THE CASH EQUIVALENCE DOCTRINE

An unsecured promise to pay of a solvent obligor, readily transferable, not subject to set-off, and not subject to a discount substantially greater than the prevailing market rate is the equivalent of cash. Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961). As such, the fair market value of the promise is includible in income upon receipt by a cash method taxpayer. Under the SCHLUDE DOCTRINE, it is also likely includible in the income of an accrual method taxpayer.

No specific authority for this doctrine appears in the code or regulations other than very general language to the effect that taxpayers have income upon the receipt of cash or its equivalency. Nevertheless, the doctrine is widely accepted; however, it is now subject to many limitations. Some courts (particularly the Court of Appeals for the Ninth Circuit) question whether it ever applied in circumstances governed by section 1001 - the sale or exchange of property (as opposed to things other than property). That issue arises in the Warren Jones opinion discussed below. A case can be made, however, that the test articulated by the Ninth Circuit differs more semantically than substantively from that articulated by the Fifth Circuit.

The more important issue involving the cash equivalency doctrine is its relationship to section 453 as well as to the accrual and inventory methods of accounting. The 1981 expansion of section 453, as well as expansions of the accrual and inventory methods, raises legitimate questions as to the continued significance of the cash equivalency doctrine. Because most transactions are governed by one of those provisions or methods, few transactions remain to which the cash equivalency doctrine can apply. A partial list of such transactions is:

- an unconditional lease
- a sale of property for which the taxpayer elected out of section 453
- past due rent on a conditional lease
- payments for services rendered
- judgments

1 E.g., Treas. Reg. § 1.61-4.
2 While, in my opinion, the doctrine clearly applies to promised payments for rendered services, others disagree. See the discussion infra regarding Childs v. Commissioner, 103 T.C. 634 (1994). In contrast promised payments for services yet to be rendered would typically be conditioned on future performance of the services; hence, such promises could not satisfy the Cowden standard requiring and unconditional promise.
Occasionally, a court will attempt to apply the doctrine to an obligation to pay future interest. The absurdity of that should be self evident. Also, courts and commentators occasionally confuse the legal notions of negotiability\(^3\) and mere assignability or transferability.

Three decisions are frequently cited in relation to the development of the doctrine: *Jay Williams*, *Cowden*, and *Warren Jones*.

1. **Jay Williams v. Commissioner\(^4\) and "Intention" as a Factor**

Although the following decision reaches the correct result, the reasoning is suspect; nevertheless, the case is often cited.

Petitioners were cash method taxpayers. During 1951, in exchange for services, Williams received an unsecured, non-interest-bearing promissory note in the amount of $7,666.60, payable in 240 days. At the time of issuance of the note, the maker lacked funds to pay anything. Williams attempted on 10 or 15 occasions to sell the note to various banks or finance companies but was unable to realize any money until 1954 when he collected proceeds from the maker to the extent of $6,666.66. Petitioners did not report on their income tax return for 1951 any income resulting from the receipt of the note during that year, but reported income in the amount of $6,666.66 received in 1954 upon the discharge of the indebtedness.

Although the government asserted the cash equivalency doctrine, the Tax Court disagreed:

Paper 3: Negotiability is a UCC issue involving holders in due course. While a negotiable instrument may indeed be a cash equivalent, negotiability is not a requirement for the doctrine to apply. Instead, mere assignability is sufficient if the other factors are met.

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\(^4\) 28 T.C. 1000 (1957).
In the event that petitioners had failed to show that the promissory note here in issue was not intended as payment, we still would be unable to sustain the respondent's determination. The note bore no interest and was unsecured. It was not payable until 1952. The maker of the note, J. M. Housley, was without funds at the time of its execution. Petitioner testified that he was in need of immediate cash in 1951 and upon receipt of the note on May 5 of that year he attempted on 10 or 15 occasions to sell it to various banks or finance companies, but was unable to realize any money thereon. Accordingly, petitioners have demonstrated that the note in question had no fair market value in 1951 and consequently it cannot be held to be the equivalent of cash during the year of receipt. Cf. J. F. Weinmann, 5 B.T.A. 885. The receipt by petitioner of the promissory note in 1951 does not constitute taxable income realized during that year.

Undoubtedly, the Williams notes were not cash equivalents, as that doctrine has developed. The makers had insufficient funds at the time the notes were issued and did not expect to obtain sufficient funds until property was later sold. While that fact may not have rendered the notes legally conditional (which would destroy cash equivalency) it clearly raised substantial doubt as to their fair market value. Further evidence existed in Williams' inability to sell the notes, despite numerous attempt.

