THE ECONOMIC BENEFIT DOCTRINE

A cash method taxpayer has income when he receives the economic benefit of the proceeds. This occurs even if he lacks actual receipt, constructive receipt, or receipt of a cash equivalent. It results when the payor irrevocably places funds for the benefit of the taxpayer beyond the reach of the payor’s creditors. Sproull v. Commissioner, 194 F.2d 541 (6th Cir. 1952). According to most authorities, the Doctrine applies only to service income and contest winnings; it does not apply to transactions involving the sale of property. The government has consistently, but unsuccessfully, disagreed with this limitation on the Doctrine.

Do not confuse this doctrine with the TAX BENEFIT RULE which is an error correction device. THE ECONOMIC BENEFIT DOCTRINE is a cash method accounting rule and is unrelated to the other rule.

THE ECONOMIC BENEFIT DOCTRINE has been around since at least 1951, but is not widely applied, being universally limited by courts to matters involving deferred compensation and contest winnings. Frequently, the government has attempted to apply the doctrine to other types of transactions; however, it has consistently lost those cases. Scant logical support exists for the courts’ limitations placed on the doctrine; nevertheless, the limitations are clear.

The doctrine essentially arose out of Glenshaw Glass and the notion that income involves an "undeniable accession to wealth clearly realized."1 Four possible ways exist such that a taxpayer “clearly realizes" income. Strategically, taxpayer/planners who wish to defer recognition of income must avoid all four aspects of realization:

1. Actual Receipt of cash, property, or other value.

2. THE CONSTRUCTIVE RECEIPT DOCTRINE.

3. THE CASH EQUIVALENCE DOCTRINE.

4. THE ECONOMIC BENEFIT DOCTRINE.

If a taxpayer receives cash, then he has surely "clearly realized" the relevant income, if any. It is measurable (by the amount received) and the taxpayer has the funds with which to pay the tax. Thus, he should do so.

Similarly, if the taxpayer receives "property," then, once again, the amount of income is likely easily measurable and the taxpayer can likely obtain the funds with which to pay the tax. Whether it is fair policy to effectively require the taxpayer to sell the property to raise the necessary funds is no longer subject to significant debate: no one credibly argues that the receipt of property is anything other than a taxable event (unless, of course, a particular code provision provides otherwise in particular circumstances).

**THE CONSTRUCTIVE RECEIPT DOCTRINE** is also well-accepted. A taxpayer should not be allowed to turn his back on the receipt of cash or property and as a result claim not to have funds with which to pay tax. While legitimate issues exist concerning the application of **THE CONSTRUCTIVE RECEIPT DOCTRINE** (such as what amounts to a substantial limitation), they do not involve the fairness of taxing someone who has indeed "constructively received" income, whatever that is.

**THE CASH EQUIVALENCY DOCTRINE** is a bit more controversial. It, too, rests on a fundamental notion: the taxpayer has "clearly realized" the income and thus should report it. Most criticism of the doctrine involves fairness: forcing a taxpayer to assign a note to raise funds with which to pay a tax is unfair. Arguably, however, such criticism essentially involves whether the factors of cash equivalency exist. If forcing a particular taxpayer to sell would be so unfair, then perhaps the discount is excessive or no *fair* market value exists. In other words, the fairness issue begs the question: if it's unfair, then maybe the note is not a cash equivalent.

Of the cash method doctrines, **THE ECONOMIC BENEFIT DOCTRINE** is the most controversial. It involves a taxpayer who neither actually nor constructively receives anything. The classic case involves deferred compensation placed into an irrevocable, non-assignable trust for the benefit of the taxpayer. Such a transfer does not amount to receipt, constructive or otherwise. Likewise, such a trust is not a cash equivalent because it is non-assignable. Nevertheless, if taxpayers could create such arrangements, they would effectively "have their cake and be able to eat it, too."

Even though taxpayers who benefit from such trust arrangements are not able to receive immediate liquidity from the trust, they nevertheless feel a sense of significant security. Necessarily, the trust must be beyond the reach of the payor's creditors. Thus, the taxpayer will receive the amount at some point, even though not currently. He will, in a sense, sleep more securely and be more willing to spend other funds or credit, knowing that he will someday receive the trust funds. Effectively, **THE ECONOMIC BENEFIT DOCTRINE** taxes that secure feeling. While the taxpayer has not "received" any income, he has effectively "realized" it and thus should be taxed.
The following explanation of the doctrine covers three areas: 1) the historical creation of the doctrine in the Sproull decision; 2) a series of Revenue Rulings explaining the doctrine and limiting it; and, 3) several court decisions that either failed to apply the doctrine despite its theoretical application, or that rejected the doctrine, using questionable analysis. This series of decisions is useful because they best demonstrate the practical limitations of the doctrine. Despite the government's pronounced intentions applying economic benefit theories broadly, courts have failed to follow suit.

