End Tax Floats by Taxing Receivables or Deferring Payables

By Calvin H. Johnson and Gregg D. Polsky

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Current law allows businesses that sell services or receive rents or royalties to pay tax on the receivables only when they are collected. Exclusion of receivables under current law allows "tax floats," under which the customer or client immediately deducts the liability but the recipient does not simultaneously include the liability in income. Tax floats make government revenue fall between the cracks and give a welfare-like subsidy to transactions with no special merit. Receivables can be replicated every year, so they are best viewed as a continuous pool or river, with the tax float continuing until the end of the business. Extending credit to customers is an income-producing investment, and it is possible, as a matter of economics, to tax the profit from a receivable only by taxing the investment in the receivable.

This proposal would end tax floats by taxing the receivables or by deferring the deduction of a payable until it is paid. The proposal generally would include a service, rent, or royalty receivable in income no later than when the bill is sent out.

The Shelf Project is a collaboration among tax professionals to develop proposals to raise revenue in the impending revenue crisis by defending the tax base. It is intended to raise revenue without a VAT or a rate increase in ways that will improve the fairness, efficiency, and rationality of the tax system. The hard work needs to be done now to develop viable proposals. Shelf projects are intended to foreclose both 85 percent income tax rates and 60 percent federal sales taxes.

An overview of the Shelf Project is found in "How to Raise $1 Trillion Without a VAT or a Rate Hike," *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4.* Congress adopted its first Shelf Project in March 2010. New section 871(l), enacted in the Hiring Incentives to Restore Employment Act, is based on the Shelf Project proposal by Reuven Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34.*

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

When a payable is deducted before the receivable is included in income on the other side, the parties have created and can share an asset, a "tax float," at the expense of the government. A tax float makes economic income disappear from the tax base year after year indefinitely, although there is no reduction of the wealth of the nation in fact. Tax floats are a kind of welfare for transactions without special merit.

In the impending budget catastrophe, the needed revenue is better met by going after tax floats and other such anomalies that prevent the tax base from reaching real business wealth, rather than raising tax rates. It is the raising of the rates that does the most economic harm. The tax float effectively exempts from tax business income that should be taxed.

The proposal would end the tax float abuse by taxing receivables from services, rents, and royalties when the claim is earned, the amount thereof can be ascertained with reasonable accuracy, and payment of the claim is reasonably expected. In an ordinary situation, the claim would be taxed when the bill is sent out.[1] The proposal would also defer deductions

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[1] *See* Cynthia Blum, "Should Professionals Accept Accrual Fate," 6 *Va. Tax Rev*. 593, 626-627 (1987) (arguing — and

(Footnote continued on next page.)

or basis from all payables until the receivable is included in income. To deduct a payable before it is paid, the payer would need to have documentation from the recipient that the liability is includable in income or exempt, and he would file a Form 1099.

Employees, however, would continue to pay tax on compensation only when actually or constructively received, and the employer would deduct the compensation or include it in basis only at the same time. Independent contractors would be subject to the general rule of taxation on billing, but they could elect to be subject to the employee treatment by subjecting themselves to withholding.

This proposal puts off some important related issues to future shelf projects. Abusive tax floats arise when buyer debt is includable in depreciable basis but not in the amount realized by seller. The scope of this project, however, is defined to exclude sales of capital assets. Deferred compensation should be taxed when earned, under the economic analysis that underlies this project, but deferred compensation is excluded from the scope of this project if it will be paid more than a year after it is earned. The exclusions from this project are not intended to endorse current law, but only prevent this project from becoming unmanageable.

A. Current Law

1. Accrual standards. A receivable is a liability arising in the ordinary course of trade or business that has not yet been paid by the customer, patient, or client by the end of the accounting year. Under nontax financial accounting standards that dominate the commercial world, a receivable arising in the ordinary course of a business is income and the receivable is an asset on the balance sheet contributing to net worth, even though it is unpaid.[2] The discipline of accounting ''attempts to record the financial effects on an entity of transactions . . . in the periods in which those transactions . . . occur rather than only in the periods in which cash . . . is received by the entity.''[3] Revenue is recognized ''not only on cash transactions, but also credit transactions.''[4]

According to the formal tax test, a taxpayer on the accrual method must pay tax on receivables when ''all the events have occurred which fix the liability and the amount thereof can be determined with reasonable accuracy.''[5] Likewise, payables are deductible when ''all the events have occurred that fix the liability and the amount can be ascertained with reasonable accuracy.''[6] In practice, however, the point of legal liability is often unknown and is considered to be an ''attenuated subtlety.''[7] The legal standard in practice ignores whether there is technically a legal liability. A taxpayer will report receivables when the taxpayer has earned the payment, has stated (or can state) the claimed amount with reasonable accuracy, and reasonably expects to be paid in the ordinary course of business. For services, earnings occur when the valuable services have been performed and the claim has been set with reasonable accuracy. For interest or rents, earning means that the time has passed for the known rent or interest to be due. For goods, it means the goods are committed to the buyer for a known price.

Whether stated as the formal rule or as a practical rule, an accrual method payer and accrual method recipient will normally take account of the payable and the receivable at the same time. If the liability is an expense and both taxpayers are in the same tax bracket, the liability has no net effect on government revenue.[8]

2. Floats with cash method. Under current law, however, a cash method recipient will not include a

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convincing us — that taxation on earning by performing services is correct in theory, but that billing date will need to be used in practice).

[2]Financial Accounting Standards Board, Accounting Standards Codification 605-1 — 25-1 and -2 (2010) (revenue is recognized when goods and services are exchanged for claims to cash; installment method is disapproved if payment is reasonably assured).

[3]FASB, Statement of Concepts No. 6, Elements of Financial Statements, para. 139 (1985).

[4]*Id.* at para. 140.

[5]Reg. section 1.451-1(a).

[6]Reg. section 1.461-1(a)(2)(i).

[7]Alan Gunn, ''Matching of Costs and Revenues as a Goal of Tax Accounting,'' 4 *Va. Tax Rev*. 1, 7-8 (1984), points out, for instance, that the Uniform Commercial Code allows a customer a reasonable time or 30 days to inspect the goods to ensure that they conform to contract, but taxpayers selling inventory on credit will book the receivables when the order is received, when the invoice is sent out, or when the inventory leaves physical possession. Indeed, taxpayers who cannot enforce their receivables in court nonetheless must pay tax on their receivables when earned. *Flamingo Resort Inc. v. United States*, 664 F.2d 1387 (9th Cir. 1982) (requiring accrual method casino to pay tax on markers gamblers lost at the tables, although gambling debts were not enforceable); *Georgia School Book Depository v. Commissioner*, 1 T.C. 463 (1943) (requiring a book distributor to schools to accrue earned and billed amounts, although the Georgia legislature would have to pass a tax increase before taxpayer could be paid). Liability is an ''attenuated subtlety.'' *See James v. United States*, 366 U.S. 213 (1961) (taxing an individual on money he embezzled without regard to attenuated subtlety of whether he had title).

[8]Liabilities to pay for investments, however, properly increase the total tax base because the recipient has gained, but the payer has not lost, and because the value of the investment offsets the cost of the expenditure.

receivable in gross income until payment is actually or constructively received.[9] Liabilities for an expense owed by an accrual method taxpayer to a cash method taxpayer are immediately deductible. The combination of deducted payable and excluded receivable makes tax base disappear for the duration of the liability, even though there has been no net reduction in the national economic tax base from the transaction. A receivable causes economic wealth to fall between the cracks, taxed on neither side for the duration of the liability. Making tax base disappear for a period of time creates a benefit, a tax float, that makes the payer or the recipient richer or both.

