When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization†

JEFFREY L. KWALL*

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* Kathleen and Bernard Beazley Professor of Law, Loyola University Chicago School of Law. B.A., Bucknell University; M.B.A., The Wharton School; J.D., University of Pennsylvania Law School. The author thanks Sam Brunson, Glenn Coven, Marjorie Kornhauser, Ajay Mehrotra, Anne-Marie Rhodes, and Larry Zelenak for helpful comments on earlier drafts. I also thank my student assistants Hillary Luegers, Bradley Phipps, Kathleen Przywara and Courtney Karamanol for their excellent work. This project was supported by a Loyola University Chicago School of Law summer research grant.

The realization requirement is one of the most basic elements of the United States income tax. Due to this requirement, any increase in the value of a person's property is not taxed when it occurs. Rather, the tax on asset appreciation is deferred until the occurrence of a realization event; that is, until the property is transferred in exchange for money or other consideration. By contrast, all other forms of income (e.g., salary, rents) are taxed immediately.

The realization requirement is inequitable because it causes asset appreciation to be taxed more favorably than other forms of income, thereby violating the normative goal of taxing all forms of income alike. The realization requirement is also inefficient because it favors investments generating economic returns in the form of asset appreciation (as opposed to periodic returns), thereby violating the normative goal of imposing taxes that do not distort investment decisions. In addition, the realization requirement adds complexity to the tax system and sacrifices potential tax revenue due to the deferral it confers.

In light of the inequity, inefficiency, and complexity of the realization requirement, the requirement should be modified. Reformers have long argued that asset appreciation should be taxed as it occurs under a mark-to-market system. However, taxing asset appreciation as it occurs presents serious administrative problems because it requires an annual assessment of the value of every taxpayer's assets. In addition, strong political resistance exists to taxing "paper gains." For these reasons, it is unlikely that a comprehensive mark-to-market system will ever be adopted.

Due to the dim prospect of adopting a mark-to-market system, this Article proposes the adoption of a "disposition" standard of realization. That standard would treat every transfer of property as a realization event regardless of whether the transferor receives consideration for the transferred property. Unlike current law, the disposition standard would tax lifetime gifts, as well as testamentary transfers, of appreciated property.

A disposition standard is a second-best alternative to a mark-to-market system. This new standard would curtail the inequity and inefficiency of the current realization requirement while posing less significant administrative and political problems than a mark-to-market system. In addition, the disposition standard would simplify existing law by substituting a clear and administrable set of rules for the current ambiguous and anachronistic system. Finally, a disposition standard should help to generate much needed tax revenue.

INTRODUCTION

For almost a century, the United States has utilized an income tax as a major revenue source.[1] From an economist's perspective, an income tax should tax any

1. Shortly after the Sixteenth Amendment was ratified, Congress passed the Tariff Act of 1913. U.S. CONST. amend. XVI; Tariff Act of 1913, ch. 16, 38 Stat. 114. Earlier versions of the income tax date to the Civil War years. *See, e.g.*, Act of Aug. 5, 1861, ch. 45, § 49, 12

increase in a taxpayer's wealth when it occurs.[2] Accordingly, asset appreciation should be taxed as it occurs. The U.S. income tax, however, has always embraced a realization requirement, thereby deferring the taxation of asset appreciation until the occurrence of a realization event (normally, a sale or exchange of the appreciated property).[3]

The realization requirement has evolved in an unprincipled manner and remains ambiguous to this day.[4] When the U.S. income tax originated, neither Congress nor the courts debated the question of whether asset appreciation should be taxed as it occurred, or instead deferred until realization.[5] Rather, the early courts were embroiled in a controversy over whether increases in the value of property should *ever* be taxed.[6] As such, the law has always been slanted toward deferring the tax on asset appreciation.

Initially, the realization requirement was seen as a constitutional mandate.[7] The jurisprudence that emerged from this view regarded realization as requiring the

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Stat. 292, 309. In 2008, federal-income-tax collections totaled more than $1.42 trillion. *Table 1. Internal Revenue Collections and Refunds, by Type of Tax, Fiscal Years 2007 and 2008*, http://www.irs.gov/pub/irs-soi/08dhb01co.xls.

2. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."); ROSWELL MAGILL, TAXABLE INCOME 18 (rev. ed. 1945) ("Income is the money value of the net accretion to economic power between two points of time." (emphasis omitted)).

3. *See infra* Part I (discussing the evolution of the realization requirement in U.S. tax law).

4. *See* Marjorie E. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES 93, 95 (Paul L. Caron ed., 2d ed. 2009) [hereinafter Kornhauser, *The Story of* Macomber] ("Although realization is a basic concept in our income tax laws, its exact parameters are hazy."); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 48 (1992) [hereinafter Kornhauser, *Constitutional Meaning*] ("[W]hat is realization? . . . [T]here is no one definitive answer . . . ."); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 358 n.8 (2004) ("'Realization' does not have a fixed meaning. There is no statutory definition and our common understanding derives from its administrative and judicial development."); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 10–11 (1992) ("The realization requirement, while implicit in the earliest federal income taxes, has never been elaborated in the Code. It developed gradually through cases and administrative practice, without ever having a well thought out unitary meaning." (citation omitted)); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 249 n.12 (1992) ("The precise definition of a realization event is unclear . . . ."); Edward A. Zelinski, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 959 (1998) ("[T]he precept of realization is not self-defining; it is not always obvious when the taxpayer's economic interest is sufficiently transformed for a realization event to have occurred.").

5. *See infra* text accompanying notes 30–37 (discussing the origin of the realization requirement).

6. *See infra* text accompanying note 29 (noting that the initial issue was whether prior years' appreciation could ever be taxed).