Nevertheless, although the Tax Court could have resolved the case on the simple grounds that the notes lacked a fair market value, it chose not to. Instead, the court relied on the dubious grounds that the notes were not "intended as payment." Exactly how a note can constitute payment of an underlying obligation, the court did not explain. Because the maker of a note must ultimately tender payment, the difference is elusive between (1) a note "intended as payment" and which must ultimately be paid, and (2) a note "not intended as payment" but merely evidencing a debt which must ultimately be paid.

Despite the questionable reasoning of the case, a well-informed tax practitioner would want to be familiar with it. If a situation occurs in which a cash method taxpayer does not want to currently recognize income, he must overcome the constructive receipt, cash equivalency, and economic benefit doctrines. As explained earlier, constructive receipt can be easily avoided with a provision delaying payment, if agreed to at the inception of the contract. As explained below, cash equivalency can also be easily avoided by making an obligation non-transferable or conditional. Nervous taxpayers who want further assurance of having no current income might, pursuant to Williams, agree that any note received is "not intended as payment." While such a contractual provision is arguably meaningless, it can do no harm, and it may convince a jurist or auditor familiar the above decision.
2. **Cowden v. Commissioner**: A Classic Case of Cash Equivalency

The principle decision explaining the cash equivalency doctrine is *Cowden v. Commissioner*, which is also an important **CONSTRUCTIVE DOCTRINE** case, discussed separately. The critical language listing the cash equivalent factors are highlighted below. It describes a cash equivalent as one satisfying six factors. The note must satisfy six conditions:

1. An unconditional promise to pay,
2. of a solvent obligor,
3. assignable,
4. not subject to set-off,
5. readily marketable, and
6. subject to a discount not substantially greater than the prevailing market rate.

While the decision might generally be viewed as a government victory, it can actually be quite favorable to taxpayers. Recall the *Williams v. Commissioner* language in which the Tax Court suggested that "promissory notes or other evidences of indebtedness received as payment for services constitute income . . . to the extent of their fair market value." Without a clear definition of "fair market value," one might have concluded (as the Ninth Circuit in *Warren Jones* concluded) that any note is a cash equivalent to the extent of its fair market value. That, however, is not the message of the Fifth Circuit; instead, the case effectively provides that a note which fails one or more of the above factors is not a cash equivalent and thus does not produce income on receipt. Arguably, the factors constitute a definition of *fair* market value, as distinguished from merely "market value."

In 1951, Cowden leased property to Stanolind Oil and Gas Company, which agreed to make advance royalty payments in an aggregate amount of $511,192.50. On execution of the instruments $10,223.85 was payable, the sum of $250,484.31 was due 'no earlier than' January 5 'nor later than' January 10, 1952, and $250,484.34 was stipulated to be paid 'no earlier than' January 5 'nor later than' January 10, 1953. The notes evidencing the debt were expressly unconditional.

On November 30, 1951, the taxpayer assigned the payments due from Stanolind in 1952 to the First National Bank of Midland. Assignments of the payments due in 1953 were made to the bank on November 20, 1952. For each assignment the bank paid the face value of the amounts assigned discounted by a few hundred dollars. The taxpayers reported the amounts received by

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5 289 F.2d 20 (5th Cir. 1961).
them from the assignments as long-term capital gains. The Commissioner determined that the contractual obligations represented ordinary income to the extent of the fair market value of the obligations at the time they were created. The Commissioner computed the fair market value of the obligations, which were not interest bearing, by the deduction of a discount of four per cent, on the deferred payments from the date of the agreements until the respective maturities. Such computation fixed a 1951 equivalent of cash value $487,647.46. The Commissioner determined that the taxpayers should be taxed in 1951 on $487,647.46, as ordinary income.

A majority of the Tax Court was convinced that the bonus payments were not only readily but immediately convertible to cash and were the equivalent of cash, and had a fair market value equal to their face value. The Tax Court decided that the entire amounts of the bonus payments, $511,192.50, were taxable in 1951, as ordinary income. Cowden v. Commissioner of Internal Revenue, 32 T.C. 853. Two judges of the Tax Court dissented.