1. Sproull v. Commissioner

Nearly all Economic Benefit Doctrine authority traces its roots to the Sproull decision. The case, however, is not the best example of how the doctrine has developed, because it apparently involved an assignable right. Under more recent opinion, assignability is an unnecessary factor for the doctrine to apply. Indeed, assignability is theoretically inconsistent with the doctrine: if the escrow or trust account were assignable, then it surely would satisfy the Cash Equivalent Doctrine, and the application of the Economic Benefit Doctrine would be moot.

Ultimately, Sproull establishes the heart of the doctrine: the transferred funds must be irrevocably beyond the reach of the payor's creditors. Arguably, that is the totality of the necessary factors. Still, the case involved deferred compensation, a trust, and interest on the trust funds. Other commentators believe those are also necessary factors.

Facts: On December 26, 1945, Sproull's employer paid $10,500 to a trust in consideration of services previously performed by Sproull. Under the trust agreement, Sproull would receive $5,250 on December 26, 1946, and the balance, including income, on December 26, 1947. In the event of Sproull's death, Sproull's estate or heirs would receive the amounts. The trustee dutifully distributed the funds as provided and Sproull included the amounts in the years received.

Issue: The Commissioner sought to tax Sproull in the year the employer transferred funds to the trust. The Court explained the issue simply:

Superficially the issue looks simple. Petitioner actually received no cash until the years 1946 and 1947. Why, then, should he be taxed in 1945? And what was the basis for respondent's action in so doing?

Holding: While the taxpayer neither actually nor constructively received the funds, he nevertheless received an economic benefit from the transfer.

2 194 F.2d 541 (6th Cir. 1952).
The Court emphasized the irrevocable nature of the transfer; however, it strangely said “this factor alone is not controlling.” Subsequent cases suggest otherwise.

[W]as was ‘any economic or financial benefit conferred on the employee as compensation’ in the taxable year? If so, it was taxable to him in that year. This question we must answer in the affirmative. The employer's part of the transaction terminated in 1945. It was then that the amount of the compensation was fixed at $10,500 and irrevocably paid out for petitioner's sole benefit. While this factor alone is not controlling, it does serve to distinguish this case from those in which the exact amount of compensation is subject to some future contingency or subject to the possibility of return to the employer.

The government argued for application of The Cash Equivalence Doctrine. Other than simply noting the argument, the Court failed to address it. But, the Court later emphasized the assignability of the trust. Subsequent cases would consider this a trigger of The Cash Equivalence Doctrine, obviating the need for application of The Economic Benefit Doctrine.

[T]he expenditure of the $10,500 in setting up the trust conferred an economic or financial benefit on petitioner properly taxable to him in 1945. The fund was ascertained and paid over by petitioner's employer for his benefit in that year. Petitioner had to do nothing further to earn it or establish his rights therein. The only duties of the trustee were to hold, invest, accumulate, and very shortly pay over the fund and its increase to petitioner or his estate in the event of his prior death. No one else had any interest in or control over the monies. The trust agreement contained no restriction whatever on petitioner's right to assign or otherwise dispose of the interest thus created in him. On the facts here there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit, and that this beneficial interest could have been assigned or otherwise alienated requires the citation of only the most general authority.

Despite the clear problems with this decision – it’s odd statements about irrevocable transfers and assignability – the case fathered The Economic Benefit Doctrine. Knowledge of it is thus essential.

2. More Recent Authority

a. Need for Three Parties

(1) Revenue Ruling 60-31

Several rulings have expanded and fine-tuned the Secretary's view of The Economic Benefit Doctrine and its requisite factors. Authors considering The Economic Benefit Doctrine frequently cite the first ruling – from 1960; thus, if for no other reason, an informed practitioner should be familiar with it.

The government hypothesized five circumstances of deferred compensation. In the first three, the original payor held the funds. Two of those situations involved an employer, an employee, and classic non-qualified
deferred compensation. In each the employer held funds promised to the employee. The amounts held were subject to the general creditors of the employer. In the third example, a book publisher held royalties promised to an author. Again, the author possessed only the publisher’s promise, which was no better than its general credit worthiness. Issues of constructive receipt and cash equivalency were thus relevant to the government’s analysis. Economic benefit, however, was not relevant, because the funds were not beyond the reach of the payor’s creditors: they thus were not irrevocably paid.

The fifth ruling example involved a boxer entitled to a share of gross receipts from a match. He contracted with the boxing club, which was not his employer, to hold his share and to pay it to him over the following four years. Essentially, the government used agency analysis to find the boxer in receipt of income. In a sense, this helps resolve the question of whether a trust or escrow account is essential for the economic benefit doctrine. Payment of the funds to a third person likely constitutes receipt by an agent, mooting the economic benefit analysis. Note also, the contrast of this example with the one involving the publisher and author. In very similar circumstances the boxer had current income while the author did not. Why? Because one critical difference existed: a third party.