3. Exemption from accrual. Taxation of receivables under the accrual method is in general mandatory for taxpayers who make or buy inventory for resale.[10] Taxpayers that only provide services to their customers, however, have so far not been required to include their receivables in income.[11] The IRS has published a revenue procedure, moreover, that allows businesses with less than $10 million in annual revenue that primarily provide services to report their receivables on the cash method even though they engage in the sale of inventory.[12] Even if the taxpayer's principal business involves selling of inventory, the IRS allows cash-method exclusion of receivables if the taxpayer has an average annual revenue of less than $1 million.[13]

Section 448 requires C corporations to use the accrual method if their average annual revenue is more than $5 million, but corporations that provide services — within specified fields and which are owned by their service providers — are exempt from the accrual requirement and may use the cash method.[14] Section 448 was passed as part of the Tax Reform Act of 1986.[15] The Treasury report that started the consideration of what became the 1986 act had recommended that all businesses with revenue of more than $5 million be required to use the accrual method, whether or not incorporated and even if they were in a services industry.[16]

4. Anti-float rules. Current law puts some limits on deduction by the accrual method payer before the cash method recipient includes the receivable in income, but the remedies are not comprehensive. If the payer and recipient are related parties, section 267(a)(2) prohibits deduction of the payable until the tax year the recipient includes the receivable in income. ''Related party'' is specifically defined by section 267(b) to include, for instance, family members, corporations within the same control group, trusts and beneficiaries, and corporations and their greater-than-50-percent shareholders.[17] Parties who are not related, however, may still create a deduction before income from the liability and share the benefit between them. The government is hurt by the same amount in a tax float whether or not the parties are related.

Sections 404(a)(5) and 83(h) sometimes defer the payer's deduction in the context of compensation for services. Section 404(a)(5) provides that deferred compensation may not be deducted until the tax year in which the recipient includes the compensation in income under its method of accounting.[18] ''Deferred compensation'' covered by section

[9]Reg. section 1.451-1(a). Amounts are constructively received only if the amount is readily available to the service provider.

[10]*Wilkinson-Beane Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970); reg. section 1.446-1(c)(3). When inventory is bought and sold on credit, the physical count of the inventory will generate a cost of goods sold that will match costs against revenue to create a fair sample of net profits or income of the business, only if both the inventory sold on credit and the purchases on credit (or made with goods and services obtained on credit) are included in the calculation.

[11]Section 446(b), which gives the IRS authority to require accounting that reflects income, has not been interpreted to allow the IRS to include service receivables in income. *Galedrige Construction Inc. v. Commissioner*, T.C. Memo. 1997-240, *Doc 97-14395*, *97 TNT 100-11* (asphalt installer was performing services); *Smith v. Commissioner*, T.C. Memo. 2000-353, *Doc 2000-29370*, *2000 TNT 221-6* (flooring installer was performing services).

[12]Rev. Proc. 2002-28, 2002-1 C. B. 815, *Doc 2002-9029*, *2002 TNT 72-6*. The $10 million annual revenue is determined by looking to the average over the last three years.

[13]Rev. Proc. 2001-10, 2001-1 C.B. 272, *Doc 2000-31536*, *2000 TNT 236-9*.

[14]The specified fields listed are the performance of medical, legal, accounting, architecture, engineering, actuary, performing arts, or consulting services (section 448(b)(2) and (d)(2)), but the list looks like a list of everything the drafters could think of and not like an attempt to put other unlisted services on the accrual method. For a personal service corporation to be immune from the section 448 requirement of accruing receivables, substantially all the shareholders must be employees, retired employees, or the estates of former employees. Heirs of the employee can be counted for eligibility of shareholdings but only for two years after the employee's death. Section 448(d)(2)(B)(ii). Section 448 also prohibits the use of the cash method by partnerships if one or more of their partners are a C corporation, not exempt as service corporations. Thus, partnerships whose partners are all individuals may use the cash method to the extent the nature of their business activities otherwise allow it. The same is true for S corporations.

[15]Tax Reform Act of 1986, section 801(a), enacting section 448.

[16]Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* 128 (1984).

[17]Section 267(b) and (c). Application of the related party rules are explained with examples by reg. section 1.267(b)-1 and (c)-1.

[18]Although section 404(a)(5) applies the remedy to employee plans for deferred compensation, subsection (b) extends the remedy to deferred compensation when there is no plan, and subsection (d) applies the remedy to service providers who are not employees.

404(a)(5) has, however, been interpreted to exclude payments delayed ''for a brief period of time'' after the end of the payer's tax year.[19] Payments made within 2½ months of the following year are presumed to qualify within the ''brief period of time.''[20] Payments made after 2½ months will also be considered to be for a brief period if they arise from exigencies not anticipated at year-end.[21]

Section 404(a)(5) thus tolerates one-year floats that can be replicated every year. Indeed a two-minute float from 11:59 p.m. on December 31 of the payer's tax year to 12:01 a.m. on January 1 of the recipient's next tax year will succeed in generating the deduction on the payable side in year 1 even though the recipient is not taxed until year 2. The tax float can be replicated at the end of each year indefinitely.

Section 83(h) sometimes also delays an accrual method payer's deduction until the time that the service provider realizes compensation income. Section 83(h) applies to transfers of ''property,'' which is defined by the regulations to exclude both cash and unfunded and unsecured obligations to pay cash or property in the future.[22] In other contexts, ''property'' is defined to include things of value, including cash,[23] and it would not have been unreasonable to interpret section 83(h) to cover either the payment of cash or employer promises to pay cash so as to end tax floats as to compensation.[24] Still, as interpreted by the regulations, section 83(h) does not stop floats as to unfunded and unsecured promises to pay cash compensation.

The 2½ month exception for section 404(a)(5) and the unsecured and unfunded promise exception for section 83(h) mean that tax floats are tolerated even for compensation for services. Sections 404(a)(5) and 83(h), moreover, apply only to compensation for services. They, therefore, have no effect on tax floats arising from receivables for rents and royalties.

[19]Reg. section 1.404(b)-1T(b)(1).

[20]*Id.*

[21]Reg. section 1.404(b)-1T(b)(2).

[22]Reg. section 1.83-3(e).

[23]*See, e.g.*, Rev. Rul. 69-357, 1969-1 C.B. 101 (money is ''property'' for the purpose of determining qualification under section 351).

[24]If property were defined to include cash, section 83(h) would defer the service recipient's deduction for all cash payments until the cash was paid. If it were defined to include unsecured and unfunded promises to pay cash, section 83(a) would tax the service provider on receipt of the promise. In either case, the tax float would be resolved because the inclusion and deduction timing would be simultaneous.

B. Reasons for Change

The current deficits are pushing toward what has been called a ''catastrophic budget failure.''[25] Government revenue will need to increase to 150 percent of current yields measured as a percentage of GDP.[26] Rate increases are the most harmful way to raise rates.[27] Trade receivables are an attractive source of revenue both to stop the abuse of a tax float, under which receivables are deducted on the payer's side and disappear from the tax base in perpetuity, and to tax businesses on their profits from extending credit. Receivables are a part of the economic income of the nation which can be taxed fairly and efficiently, even when the liability has not yet been deducted on the payable side. Still, at least the tax float abuse should be stopped to end the revenue pit hole, where economic income falls between the cracks. Receivables are not cash, but a tax system that taxes only cash will be too narrow a tax base and subject to easy manipulation by taxpayers who avoid the cash but still have the economic value.