7. *See infra* text accompanying notes 39–43 (discussing the Supreme Court's decision

transfer of property in exchange for a tangible benefit (normally money or other property).[8] By conditioning realization on the contemporaneous receipt of a tangible benefit, the courts treated asset appreciation in the same manner as other forms of income (e.g., salary, rents), which normally occur when a person receives money or property.[9] Unlike other forms of income, however, asset appreciation confers a benefit on the property owner as the appreciation occurs by increasing the taxpayer's wealth.[10] Hence, the benefit from the appreciation is derived *before* the asset is transferred and is *independent* of the transfer. Indeed, the timing of the benefit is precisely why economists have argued that asset appreciation should be taxed as it occurs.[11]

The view that realization is constitutionally mandated has dissipated during the past three-quarters of a century.[12] Now the realization requirement is generally regarded as a concession to the administrative burdens of, and political opposition to, a system taxing asset appreciation as it occurs.[13] Nevertheless, the common law requirement that a contemporaneous benefit must be received for realization to occur still exists.[14]

The theme that realization requires the receipt of a contemporaneous benefit has been blurred by long-running statutory language associating realization with a mere "disposition" of property.[15] If realization were truly governed by a disposition standard, as the statutory language suggests, a mere transfer of property would be sufficient for realization to occur without regard to whether a contemporaneous benefit was received. Quite clearly, a mere transfer of property is not sufficient for realization under current law because gratuitous transfers of appreciated property are not realization events.[16] In fact, Congress's use of the term "disposition"

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in *Macomber* involving the interpretation of the Sixteenth Amendment).

8. *See infra* text accompanying notes 43–48 (discussing how *Macomber* stands for the proposition that realization requires more than a mere transfer, and there must be a receipt of a contemporaneous benefit).

9. *See generally* I.R.C. § 61 (2006). The precise timing of income depends on the taxpayer's tax accounting method. *See id.* § 451(a).

10. At a minimum, an increase in the taxpayer's wealth should increase the taxpayer's borrowing ability.

11. *See supra* note 2 and accompanying text.

12. *See infra* Part I.C (outlining the Supreme Court's retreat from a realization requirement that was constitutionally mandated).

13. *See infra* Part I.C (detailing the evolution of the realization requirement from one of constitutional dictate to one of administrative convenience).

14. *See* I.R.C. § 1001(a)–(b).

15. *See* I.R.C. § 1001(a) ("The gain from the sale or other *disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis . . . ." (emphasis added)). This statutory language dates from 1924. Revenue Act of 1924, ch. 234, § 202(a), 43 Stat. 253, 255.

16. *See* Campbell v. Prothro, 209 F.2d 331, 336 (5th Cir. 1954) (confirming Congress has not taxed donors on the appreciation in gifted property). President Kennedy proposed to tax testamentary and gratuitous transfers of appreciated property in 1963 and the Treasury proposed regulations to this effect in 1969, but neither proposal reached fruition. *See President's 1963 Tax Message: Hearings Before the H. Comm. on Ways & Means*, 88th Cong. 24 (1963) [hereinafter *President's 1963 Tax Message*]; STAFF OF H. COMM. ON WAYS & MEANS AND S. COMM. ON FINANCE, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS,

appears to have been a matter of happenstance, rather than being indicative of an intention to treat every transfer of property as a realization event.[17]

Due to the unprincipled foundation of the realization requirement and the nation's current immense need for revenue,[18] the requirement should be reexamined to determine how the deferral it confers might be mitigated. The current realization requirement causes the tax law to deviate from the economic ideal of taxing increases in wealth as they occur.[19] To remedy this shortcoming, reformers have long advocated adoption of a "mark-to-market" system that taxes asset appreciation as it occurs.[20] Under such a system, any increase in the value of a taxpayer's assets is taxed as income when it accrues, without regard to when a disposition of property occurs. To date, little progress has been made toward a mark-to-market system.[21] The adoption of a comprehensive mark-to-market system has been impeded by: (1) the burden of perpetually valuing the taxpayer's assets, (2) the hardship of imposing tax on an event that does not create liquidity for the taxpayer, and (3) the political resistance to a system that would tax "paper gains."[22]

U.S. TREASURY DEPT. 26–32 (Comm. Print 1969). This was not the first time the Treasury attempted to tax the donor of appreciated property. *See* White v. Broderick, 104 F. Supp. 213, 214 (D. Kan. 1952); I.T. 3910, 1948-1 C.B. 15; I.T. 3932, 1948-2 C.B. 7. *See generally* Note, *Gratuitous Disposition of Property as Realization of Income*, 62 HARV. L. REV. 1181 (1949) (discussing the aforementioned IRS rulings).

17. *See infra* Part I.D (noting that a review of the legislative history suggests that use of the term "disposition" was not intended to treat every transfer of property as a realization event).

18. *See Policy Experts Revisit VAT as Debt Crisis Looms*, 124 TAX NOTES 644, 645 (2009) ("The fiscal track of the country is unsustainable. . . . The government will have to raise more money and control spending." (quoting Chuck Marr, director of federal tax policy at the Center on Budget Policy and Priorities)); Jonathan Weisman & Deborah Solomon, *What's News*, WALL ST. J., Aug. 26, 2009, at A1 (reporting that the U.S. budget deficit was revised to a record of nearly $1.6 trillion for the fiscal year ending Sept. 30 and that the White House forecast $9 trillion in debt over the next decade).

19. *See supra* note 2 and accompanying text.

20. For a discussion of mark-to-market systems, see, for example, Fred B. Brown, *"Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559 (1996); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Victor Thuronyi, *The Taxation of Corporate Income—A Proposal for Reform*, 2 AM. J. TAX POL'Y 109 (1983); Mark L. Louie, Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982). The opposite extreme of accrual taxation would be to defer taxation until consumption occurs. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). This Article does not explore the merits of a consumption tax.

21. Only a few discrete Code provisions employ economic accrual principles. *See, e.g.*, I.R.C. §§ 467, 475, 817A, 1271–75, 1296 (2006).

22. *See infra* Part II.B (discussing practical problems presented by a mark-to-market system and how a disposition system would alleviate these concerns). "[T]he accrual system has never attracted a large group of adherents . . . ." Shakow, *supra* note 20, at 1113. "[B]roader proposals to switch to an accretion system have not met—and most likely will not meet—with success." Kornhauser, *The Story of* Macomber, *supra* note 4, at 134.