The publisher was the original payor while the boxing club was not. Thus, the publisher example involved but two parties, while the boxer example involved three. An employment relationship was not essential, but some relationship as original payor/payee is essential and must be coupled with a transfer by the original payor to another person or entity. This could result from employment or independent contractor status or a purchaser/seller relationship, as long as the employer, contractor, or purchaser transfers the funds to another person.

The fourth example further illustrates this factor. It involved a football player who agreed to play for two years. In addition to his salary, the player negotiated a substantial signing bonus. He and the club agreed to the following:

The player shall receive the sum of 150x dollars upon signing of this contract, contingent upon the payment of this 150x dollars to an escrow agent designated by him

Although he could have demanded—and then received—payment, he did not. Under the Cowden interpretation of The Constructive Receipt Doctrine, the football player did not trigger income by his refusal: a taxpayer may, at the inception of an agreement, defer receipt of income.

Under the escrow arrangement, the account bore interest and the taxpayer’s name. The amounts were payable over a period of five years and the account was not assignable. The Ruling properly applied The Economic Benefit Doctrine:
Applying the principles stated in the *Sproull* decision to the facts here, it is concluded that the 150x-dollar bonus is includible in the gross income of the football player concerned in 1957, the year in which the club unconditionally paid such amount to the escrow agent.

(2) Rabbi Trusts and Secular Trusts: Ltr. Rul. 8113107

Rabbi Trusts escape THE ECONOMIC BENEFIT DOCTRINE. Secular trusts (those which fail to satisfy the factors of the ruling) do not. The following private ruling first approved the classic Rabbi Trust, which drew its name from the facts involved. The taxpayer involved (the Rabbi) escaped current income because he did not actually or constructively received payment, nor did he receive a cash equivalent or the economic benefit of the amount involved. He lacked economic benefit because the funds remained subject to claims of creditors of the payors. The factor of assignability was also missing; however, that factor is logically irrelevant to the economic benefit doctrine whenever the funds remain reachable by the payor's creditors. It is, instead, a factor of the cash equivalent doctrine, an issue not addressed by the ruling.

The ruling plows no new ground. I include it because it is so famous and often referred to.

[A] ruling is requested as to whether N, a rabbi, will be in receipt of income by virtue of the funding of a trust for his benefit by congregation M.

M proposes to fund the trust with r dollars. Under the terms of the trust agreement, the trustees will manage, invest, and reinvest the trust estate, and pay the net income derived therefrom to N at least quarter annually. Upon the death, disability, retirement, or termination of services of N, the trustees will make distributions of principal and income to N as provided for in the trust agreement.

Although M may not alter, amend, revoke, change, or annual any provisions of the trust agreement, the assets of the trust estate shall be subject to the claims of M's creditors as if the assets were the general assets of M. Furthermore, N's interest in the trust is not subject to the assignment, alienation, pledge, attachment, or claims of creditors, and may not be otherwise alienated or encumbered by N.

The principal generally known as the 'economic benefit' doctrine provides one method for determining when amounts must be included in gross income. Pursuant to this theory, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A 'fund' is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in the fund is 'vested' if it is nonforfeitable.

The economic benefit doctrine was judicially applied in E.T. Sproull v. Commissioner, 16 T.C. 244 (1951), affirmed 194 F. 2d 541 (6th Cir. 1952), in which a corporation in 1945 created a trust of $10,500 for the taxpayer, its president. The trustee was directed to invest the principal and pay one-half of it, together with the accumulated income, to the taxpayer in 1946 and one-half in 1947. The creation of the trust itself was viewed as of such an economic or financial benefit to the taxpayer to
justify the taxation of the principal to him in 1945, since it was then that the amount of the compensation was fixed and irrevocably paid out for the taxpayer's sole benefit.

Because the assets of the trust estate are subject to the claims of M's creditors and are not paid or made available within the meaning of section 451 of the Code, we conclude that the funding of the trust will not constitute a taxable event for N. Thus, payments of income or principal under the terms of the trust agreement will be includible in N's gross income in the taxable year in which they are actually received or otherwise made available, whichever is earlier.

b. Expansion beyond Deferred Compensation and No Need for Interest or Assignability

The following rulings and case further expand THE ECONOMIC BENEFIT DOCTRINE beyond the realm of deferred compensation and into that of contest winners. This point is quite significant: current application of THE ECONOMIC BENEFIT DOCTRINE extends only to deferred compensation and contest winnings. While that limited application may be illogical, it is nevertheless clear.