1. Tax float.[28]

a. Tax float explained. When an expense liability is owed by an accrual taxpayer to a cash method taxpayer at the end of a tax year, the liability is deducted on the payable side without reappearing on the receivable side until a subsequent tax year. The transaction creates a benefit, a tax float, which can be shared by the parties at the expense of the government.

For example, assume that a law firm sends out a $100,000 bill for legal services near the end of the year 2009 that is a business expense to a corporate client. The $100,000 is a receivable that is unpaid at year-end, and the law firm is on the cash method, which is the usual situation. The client, an accrual

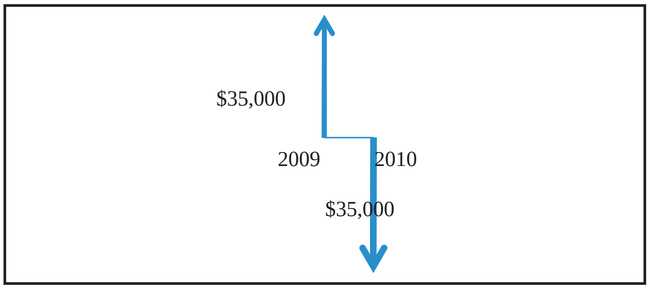
[25]Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, and Katherine Lim, ''Catastrophic Budget Failure,'' 63 *Nat. Tax J.* 561 (Sept. 2010).

[26]We are taking 15 percent of GDP in as revenue and spending over the next decade is projected to be 22.5 percent of GDP, implying a need to increase revenue by 150 percent of GDP. Congressional Budget Office, ''The Budget and Economic Outlook: An Update'' (Jan. 2010), *Doc 2010-2863*, *2010 TNT 25-82*; Summary Table 1, Office of Management and Budget, U.S. Budget for Fiscal Year 2010, Updated Summary Table, Table S-1. Budget Totals, *available at* http://www.gpoaccess.gov/usbudget/fy10/pdf/summary.

[27]*See, e.g.*, Joseph Stiglitz, *Economics of the Public Sector*, 376 (1986) (dead-weight loss from tax rises with the square of the tax increase).

[28]Johnson, ''A New Way to Look at the Tax Shelter Problem,'' *Tax Notes*, May 14, 1984, p. 765, used the tax float concept as a way to explain tax shelters.

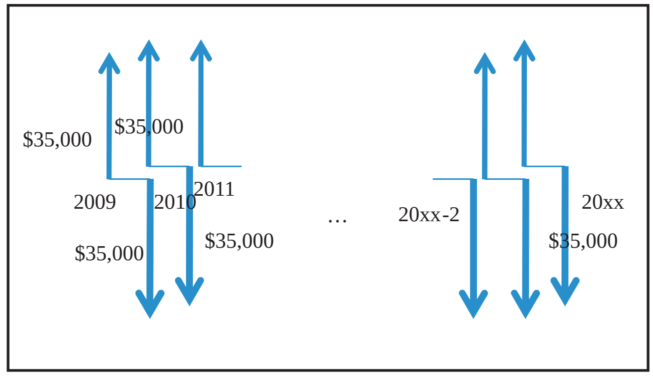
method taxpayer, immediately deducts $100,000, and saves $35,000 in 2009 taxes (35 percent of $100,000). In 2010 the client pays the $100,000 and the partners of the law firm pay tax of $35,000. Between the two parties, tax liability is reduced by $35,000 in 2009 and increased by $35,000 a year later. The transaction has the cash flow pattern of an interest-free loan from the government to the parties as illustrated in the cash flow chart below:



The value of the loan[29] can be expected to be shared between the parties by some split of the value or other. A law firm and client are adverse as to the amount of a bill, as indeed all providers and customers are adverse on amount. But vis-à-vis the government, they are partners who as a matter of economics will maximize the tax float to the extent they are able.

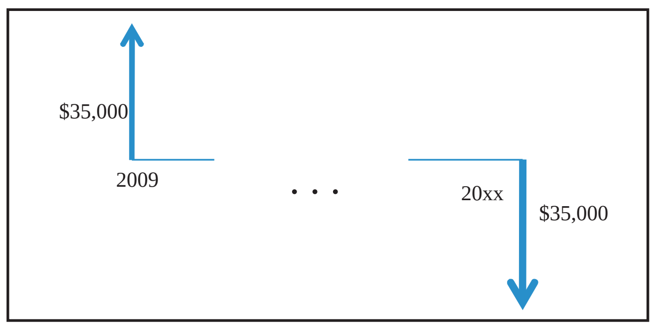
The tax float is a loan of long and indefinite duration; moreover, it's not a one-year loan, because the transaction can be expected to be replicated at every year-end for as long as the law firm sells its services. What counts is that the receivable is a part of a pool that continues on. The identity of the specific receivable and indeed the identity of the client do not matter any more than say the identity of individual pints of water matter in a passing river.

Assume, for example, that the law firm always has a $100,000 receivable at year-end, perhaps from different accrual method clients, for as long as it continues to sell its legal services. If we look at the law firm and its clients as a single pool, the liability saves tax every year on the payable side and requires payment of tax a year later on the receivable side. The pattern for a number of years 2009 to year 20xx, which is far away, would look like the graph:



As long as the law firm has $100,000 receivables at the end of all the years and the tax rate remains the same, the $35,000 loan vis-à-vis the government remains. An interest-free loan is more valuable as the years grow longer, and this loan, ending only in year 20xx, when the firm ceases to have receivables, is very valuable.[30]

The transactions offset each other in every year except for the first and last year, and by dropping out the offsetting cash flows, we can simplify the cash flow presentation into a far simpler cash flow:



If the law firm is in existence for a very long time, the present value of the repayment of the tax float loan is very low because the final payment is very far in the future. The present value is asymptotic to zero, but never reaches it. The maximum value of the tax float to the parties thus approaches the $35,000 tax saved in 2009. The government's maximum loss thus approaches the full $35,000 lost in 2009.

The government's loss and the two parties' benefit of an amount approaching $35,000 does not reflect the underlying economics. The $100,000 bill is not a reduction of the tax base in terms of real

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[29]At 5 percent, an interest-free, one-year loan has a value of $35,000 - $35,000/(1+5 percent), or $1,667.

[30]The present value of the loan is tax saved - tax paid/(1+i percent)^n, where i is the discount rate and n is the years before the government is reimbursed, and the loan becomes more valuable in present value as n increases. With large n's, the repayment value diminishes toward zero and the $35,000 initial tax savings represents nearly the net value.

economics. Whatever was lost on the client's side by the payable was gained on the recipient's side by the receivable. The payable and receivable are the same liability viewed from different sides. The loss of $100,000 tax base and $35,000 tax indefinately is simply a result of inconsistent treatment of the liability by the client and the law firm. The $100,000 of real economic tax base falls between the cracks each year indefinitely to the benefit of the two parties who are in control of the deal.

b. Defer deduction remedy? The tax float inconsistency could be fixed by deferring the deduction on the payer's side in every case until the recipient includes the payment in income. Section 267(a)(2), for instance, which now defers the deduction of the payable owed to a related party on the cash method, could be extended to defer deductions on payables to unrelated persons who are on the cash method. Tax floats make tax base fall between the cracks even when the payer and recipient are unrelated. Tax floats are equally valuable for the two parties vis-à-vis the tax system whether the parties are related or unrelated.