In light of the poor prognosis for a mark-to-market system, this Article advocates the adoption of a disposition standard of realization that defers taxation only until property is transferred. That is, rather than conditioning realization on the receipt of a contemporaneous benefit, a mere transfer of property should be sufficient for a realization event. Under the proposed disposition standard, all the untaxed appreciation previously shielded by the realization requirement would be taxed when the property is transferred.[23] Unlike current law, therefore, gratuitous inter vivos transfers of appreciated property, as well as death, would constitute realization events and thereby terminate the deferral of tax on accrued gains. This Article focuses on dispositions of appreciated property, but the proposed disposition standard would also apply when property with a basis in excess of value is transferred, in which case a loss would be realized.[24]

In contrast to the existing realization requirement, a disposition standard for realization is fair, efficient, clear, and administrable. This standard is a viable second-best alternative to a mark-to-market system. Ironically, the statutory "disposition" language long associated with realization, though apparently selected by happenstance, would be literally applied under the standard proposed by this Article.

Part I of this Article explores the history of the realization requirement and demonstrates that no legal impediment exists to treating the mere transfer of property as a realization event. Part II examines the policy implications of a disposition standard of realization and shows that such a standard is more equitable and efficient than current law, but less administratively and politically problematic than a mark-to-market system. Finally, Part III delineates the statutory framework to implement a disposition standard of realization and demonstrates how that standard would impact current law.

I. EVOLUTION OF THE REALIZATION REQUIREMENT

Although the realization requirement has long been an integral part of U.S. tax law, Congress has yet to clearly define the contours of the requirement. The legislative source of the requirement consists of two obtuse statutory provisions with long but unremarkable histories. One of these provisions offers as an example

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23. This Article also proposes that the transferor's gain be measured by the value of the property transferred (without regard to the nature or amount of consideration received) because the value of the transferred property always captures the untaxed appreciation that has been shielded by the realization requirement. *See infra* text accompanying note 129 (proposing a new statutory rule for quantifying realized gain). The disposition standard for realization proposed by this Article would continue to accommodate nonrecognition rules in circumstances where Congress makes a policy judgment that the immediate taxation of a realized gain is inappropriate. *See infra* text accompanying notes 155–60.

24. Unlike gains, however, losses have no tax effect unless the loss is allowed. *See* I.R.C. § 165(a). Hence, although more losses would be realized under the proposal advanced in this Article, the additional losses would not normally be allowed. Moreover, the limitations on losses on transactions between related parties would presumably be extended to all dispositions of property. *See id.* § 267(a)(1).

of gross income "[g]ains derived from dealings in property."[25] The other provision quantifies the resulting income when a realization event occurs: "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis."[26] Neither provision defines the requisite event for realization to occur. Nor have the courts filled this gap, as the myriad of decisions involving the realization requirement lack an edifying theory.[27]

Any effort to reform the realization requirement must necessarily begin with a review of its history. This Part, therefore, explores the evolution of the realization requirement. As this Part demonstrates, the history of the realization requirement should not impede Congress from curtailing the deferral it confers.

A. The Infancy of Realization—Should Asset Appreciation Ever Be Taxed?

The contemporary academic debate on the realization requirement does not mirror the controversy that existed when the requirement originated. Today, most analysts agree that the realization requirement is an undesirable element of the income tax, at least in theory, and that an ideal system would not sanction the tax deferral conferred by the requirement.[28] From this perspective, one might think that the realization requirement represented a victory for proponents of tax deferral. That is a mistaken view, however, because the realization requirement emerged when uncertainty existed as to whether increases in the value of assets that accrued in prior years could *ever* be taxed.[29] At that time, the leading alternative to a realization-based system was not one where gains would be taxed as they accrued, but rather a system where prior years' accruals would never be taxed, even after realization occurred. As such, the establishment of a realization requirement was, at the time, a victory for anti-deferral forces who opposed the permanent exclusion of asset appreciation from the income tax base.

The twisted tale of realization began prior to the enactment of the "modern" income tax in 1913.[30] Shortly after the first U.S. tax was imposed on "income" in 1861,[31] the tax base was expanded to "gains, profits, or income."[32] The Supreme

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25. *Id.* § 61(a)(3).

26. *Id.* § 1001(a).

27. *See infra* Part III.B (discussing the common law underlying the realization requirement).

28. *See* William D. Andrews, *The Achilles Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, at 278 (Charls E. Walker & Mark A. Bloomfield eds., 1983) (identifying the realization requirement as one of the main culprits for the failure to adhere to a comprehensive income tax ideal); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 889 (2005) ("The realization requirement destroys the source of neutrality of an ideal income tax."); Deborah H. Schenck, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 629 (1995) ("The realization requirement is not an inherent characteristic of an income tax. It has no normative role to play . . . .").

29. *See* MAGILL, *supra* note 2, at 103–13 (discussing the early history of realization).

30. The "modern" income tax refers to the tax laws enacted subsequent to the passage of the Sixteenth Amendment allowing a direct income tax without apportionment among the states. U.S. CONST. amend. XVI; Tariff Act of 1913, ch. 16, 38 Stat. 114.

31. Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309.

32. Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473; *see also* CONG. GLOBE, 37TH

Court, construing statutory language from the Act of 1867 taxing gains "for" the year, ruled that gains that accrued over a series of years could not be taxed in the year of sale.[33] Rather, only the gain that accrued in the year of sale was within the scope of the tax.[34] Decades later, the Court reached a different result under the Corporate Tax Act of 1909 when, in construing language taxing gains "received" during the year, it permitted the taxation of all gains in the year of sale, including those that accrued in prior years.[35]

After the advent of the modern income tax in 1913, the courts continued to struggle with whether gains accrued in prior years could be taxed in the year of sale.[36] Doubts about taxing prior years' gains arose once again in 1918 when the Court, in dictum, suggested that gains accruing in years prior to the year of sale are "not income at all, but merely increase of capital and not subject to a tax as income."[37] By 1921, however, the Court eliminated any doubt as to the legitimacy of taxing prior years' appreciation when a sale occurred, stating that "'[i]ncome may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."[38]

The realization requirement, therefore, did not emerge as an alternative to taxing appreciation as it occurred. Rather, the requirement arose in an environment marked by uncertainty as to whether asset appreciation could ever be taxed. By the early 1920s, any doubt about taxing prior years' appreciation had been laid to rest as the permanent exemption of accrued gains had been soundly rejected. Nevertheless, the fact that courts were mired for decades in the quagmire of whether asset appreciation could ever be taxed likely retarded progress that otherwise might have been made toward a system that accelerated the taxation of accrued gains.