In addition, they each apply present value notions to measure the amount of income. This resolves another issue left open by Sproull: whether an account must bear interest to trigger the doctrine. Logically, it need not, as that issue merely relates to the amount of income, rather than to whether any income exists. The taxpayer should have income equal to the present value of the fund's future obligation to pay. The greater the interest accumulated by the fund, the greater the present value. Inversely, the less the interest to be earned, the less the present value. Thus the absence of an obligation to pay interest does not destroy the present value - and thus application of THE ECONOMIC BENEFIT DOCTRINE - it merely lowers it. The government agrees. As shown later, other authorities do not.

(1) Revenue Ruling 62-74, 1962-1 C.FD. 68

The hypothesized cash method taxpayer won a prize. The contest sponsor placed the winnings in a non-interest bearing escrow account to be paid over time.

The only substantial difference between the Sproull case and the instant situation is that in the former interest was to be paid to the taxpayer with the last installment of trust principal. In this case, no interest is to accrue to the benefit of the taxpayer. Therefore, the present value of the fund to the taxpayer is not equivalent to the amount paid over for his benefit, but, rather, is equivalent to the ... dollars paid to him immediately plus the discounted value of the future payments to be received. . . .

The excess of future payments received over the discounted value is includible in the taxpayer's gross income for the taxable years in which received.

Actually, the Ruling situation involved an irrevocable transfer – a second and substantial difference. Readers should also be careful with the
final paragraph: it includes the present value currently and the interest upon receipt. Sections 1271 through 1286, if applicable, would force the winner to use the accrual method for interest, resulting in inclusion of interest over time.

(2) Revenue Ruling 67-203, 1967-1 C.B. 105

Again, the hypothesized cash method taxpayer won a prize – this time, the Irish Sweepstakes. Because he was a minor, the Irish Court held the proceeds for him.

Held, the economic benefit doctrine applies and requires the inclusion of the present value of the sweepstakes winnings in the minor's gross income at the time the funds are paid over to the Irish court. See E. T. Sproull v. Commissioner, 16 T.C. 244 (1950), affirmed, 194 F.2d 541 (1952).

(3) Pulsifer v. Commissioner. 3

A 1975 Tax Court decision was consistent with the 1967 ruling, adding the additional notion that assignability is irrelevant to the economic benefit doctrine. Logically, it goes to the essence of the doctrine: if the trust or escrow account, funded and beyond the reach of the payor's creditors, were assignable, it surely would satisfy the definition of a cash equivalent. This would render the application of THE ECONOMIC BENEFIT DOCTRINE a moot issue. Thus the taxpayer's argument in the following decision, claiming the inapplicability of the doctrine if the trust interests were non-assignable is clearly wrong. To the contrary, the non-assignability is what makes the doctrine relevant.

The case was Pulsifer v. Commissioner. It involved three minors who were partial winners of the Irish Sweepstakes. Irish law required the children's portion to be deposited into an Irish bank account for the benefit of the children. The court explained:

Under the economic-benefit theory, an individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor's debtors. . . .

The record does not show whether the right to the funds held by the Bank of Ireland was assignable. Petitioner claims they were not, but cites no authority for his position. However, the result is the same whether or not the right to the funds is assignable.

3 64 T.C. 245 (1975). A later Tax Court decision, Anastasio v. Commissioner, 67 T.C. 814 (1977), follows Pulsifer. It's analysis is, perhaps, faulty. The case involved a lottery won by a minor. The state lottery commission paid the winnings to the minor's parent, to be held by them under the state's Uniform Gifts to Minors Act. The court held the minor to have had the economic benefit of the funds transferred. Oddly, the court distinguished the economic benefit doctrine, on which it relied, from the constructive receipt doctrine, but not from an agency analysis. This criticism is small, as it does not affect the outcome: the minor would be taxed anyway. However, agency theory should have been sufficient to resolve this case in which the money was received by the child's parents.

The last expansion of THE ECONOMIC BENEFIT DOCTRINE was long ago in 1971: the government asserted that it applies to transactions involving the sale of property, rather than merely to deferred compensation and contest winnings. The government, however, has been unsuccessful in applying this ruling. Reported decisions considering the issue have nearly all been decided in favor of the taxpayer.4

Logically, the government view is correct. THE ECONOMIC BENEFIT DOCTRINE is a cash method accounting rule. No fundamental accounting reason exists for such rules to be a function of the type of income earned. Certainly generally accepted accounting rules for financial reporting make no such distinction.

Revenue Ruling 71-352 hypothesize a taxpayer/seller of land. He realized a gain on the sale. Under the sales agreement, the purchaser paid some cash to the taxpayer and the remainder to a bank to be held in trust for the taxpayer and his survivors. The account bore interest and was non-assignable. Annual distributions were limited to 20% of the corpus. The Ruling logically applied THE ECONOMIC BENEFIT DOCTRINE. First, it reviewed the Sproull decision:

In E. T. Sproull v. Commissioner, 16 T.C. 244 (1951), affirmed 194 F.2d 541 (1952), the court held, in determining the taxable year of inclusion of an amount placed in a trust established in 1945 but to be paid to the taxpayer in later years, that though the doctrine of constructive receipt was not applicable, still the entire amount was the measure of the economic benefit conferred on the taxpayer in 1945.