While it is true that the parties may enter into any legal arrangement they see fit even though the particular form in which it was cast was selected with the hope of a reduction in taxes, it is also true that if a consideration for which one of the parties bargains is the equivalent of cash it will be subjected to taxation to the extent of its fair market value. Whether the undertaking of the lessee to make future bonus payments was, when made, the equivalent of cash and, as such, taxable as current income is the issue in this case.

The taxpayers urge that there can be no 'equivalent of cash' obligation unless it is a negotiable instrument. Such a test, to be determined by the form of the obligation, is as unrealistic as it is formalistic. The income tax law deals in economic realities, not legal abstractions, and the reach of the income tax law is not to be delimited by technical refinements or mere formalism.

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignible, 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. The principle that negotiability is not the test of taxability in an equivalent of cash case such as is before us, is consistent with the rule that men may, if they can, so order their affairs as to minimize taxes, and points up the doctrine that substance and not form should control in the application of income tax laws.

The Tax Court stressed in its findings that the provisions for deferring a part of the bonus were made solely at the request of and for the benefit of the taxpayers, and that the lessee was willing and able to make the bonus payments in cash upon execution of the agreements. It appears to us that the Tax Court, in reaching its decision that the taxpayers had received equivalent of cash bonuses in the year the leases were executed, gave as much and probably more weight to those findings than to the other facts found by it. We are persuaded of this not only by the language of its opinion but because, in its determination of the cash equivalent, it used the amounts which it determined the taxpayers could have received if they had made a different contract,
rather than the fair market value cash equivalent of the obligation for which the taxpayers had bargained in the contracts which they had a lawful right to make. We are unable to say whether or not the Tax Court, if it disregarded, as we think it should have done, the facts as it found them as to the willingness of the lessee to pay and the unwillingness of the taxpayers to receive the full bonus on execution of the leases, would have determined that the equivalent bonus obligations were taxable in the year of the agreements as the equivalent of cash. This question is primarily a fact issue. ****

Those six factors are worth further exploration. To an extent, they are redundant.

(a) Unconditional. This requirement overlaps with the fifth factor requiring the note to be "readily marketable." Practically, a conditional obligation is unlikely to be readily marketable: who would buy it if it is subject to the assignor's fulfillment of a condition to the maker. An example of such a condition - which would destroy cash equivalency - would be the typical lease condition of continued availability of the premises. In contrast, unconditional leases - such as a triple net lease - can satisfy this factor.

(b) Solvent Obligor. This requirement similarly overlaps with the necessity of ready marketability. If the maker of the obligation is insolvent, how could the note be realistically marketable? Surely, if would not be.

(c) Assignable. This factor is important. Naturally, it, too, overlaps with "marketability." However, the factor is important for another reason: it provides taxpayers with a ready escape from the cash equivalency doctrine. Anyone desiring to avoid receiving a cash equivalent need only agree that the note is non-assignable. Note that destroying the negotiability of the instrument is insufficient; instead, the instrument must be legally non-assignable. If so, no one would buy it and it would have no fair market value.

(d) Not subject to set-off. This factor overlaps with the factor proscribing conditions and requiring marketability. If the instrument is subject to claims against the obligee, it will hardly be marketable and effectively will not be unconditional.

(e) Readily Marketable. This factor is the essence of a Cowden-type cash equivalent. Note that the court did not describe an instrument that merely has "value" or that someone might be willing to purchase. Instead, the instrument must truly be marketable and must be readily so. In the court's words, it must be of a type "that is frequently transferred to lenders or investors." That suggests a true market.

(f) Not subject to a discount substantially greater than the prevailing market rate. This factor overlaps with the requirements of marketability and solvency. Obligations of debtors with questionable solvency will be marketable only at a steep discount. Similarly, a deep discount in the transfer of an obligation suggests the absence of a ready market. The factor is also one
which strongly favors taxpayers. Conceivably many taxpayers accept instruments which they believe to be good, but which, because the maker is small or relatively unknown, lack an organized market. A doctrine recognizing such instruments as cash equivalents - and thus the progenitors of current income - would effectively require the recipient taxpayers to transfer the obligations. Otherwise, how might the taxpayers obtain the cash with which to pay the resulting tax? Obviously, in many cases they would have no choice but to sell the notes at a considerable discount. Arguably, that would be unfair. After all, the point of the doctrine is that taxpayers who receive cash or its equivalent ought to be able to pay the tax due on the corresponding income: by receiving cash or its equivalent, they necessarily have the funds (or can readily get them) to pay the tax. Effectively requiring them to sell obligations at what might amount to substantial losses would not appear to be wise public policy. In any event, that appears to be the rationale behind the Fifth Circuit’s decision.