CONG., 2D SESS. 1531 (1862) ("The words 'gain' and 'income' mean the same thing.").

33. Gray v. Darlington, 82 U.S. (15 Wall.) 63, 67 (1872).

34. *Id.* at 66.

35. Hays v. Gauley Mountain Coal Co., 247 U.S. 189, 192 (1918) (applying only to gains that accrued after the 1909 Act went into effect); *see also* Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112 (stating that a corporation is subject to an excise tax of one percent of "the entire net income . . . received by it from all sources during such year"); T.D. 1571, 12 Treas. Dec. Int. Rev. 131, 136 (1909) (clarifying that only asset appreciation after January 1, 1909, is subject to tax).

36. Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167; 50 CONG. REC. 506 (1913) (addressing the question of whether gains accrued in prior years are taxed on sale); *see also* Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757; Revenue Act of 1917, ch. 63, § 1200, 40 Stat. 300, 329–30; Revenue Act of 1918, ch. 18, § 213, 40 Stat. 1057, 1065.

37. Lynch v. Turrish, 247 U.S. 221, 231 (1918). *But see* Loren D. Prescott, Jr., Cottage Savings Association v. Commissioner*: Refining the Concept of Realization*, 60 FORDHAM L. REV. 437, 438 n.9 (1991) (referencing "taken up on the books" language in a regulation promulgated under the Act of 1913 as possible evidence of a mark-to-market element in early law).

38. Merchs.' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 518 (1921) (emphasis omitted) (quoting Eisner v. Macomber, 252 U.S. 189, 207 (1920)).

B. The Youth of Realization—The Necessity of a Contemporaneous Benefit

The emergence of the realization requirement can be seen as a victory for anti-deferral forces relative to the alternative of exempting asset appreciation from tax. That victory, however, was short lived. In 1920, the Supreme Court, in *Eisner v. Macomber*,[39] constrained the range of realization events by limiting realization to circumstances in which the transferor of appreciated property received a contemporaneous benefit.

In *Macomber*, the Supreme Court was called upon to interpret the scope of "income" in the Sixteenth Amendment which gave Congress the power "to lay and collect taxes on income, from whatever source derived."[40] The government sought to enforce a provision of the Revenue Act of 1916 stating that a "stock dividend shall be considered income."[41] Searching for a clear definition of income, the Supreme Court embraced a definition adopted by earlier courts under the Corporate Tax Act of 1909: "'Income may be defined as the *gain derived from capital*, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."[42] The government invoked this definition of income when it argued that a stock dividend was income. The Court nevertheless criticized the government for emphasizing the word "gain" in the definition "while the significance of the next three words ['derived from capital'] was either overlooked or misconceived."[43] The Court found that the "derived from capital" language was indicative of a realization requirement:

> Here we have the essential matter: *not* a gain *accruing to* capital, *not* a *growth* or *increment* of value *in* the investment; but a gain, a profit, *something of exchangeable value proceeding from the property, severed from the capital* however invested or employed, *and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that* is income derived from property. . . .
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> The same fundamental conception is clearly set forth in the Sixteenth Amendment—"incomes, *from* whatever *source derived* . . . ."[44]

The Court's description of the realization requirement reveals that realization requires more than a mere transfer of property; the receipt of a contemporaneous benefit by the transferor is an integral part of the requirement. Hence, the fact that the property owner's wealth increased when the appreciation occurred was not sufficient to impose a tax when the property was transferred. Rather, the Court tied realization to "something of exchangeable value, proceeding from the property, . . . and coming in, being . . . received or drawn by the recipient."[45] This language

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39. 252 U.S. 189 (1920).
40. U.S. CONST. amend. XVI.
41. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757.
42. *Macomber*, 252 U.S. at 207 (emphasis added) (citation omitted).
43. *Id.* (emphasis omitted).
44. *Id.* (emphasis in original, some emphasis added).
45. *Id.* (emphasis omitted).

inextricably linked the receipt of a contemporaneous benefit to the transfer of the underlying property in order to establish a realization event.[46]

Four years after the *Macomber* decision, Congress effectively crystallized the contemporaneous-benefit requirement in the Revenue Act of 1924. Although this legislation refrained from defining a realization event, it provided the following formula for computing gain: "[T]he gain from the sale or other disposition of property shall be the excess of the *amount realized* therefrom over the basis . . . ."[47] The 1924 Act then defined amount realized as follows: "The amount realized from the sale or other disposition of property shall be the sum of any money *received* plus the fair market value of the property (other than money) *received*."[48] By defining amount realized based on the consideration received by the transferor (rather than the value of the property transferred), Congress established a realization framework incorporating the receipt of a contemporaneous benefit. That same framework still exists today.[49]

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46. The contemporaneous consideration requirement for realization is reinforced by a Treasury regulation promulgated under the Revenue Act of 1918. T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 393 (1919) ("Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction . . . the property is converted into cash or into property . . . ."); *see also* T.D. 3295, 24 Treas. Dec. Int. Rev. 207, 498–99 (1922) (containing similar language but promulgated under the Revenue Act of 1921).

47. Revenue Act of 1924, ch. 234, § 202(a), 43 Stat. 253, 255 (emphasis added). The committee report provides: "There is no provision of the existing law which corresponds to this section of the bill. The purpose in embodying in the law this section is to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property." H.R. REP. NO. 68-179, at 12 (1924), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1861, at 684 (Prentice-Hall 1938).

48. Revenue Act of 1924 § 202(c) (emphasis added). The Revenue Acts prior to 1918 merely included "gain from sales or dealings in property" in the definition of income without any guidance as to when and how such gain was measured. *See* Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167–68 ("[T]he net income of a taxable person shall include gains [from] . . . sales[] or dealings in property . . . ."); Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757 (same). The Revenue Act of 1918 provided that in the case of an exchange of properties, "the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any . . . ." Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060. Three years later, Congress converted the rule to one of recognition. Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230 ("[O]n an exchange of property . . . for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value . . . ."). Congress retreated from the market value standard in 1924 when it enacted the definition of amount realized that still applies today. I.R.C. § 1001(b) (2006). The committee report to the 1924 Act explained that the amendment was made due to the difficulty of determining whether property has a readily realizable market value. *See* H.R. REP. NO. 68-179, at 13 (1924), *reprinted in* SEIDMAN, *supra* note 47, at 686; S. REP. NO. 68-398, at 13–14 (1924), *reprinted in* SEIDMAN, *supra* note 47, at 686–87.