Then, the Ruling expanded THE ECONOMIC BENEFIT DOCTRINE, applying it to the sale of property – and not simply matters involving deferred compensation and contest winners.

Accordingly, it is held that the taxpayer is not entitled to elect the installment method of accounting since the entire amount of the gain from the sale of the land was received by him and is includible in his gross income for the year of sale.

Note what the government argued regarding the availability of the installment method to transactions involving the sale of property. While some authorities may suggest that section 453 - the installment method - carves out sales of property within its ambit and fences them off from THE ECONOMIC

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4 A significant exception is the Tax Court opinion in Reed v. Commissioner, the Circuit Court reversal of which is quoted below. Most interesting is that the decision was a memorandum opinion of the Tax Court. That is inconsistent with the generally accepted notion that memorandum opinions are non-ground-breaking. Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983), rev’g 45 T.C.M. 398 (1982).
**Benefit Doctrine**, the government suggests they are wrong. The installment method itself is merely an accounting rule measuring gain as a function of "payments." It essentially restricts the application of **Cash Equivalency Doctrine** because the receipt of a cash equivalent is not considered receipt of a "payment."

**The Economic Benefit Doctrine**, in contrast, does involve payments because it necessarily involves a transfer by the original payor to a third person (typically, but not necessarily, a trust or escrow account). Thus, **Economic Benefit Doctrine** and the installment method are not distinct tax accounting methods or rules; instead, the economic benefit doctrine is more a definitional doctrine, defining terms applicable to several accounting methods, including the cash method and the installment method. At least, that is the government's position. I agree with it.

2. Some Court Decisions

I include some court decisions, with which I disagree, discussing the relationship between **Economic Benefit Doctrine** and the sale of property. Taxpayers should rely on them at their peril, realizing the government may continue trying to expand the doctrine to property transactions. Considering the number of times the government has lost decisions such as these, however, that "peril" is likely small.

a. *Reed v. Commissioner*

The following case is inconsistent with the earlier discussed revenue rulings and theoretical basis for the economic benefit doctrine. One might fairly consider it incorrect. But, it so strongly favors taxpayers, practitioners would be unwise to ignore it. Arguably, it should have been decided under cash equivalency theory in favor of the government. The government, however, argued it as an economic benefit case, apparently confusing the doctrine with that of cash equivalency.

Facts: The *Reed* taxpayer sold 80 shares of stock in 1973 and the purchaser deposited the sales proceeds into an escrow account. In 1974, the escrow agent disbursed the funds to Reed. Reed reported the gain in 1974. The government sought a deficiency for 1973 (in the amount of $71,412.68), claiming application of **Economic Benefit Doctrine**. The Tax Court found for the government.

Issue: In 1973 – when the purchaser transferred the funds beyond the reach of his creditors – did Reed receive the economic benefit of the payments? Does **Economic Benefit Doctrine** apply to matters involving the sale of property?
Holding: Reed did not receive the economic benefit of the transferred payments in 1973; hence, he had income in 1974 when the escrow disbursed the funds. **The Economic Benefit Doctrine** does not apply to matters involving the sale of property.

The Commissioner asserted application of the three doctrines:

1. Receipt by an agent (claiming the escrow was Reed’s agent).

2. **The Constructive Receipt Doctrine.**

3. **The Economic Benefit Doctrine.**

The Circuit Court easily rejected the first two claims and then focused on the third. Consider the various reasons the court gave for finding the taxpayer not to have the economic benefit of the amounts involved. The following analysis is what one might expect in a future government attack on the case. The Court bizarrely supported each of the listed arguments:

1. *The Account Accrued No Interest.* The court first suggested that Reed received no "present, beneficial interest" in the escrow account because he "was not entitled to receive the income earned from the investment of funds held by the escrowee . . .." In other words, the account was non-interest bearing. So what? Despite the court's questionable appeal to prior case authority, where is the logic in making the accrual of interest a significant factor in the economic benefit doctrine? Surely, as the government has ruled, the accrual of interest is relevant only to the amount of income and not to whether income exists. What difference does it make whether the account is expressed in terms of a future value (a non-interest bearing account) or a present value bearing interest? The two are economically equivalent. The present discounted value of the future value involved in Reed is easily computable, pursuant to the guidelines of section 7872.\(^5\) Thus the court’s analysis is flawed.

2. *The Transaction Was Arm's Length.* The court emphasized that the deferral agreement was arm's length. Again, so what? Of course it was an arm's length agreement. That has nothing to do with the traditional doctrine. For example, an employer and employee may agree - for their own individual, selfish motives - to defer compensation and to place the deferred amount into an irrevocable trust. Under traditional authority, the validity of the agreement provides no protection against the economic benefit doctrine. Such a deferral would, of course, produce income to the employee at the time the account was created.