The "no substantial discount" factor is easily misunderstood. Logically, it should not apply to the discount below face to which a note may be subject; instead, it should merely apply to the risk factor used in measuring the value of an instrument. To understand, consider why people charge interest. They do so for three reasons:

1. **To compensate for inflation.** In times of low inflation, this factor is small, while in times of high expected inflation, this factor is correspondingly high. Instruments which bear interest in an amount that fully compensates for expected inflation are not subject to discount for this factor. In contrast, non-interest or low-interest bearing notes must be discounted to reflect their insufficient interest. This has very little to do with their marketability or the solvency of the obligor; instead, it merely reflects the nature of the contract. As a result, the extent a particular note must be discounted to reflect this factor should be irrelevant in determining whether it is a cash equivalent.

Consider an unconditional and assignable promise (not subject to setoff) issued by a highly solvent and profitable, well-known corporation. Such an instrument might be issued with a low coupon interest rate - perhaps even zero - or at a high rate. The lower the stated interest, the lower the present value of the instrument, and the higher the stated interest rate, the higher the value. Nevertheless, the instrument would surely be a cash equivalent. To the extent it is subject to a large discount (if it is low-interest bearing), the discount would merely be reflecting unstated interest and would not reflect any "problem" with the instrument.

2. **To compensate for liquidity.** Historically, people charge approximately 2.5% to 3% interest in times of no inflation and cases of no risk. This is to compensate lenders for their lack of liquidity. As
with the above factor or interest, an instrument which reflects this liquidity factor will not be subject to a discount for the factor. In contrast, an instrument that bears no interest will be subject to a discount reflecting liquidity, in addition to a discount reflecting the other two factors. As with the first factor, this discount should be irrelevant to a determination of cash equivalency.

3. To compensate for risk. This factor - unique to the maker - reflects the creditor's impression of the risk of default. Highly solvent makers are subject to little, if any, discount for this factor. In contrast, insolvent debtors will be subject to a very high risk interest factor. Of the three interest factors, this is the one to which the Cowden court was surely referring. Risky instruments - which includes those of relatively unknown makers - are not cash equivalents because they are subject to great discounts. Naturally, this sub-factor overlaps with the "readily marketable" and "solvent obligor" factors.

- Example: Inflation is generally expected to be 12% for the foreseeable future. Microsoft, Inc., a highly solvent corporation, issues a promise bearing zero interest. ABC, Inc., a small business with questionable finances, issues a promise bearing 25% interest.

- The Microsoft instrument will be discounted by a rational purchaser at rate of perhaps 16%, reflecting 12% inflation, 3% liquidity (real interest), and 1% risk. In contrast, the ABC note will likely be discounted by a much smaller amount because it already reflects adequate interest to compensate for inflation and liquidity, plus it reflects an additional 10% interest to compensate for risk.

In The Example, the Microsoft instrument is certainly a cash equivalent, even though it appears to be subject to a 16% discount rate, which some might view as "substantial." In contrast, the ABC note may or may not be a cash equivalent, even though its apparent discount rate would likely be less than 16%. This is true because it is the far riskier instrument and is surely less readily marketable. Exactly what the Fifth Circuit meant by "substantial" in its requirement that the instrument not be subject to a discount rate "substantially greater than the prevailing market rate" is unclear. In any event, a taxpayer should only consider the risk element of a discount rate (including the portion reflected in the instrument itself)\(^6\) in analyzing this factor.

3. Warren Jones and other cases.

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\(^6\) The actual computation discounting a note will subject the entire stream of payments - both principal and interest - to an interest rate. This is the rate which should be examined in determining whether the rate is substantially greater than the prevailing market. In other words, is the instrument particularly risky, as compared to other traded instruments. Note that a comparison of the face amount of the instrument with the present discounted value would be irrelevant and potentially misleading. This is true because such a comparison would not remove the irrelevant inflation and liquidity factors.
Arguably, the Court of Appeals for the Ninth Circuit has restricted the cash equivalency doctrine to cases not involving the sale of property.

The case was *Warren Jones Company v. Commissioner*\(^7\) The taxpayer received a transferable promissory note, bearing 8% interest, in exchange for the sale of real property. The face value of the note was approximately $133,000.00; however, a bank approached by the taxpayer was willing to purchase only 60% of the note, discounted at 9.5%, for $76,000.00 cash. In addition, the bank was willing to accept the remaining 40% of the note conditionally. It proposed placing $41,000.00 - the discounted value of the 40% - in an interest bearing escrow account until such time that it collected the entire note from the maker.

