompanying text.

[213] *See supra* Part IV.A.

[214] In addition, the installment method is also denied to sales of property with recapture income (to the extent of such income) and sales of depreciable property to controlled entities. *See supra* note 114 and accompanying text.

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because cash method taxpayers and taxpayers eligible for installment method reporting are similarly situated with respect to perceived liquidity.[215]

c. *A Single, Fact-Intensive Test Would Not Achieve the Same Benefits.* As an alternative, a single, fact-intensive test could be used instead of a test that requires that an obligation be designed to be readily tradable in an established securities market. Such a test could be based, for example, on the "received in payment" standard contained in the regulations under section 61 or the *Cowden* requirements for cash equivalency.[216]

i. *Received in Payment Test.* Although it prevents the blurring of the cash and accrual methods for rights to receive income, a test for cash equivalency based on the "received in payment" standard does not satisfy several of the desired policy objectives mentioned above. First, if this test is based on the intent of the parties to a transaction, the fact that the parties intend that an obligation serve as payment seems to have no effect on whether the obligation is marketable and can function like cash.[217] In addition, as described previously,[218] an intent test raises both administrative and liquidity concerns, thus failing to promote the simplicity and liquidity policies that underlie the cash method of accounting. And because this test differs considerably from the effective cash equivalency test used for purposes of the installment method, consistent treatment with section 453 is not achieved. In contrast, if such a test is determined based on objective evidence of the

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[215] It is worth noting that there may be different treatment of the obligor in the installment sale context verses the situations where cash equivalency is relevant, but this does not seem to justify using a different test for payment under section 453 and cash equivalents. Specifically, in the installment sale context, the obligor acquiring property would typically capitalize the amount of the deferred payments and include this amount in the basis of the acquired property (unless the cost was immediately deductible under section 168(k) or section 179), which could then be deducted over time if the property is depreciable. *See* I.R.C. §§ 1012, 167, 168. In the situations where cash equivalence is relevant (*e.g.*, performance of services, leases of property), the obligor, if using the accrual method, may be able to deduct the amount of the deferred payments upon incurring the obligations, although capitalization of this amount may be required in some circumstances, and an employer's deduction for deferred compensation under a nonqualified plan will be delayed until the employee includes the compensation in income. *See* I.R.C. §§ 461, 162, 404(a)(5); Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2). Nevertheless, any difference in the timing of the obligor's deduction for the deferred payments does not seem to support a more stringent test for payment in the installment sale context as compared to that for cash equivalency.

[216] Alternatively, as recommended by a commentator, a fact-intensive standard could require that an obligation be readily marketable or immediately convertible into cash, based on certain characteristics pertaining to the obligations. *See supra* note 162.

[217] Indeed, one commentator argues that whether a note is intended as payment or not seems like a highly legalistic basis for determining tax consequences because, whether so intended or not, the payee still ends up with the same note (same value and other attributes). *See* Brandis, *supra* note 81, at 95-96. Similarly, Judge Learned Hand questioned the application of the intended as payment test in *Schlemmer v. United States*, commenting that even if the note has been so intended, the note did not change the substance of the debt. *See* Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938).

[218] *See supra* notes 156-158, 160 and accompanying text.

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marketability of the obligation at reasonable discounts, which some commentators have proposed,[219] valuation and liquidity concerns can be abated. Nevertheless, there are still administrative concerns in applying such a fact-intensive test, as well as the inconsistency with the application of the installment method of reporting.

ii. Cowden *Test.* The use of the *Cowden* test prevents the blurring of the cash and accrual methods for rights to receive income and should ensure that obligations meeting the standard function like cash and are easily valued and liquid. Unfortunately, the administrative difficulties that were previously mentioned would exist.[220] These include the need to determine whether the obligation is frequently traded at a discount that is not substantially greater than the generally prevailing premium for the use of money, which may not always be apparent without a detailed factual analysis,[221] as well as the solvency of the obligor.[222] Moreover, using the *Cowden* test results in inconsistent treatment with the operation of the installment method of reporting.

d. *Bright-Line Rule vs. Facts & Circumstances Standard.* Of course, there are always trade-offs in the use of a bright-line rule versus a standard that can take into account the facts and circumstances of a particular situation: while the former can promote administrative ease, the latter can allow for results that are more precise in terms of effectuating a particular policy.[223] This may be the case in some situations with the use of the proposed test as opposed to a facts-and-circumstances approach to cash equivalency. In particular, as previously mentioned, a given obligation, although not readily tradable in an established securities market, may be of such a quality

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[219] *See supra* note 161 and accompanying text.