\(^5\) I.R.C. section 7872 deals with imputed interest and present values with respect to below market loans.
3. The Account Was Not a Cash Equivalent. This court actually states that "in applying the economic benefit doctrine . . . we must . . . ask the separate question of whether the contract right is the equivalent of cash." That is true, but only because a finding a cash equivalency moots the need for the economic benefit doctrine: if the instrument involved is a cash equivalent, then receipt of it produces income without further inquiry into economic benefit theories. Thus every economic benefit case will first conclude that the instrument is not a cash equivalent. This court, unfortunately, suggested that the opposite is true - that all economic benefit instruments must also be cash equivalents. The absurdity of that conclusion is obvious: it renders the economic benefit doctrine superfluous.

4. The Escrow Account Was Not Negotiable. Of course it was not negotiable - these things never are. If it was negotiable, the instrument would likely be a cash equivalent and the economic benefit doctrine would be irrelevant.

5. The Account Was Not Intended As Payment. This court argument arises from the unfortunate Jay Williams decision. As explained earlier, the intention of the parties is logically irrelevant to an objective determination of whether an instrument is a cash equivalent or whether it provides a current economic benefit. Other than in that one questionable decision, the subjective intent of the parties has little to do with the two doctrines. A person who receives a valuable, easily transferable note is no less wealthy if the maker did not intend it as payment than if he did. The instrument is a cash equivalent regardless of that intention. The same should be true of an escrow account subject to the economic benefit doctrine.

6. Reed Never Attempted to Assign His Rights. Both the government and the court argued the case illogically with regard to this issue. In most instances, accounts which confer an economic benefit are non-assignable. This is true because assignable rights will frequently satisfy the tests of cash equivalency. Making an instrument non-assignable is one sure way of defeating the cash equivalency doctrine, which prompted the need for the economic benefit doctrine dealing with non-assignable, irrevocable rights beyond the reach of the payor's creditor. Because most instances in which the economic benefit doctrine applies involve a non-assignable right, Reed's failure to attempt assignment of his right hardly indicates non-application of the doctrine.

While not an additional reason given by the court, the circuit noted that the doctrine emerged from and has primarily applied to cases involving deferred compensation. That is true. Unfortunately, by misunderstanding the

6 As explained earlier, negotiability is not even a requirement of the cash equivalency doctrine; instead, mere assignability is the touchstone.

7 Williams v. Commissioner, 28 T.C. 1000 (1957).
factors of the doctrine, the court failed to analyze whether the traditional effective limitation of the doctrine to cases involving deferred compensation and contest winnings is valid. Interestingly, the Tax Court opinion - reversed by the First Circuit - applied the doctrine to the sale of property, an area to which it had not before applied. And, the Tax Court did so in a Memorandum opinion, a status supposedly reserved for cases breaking no new ground.

b. *Busby v. United States*\(^8\) and the Cotton Cases

In the early 1970's conditions in Texas were such that many farmers apparently faced receiving payment for two cotton crops in a single year. Faced with artificially high income at high brackets, many of the farmers attempted various schemes to defer some of the payments. Naturally, those who actually chose to receive payments in a later year were successful: as cash method taxpayers they recognized income only upon actual or constructive receipt of cash, the equivalent of cash, or the economic benefit of cash. Thus, those who received nothing until a later year had no income until the later receipt.

Pursuant to the old saying, however, many farmers "wanted to eat their cake and to have it, too." In the typical case, the farmer arranged for a cotton gin to sell his crop. The gin did so, received payment, and deposited the funds with a bank or escrow agent. In at least two reported cases, the depositee bank issued a letter of credit to the farmer, representing the deposited funds. In each, the Tax Court, affirmed by the Fifth Circuit in one, found the farmer in receipt of income, considering the letter of credit a cash equivalent.\(^9\) While I agree with the judicial results recognizing income, I disagree with the analysis. Two alternate viewpoints are plausible:

1. The letter of credit - issued by a third party, not the purchaser - amounted to a third party note and thus "property." As such, it constituted the receipt of "property" and thus triggered income equal to its fair market value. This result is the same as that achieved by using the cash equivalency doctrine; however, it is cleaner analysis in that it precludes any possible taxpayer argument regarding the exclusionary aspect of the doctrine.

2. The transfer of funds by the cotton gin to a third party, beyond the reach of the gin's creditors triggered the economic benefit doctrine and thus income recognition by the farmer. True, the funds held by the bank issuing the letter of credit were subject to the bank's creditors' potential claims; but, so what? As explained earlier, Revenue Ruling 60-31 contains examples of the economic benefit

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\(^8\) 679 F.2d 48 (5th Cir. 1982)

doctrine applying without the existence of an escrow or trust account. All that is needed is the irrevocable transfer of the funds to a third party beyond the reach of the payor's creditors. Assuming the government's examples are correct, these cotton cases involved income under the economic benefit doctrine.