The Tax Court approached the case from a cash equivalency standpoint, finding that the present value of the note was merely $76,000, which was only 58% of the face value.\(^8\) As a result, the court refused to find the promise to be a cash equivalent, suggesting that a 42% discount was too great. The Ninth Circuit reversed, claiming that notions of cash equivalency do not apply to cases under section 1001.\(^9\) Under that code section, reasoned the court, taxpayers who sell "property" must recognize an amount realized equal to the amount of cash or the fair market value of property received. The court suggested that the code thus left no room for the exclusionary aspect of the cash equivalency doctrine: that a note subject to a substantial discount is not a cash equivalent and does not trigger current income. Thus the Ninth Circuit found the taxpayer to have received $76,000 income on the receipt of the note.

Both the Tax Court and Circuit Court opinions are subject to criticism. For starters, the Tax Court violated the "discount" analysis explained previously in relation to *Cowden*. The relationship between the present value of the note and its stated face value is not particularly relevant; instead, the court should have merely examined the "risk" element of the discount rate to be used. In addition, the court apparently placed a zero value on the escrow account suggested by the prospective purchaser. Granted, such a restricted account would be difficult to value; however, $41,000 in an interest bearing account surely had a value greater than zero.

Rather than suggesting that the note had a value equal to only 58% of its face, the Tax Court should have explained that a portion of the note - 60% - was readily marketable, at a discount rate of 9.5%, only slightly greater than other prevailing rates. The court would then have faced the novel question: "Can a note be partially a cash equivalent and partially not one." Considering

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\(^7\) 524 F.2d 788 (9th Cir. 1975).
\(^8\) 60 T.C. 663 (1973). The offered amount - $76,000 - was approximately 58% of the face amount of $133,000.
\(^9\) I.R.C. § 1001(b) defines the amount realized on the sale of property as "the sum of any money received plus the fair market value of the property (other than money) received."
how the court analyzed this case, it likely would have answered the question in the negative.

The Ninth Circuit is subject to some criticism for attempting to carve out a special rule for sales of property under section 1001. Nothing in that code section clearly proscribes the use of the cash equivalency doctrine. Relying on the code language which defines "amount realized" as, among other things, "the fair market value of property received" presupposes that the receipt of a promise to pay money constitutes "property." In at least some areas of tax theory, such a promise is not "property," and the court did not explain why the rule should be different under section 1001, at least under the law then existing.  

In any event, a plausible analysis might conclude that the Warren Jones decision is consistent with the Cowden opinion. The essence of each case is whether the promise is "readily marketable" and has a "fair market value." Faced with the Jones facts, the Fifth Circuit (the Cowden court) might well have concluded that Jones essentially received two obligations: a cash equivalent valued at $76,000 and a non cash equivalent with speculative value. Under this alternate view, the critical issue is whether the step transaction doctrine might bifurcate a single note into its component parts. For the two circuits to disagree on this issue is quite different from the common view that they disagree as to the basic application of the cash equivalency doctrine. Perhaps the courts will ultimately so disagree; however, one might withhold judgment until the Ninth Circuit requires current inclusion by a taxpayer receiving a note subject to a true discount of 42%. Despite the claims of many respected commentators, Warren Jones was not such a case.

4. Childs v. Commissioner and Does the Doctrine Apply to Services?

Yes, the doctrine applies to an unfunded or unsecured promise to pay money for services. At least that is the opinion of most commentators and the government. Recent court authority for the proposition is scant.

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10 Treasury Regulations issued since the Warren Jones decision treat the receipt of a promissory note as the receipt of "property" for taxpayers electing out of the installment sales provisions of section 453. The regulations explicitly proscribes the use of the cash equivalency doctrine to defer income in such an event. Treas. Reg. § 15A.453-1(d)(2).
12 103 T.C. 634 (1994).
13 See, Sanford M. Guerin & Philip F. Postlewaite, FEDERAL INCOME TAXATION (4th Ed. 1994) at 315-16 (positing cash equivalency problems using cosmetology services as the underlying contractual subject and suggesting, in the Instructor’s Manual that notes to pay for such services raise cash equivalency questions); Michael J. Graetz & Deborah H. Schenk, FEDERAL INCOME TAXATION, (3d Ed. 1995) at 728 (positing a law firm’s account receivable for services as a possible cash equivalent, although concluding that “typically” such an item would not satisfy the factors); Boris Bittker, FEDERAL TAXATION OF INCOME, ESTATES
Naturally, such a promise is not automatically a cash equivalent: it must first satisfy the six factors. But, if it does so, no reason exists to preclude application of the doctrine merely because the promise relates to the performance of services. Why, then, would anyone disagree? The answer involves the language of section 83.