[220] *See supra* notes 145-148 and accompanying text.

[221] *See supra* notes 145-148 and accompanying text. This should be compared to the proposed test, under which the determination of whether an obligation can be converted at a substantial discount plays a very limited role. The proposed test only requires such a determination if the obligation contains a right that allows the holder to covert the obligation either into another obligation that would be treated as a cash equivalent under the test, or stock that is treated as readily tradable or designed to be readily tradable in an established securities market; if the obligation is convertible only at a substantial discount, the obligation will not be treated as a cash equivalent even though it contains the aforementioned conversion right. *See supra* note 128 and accompanying text. Moreover, the section 453 regulations provide safe harbors for determining whether a substantial discount exists for this purpose. *See supra* notes 129-130 and accompanying text. In contrast, provided that the other requirements are satisfied, the *Cowden* test will always require a determination of whether the obligation is frequently traded at a discount that is not substantial. *See supra* notes 145-147 and accompanying text.

[222] *See supra* note 148 and accompanying text.

[223] *See* David A. Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 861 (1999) (referring to the usual assumption that "[r]ules are over and underinclusive relative to underlying norms but, because they are simple, rules are certain, easy to apply, and uniform. Standards better conform to the purposes underlying the law, but they are more uncertain and apply less uniformly" (citing to other authorities); however, arguing that rules are typically more complex than standards).

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that it is readily accepted in the market place with no discount from its face amount, as a result of its interest rate and the credit worthiness of the obligor.[224] This (likely rare) benefit of a fact-intensive approach seems, however, outweighed by simplicity concerns that are the primary basis for the cash method of accounting.

e. *Proposed Definition Would Result in a Single Test for Cash Equivalency Under the Cash and Installment Methods, Which is Frequently Used Under the Code.* The proposed definition of cash equivalents would have the added administrative benefit of using a single test for cash equivalency under the cash method and payment under section 453's installment method of reporting. With the proposed test for cash equivalency, the body of law that constitutes the current common law cash equivalency doctrine can be eliminated. As previously mentioned, eliminating duplicative rules helps to simplify the federal tax laws.[225]

Moreover, the standard of being readily tradable in an established securities market, which substantially constitutes the proposed definition, is frequently used under the Code, thus suggesting it is a very workable and reliable standard. At least 15 provisions use this standard (or a very similar standard), including sections 280G,[226] 351,[227] 409,[228] 453(k),[229] 469,[230] 664,[231] 871,[232] 897,[233] 1042,[234] 1445,[235] 2701,[236] 3406,[237] 6166,[238] 6664,[239] and 7704.[240] Consequently, the adoption of the proposed definition for cash equivalency would replace one-off common law standards with a dependable test that is widely used under the Code, helping to streamline and simplify the tax law.

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[224] *See supra* notes 190-191 and accompanying text.

[225] *See supra* notes 179-180 and accompanying text.

[226] I.R.C. § 280G(b)(5)(A)(ii)(I).

[227] I.R.C. § 351(g)(2)(C)(ii)(I).

[228] I.R.C. § 409(h)(1)(B).

[229] I.R.C. § 453(k)(2)(A) ("[T]raded on an established securities market").

[230] I.R.C. § 469(k)(2) ("[T]raded on an established securities market" or "readily tradable on a secondary market (or the substantial equivalent thereof)").

[231] I.R.C. § 664(g)(4)(A).

[232] I.R.C. § 871(m)(3)(A)(iii).

[233] I.R.C. § 897(c)(3).

[234] I.R.C. § 1042(c)(1)(A).

[235] I.R.C. § 1445(b)(6).