49. *See* I.R.C. § 1001(a)–(b) (2006).

C. The Maturity of Realization—Erosion of the Contemporaneous Benefit Requirement

After the *Macomber* decision, the realization requirement appeared to be a constitutional requirement mandating the transfer of property in exchange for contemporaneous consideration. The requirement, however, continued to evolve. By 1940, the Court had retreated from the *Macomber* standard and regarded realization as a mere administrative rule establishing when the deferral conferred on asset appreciation should terminate.

In *Helvering v. Bruun*,[50] the Supreme Court retreated from its earlier view that a separation of income from capital was a prerequisite to a realization event. In *Bruun*, a landlord leased a lot and building under a ninety-nine-year lease during which the tenant erected a new building on the site.[51] Shortly thereafter, the tenant defaulted and the landlord took possession of the land and the new building.[52] The government sought to tax the landlord on the difference between the value of the reclaimed property and the landlord's basis in the property.[53] The lower courts held for the landlord, finding that the added value could not be taxed until the landlord disposed of the property because the added value "is not gain derived from capital or realized within the meaning of the Sixteenth Amendment."[54] The Supreme Court reversed, stating:

> While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. . . . The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization. . . . It is not necessary to recognition of taxable gain that [the taxpayer] should be able to sever the improvement . . . from his original capital.[55]

The *Bruun* Court's opinion marked a dramatic retreat from the standard for realization previously set by *Macomber*. As Professors Bittker and Lokken have stated:

> Although the *Bruun* opinion did not reject the famous definition promulgated by *Eisner v. Macomber*, it watered down the requirement of a realization by suggesting that *any definite event*—here the forfeiture of a leasehold—could properly be employed as the occasion for taking account of the taxpayer's gain.[56]

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50. 309 U.S. 461 (1940).
51. *Id.* at 464.
52. *Id.*
53. *Id.* at 464–65.
54. *Id.* at 467.
55. *Id.* at 469. Congress subsequently overruled the *Bruun* holding. *See* I.R.C. § 109 (2006).
56. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 5.1 (3d ed. 2005) (emphasis added).

A mere eight months after the *Bruun* decision, the Supreme Court explicitly acknowledged that the realization rule was founded on "administrative convenience." [57] In *Helvering v. Horst*, a father gave the interest coupons from a coupon bond to his son.[58] The government sought to tax the father on the interest payments collected by the son.[59] The lower courts reached conflicting results, but the Supreme Court held that the father could indeed be taxed.[60] The Court elaborated on the realization rule as follows:

> The [realization] rule, *founded on administrative convenience*, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or other property.[61]

Although *Horst* dealt with interest income rather than income in the form of asset appreciation, the Court retreated from the *Macomber* Court's view of realization as a general matter by finding that realization is based on administrative convenience.[62] Moreover, the Court continues to adhere to this view. As recently as 1991, the Court reiterated its view that "the concept of realization is 'founded on administrative convenience.'"[63] Thus, the strictures imposed on the realization requirement by *Macomber* have been significantly relaxed.[64]

Now that the *Macomber* Court's view of realization has been relaxed, the antiquated statutory scheme that germinated from *Macomber* lacks conceptual support.[65] That scheme conditions realization on the receipt of an economic benefit—gain is measured by the amount realized, by what comes in.[66] But if the

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57. Helvering v. Horst (*Horst III*), 311 U.S. 112, 116 (1940).

58. *Id.* at 114.

59. *Id.*

60. *Id.* at 120. The Board of Tax Appeals sustained the tax. Horst v. Comm'r (*Horst I*), 39 B.T.A. 757, 761 (1939). The Second Circuit later reversed. Horst v. Comm'r (*Horst II*), 107 F.2d 906, 908 (1939).

61. *Horst III*, 311 U.S. at 116 (emphasis added).

62. *Id.*

63. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) (quoting *Horst III*, 311 U.S. at 116).

64. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 5.01 (11th ed. 2009) ("[R]ealization is strictly an administrative rule and not a constitutional, much less an economic requirement, of 'income.'"); Charles L.B. Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 176 (1964) ("[I]t appears that as a constitutional prerequisite realization is no longer required . . . ."); Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. NW. U. 779, 791 (1941) ("[T]he formalistic doctrine of realization proclaimed by [*Eisner v. Macomber*] is not a constitutional mandate."). *But see generally* Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution,* Macomber*, and Mark to Market*, 13 VA. TAX REV. 1 (1993) (arguing that realization remains a constitutional prerequisite for the taxation of gains from property).

65. *See* I.R.C. § 1001(a)–(b) (2006); *supra* text accompanying notes 47–49.

66. *See* I.R.C. § 1001(a)–(b); *supra* text accompanying notes 47–49.

realization requirement is merely a matter of administrative convenience, realization need not be conditioned on the receipt of a contemporaneous benefit. Rather, Congress has the power to terminate the deferral of tax on accrued gains at any convenient time.

If Congress were to reject the contemporaneous benefit requirement for purposes of establishing a realization event, no compelling reason would exist to perpetuate the amount realized construct of current law, which looks to the consideration received by the transferor to quantify the transferor's gain. When realization occurs, gain should logically be measured by the value of the property transferred, without regard to the amount of consideration received, because the value of the transferred property captures all the untaxed appreciation that previously accrued. Unfortunately, Congress has yet to modernize the statutory scheme and establish a rational standard for realization that would mitigate the tax deferral conferred by current law.