Section 83(h) defers the deduction of compensation paid in the form of property to the year the compensation is included in the service provider's income. If ''property'' within the range of section 83(h) were defined to include either cash claims or cash payments, then section 83(h) would end tax floats from compensation. Section 404(a)(5) also defers deduction until the deferred compensation is included in income, but the regulations exclude payables that are paid within 2½ months. If the 2½ month allowance were repealed, section 404(a)(5) would end tax floats with compensation for services. Sections 83(h) and 404(a)(5) apply only to compensation-for-services transactions, but tax floats also arise from receivables for rents and royalties and other expenses.

As explained next, fixing the tax float by treating payment as the time for both the deduction and the inclusion of the liability would undertax the recipient of the receivable on its underlying economics.[31] Symmetrically, deferring the deduction overtaxes the payer by delaying its deduction. The proposal here does rely on the deferring of the deduction remedy, in certain circumstances, and because that remedy is more administrable, but it does so while conceding that reflection of economic income would tax the receivable at its value when the goods and services are provided and recognize the payable at the same time.

2. Taxing the receivables.

a. Exemption of return under current law. Selling services on credit will give the service provider a separate profit attributable to extending the credit to the customer or client. A receivable is an income producing investment. All businesses have access to an interest return or have to pay an interest cost for use of money. A business tolerating delay in payment once its valuable goods or services are delivered has lost the opportunity to make interest or will have to pay more interest to its creditors. Symmetrically, a customer that defers payment can make an interest return on the money for the term of the liability or will avoid paying interest to borrow cash for the term of the receivable. Because of the opportunity to make interest or the obligation to pay interest, it can be assumed that a receivable gives an interest return between two parties with any commercial or economic sophistication. The interest may be disguised, or in fact returned to the vendor as an additional price for the goods or services, but given the opportunity baseline, there is always stated or unstated interest in the receivable.

Interest will run from the time that the business gives up valuable resources to the customer. A lawyer, for example, does custom work for the client, and by professional responsibility rules, excludes conflicting loyalties to anyone other than the client. A lawyer knows what his services are worth in the market, and he will work for one client rather than another because the client is willing to pay his

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[31]As Emil Sunley first showed (''Observation on the Appropriate Tax Treatment of Future Costs,'' *Tax Notes*, Feb. 20, 1984, p. 719, arguing that future costs discounted at pretax value should be included in basis), and others have confirmed (Donald Keifer, ''The Tax Treatment of a 'Reverse Investment','' *Tax Notes*, Mar. 4, 1985, p. 925, supporting Sunley with tables; William Klein, ''Tax Accounting for Future Obligations: Basic Principles,'' *Tax Notes*, Aug. 10, 1987, p. 624, supporting Sunley with spreadsheets; Theodore Sims, ''Environmental 'Remediation' Expenses and a Natural Interpretation of the Capitalization Requirement,'' 47 *Nat. Tax J*. 703 (1994), supporting Sunley with calculus), future payments need to be discounted to their present value at the pretax rate of return and recognized when they arise if the tax system is going to recognize the pretax internal rate of return (IRR) of the business that incurred them. IRR is the interest on a bank account that matches the business under consideration, and it is the universal yardstick to measure economic income from diverse kinds of investment. A future payment reduces the IRR from a transaction. It is possible to identify the IRR from a transaction and reduce it by the statutory tax rate only if the obligor includes the discounted present value of the future payment as a cost when it arises and then takes an interest deduction as the time value discount expires. Only then will the tax accounting reduce the IRR by the statutory tax rate and leave the investment with the same value to both a high-bracket and low-bracket bidder. The argument is a variation of Samuelson depreciation (Paul Samuelson, ''Tax Deductibility of Economic Depreciation to Insure Invariant Valuations,'' 72 *J. Pol. Econ*. 604 (1964) on making the price of investments immune to tax rate variations) and it is very powerful stuff.

bill. A business will sell goods on credit only because the customer is paying interest from the time the goods are delivered. Rent, royalties, and interest are due as time passes because they are the use of resources, and the business will insist on interest if payment is delayed beyond that time. A business can avoid extending credit to clients or customers by insisting on cash retainers or prepayments or periodic payments. When credit is tight, the business can charge more for extending credit. If the business forbears from claiming cash when it provides resources, it will demand interest on top of the sales price to compensate for the later payment.

The ability to exclude the receivable from income is ordinarily as good as getting an exemption from tax for the subsequent profit from the investment.[32] Thus deferral of taxation of receivables until payment means that the profit from credit is not taxed to the business. Assume for Table 1 that a law firm incurs $90,900, incurring partner time and paying out cash salary to associates and staff. The law firm bills the client $100,000 payable in the following year. The $90,900 worth of services is an investment yielding 10 percent and not a loss when made, because the $90,900 is invested in return for an expected value of $100,000. Ordinarily investments are made in an income tax only after gross income is reduced to take-home after-tax amounts. Table 1 assumes a 40 percent tax rate for illustration. Column (1) of Table 1, however, assumes that there is no tax on the 10 percent profit from extending credit. With the exemption of profit from tax, the end result is $60,000 after cash.

Table 1. Equivalence of Exempt Yield and Tax-Free Investing

	(1) No Tax On Profits	(2) Tax-Free Investing
1. Income	$90,900	$90,900
2. Tax on income @ 40%	($36,360)	No tax!
3. Investable [rows 1 - 2]	$54,540	$90,900
4. Growth [1+10% of row 3]	$60,000	$100,000
5. Taxable amount	No tax!	$100,000
6. Tax on profit @ 40%	No tax!	($40,000)
7. End result	$60,000	$60,000!

Column (2) of Table 1 represents tax-free investing by the law firm in client receivables. The cash paid to staff and associates is deductible when made, and the valuable resource of partner time is not taxed when the services are rendered, so there is no tax before the law firm invests in the $90,900 in resources. The 10 percent return built into the client bill is taxed in full when paid the following year. The two columns, yield exemption and tax-free investing, give the same after-tax end results indicated by Table 1, row 7.

Ordinarily in an income tax, the profits from the 10 percent profit in column (1) would be subject to an income tax, but not as assumed here, when the yield is tax exempt. Tax exemption for a return is recognized as a privilege or benefit under the income tax. But column (2), which allowed tax-free investing gave the exact same after-tax final result. The equivalence of profit-exemption and tax-free investing shown in Table 1 can be generalized through algebra for any tax rate and any growth rate, whether modest or extraordinary.[33]

The tax-free investment in receivables can also be expected to be replicated every year, as long as the firm remains in business. The return on a short-term investment is not very much. A tax float works for a liability that lasts two minutes if the liability straddles one tax year from payable to receivable. Exemption from tax or its equivalent on very short-term liabilities will not be much, because the income is not much. The exemption equivalence, however, can be replicated at each year-end, year after year, and the exemption of receivables for one year are just drops within the passing river. Receivables as a pool are a very long-term investment that will last for as long as the law firm performs services.

To identify and tax the internal rate of return (IRR) of an investment, the receivables have to be included in income at their value. IRR is the universal yardstick used by financial economics to compare diverse investments. IRR is the interest paid by a bank account (possibly a hypothetical

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[32]The equivalence of yield exemption and capital expensing arises from Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson* 300 (1948) and is sometimes called the Cary Brown thesis in his honor.