That section, first effective in 1969, provides:

If, in connection with the performance of services, property is transferred to any person . . . the excess of . . . the fair market value of such property . . . over . . . the amount . . . paid for such property, shall be included . . . in the first taxable year in which the rights . . . are transferable or are not subject to a substantial risk of forfeiture . . . .15

Treasury Regulations pursuant to section 83 exclude from the definition of “property,” an unfunded or unsecured promise to pay money.16 According to at least one respected commentator,17 section 83 both “carved out” employment contracts from traditional cash method theories, apparently including the cash equivalency doctrine. I disagree.

With regard to transfers of “property” for services, section 83 clearly controls the timing of inclusion. However, on the face of the statute, if something other than “property” is transferred for services, section 83 does not apply. Hence, more traditional cash method rules - including the cash equivalency doctrine - must apply. Whether an unfunded or unsecured promise to pay money for services can satisfy the six cash equivalency factors is a question of fact. For example, until completion of the services, the promise will likely be conditional, precluding application. In addition, many unfunded and unsecured promises will lack a ready market at a reasonable discount rate, also precluding application. Nevertheless, if the promise satisfies the factors, the doctrine applies.

AND GIFTS (1981) at 105-32 to 105-33 (stating clearly that a “secured or negotiable instrument” received by a cash method employee raises cash equivalency questions, although in discussion the matter, the courts have been far from consistent.”); J. Martin Burke & Michael S. Friel, TAXATION OF INDIVIDUAL INCOME (3d Ed. 1994) at 552 (positing various promises received in exchange for services as examples to illustrate the intricacies of the cash equivalency doctrine).

14 Cf., Rev. Rul. 76-135, 1976-2 C.B 114 (lawyer who received a marketable note for services taxed on its value; however, because the lawyer also discounted the note, the ruling is unclear whether the receipt or the discounting triggered income).
15 I.R.C. § 83.
17 Brooks D. Billman, U.S. INCOME -- RESTRICTED PROPERTY -- SECTION 83, 384 T.M. 36 (1982). The author suggests that a mere contract right to pay compensation would not trigger income. He suggests, however, that a transfer of notes or other evidences of indebtedness may constitute “property” under section 83, although the recipient may have a legitimate argument for exclusion under the cash equivalency doctrine.
A recent Tax Court opinion, however, casts some doubt on this notion. The 1994 opinion in Childs v. Commissioner\textsuperscript{18} did not mention the cash equivalency doctrine. The court, however, painstakingly explained why neither the constructive receipt\textsuperscript{19} nor the economic benefit doctrine\textsuperscript{20} applied. It’s failure to mention the third cash method doctrine - cash equivalency - suggests that the court not only felt the doctrine to be inapplicable, but that it also found the inapplicability to be so clear as to not merit discussion\textsuperscript{21}.

Childs was a partner in a law firm which represented a successful tort plaintiff. The plaintiff accepted a structured settlement of the claim. At the insistence of the plaintiff, the law firm also accepted a structured settlement of its attorneys’ fees\textsuperscript{22}. Georgia Casualty was the insurer for the tortfeasor. Pursuant to the settlement, it promised to pay damages and attorneys’ fees and had the right to purchase an annuity fulfilling the promise. It did so, transferring money to a separate annuity company and ultimately the company’s subsidiary. Georgia Casualty remained liable for future payments, and, in fact, subsequently made payments when the annuity company and its sub had financial difficulties\textsuperscript{23}. The plaintiff and the law firm each had transferable rights against Georgia Casualty, although neither sold those rights\textsuperscript{24}. In addition, neither the plaintiff nor the law firm had any legal right to the annuity contract, which remained the property of Georgia Casualty\textsuperscript{25}.