Two other cases involving Texas cotton farmers are more disturbing because, on similar facts, the courts found the farmer in receipt of no income. Neither case involved the letter of credit, but both involved a sale of cotton with an irrevocable transfer of funds to a third party beyond the reach of the purchaser's creditors. The cases were *Schniers v. Commissioner*, a 1977 Tax Court decision, and *Busby v. United States*, a 1982 opinion of the Fifth Circuit. Arguably, Mr. Schniers was unaware of the transfer, which would raise the important issue of whether a person can have income of which he is unaware. Nevertheless, the importance of each case involves the issue of agency. In each, the court found that the cotton gin holding the funds was not the agent of the farmer and thus the farmer had no income. Each court concluded that a person receiving and holding funds for another does not necessarily act as an agent for that other person. This is consistent with analysis in other areas of tax law and thus cannot be dismissed as illogical. Nevertheless, neither court discussed the relevance of the economic benefit doctrine, which would appear to have been satisfied. The logical conclusion is that historically the doctrine has not applied to sales of property, which were the transactions involved. As arbitrary as that limitation may appear, these two cases reinforce it.

As is evident in the earlier quoted revenue rulings, the government disagrees. Practitioners should thus be cautious in relying on these decisions.

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Appellants, the Busbys, are Texas cotton growers using the cash receipts and disbursements method of accounting for tax purposes. In 1972 they harvested a crop which they then sold in 1972. Unfortunately, they were unable to collect the proceeds from that sale until 1973 because of collection difficulties. When the 1973 crop came in, the taxpayers wished to avoid the greatly increased tax liability they would have suffered had they received the proceeds for the 1973 crop in the same year they received the proceeds from the 1972 crop. To accomplish this, appellants sought to defer payment.

The Busbys negotiated the sale of their 1973 crop to the Texana Cotton Company through the Farmers Coop Association of Springlake. Although the Farmers Coop is a gin owned by the farmers that use it, it also operated as purchasing agent for

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10 69 T.C. 511 (1977)
11 679 F.2d 48 (5th Cir. 1982).
12 Steven J. Willis, *Masks, Magic and Games: The Use of Tax Law As a Policy Tool*, 4 AM. J. TAX POL 41, 70-71 (1985) (discussing "non-agents" and gift-leasebacks); Steven J. Willis, Of [Im]Permissible Illogic and Section 1031, U. FLA. L. REV. 72, 76-77.
Texana for which it received a commission of a dollar per bale. Once a deal was completed, Texana had authorized the gin to sign drafts on its behalf in payment for the cotton.

From the very beginning, the Busbys had emphasized the importance of deferred payment and conditioned the sale upon it. The gin agreed to take care of the matter and, thereafter, contacted the Olton State Bank and established an irrevocable escrow account. Under the terms of the agreement, Texana was to deposit the proceeds of the sale into the escrow account following the delivery of the cotton. Once in, the appellants had no right to receive the monies held by the bank until 1974. In addition, the Busbys were not entitled to receive any incidental benefits from the account such as interest or the issuance of a letter of credit. In compliance with the agreement, the funds were subsequently transferred out of the escrow account into appellants’ account in January of 1974.

Taxpayers reported the proceeds of their 1973 crop on their 1974 income tax returns. After being audited, however, the Commissioner determined that those proceeds should have been reported in 1973, the year in which the proceeds were deposited into the escrow account, and asserted deficiencies against the Busbys for 1973 in excess of $120,000. Taxpayers paid those asserted deficiencies and brought the instant action seeking a refund of the taxes paid. At the close of the evidence, the court submitted two interrogatories to the jury. The first asked the jury to determine whether the gin was acting as the agent of Texana or the Busbys; the jury answered that it was the agent of Texana. The second interrogatory asked the jury to determine whether the deferral agreement was an arms-length transaction; they felt that it was.

The government subsequently filed a motion for judgment n. o. v. or, alternatively, for a new trial, claiming that the evidence established as a matter of law that, in working out and executing the deferral arrangement, the gin had been acting on behalf of the taxpayers rather than Texana. ****

The district court admitted that the evidence could be construed to show that the gin was the agent for Texana in purchasing the cotton. It did not believe, however, that there was any evidence to support the finding that the gin agreed on behalf of Texana to deposit the money in escrow for the benefit of the Busbys. After reviewing the record, we reach the opposite conclusion. It cannot be said that Texana was ignorant of the agreement; they had received a copy of it from the gin. Secondly, although the gin was authorized to sign drafts for the payment of cotton received, such drafts had to be approved by Texana before they could be paid. Testimony elicited at trial indicates that the drafts deposited into the escrow account at the Olton State Bank were in fact approved by Texana’s home office. Construing these and other facts produced below in the light most favorable to the Busbys, this court finds that there was more than ample evidence to support the jury’s findings.