[33]The profit exemption of column (1), is $\$100 * (1\text{-}t) * (1\text{+}R)^n * (1\text{-}0)$, where $100 is a unit of income, t is the tax rate and $(1\text{+}R)^n$ is the compound growth at rate R for period n. The 1-0 term at the end just says there is no tax on distributions. The tax-free investing, column (2), is $\$100 * (1\text{-}0) * (1\text{+}R)^n * (1\text{-}t)$. Profit exemption (1) must equal soft money investing privilege (2):

$$(1)\ \$100 * (1\text{-}t) * (1\text{+}R)^n * (1\text{-}0) =$$
$$(2)\ \$100 * (1\text{-}0) * (1\text{+}R)^n * (1\text{-}t)$$

because of the "commutative law of multiplication," which says that it does not matter here whether you put the reduction by tax "(1-t)" near the front of the expression or at its end.

The equivalence breaks down if the tax rates vary, and tax-free investing in column (2) is better than exemption if tax rates drop. If a taxpayer puts his tax savings (row 2) into some use other than the investment under consideration, the value of yield exemption versus tax-free investing will depend on whether the alternative investment has a greater or lesser yield than the investment under consideration.

bank account) that matches the investment under consideration as to cash flows. To identify IRR on the receivable (the interest earned) for tax, it is necessary to identify simultaneously the bank account balance and keep it as taxed but not yet depreciated basis. Only by identifying the value with adjusted basis is it possible to reduce the pretax IRR to an after-tax rate of return consistent with the statutory tax rate. Indeed, the ratio of basis to fair market value of an investment identifies the ratio of the (IRR-reducing) effective tax rate to the statutory tax rate.[34] A tax value for receivables that is reasonably close to the fair market value will yield an (IRR reducing) effective tax rate that is reasonably close to the statutory tax rate. The closer the tax system can come to taxing the fair market value of the receivable when the goods or services are delivered, the closer the true effective tax rate will be to the statutory tax rate. Zero present value for the receivable when it arises means a zero effective tax rate on the return from the receivable. Zero value, which cash method accounting assumes, is not a reasonable estimate of the value of the receivable when the services have been performed. Zero value for the investment in the receivable will lead to a zero effective tax rate on the very long-term profit from receivables.

b. Negative tax subsidy. Businesses, moreover, typically finance the deferred payment by clients and customers by borrowing from a third party. If income is exempt from tax, or its equivalent, and interest is deductible, then a law firm, like that in Table 1, can come out ahead by the amount of the interest deduction, at the expense of the tax system, on what is just a break-even transaction in absence of tax.

Assume, for instance, that client and law firm are equal credit risks that must pay equal interest costs to borrow and that therefore the law firm pays interest to its creditors exactly equal to the return on its receivables. With the borrowing cost and receivables return just equal to each other, the taxpayer comes out ahead when receivables are tax-free investments by the amount of the interest deduction.[35] With interest deduction and exemption of the return, the tax accounting is a negative tax, a kind of Cadillac welfare for the law firm.

The phenomenon of interest deductions vís-a-vís funding receivables is like the target of section 265(a) and (b), which disallow the deduction of interest and other costs that are related to tax exempt income. The negative tax subsidy also allows the law firm to lose money economically, by the value of the interest deduction, and break even once the negative tax is taken into account, on transactions that have no special merit for subsidy. The subsidy allows inefficient transactions, defined as transactions that would not be undertaken in absence of tax.

c. Complexity and liquidity. Immediate taxation of receivables is the system of accounting required by generally accepted accounting principles and by the financial accounting standards. Businesses that buy or make inventory for resale are already required to pay tax on receivables, and generally speaking businesses with inventories need working capital and are subject to liquidity constraints that are more demanding than service industries, or at least their liquidity needs are of the same kind. Receivables are viewed as revenue when they arise under the ordinary mores of the business and merchant world. The tax law's ignoring of service receivables is the odd exception in the commercial world.

Taxation of receivables at their face amount would always require no additional accounting for businesses, since every business keeps track of what its customers owe — or at least every business that has survived to the present day keeps track of what customers have not yet paid. The best of the starter accounting programs for small businesses that cover almost everything the small business needs to sell for less than $200.[36]

A business unwilling to sell on credit will sell for cash only. Lawyers do insist on retainers and progress payments when they have doubts about the credit-worthiness of their clients. A business chooses to sell on credit, rather than cash only, solely because of the extra profit that can be made from extending credit. The receivable needs to be worth the value of the goods or services or the

[34]Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289, *Doc 2008-24799*, *2008 TNT 242-46*.

[35]In column 1 of Table 1, the taxpayer borrows $1, receives $1 * (1+R) from his investment at end, and repays $1 * (1+I) including interest at the end. With both R and I the same (here at 10 percent), the pretax situation is a wash, but the taxpayer gets a tax deduction worth $1 * I * t.

Column 2 is equivalent to tax exemption, but the upfront investment is bigger by the tax saved or avoided at the start. If a pretax borrowing of $1 allows an investment of $1/(1-t) because of expensing, then the return at rate R is $100/(1-t) * R. Interest at rate I is incurred only on $1 borrowed to justify the $1/(1-t), and so the net return is reduced by interest to $1/(1-t) * R - $1 * I, which net is taxed to give an after yield of [$1/(1-t) * R - $1 * I)] * (1-t) or $1 * R - $1 * I * (1-t) or $1 * R - $1 * I + $1 * I * t. When I and R are equal (here at 10 percent), the net result is against $1 * I * t, the value of the interest deduction. The algebra assumes that the amount invested is increased by tax not paid.

[36]http://accounting-software-review.toptenreviews.com/.

business would not be willing to take the receivable in exchange for delivering the goods or services. To tax the extra profit from extending credit, the tax system must tax the value of the receivable when it arises.

Receivables are near cash. The legal framework for using receivables as collateral for an immediate loan and for selling receivables is well established. Sale of receivables or loans regarding receivables are usually the best way that a small business gets access to capital at the lowest rate.[37] Receivables are short-term debts. The estimated taxes for the last quarter of a year are not due until January 15 of the following year, and they can be deferred until January 31 of the following year, if the taxpayer files the return with tax due by then.[38] By then enough cash will ordinarily come in on trade receivables even for a top, 35 percent bracket taxpayer.

Taxation of the economic income from receivables at an effective tax rate equal to the statutory tax rate requires that the receivables be included at their real fair market value, when the goods or services are provided. The face amount of the receivable is often the correct expected value of the receivable. A business will typically give customers 30 days or some other short term to pay without interest, but then interest is charged at a high enough rate that customers will avoid it. A customer's willingness to pay the extraordinary rate is a telltale indicator that the customer needs special attention.[39] The high interest rate keeps receivables short term and prevents them from declining below face value. Face value, moreover, is often the best approximation of the expected value of the receivable, even when the expected value might be slightly lower than face value. Some complexity can be tolerated toward reaching the best value of receivable when the goods or services are delivered; the proposal here allows a business to discount its receivables below the face amount to an expected present value by looking to interest paid and defaults over the prior three years. But there is no good reason to lean toward undertaxation of receivables instead of overtaxation.

[37]John Francis Hilson, *Asset-Based Lending: A Practical Guide to Secured Financing* 1-2 (2010) (financing of receivable is ''linchpin'' of asset-based financing for businesses). *See* Hilson for a description of legal framework, at ch. 1 (use of receivables as collateral) and ch. 2 (sale of receivables).