The Tax Court correctly held that the firm never had constructive receipt of the fees. The firm negotiated deferral of the fees from the inception of the agreement and thus never had the right to demand money. The court also correctly held the inapplicability of both the economic benefit doctrine and section 83. Its reasoning, however, was suspect. Essentially, the court saw the annuity funds as subject to the creditors of the annuity company and its subsidiary. As such, the court saw it as insufficiently funded\textsuperscript{26}. I disagree with the relevance of that fact; instead, I would have focused on rights possessed by Georgia Casualty’s creditors. If, as apparently was not the case, such creditors could not reach the annuity, then the transfer of funds to purchase it would have satisfied the economic benefit doctrine, as well as section 83.

\textsuperscript{18} 103 T.C. 634 (1994).
\textsuperscript{19} Id. at 653-54.
\textsuperscript{20} Id. at 653. The court dealt with the application of section 83, rather than with the economic benefit doctrine; however, the statute is essentially an enactment of the doctrine, as applied to services. The court’s conclusions as to the non-application of section 83 doctrine are questionable.
\textsuperscript{21} Then, again, the court could have merely been sloppy in its research and analysis. I’d rather, however, criticize the court for faulty reasoning than for ignorance.
\textsuperscript{22} 103 T.C. at 642.
\textsuperscript{23} 103 T.C. at 644.
\textsuperscript{24} Id. at
\textsuperscript{25} Id. at 651.
\textsuperscript{26} Id.
Despite those two correct conclusions, the court failed to consider the relevance of the cash equivalency doctrine. Why it did so was unclear. Perhaps the court believed, incorrectly that section 83 supplanted the doctrine. If so, I wish the court had said so and defended such a position. Or, perhaps the court believed the promise of Georgia Casualty lacked one or more of the requisite cash equivalency factors. Again, if so, I wish the court had explained which were lacking. Further speculation is in order.

This court may have believed that a separate note is necessary to trigger the doctrine. As explained below, I disagree with that notion, but it has its proponents, including early Board of Tax Appeals authority. The court may also have legitimately concluded that few potential purchasers existed for a document structuring and settling contingency legal fees. Perhaps not. But, the court did not state any facts that lead clearly to that conclusion. While I envision a complicated settlement agreement, which would not generally be very marketable, I can also envision a fairly brief agreement which would indeed have potential buyers. Because the court did not explain the nature of the document, we cannot determine its reasons for not discussing the cash equivalency doctrine.

5. Does the Doctrine Apply to a Mere Contract Right, or Must a Separate Evidence of Indebtedness Exist?

Logically, the cash equivalency doctrine applies to any enforceable obligation regardless to whether a separate note or other instrument evidences it. Naturally, this does not mean that all obligations are cash equivalents. Nevertheless, the doctrine applies to them such that the recipient must analyze the obligation in light of the Cowden factors.

Suppose, for example, a taxpayer executes a “triple net” lease, which comprises ten typewritten pages and the entire agreement between the parties. No separate evidence of indebtedness exists. Must the landlord analyze the lease in terms of the cash equivalency doctrine? Yes, although the lease may very well fail to satisfy one or more of the factors. Such a net lease would be an unconditional promise to pay and likely would be both assignable and not subject to set-off; but, would the obligor be solvent? Would the lessor’s rights be “readily marketable” at a discount “not substantially greater” than the prevailing rate? Who knows, for those are factual rather than legal issues. The doctrine would apply, but the facts may not justify current inclusion. Remember, the doctrine acts both to include and to exclude income. In all likelihood, a ten page lease - no matter how unconditional and assignable - is not typically “readily marketable” of its physical characteristics. Ten pages of complicated writing will look like conditions and thus will often destroy “marketability” even if such a result is unjustified. Busy bankers and investors will probably prefer simple, clear evidences of indebtedness styled in the more typical fashion of a note. This practical reality, however, should not rise to the
level of a legal requirement. If, indeed, the triple net lease\textsuperscript{27} - or other contract right - satisfies the various cash equivalent factors, it ought to result in current taxable income without regard to whether a separate piece of paper - entitled an evidence of indebtedness - exists.

Despite this clear logic, some authorities appear to disagree. For example, often quoted language from Revenue Ruling 60-31 provides:

A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method.\textsuperscript{28}

Despite the apparent clarity of those words, the ruling offered no illustrations supporting its conclusion. While it provided five examples, three of them involved a conditional contract right, one triggered the economic benefit doctrine and the other triggered constructive receipt. As a result, the Service failed to give a concrete example of a “mere contract” right satisfying the cash equivalency factors but not triggering income for the lack of a separate note.