3. *Goldsmith v. United States*\(^\text{13}\) and Economic Benefit Without Three Parties

The following decision involves an interesting - and highly questionable - application of **The Economic Benefit Doctrine** to the mere promises of an employer. The hospital/employer promised to Dr. Goldsmith various benefits, including retirement, severance pay, and life insurance. None were funds with

\(^{13}\) 586 F.2d 810 (Cl. Ct. 1978).
an account beyond the reach of the hospital's creditors. As a result, Dr. Goldsmith never had any right greater than that of the hospital's promise. Normally, one would analyze such transactions in light of the cash equivalency doctrine. This court, however, chose to use economic benefit theories. It did so with scant authority for such an expansion of traditional cash method theories.

The court was on solid ground in finding that mere promises of future retirement and severance pay do not, as such, result in income to the recipient. However, one might seriously question the court's application of the economic benefit doctrine to a mere promise that happens to "be the equivalent" of more traditional life insurance. No matter how clear the recipient taxpayer may have a current economic benefit, the cash method of accounting does not traditionally result in taxation without more. A transferable promise could satisfy THE CASH EQUIVALENCY DOCTRINE and a transfer to a third party could satisfy the economic benefit doctrine. In this case, however, neither occurred, and the taxpayer should not have had income. The court, however, disagreed.

The economic benefit doctrine does not depend for its applicability on whether the employee could have received cash by stretching out his hand. It is based on the theory that the promise to pay deferred compensation in the future in and of itself under certain circumstances may constitute an economic benefit or the equivalent of cash to be taxed currently at present value, if it can be valued currently with some exactness." McDonald, Deferred Compensation: Conceptual Astigmatism, 24 Tax L. Rev. 201, 204 (1969). The question is therefore whether any of the promises by the hospital were such economic benefits to the taxpayer in the years in question, and were capable of valuation.

The hospital's promises to pay retirement benefits and severance benefits would come due 27 years in the future when the taxpayer reached 65. The promises were not secured in any way. No trust or escrow was established granting the taxpayer a current benefit or removing these deferred sums from the potential claims of the hospital's other creditors, as was the case in E. T. Sproull v. Commissioner, 16 T.C. 244, 247-48 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952) and in example 4 of Rev. Rul. 60-31, supra, 1960-1 Cum. Bull. at 180. Nor were these promises by the hospital represented by a note or other writing delivered to the taxpayer, which he could sell or assign. ****

The payments due upon death were a different matter. They were payable if the taxpayer died before age 65, while still employed by the hospital. For example, should the taxpayer die during the first year of the agreement, the hospital promised to pay his beneficiaries - he named his children - a death benefit of $ 157,603 in 120 monthly installments, with interest, liquidated as $ 1,479.89 per month. ****

The size of these payments is to be contrasted with the amounts due as a severance benefit for one year's service. If the taxpayer left the employ after one year of employment he would receive 10 annual payments of $ 633, a total of $ 6,330, beginning only when he reached 65. The monthly payments upon death during the same one year of employment, were $ 1,479 monthly, more than twice the annual severance payment for the same amount of employment. The contrast emphasizes the deliberateness with which life was insured, effective currently, and not at all postponed until retirement. In case of total disability, there was a still further promise that rights
under the deferred compensation agreement would continue to accrue, as if the taxpayer were actively at work, earning money, and $450 was by the agreement being remitted by the hospital each month towards the increase in benefits.

It becomes quite clear that the promises of payment on death or disability were the familiar undertakings of a life insurance company, albeit made by a hospital. To the extent of these promises, the deferred compensation agreement provided the taxpayer with a current economic benefit as valuable as comparable promises by a life insurance company. Taxability is as plain as the taxability of an insurance premium paid by an employer, in other than a qualified pension or group plan, on a policy of which the employee is beneficiary. ****

Square authority is scant but current economic benefit is plain. Close to the facts of the present case is United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950), which concerned the taxability of single premium annuity contracts containing insurance features, purchased by an employer for an employee aged 45, the annuity to be payable when he reached 65. In a decision holding both annuity and insurance features to be taxable, as conferring a present economic benefit, the court said this of the insurance features of the annuities (179 F.2d at 866):

Likewise, the assurance that any beneficiary named by him at the time the contract was executed, or substituted by him at a later date, would in the event of his death receive the cost of each contract, plus interest after a few years, conferred a present economic benefit on him. Whatever present value the life insurance feature had to him is clearly taxable. ****

Valuation of the economic benefits conferred by the insurance features of the hospital's promises is in principle easily accomplished with evidence of the cost of comparable commercial insurance, in this case the portion of the premium for the policy which is attributable to its life insurance and disability features. ****