D. A Parallel Strand—Is a "Disposition" Sufficient for Realization?

In light of the Supreme Court's finding that the realization requirement was founded on administrative convenience, Congress is now able to terminate the deferral of tax on asset appreciation when property is transferred, regardless of whether a contemporaneous benefit is received by the transferor. One might be tempted to bolster the case for this result by highlighting the statutory language dating to 1924 that quantifies gain from the "sale or other *disposition*" of property.[67] A "disposition" of property is generally understood to encompass *any* transfer of property regardless of whether consideration is received by the transferor.[68] If the use of the term "disposition" by Congress manifested an intent to tax all accrued appreciation as soon as property is transferred, then one might argue that existing law already incorporates the disposition standard proposed by this Article. The legislative history reveals, however, that Congress's use of the term "disposition" was apparently a matter of happenstance. The presence of the term in the statute does not support the view that current law incorporates a true disposition standard for realization.

The statutory phrase "sale or other disposition" first appeared in the Revenue Act of 1916, in a basis provision, without any explanation as to why Congress chose the term "disposition" or what that term was thought to mean.[69] Eight years

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67. *See* I.R.C. § 1001(a) ("The gain from the sale or other *disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis . . . ." (emphasis added)). This statutory language dates from 1924. Revenue Act of 1924, ch. 234, § 202(a), 43 Stat. 253, 255.

68. Herbert's Estate v. Comm'r, 139 F.2d 756, 758 (3d Cir. 1943) ("The dictionary definition of 'disposition' is . . . '[t]he getting rid, or making over, of anything . . . .'" (citation omitted)).

69. "For the purpose of ascertaining the gain derived from the sale or other disposition of property . . . the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived." Revenue Act of 1916, ch. 463, § 2(c), 39 Stat. 756, 758. In subsequent revenue acts, Congress continued to use the term "disposition" without defining it. *See* Revenue Act of

later, in section 202(a) of the Revenue Act of 1924, Congress first employed the "sale or other disposition" standard to quantify gain or loss after a realization event occurs.[70] That same statutory standard still applies for this purpose today.[71] The Committee Reports to section 202(a) state:

> There is no provision of the existing law which corresponds to this section of the bill. The purpose in embodying in the law this section is to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property.
>
> . . . This merely embodies in the law the present construction by the department and the courts of the existing law.[72]

This legislative history suggests that Congress did not intend to define the contours of realization when the statutory term "disposition" was introduced.

Not surprisingly, Congress's use of the term "disposition" in connection with quantifying gain has generated much confusion over the years. Indeed, some courts have interpreted the term to mean that any transfer of property constitutes a realization event.[73] Although the statutory term "disposition" has applied to the computation of gain for more than eighty years, that term has no bearing on the requirements for a realization event.[74] While Congress could mitigate the tax

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1918, ch. 18, § 202(a), 40 Stat. 1057, 1060; Revenue Act of 1921, ch. 136, § 202(b), 42 Stat. 227, 229. The Committee Reports to the 1916 Act indicate that the provision responds to the judicial uncertainty concerning the taxation of gains accrued in prior years when realization occurs. *See* 53 CONG. REC. 13407–08 (1916), *reprinted in* SEIDMAN, *supra* note 47, at 958–59. The legislative history to the 1921 Act indicates that the Supreme Court's decision in *Merchants' Loan* made it "necessary" for Congress to articulate a more detailed statement of the general rule that the basis for determining gain or loss for property acquired prior to March 1, 1913, is the value of the property as of that date. H.R. REP. NO. 67-350, at 9 (1921), *reprinted in* SEIDMAN, *supra* note 47, at 787.

70. Revenue Act of 1924 § 202(a).

71. *See* I.R.C. § 1001(a), (b) (2006).

72. H.R. REP. NO. 68-179, at 12 (1924), *reprinted in* SEIDMAN, *supra* note 47, at 684. The language appeared in similar form in early Treasury decisions. T.D. 2690, 20 Treas. Dec. Int. Rev. 186 (1918) (including the "sale or other disposition" language in both the basis rule and the gain computation rule whereas statutes only used the language in the basis rule); T.D. 2831, 21 Treas. Dec. Int. Rev. 176 (1919) (addressing the definition of net income); T.D. 3295, 24 Treas. Dec. Int. Rev. 220 (using the "sale or other disposition" language in the basis rules but using "sale or conversion" language to define income under the Revenue Act of 1921); T.D. 3640, 26 Treas. Dec. Int. Rev. 751, 755 (using the "sale or other disposition" language in the meaning of net income, the "sale or conversion" language for gross income, and the "sale or other disposition" language with respect to determining the amount of gain or loss). Since 1934, however, the regulations have not used the term "disposition" but instead refer to "conversion of property into cash" and "exchange of property *for* other property." Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 561 n.6 (1991) (emphasis added).

73. *See infra* notes 161–62 and accompanying text (noting that some courts have treated a charitable contribution of appreciated property as a realization event).

74. *See* 1 STANLEY S. SURREY, WILLIAM C. WARREN, PAUL R. MCDANIEL & HUGH J. AULT, FEDERAL INCOME TAXATION: CASES AND MATERIALS 818 (Harry W. Jones et al. eds., Foundation Press 1972) ("Section 1001(a) governs the computation of the amount of gain or

deferral conferred by current law by adopting a disposition standard of realization, it has not previously employed that standard. Whether it is desirable for Congress to now adopt a disposition standard of realization depends largely on the policy implications of doing so, a subject that is explored in Part II.

II. POLICY IMPLICATIONS OF A DISPOSITION STANDARD FOR REALIZATION

Under current law, realization is deferred until appreciated property is transferred for a tangible benefit.[75] The realization requirement is inequitable because the deferral it confers causes asset appreciation to be taxed more favorably than other forms of income.[76] In addition, the realization requirement is inefficient because it creates an incentive to invest in property generating economic returns in the form of asset appreciation and thereby distorts investment decisions.[77] For these reasons, Congress can and should retreat from the tax deferral sanctioned by current law.

Commentators have long argued that the realization requirement should be eliminated in favor of a mark-to-market system that taxes asset appreciation as it accrues, consistent with the economist's definition of income.[78] Such a system would eliminate the inequity and inefficiency of a realization based system by terminating the tax deferral current law confers on asset appreciation.[79] However, mark-to-market taxation presents serious administrative and political hurdles with regard to measuring income and taxing "paper gains."[80]

In contrast to a mark-to-market system, the disposition standard of realization proposed by this Article would curtail the inequity and inefficiency of current law while minimizing the administrative and political issues posed by a system that taxes gains as they accrue. Under a disposition standard, the deferral of accrued gains would be terminated whenever property is transferred, without regard to whether a contemporaneous benefit is conferred on the transferor. Moreover, the transferor's gain would be measured by reference to the value of the property transferred, without regard to the amount of consideration received. The value of the transferred property should measure the transferor's gain because that value captures all the untaxed appreciation that previously accrued.