[236] I.R.C. § 2701(a)(2)(A) ("[M]arket quotations are readily available (as of the date of the transfer) for such interest on an established securities market").

[237] I.R.C. § 3406(h)(6).

[238] I.R.C. § 6166(b)(7)(B) ("[N]o market on a stock exchange or in an over-the-counter market").

[239] I.R.C. § 6664(c)(4)(A) ("[R]eadily available on an established securities market").

[240] I.R.C. § 7704(b) ("[T]raded on an established securities market" or "readily tradable on a secondary market (or the substantial equivalent thereof)").

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VII. Considering Additional Measures to Prevent Possible Abuse

Along with the proposed definition of cash equivalents, consideration should be given to adopting additional measures to prevent potential abuse. While the proposed definition incorporates certain rules aimed at preventing manipulation—the categories pertaining to obligations that are comparable to, or convertible into, obligations that are readily tradable in an established securities market, as well as the "steps taken to create a market" category of obligations[241]—other measures that apply in the installment sale context should also be considered.[242] These are the pledging rule and the related party, second disposition rule.

A. *Pledging Rule*

With the proposed definition of cash equivalents, a cash method taxpayer who receives an obligation that is freely transferable yet is not a cash equivalent (because it is not designed to be readily tradable in an established securities market, does not have interest coupons, is not in registered form, and is not payable on demand) may be tempted to pledge the obligation for a loan, and thus have access to the loan proceeds while avoiding an income inclusion on the receipt of the obligation. Concerns over similar behavior in the installment sale context led to the enactment of section 453A(d),[243] which, with respect to installment sales in excess of $150,000, treats the receipt of loan proceeds pursuant to pledging an installment obligation as the receipt of payment on the installment sale.[244]

Consequently, with the proposed definition, a similar measure may be appropriate for situations where obligations received by cash method taxpayers are pledged as security for a loan. While taxpayers may be taking advantage of the current cash equivalency doctrine to pledge obligations for cash while avoiding current income, the proposed definition of cash equivalents may present more opportunities where taxpayers can avail themselves of this technique, given that freely transferable obligations would not constitute cash equivalents unless they are designed to be readily tradable in an established securities market or meet one of the other conditions for cash equivalency.[245]

To address this concern, Congress could broaden the pledging rule of section 453A(d) to include the pledging of an obligation by a cash method taxpayer, where the obligation is a second-party promise to pay that is not a cash equivalent. Under this approach, the loan proceeds received upon pledging the obligation would be treated as the receipt of cash with respect to the

[241] *See supra* note 163 and accompanying text.

[242] It should be noted that the need for additional rules to guard against abuse does increase the administrative costs of using the proposed definition of cash equivalency.

[243] *See* James J. Freeland, et al., Fundamentals of Federal Income Taxation 783 (17th ed. 2013).

[244] *See* I.R.C. § 453A(a), (b), (d).

[245] *See supra* Part VI.A.1.

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transaction in which the obligation was received, thus resulting in an income inclusion under the cash method upon the receipt of the loan proceeds.

B. *Related Party, Second Disposition Rule*

Another anti-abuse rule that applies in the installment sale context—the related party, second disposition rule under section 453(e)—should also be considered with the proposed test for cash equivalency. Section 453(e) was enacted to address the situation where a taxpayer sells property to a related person using an installment sale, and the related person then resells the property to another person for cash.[246] Absent section 453(e), the initial seller would recognize gain on the first disposition under the installment method even though the related party group (consisting of the initial seller and the related person) is in possession of the cash proceeds from the second disposition. It is important to note that the related person would likely have no gain on the second disposition if the property is resold shortly after its purchase, because her basis in the acquired property would include the amount of the installment obligation on the first disposition.[247] Section 453(e) responds to this situation by generally treating the proceeds of the second disposition as a payment received by the initial seller at the time of the second disposition, thus causing the initial seller to recognize gain with respect to the first disposition.[248]