[38]Section 6654(c), (d)(1)(A), and (h).

[39]The terms of receivables are set privately between the parties and not published, but it is our understanding that they often give a grace period of 30 to 90 days and then charge an interest rate high enough to alert the business that the customer must be having problems if it is willing to pay the interest.

3. Ending tax floats is the first priority. As shown, in theory, the fair market value of the receivable should be taxed when goods or services are delivered or time has passed for rent or royalties. We have concluded, however, that we need to make compromises with good theory in order to make the proposal as administrable as possible. The first priority is to end the per se abuse of tax floats in which the payable disappears from the tax base before the receivable appears in the tax base. In the interest of administrability, the proposal will exempt employees from paying tax on their unpaid compensation but will defer the employer's compensation deduction in every case. The proposal would also allow the billing of clients and customers to be the taxable event even when the bill is sent out after the receivable is earned, absent clear abuse, but would defer the deduction of the payable until the bill is received. The proposal would also combat tax float inconsistencies by requiring the payer to have an acknowledgement from the payee that the bill is includable in income, or an exception applies to it, and to have filed a Form 1099 with respect to the liability.

C. Explanation of the Proposal

1. When taxed. The proposal would tax receivables owed by a customer, patient, or client to a taxpayer in a trade or business or for the production of income when the claim has been earned, the amount of the claim can be ascertained with reasonable accuracy, and the taxpayer reasonably expects to get paid. Receivables for services are earned when the services have been performed, receivables from the sale of goods are earned when the goods are delivered, services for rents are earned when the time of use of the leased property has passed, and royalties are earned when the time of use has passed. Earned receivables which can be ascertained with reasonable accuracy would be taxed to the recipient, regardless of the taxpayer's general method of accounting. All the events to fix enforceability of the liability in a court of law need not have occurred if payment has been earned.

The proposal would consider the communication of a bill or invoice to the customer or client as the taxable event in the ordinary case. The taxpayer thus can communicate an invoice to the customer and simultaneously send another copy of the invoice to the accounting department (or indeed to the cigar box) where tax records are kept.

Our willingness to use the billing date as the taxable date is conditioned on ending the tax float possibilities by deferring the client's or customer's deduction until billing. As a condition of a deduction or addition to basis, the client or customer who will pay the claim must have received a communication of an invoice that states that the liability will be included in income or qualifies for an exception that does not undermine the deduction. The payer must also send a Form 1099 to the IRS and to the recipient of the receivable.

Some taxpayers book revenue earlier than services are billed. Some businesses book revenue when a customer order comes in, or when work is done to satisfy a fixed price contract even before billing. The proposal would allow an earlier booking of revenue in conformity with business books presented to creditors, owners, and potential investors if the method is used consistently.

If a taxpayer has a retainer or cash security from the customer in hand, however, and the cash has not yet been taxed, the taxable event would be no later than when the cash or retainer on hand is earned.

If the taxpayer has earned the receivable but has not yet presented a bill to the customer, the proposal would ordinarily allow deferral of taxation of the earned amount, except when the delay is abusive. The earned but unbilled liability, however, would not be deductible by the client or customer's bookkeeping so as to create a tax float. Ending the tax floats is the first priority of the proposal. If the earned but unbilled receivables are material, however, the receivable will be taxed as earned unless the taxpayer can show that the delay in billing did not have as one of its motivations the avoidance of tax. Earned but unbilled receivables that do not exceed 30 days of a year's flow (one-twelfth of revenue) would not be treated as material.

The proposal would tax billed receivables even though there remains some immaterial contingencies to be settled before the liability is enforceable in a court of law. Modern accounting ignores minor contingencies, as long as the critical event has occurred, because the receivable is an asset of value even if minor, immaterial contingencies remain. Small items — the tail of the dog — should not be allowed to wag the dog. Taxation of the receivable also does not require that the receivable be paid or that the amount due be made available to the recipient for payment, and it does not require that collection efforts have started.

2. Valuation. The proposal would generally require the face amount of receivables to be included in income when the liability is billed but would allow the taxpayer to reduce the value of the receivable below its face amount to a present value and a probability-discounted expected value, according to its own experience over the prior three years. The discount would take into account all cash flows received in the three-year period, including interest and finance fees and penalties for late payments.

The reduction for expected defaults would be available only as reflected in the history of the taxpayer over the last three years including the current year. No judgments would be allowed that some receivables are more likely to default than the firm history would indicate. A start-up business would get no reduction for expected defaults in the first year, and would use all years it was in existence until it reached three years.

The proposal would allow a discount for time value based on the same three-year historical experience. The discount used will be 110 percent of the applicable federal rate. Cash flows to be discounted include interest payments, fees, and penalties received on the payable. If the receivable remains unpaid at the end of the three historical years, but it is not worthless, the face amount of the receivable would be treated as a cash flow at the end of the tax year under consideration.

Section 448(d)(5) of current law allows some service businesses to avoid accrual of their receivables to the extent that the taxpayer's own experience indicates the receivable will not be paid. The section 448(d)(5) allowance is not available, however, if the taxpayer collects interest or late payment fees on the receivables. The proposal here would allow the exclusion for receivables not expected to be paid even if the taxpayer charges interest.

Many industries have bad debt reserves in the 1 percent range, in which the reserve is easily covered by extra interest. But some industries who extend credit for their services to nonbusiness consumers with modest wealth take bad-debt reserves that are substantially higher.[40] Looking to the history of the specific taxpayer will distinguish between the two.

We would expect that many businesses will choose to use a simplified method that would tax receivables at face amount and would not do a study of their receivables over the last three years because they do not think it would be worth it. We want to encourage that simplification by denying recognition to any discount that turns out to be less than 2 percent of the face amount of the receivable.

Payers would, in general, be able to deduct the face amount of payables subject to the proposal at the same time that the payee includes the receivable in gross income. If the payable does not bear adequate interest, this rule would overstate the payer's deduction.[41] Given the one-year term of receivables subject to this proposal (as explained

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[40]Bad-debt reserves by industry for 2008 are *available at* http://www.creditpulse.com/node/84.

[41]Note that the economic performance rule in section 461(h) would continue to apply to ensure that the payer could not deduct any amount before economic performance. However, the payer's deduction could still be overstated if, for example, the liability arises after services are performed and the liability does not bear adequate interest.

below), the amount of overstatement will generally be modest. Therefore, the simplicity of the face value deduction rule generally outweighs any overstatement concerns.

Nevertheless, in high interest rate environments, the face value deduction rule could be exploited to generate excessive deductions for payers. To avoid this, we would give regulatory authority to reduce the payer's deduction or addition to basis when the fair market value of a receivable is substantially lower than its face amount.

If, on the other hand, a receivable bears clearly excessive interest, the proposal would value the receivable at fair market value to prevent service providers from circumventing the proposal by using instruments with unreasonably low face values.[42]

3. Rejected proposals.

a. Automatic 5 percent discount. This shelf project considered but rejected a proposal to discount all service receivables by 5 percent of the face amount or some similar modest amount to reflect the fact that they are not quite cash. The 5 percent would have been an indulgent discount. Receivables are short-term liabilities that do not usually last on average for a full year. In low inflation times, the time value discount for payments that came in two weeks after the year-end would be 5 percent/24 or 21 basis points, which is far too small to justify the effort. The interest charges or fees imposed on the liabilities after 30 days will generally keep the value of the receivable at face value or near it.