If Congress were to adopt a disposition standard of realization, current law would change in two major ways. First, any inter vivos gratuitous transfer would

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loss from the sale or other disposition of property. This section does not determine the inclusion of gains or the amount allowance of losses. Rather, it relates to gains which have qualified for inclusion under section 61(a) as a result of the construction of that section . . . .") (emphasis omitted)).

75. *See supra* Part I (summarizing the current status of the realization requirement).

76. *See infra* Part II.A.1 (describing how the realization requirement causes income in the form of asset appreciation to be more favorably taxed).

77. *See infra* Part II.A.2 (describing how the realization requirement affects investment decisions thereby decreasing economic efficiency).

78. *See supra* note 20 and accompanying text.

79. *See infra* Part II.A.1–2 (explaining how a mark-to-market system would eliminate the inequity and inefficiency created by the realization requirement).

80. *See infra* Part II.B (discussing the administrative and political issues presented by a mark-to-market system).

constitute a realization event so that gifts and charitable contributions of appreciated property would trigger a tax on the appreciation when the transfer occurs. Second, death would be a realization event thereby causing the gain on all appreciated assets to be taxed at the time of death. Other less significant changes in the law would also result from a disposition standard.[81]

This Part demonstrates that a disposition standard of realization would mitigate the inequity and inefficiency created by the existing realization requirement. In addition, a disposition standard of realization would pose less serious administrative problems and political concerns than a mark-to-market system. Finally, a disposition standard would dramatically simplify current law.

A. Disposition Standard Mitigates Inequity and Inefficiency of Current Law

By virtue of the realization requirement, the tax on asset appreciation is deferred until property is transferred for a contemporaneous benefit. As such, the income tax system confers preferred treatment on asset appreciation relative to other economic benefits which are taxed when they occur. The favorable tax treatment of asset appreciation adversely impacts the equity and the efficiency of the tax system. These shortcomings could be mitigated by enacting a rule that treats any transfer of property as a realization event without regard to the consideration, if any, received by the transferor.

1. Equity Considerations

From a fairness standpoint, similarly situated taxpayers should be taxed alike regardless of the sources of their income.[82] Generally, income is deemed to occur when an economic benefit is derived.[83] For example, income from labor is taxed when the benefit is derived by the service performer; namely, when compensation is received.[84] Similarly, periodic income from capital (e.g., interest and dividends) is taxed on receipt.[85] In the case of asset appreciation, a benefit is derived when the appreciation occurs because the taxpayer's wealth increases at that time.[86] The tax on that benefit is deferred, however, until realization occurs.[87] In addition to deferring the tax on accrued gains, current law permits those gains to be shifted to other taxpayers when inter vivos gifts occur.[88] Moreover, current law eliminates accrued gains without taxing them when appreciated property is transferred to

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81. For example, the destruction and theft of property could constitute realization events. *See infra* Part III.B.9.

82. RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 160 (1959).

83. *See* JAMES J. FREELAND, DANIEL J. LATHROPE, STEPHEN A. LIND & RICHARD B. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 46–47 (15th ed. 2009).

84. *See* I.R.C. § 61(a)(1) (2006).

85. *See id.* § 61(a)(4), (7).

86. *See supra* note 2 and accompanying text.

87. *See* I.R.C. §§ 61(a)(3), 1001(a).

88. *See id.* § 1015 (providing that a donee receiving a gift of appreciated property takes a transferred basis).

charity or held until death.[89] Hence, asset appreciation is taxed more favorably than other forms of income.

The ability to defer the tax on asset appreciation confers a benefit on the taxpayer due to the time-value of money, a benefit not enjoyed by recipients of other forms of income.[90] Consequently, horizontal equity, the notion that all taxpayers with a like amount of income should be taxed alike, is violated by the realization requirement.[91] A taxpayer with income in the form of gains from property bears less of a tax burden than a taxpayer with a like amount of income from other sources.

The realization requirement also violates vertical equity, the principle that higher income taxpayers should be taxed more heavily than lower income taxpayers.[92] In all likelihood, the benefits of the deferral conferred by the realization requirement accrue disproportionately to the wealthy because wealthier taxpayers tend to own greater amounts of capital.[93] To the extent that wealthier taxpayers benefit disproportionately from the realization requirement, vertical equity is violated.

These inequities could be remedied by eliminating the realization requirement and substituting a mark-to-market tax system. A mark-to-market system would tax asset appreciation when the taxpayer's wealth increased, like the taxation of all

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89. *See id.* § 1014 (eliminating appreciation in property transferred at death by establishing a fair-market-value basis in the property). Section 1014 does not apply in 2010 but automatically returns in 2011. *See id.* § 1014(f); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a)–(b), 115 Stat. 150 (sunset provision). In 2010, the step-up in basis at death is limited to $1.3 million and an additional $3 million for property transferred to a surviving spouse. *See* I.R.C. § 1022.

90. In this context, the time-value of money accounts for the economic differential between incurring a tax liability as property appreciates and incurring a tax liability in the future when appreciated property is sold. Deferring realization reduces the present value or cost of the taxpayer's tax liability because "taxpayers are not charged interest for the resulting deferral of their tax payments." Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53, 58 (2003). For additional discussion on the time-value of money, see Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983). The time-value of money benefit could be neutralized by imposing an interest charge on the deferred tax, but such an approach would add much complexity to the law. *See* Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991).

91. The principle of horizontal equity, that taxpayers in similar positions should be treated equally, is "[p]erhaps the most widely accepted principle of equity in taxation . . . ." MUSGRAVE, *supra* note 82, at 160.