\textsuperscript{27} Under such a lease, the tenant must pay taxes, insurance, and maintenance. As a result, the obligation to pay rent is unconditional and potentially a cash equivalent. At least two other authors have speculated whether the cash equivalency doctrine applies to a triple net lease. See, J. Martin Burke & Michael K. Friel, TAXATION OF INDIVIDUAL INCOME (3d Ed. 1994) at 554. The authors raise the question, without answering it (presumably leaving it to their students); however, they add “as you formulate an answer for these questions, consider the fact that, like the constructive receipt doctrine, the cash equivalency doctrine, if extended too far, will blur the distinction between cash and accrual accounting.” An earlier example provided by Professors Burke and Friel suggests their apparent conclusion that a separate note is indeed required. The example posits a taxpayer receiving, alternatively, an oral promise, a letter of acknowledgment, and a promissory note. All agree the mere oral promise would not be a potential cash equivalent. Surely no clear market exists for such a right. At the opposite end, the promissory note would, in contrast, be subject to the doctrine and would prompt income if its particular characteristics so justified. However, the Professors’ middle example - the letter of acknowledgment - illustrates my question and suggests a conclusion different from mine. The authors assert - in language reminiscent of the flawed \textit{Jay Williams} decision – “The letter merely evidences a debt; it doesn’t constitute receipt of anything. Like the oral promise, the letter cannot be viewed as bargained-for consideration. It is not commonly traded and cannot be reduced to cash. Under these circumstances, deferral is appropriate. Both the oral promise and the letter establish that [the taxpayer] has an account receivable and nothing more. To the cash method taxpayer, an account receivable does not constitute income.” \textit{Id.} at 553. I partially agree; however, the illustration assumes its own answer. If such letters of acknowledgment are “not commonly traded,” then, no, they would not satisfy the doctrine. But, that is the issue - is such a letter, in the form given, commonly traded and does it satisfy the doctrine’s other factors? In my view, letters, accounts receivable, and other “mere contract rights” have no inherent quality precluding application of the doctrine. They may typically lack the requisite attributes - as surely would mere oral promises; however, that amounts to a factual, rather than legal issue.

\textsuperscript{28} Rev. Rul. 60-31, 1960-1 C.B. 174, 177. In addition, the ruling quoted an early court decision for the proposition that “Taxpayers on a receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more.” \textit{Id., quoting} Zittel v. Commissioner, 12 B.T.A. 675, (1928).
Similar language appeared in the holding of a 1942 Board of Tax Appeals opinion. The case involved the sale of mineral royalty payments. The taxpayer received a contract right for payment in 1933 and 1934, but no separate note. The court explained:

It, however, does not follow, as respondent contends, that the entire gain is taxable in 1933, the year the sale was made . . . . Section 111(b) [now section 1001(b)] provides:

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

What "property" did petitioners receive during 1933 other than the sum of $74,670.75 in money? Obviously, petitioners received nothing more in the year 1933 than the contractual promise of the King estate to pay the remaining one-half of $149,341.51 during 1934 . . . . [We reviewed] several cases where a part of the consideration for the sales there involved was evidenced only by a contract to pay in a later year . . . . In all of the court decisions . . . the courts took the position that, when evidence was introduced showing that the deferred payments were evidenced only by contract, where no notes, bonds, or other evidences of indebtedness other than the contract were given, such contract had no fair market value, and that the amounts of the deferred payments should be included in income when received.

The Court of Appeals for the Fifth Circuit, in the Cowden opinion, cited the above language in its landmark description of the cash equivalency doctrine. Because the Cowden facts involved a separate note, the court's purpose in citing Kleberg is unclear. Perhaps it indicates agreement with the "separate note requirement," or, perhaps it shows the court cited a case not directly on point. In any event, I disagree.

6. Must a Cash Equivalent Involve a Promise to Pay Cash?

Apparently not, according to a 1963 decision of the Court of Claims. The case involved a promise to deliver railroad cars in the future. While the court spoke of the taxpayer's right to demand the cars - reminiscent of the constructive receipts doctrine - it phrased its holding in terms of cash equivalency. Indeed, the court spoke of the taxpayer's ability to sell the right.

30 The court quoted "where no notes, bonds, or other evidences of indebtedness other than the contract were given, such contract had no fair market value." Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961), quoting from Kleberg v. Commissioner, 43 B.T.A. 277, quoting from Titus v. Commissioner, 33 B.T.A. 928.