The 5 percent automatic discount allowance, even at a modest level, would be inconsistent with the business environment in which taxpayers operate. Business customers and clients deduct the full face amount of the liability when it arises or add the cost to inventory, and the liability is the same item on the payable and receivable side. Service business going to the accrual method in full would get to deduct the matching costs of their expenses that are still payables at full face value. Taxpayers keeping inventories must now include receivables at face value. It would be unjust to allow service businesses to take an automatic discount on receivables, while inventory businesses do not.

b. Exemption for small business? The proposal considered but rejected an exemption from taxation of receivables for small businesses, defined in some way. De minimis amounts are those that are too small to be worth taking into account by an accounting system. But all businesses, including especially small businesses, keep track of what their customers owe them down to the dime. Those that do not are no longer in business. No customer debt is too small to be kept track of. Computer accounting for small businesses is cheap and getting cheaper — the best full-service accounting programs, as noted, are selling for less than $200. A small business might make life even simpler by forgoing the experience-based bad debt reserve.

''Small business'' is an honorific status in American society. Still, it is important to keep honest and accurate books even for honored categories of taxpayers. Many small businesses are owned and run by taxpayers with a very high standard of living. They should not be entitled to understate their income. The bracket system of section 1, combined with dependency exemptions and standard deduction, reflect Congress's judgment of when income should bear zero or modest rate tax. Section 1(a)-(d) judgments are fair because they apply to all taxpayers without regard to the source or nature of the income that supports their standard of living. No extra exemption, beyond that allowed under personal exemptions and low brackets, is proposed for small business from the taxation of receivables.

4. Exception for employee compensation. The proposal would exempt employees subject to withholding from the requirement that they include receivables in income. It would also end tax floats on employee compensation, however, by ending the 2½ month rule that allows employers to deduct compensation payables before the compensation is included in income if they pay the compensation shortly after the end of their tax year.[43] The 2½-month rule allows perpetual tax floats: As noted, a two-minute deferral from 11:59 p.m. at the end of the employer's year to 12:01 a.m. of the employer's tax year will be sufficient to create a tax float for a year in which tax base disappears from one side before reappearing on the other. Since the tax float will be renewed perpetually for as long as the business continues, tax floats can be expected to be significant. The deferral of deduction would be required for any payment made after the end of the employee's tax year. An employer would be able to presume for unrelated employees, however, that the employee is on the calendar year.

[42]*Cf.* reg. section 1.1274-3(b)(3) (defining ''clearly excessive interest'' for purposes of section 1274 as an amount ''clearly greater'' than the amount of interest that would have been charged in a cash lending transaction between two arm's-length parties).

[43]Alternatively, the 2½-month rule could be eliminated only for those employers whose tax years end on or after October 31. Because the vast majority of cash method service providers are on the calendar year, this more limited approach would target only those transactions that have the potential to create the tax float.

The deferral of the deduction of the payable is an inferior remedy. It overtaxes the payer who needs an immediate present-value deduction to reflect economic income, and it undertaxes the recipient who needs to have a basis equal to the value of the goods or services when he makes an investment by extending customer credit.[44]

Deferring the deduction relies on substitute taxation to approximate the correct tax result, and substitute taxation is often not wholly effective. If the employer and employee are in the same tax bracket, the tax system is not affected by using the deferral remedy instead of immediate taxation of the value of the receivable. The employer and employee are repeat players who can work out the over and undertaxation between themselves. Substitute taxation by deferral, however, does not work well if the tax rates of employer and employee differ. For example, substitute taxation does not work at all in the case of tax-exempt employers or those with excess net operating losses, who would be unaffected by the deferred deduction approach. Substitute taxation would also not generate correct results if the employer is indifferent to delayed tax deductions.[45]

Nevertheless, the deferred deduction approach is sufficiently easier to apply and administer in the employer-employee context that we recommend it. Employees are not likely to keep professional books, while employers will. The view of the commercial world that receivables are an asset improving net worth immediately and very near to cash is familiar to a business, but it might be strange to employees.

5. No deferral for independent contractors. The shelf project considered extending the deferred deduction approach to independent contractors but ultimately rejected it. As noted above, the deferred approach is not the ideal way to describe economic income, and substitute taxation fails to be an adequate remedy in some cases. Independent contractors are often much more financially sophisticated than employees, because they have to handle their own quarterly estimated taxes. Independent contractors also have expenses that they need to account for; therefore, they are more capable of applying the immediate taxation of receivables rule. Independent contractors' expenses are deductible in full, whereas employee expenses are deducted only in excess of 2 percent of their adjusted gross income[46] because of the assumption that employees do not ordinarily keep professional accounting books.

Thus, under the proposal, an independent contractor will be required to include the receivable income as soon as the claim arises, usually on billing. Service providers who now report as independent contractors would, however, be allowed to elect to report as employees, by notice to the service recipient at the beginning of the tax year that the services are provided. The employer would withhold from all payments and would not be able to deduct unpaid compensation, but the service provider would be able to defer taxation until payment. It may well be that the proposal taxing independent contractors on their receivable would induce more taxpayers to come within the withholding system as employees, which would improve the collection of revenue.

6. Expansion of matching with recipient tax. It is proposed that section 461(a) be amended to provide not only that the taxpayer shall deduct expenses according to its own method of accounting, but also that no deduction or addition to basis for a payable shall occur until the receivable is included in the income of the payee. Once payment occurs, however, deduction or addition to basis would be allowed without regard to what the recipient did.

As revised, section 461(a) would be a generalized anti-tax-float rule applied to all liabilities. The rule would replace section 404(a)(5), (b), and (d), which together in not very elegant prose defer deductions for payment for services until the employee or independent contractor includes payments income. The revised section 461(a) would defer payments of rents and royalties as well as compensation for services. There would be no exemption in the revised section 461(a) for payments to be made shortly after the end of the tax year.

7. Form 1099 responsibilities for the payer. The proposal would also adopt an administrative rule requiring that the payer, to deduct a payable or add it to basis, would have to have had a bill from the payee or other indication that the recipient would include the claim in income (or had a reason for nontaxation of the receipt that is not inconsistent with the payer's deduction). The payer would also need to show that a Form 1099 was issued to the recipient. Once the payable is paid, however, the deduction or basis would be allowed under ordinary principles even if no Form 1099 was issued. Both the bill and the Form 1099 may be delivered after the end of the tax year, but they must indicate

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[44]*See supra* note 31.

[45]*See* Christopher H. Hanna, ''The Real Value of Tax Deferral,'' 61 *Fla. L. Rev*. 203 (2009) (arguing that corporate managers are not concerned with the deferral of deductions from compensation because, despite the economic cost to shareholders of such deferral, the financial accounting treatment of deferred compensation does not reflect the cost).

[46]Section 67.

that the tax year the payable arose was the year in which the recipient is taxed.

The proposal for a bill and the Form 1099 is in the nature of an administrative remedy designed to double check taxation of receivables. One of the reasons why a VAT is superior to a sales tax is that the taxpayer wants credit for VAT tax paid by its seller, and the paper exchanged to get the credit for the VAT helps enforce supplier payment of the tax. So the bill, acknowledging tax or exception, and the Form 1099 help administer the tax. In theory the receivable should be taxed when it arises. The Form 1099 helps make that theory truer as applied to the real world.