In the context of deferred-payment obligations received by cash method taxpayers, it may not be necessary to apply an approach like section 453(e) to address any perceived abuse, although this measure should be considered. To illustrate a scenario that gives rise to possible abuse, assume that a cash method taxpayer agrees to perform certain services for a related person in exchange for an unsecured deferred-payment obligation of the related person that is not a cash equivalent under the proposed test. Prior to the performance of the services, the related person transfers the right to receive the services (which is assignable) to an unrelated person in exchange for cash. Similar to situations involving second dispositions by related persons in the installment sale context, the concern is that the service provider is able to defer income until she receives payment on the related person's obligation even though the related group (consisting of the service provider and the related person) is in possession of cash as a result of the assignment of the right to the services to another person. It is not clear in this context, however, whether the related person would receive a basis in the right to receive the services that is equal to the amount of her obligation to the service provider; instead, the related person's basis may simply be zero with the recovery of her cost delayed until the

[246] *See* S. Rep. No. 96-1000, at 12-17 (1980).
[247] *See* I.R.C. § 1012; S. Rep. No. 96-1000, at 13 (1980).
[248] *See* I.R.C. § 453(e).

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related person pays off the obligation to the service provider.[249] If this is the case, then the related person would have to include into income the amount of the proceeds received on the assignment of the right to receive the services, thereby frustrating the attempt by the related parties to possess the proceeds from the provision of services yet defer the inclusion of income.

Moreover, given the somewhat unusual nature of assigning the right to receive services as compared to resales of property, the Service may well have a strong case under common law doctrines (such as the substance over form or sham transaction doctrines) that the transaction should simply be treated as a transfer of the right to receive services by the service provider to the ultimate recipient of the services for the cash proceeds, thereby defeating the related parties' attempt at deferring income. In this regard, the Senate Report in connection with section 453(e) points out that the Service would still have the authority to use the sham transaction doctrine to assert the proper tax treatment of related party transactions that are not covered by section 453(e); the Senate Report also mentions a few cases where the Service was successful in challenging related party transactions involving installment sales (as well as some cases in which the courts held otherwise).[250] Finally, the concerns raised by this possible scenario also exist under the current cash equivalency doctrine, although they may be exacerbated with the more stringent approach for cash equivalency under the proposed test.[251]

VIII. Conclusion

The current common law approach to cash equivalency suffers from the lack of a uniform standard, as well as uncertainty in applying the standards given the fact-intensive, imprecise inquiry that is required. The current standards for cash equivalency may also present liquidity difficulties for taxpayers.

The single test proposed by this Article for determining whether a second-party obligation calling for future payments is a cash equivalent would generally define a cash equivalent as an obligation that is designed to be readily tradable in an established securities market. Having a single test for cash equivalency obviously has administrative benefits over current law's multiple tests, and the proposed test is administratively superior to the other tests

[249] This could be the case whether the related person is a cash method taxpayer (deduction occurs upon payment, *see* Reg. § 1.461-1(a)(1); Helvering v. Price, 309 U.S. 409 (1940)) or an accrual method taxpayer, as a result of section 267(a)(2) (deduction to accrual method taxpayer will occur no earlier than the day of inclusion by related cash method taxpayer, *see* I.R.C. § 267(a)(2)). It should be noted that where a cash basis taxpayer purchases tangible property on credit, which would give rise to a deduction upon the payment of the obligation (*e.g.*, small tools), the taxpayer does receive a basis in the property equal to the amount of the obligation prior to its payment. *See* Staff of Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, 219 n.7 (1979) (discussing section 357(c)(3)(B)). It is not clear, however, whether the same result would occur where a taxpayer acquires an intangible right (*e.g.*, a right to receive services) on credit.

[250] S. Rep. No. 96-1000, at 12-17 (1980).

[251] *See supra* notes 169-171 and accompanying text.

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used for cash equivalency in that it generally avoids the fact-intensive inquiries occasioned by these other tests. The proposed test also avoids illiquidity problems, which could possibly occur under some of the current tests for cash equivalency. Thus, the proposed test promotes the simplicity and liquidity policies that underlie the cash method of accounting. The proposed test would also create consistency with the results under the installment method of reporting where a taxpayer receives a deferred-payment obligation on the sale of property. The Article also considers certain measures for addressing possible abuses.

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