8. Limits of this Shelf Project. This proposal puts off some important related issues to future shelf projects. Abusive tax floats arise when buyer debt is includable in depreciable basis. Moreover, deferred compensation to be paid long in the future could be reasonably included in income when accrued, within the economic analysis that underlies this project. The current proposal excludes both basis on capital assets and deferred compensation to be paid more than a year later. The exclusions are not intended to endorse current law, but only to prevent this project from becoming unmanageable.

a. Deferred compensation. The proposal taxing receivables when earned could rationally be applied to all non-qualified deferred compensation. The deferral of service-provider tax on non-qualified compensation has recently been under review, however, and the requirements for achieving deferral have been tightened by the enactment of section 409A.[47] Deferred compensation is a long-term debt, and payouts are commonly measured by stock price or some other reference asset or by a defined benefit formula. The trade receivables governed by this proposal are usually short-term liabilities expected to be paid within a short billing cycle, and the contingencies are immaterial. Valuation of them is much less problematic. We conclude, although not without some reservations, that deferred compensation should continue to be governed by its own rules and would not be covered by this proposal. The proposal would allow the current treatment of ''deferred compensation'' to be continued.

We define the deferred compensation outside this proposal somewhat arbitrarily as payments that are on the terms of the contract to be made more than a year after earning. Shorter-term liabilities would be governed by this proposal. Alternative cutoffs are reasonable. The cutoff does not make a fundamental economic distinction, but only puts off for another shelf project the reform of deferred compensation not covered here.

For employees this proposal and the rules for deferred compensation are congruent because the employee would be taxed in both cases only when paid or constructively paid. For independent contractors, however, the proposal for receivables means the receivable is taxed when the claim arises, that is, when the claim is earned, reasonably likely to be paid, and estimable with reasonable likelihood. For compensation claims written to be paid more than a year after the claim is earned, however, the deferral until payment would be allowed. In all cases, however, the payer cannot deduct the payable until the independent contractor includes the receivable in income.

b. Deferred payment sales of property. We also carve out from this project sales of capital assets by the taxpayer on credit. Important and abusive tax floats arise when a buyer includes his debt in depreciable basis and the seller excludes the debt from amount realized until sale.[48] Shelf Project proposals go after loopholes in which economic income falls between the cracks. No endorsement of the abuse is intended by taking it out of this proposal. But one should chew problems one bite at a time, and the basis-realization inconsistency for capital assets is another project.

Moreover, a separate Shelf Project has a proposal for greater tax revenue from sales of property not in the ordinary course of a trade or business for deferred payments, including both installment sales and open transactions. The proposal would not require tax until payments are received, but it would tax the first cash that came as boot, that is, all gain would be taxed before any basis is recovered. Receipts after the year of sale would not qualify as capital gain. The proposal here defers to the earlier Shelf Project by exempting from the scope of this proposal sales of property not in the ordinary

[47]Section 409A. For criticisms that section 409A is ineffective in taxing non-qualified deferred compensation appropriately, see Ethan Yale and Gregg D. Polsky, ''Reforming the Taxation of Deferred Compensation,'' 85 *N.C. L. Rev.* 571, 573-574, n.7 (2007); Eric D. Chason, ''Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season,'' 67 *Ohio State L. J.* 347, 349 (2006); Dan L. Trier, ''Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032,'' *Taxes*, 141, 151 (2006). For a criticism that section 409A is both ineffective and overcomplicated, see Michael Doran, ''Time to Start Over on Deferred Compensation,'' 28 *Va. Tax Rev*. 223 (2008).

[48]Johnson, ''Johnson Says IRS Should Develop Different Approach to Settle Tax Shelter Cases,'' *Tax Notes*, June 8, 1987, p. 1019.

course of trade or business.[49] The earlier Shelf Project may need to be revisited in view of the tax float problem, but not here.

9. Transition. The proposal would not apply to receivables earned before the effective date of the proposal. All taxpayers would thus have notice of the new tax rules when they delivered the goods or services, and they would be able to set their bills knowing of the tax treatment.

A service business that has been paying tax on receivables only when they are paid will have more revenue in the first year in which it is required to include receivables in income. For example, assume a business that collects half its revenue in cash and retainers and half in 30-day receivables. The business will have 12½ month's worth of revenue flow in 20xx, the year the proposal is effective, because it will have to pay tax on the receivables that will not be paid until January.

The tax floats need to be ended immediately, because they are per se an abuse. The tax floats pull GDP of the nation out of its tax base just by making it fall between the cracks. Thus, there will be no transitional relief from the new proposed section 461 rules denying deductions for the payable until the recipient includes the amounts in income and no transitional relief for ending the 2½-month tax floats in section 404(a)(5).

From the year of enactment, no business would be entitled to elect the cash method when the effect of the election would be to exclude from tax receivables covered by this proposal. Employees, however, would be entitled to continue the cash method on their compensation from employees.

For 30-day notes, the added revenue is small enough that reform, improving the tax base description of economic income, can be applied immediately. A business with receivables of less than 10 percent of its existing revenue in the form of receivables would include the full receivable income.

There is an irony in that receivables larger than 10 percent of current revenue are not only more of a shock to the taxpayer, but also an indicia of greater prior abuse. The move to end the floats and tax the economic income needs to be as rapid as feasible. It is proposed that at least receivables at least equal to 10 percent of current revenue be taken into income in the year of enactment. For the second year at least the 10 percent rule would be increased to include the receivables taken into account the prior year.

In addition receivables in excess of 10 percent compounded every year would be taken into account over three years. In the first year after enactment, one-third of all receivables exceeding the 10 percent rule would be taken into account. In the second year, two-thirds of excess receivables would be taken into account. By the third year, all receivables would be taken into account.

10. Revenue. By a very crude estimate, the government revenue and savings from the end of the tax floats from the proposal are between \$1.75 billion and \$4.2 billion a year.[50] Revenue estimates for the use of Congress are performed by the Joint Committee on Taxation. This estimate is neither official nor as accurate as they can do. But the range indicates that the proposal is a modest proposal representing between one and three one-hundredths of a percent of the revenue that needs to be raised. The modesty of the revenue as a fraction of the needs in the impending budget crisis is an indication of how large the crisis will be.

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[49] Johnson, "Deferred Payment Sales: Change the Basis and Character Rules," *Tax Notes*, July 14, 2008, p. 157, *Doc 2008-14804*, *2008 TNT 136-34*.

[50] Revenue from Professional, Scientific, and Technical Services (NAICS 54) and Performing Arts (NAICS 711) totaled \$1.4 trillion in 2008 (U.S. Census, Service Annual Survey, tables 6.1 and 9.1), which was 5 percent of all business income (Census, Stats. of U.S. Business). Trade receivables are 30-day notes and the like, and we assume that half of revenue from a business is in receivables with half-month average duration, then 1/24th of \$1.4 trillion, or \$58 billion, is in receivables at year-end. This is a balance sheet figure; however, it will reduce federal debt on a one-time basis. If we assume federal long-term interest will be 3 percent, then the balance sheet reduction of federal debt will save \$1.75 billion a year.

The Federal Flow of Funds lists trade payables by non-financial corporate businesses and non-farm unincorporated businesses as \$2.772 trillion. Federal Reserve, Flow of Funds Accounts Table F.223 (Sept. 17, 2010). With service industries representing 5 percent of that total, the balance sheet for trade payables for service industries would be 5 percent of \$2.77 trillion or \$139 billion. At 3 percent assumed long-term federal borrowing, the annual saving would be \$4.2 billion.