92. *See id.*

93. Engler & Knoll, *supra* note 90, at 58–59 (noting that the realization requirement not only creates discrimination across asset classes, but also creates discrimination across taxpayers, because taxpayers who can hold onto appreciated assets longer, typically wealthy individuals, "disproportionately reduce their income tax burden relative to those with lesser deferral opportunities").

other forms of income.[94] As such, asset appreciation would no longer be tax-favored from a timing perspective and the resulting inequity would disappear.[95]

In contrast to a mark-to-market system, the proposed disposition standard would still foster inequities because the tax on accrued gains would be deferred until a disposition occurs. The disposition standard would nevertheless improve current law by curtailing the disproportionate benefits now conferred on asset appreciation. Under a disposition standard, it would no longer be possible to defer or escape tax by making an inter vivos gift of appreciated property or transferring such property at death. These transfers would constitute realization events under a disposition standard of realization. As a result, a disposition standard would reduce the disparity between the tax treatment of asset appreciation and income from other sources. Thus, the implementation of a disposition standard for realization would mitigate, but not eliminate, the inequities of current law.

2. Efficiency Considerations

To maximize efficiency, a tax should be designed so as not to distort an investment decision that would normally be driven by economic considerations.[96] The U.S. tax system taxes periodic investment returns (e.g., dividends, interest) when they occur.[97] By contrast, asset appreciation is not taxed until realization occurs.[98] The deferral conferred by the realization requirement creates a tax incentive to invest in property generating economic returns in the form of asset appreciation. As such, the realization requirement likely causes investment dollars to be allocated differently from how those dollars would be allocated if asset appreciation were taxed as it occurred. Thus, the realization requirement distorts investment decisions and thereby fosters inefficiency.

In addition to distorting initial investment decisions, the realization requirement creates a "lock-in" effect after appreciating assets are acquired.[99] When an acquired asset appreciates in value, an owner who would normally sell the asset based on economic considerations will be less likely to sell the asset because the sale would trigger the deferred tax on the asset appreciation. This lock-in effect is exacerbated

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94. *See supra* note 19–20 and accompanying text.

95. In addition to the deferral conferred on asset appreciation, such appreciation is also often subject to favorable capital gains tax rates. *See* I.R.C. §§ 1221, 1231, 1(h) (2006). The characterization benefits accorded asset appreciation are beyond the scope of this Article.

96. When a tax causes an economic decision to be made differently from how it would have been made in the absence of the tax, the taxpayer generally bears a burden in excess of the tax itself. The tax creates inefficiency because it makes one person worse off without conferring a corresponding benefit on anyone else. *See* RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 279–91 (5th ed. 1989).

97. *See* I.R.C. § 61(a)(4), (7) (2006).

98. *See id.* §§ 61(a)(3), 1001(a).

99. *See* David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1610 (1998) (explaining the lock-in effect). The reduced tax rates that apply to capital gains mitigate lock-in to some extent. *See* Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 350 (1993); Schizer, *supra* at 1611; *supra* note 95.

by the fact that gains accruing to property can be deferred and ultimately eliminated by holding property until death.[100] The fact that death does not constitute a realization event under current law creates a strong tax incentive to hold assets longer than they would otherwise be held if the decision to transfer assets were based solely on economic considerations.[101] Hence, not only does the realization requirement distort the initial investment decision, but it also distorts the decision to reallocate investment dollars as time passes, further undermining the efficiency of the tax system.

The inefficiencies caused by the realization requirement would be eliminated under a mark-to-market system. If asset appreciation were taxed as it accrued, property owners could no longer control the time when asset appreciation would be taxed. As a result, the timing of the taxation of accrued gains would be consistent with the timing of the taxation of other types of investment income. Thus, the decision to invest in appreciating assets would not be influenced by tax considerations stemming from the deferral of tax on asset appreciation.

A mark-to-market system would also eliminate current law's lock-in effect because the act of transferring property would no longer trigger a tax. Rather, asset appreciation would be taxed when it occurred (with a corresponding step up in the basis of the asset to market value to reflect that the appreciation was taxed) and thereby eliminate any gain on the subsequent disposition of the asset. Thus, the decision to retain or sell an asset would be solely a function of economic considerations without regard to tax effects.

Unlike a mark-to-market system, a disposition standard for realization would not eliminate all the inefficiencies of current law. Those inefficiencies should be mitigated, however, if the realization requirement is curtailed by no longer conditioning realization on the receipt of a contemporaneous benefit. Although the tax on asset appreciation would still be deferred until property was transferred, avenues that now exist to escape or shift the taxation of accrued gains (namely, testamentary and inter vivos gratuitous transfers) would be closed. As a result, the tax incentive to invest in appreciating assets relative to other investment alternatives would be reduced.

Implementation of a disposition standard would have a less predictable impact on the lock-in effect of current law. Under a disposition standard, death would constitute a realization event. Treating death as a realization event would eliminate the tax incentive to hold property until death by ensuring an eventual tax on all gains. This change from current law should reduce the lock-in effect. However, a disposition standard would also trigger gains when inter vivos gifts of appreciated property occur. The elimination of the tax incentive to make gratuitous lifetime transfers of appreciated property could exacerbate the lock-in effect by discouraging gifts. On the other hand, the disposition standard would eliminate the benefit conferred by current law on a gift of appreciated property; namely, the ability of the donor to extend the deferral period (to the life of the donee) and shift the potential future tax burden to another taxpayer. Hence, the gap between the burdens imposed on different forms of income would diminish. Consequently,

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100. *See* I.R.C. § 1014. *But see supra* note 89.

101. Estate taxes will sometimes encourage transfers of property before death.

property owners might be more inclined to transfer appreciated assets knowing that a tax will eventually be imposed. These cross currents create some uncertainty as to the actual impact of the proposed disposition standard on current law's lock-in effect.[102]

Quite clearly, a disposition standard for realization would reduce the disparity between the treatment of asset appreciation and other forms of income by eliminating outlets that now exist for a taxpayer to escape tax on asset appreciation. By mitigating the favorable tax treatment of asset appreciation, the tax incentive to invest in appreciating assets should decline, thereby furthering economic efficiency. Although it is unclear how a disposition standard will impact the lock-in effect, that element of the equation should not neutralize the systemic gains achieved by mitigating the distortions created by current law.

B. Disposition Standard Mitigates Administrative and Political Problems Posed by a Mark-to-Market System

As previously discussed, a realization requirement of any sort undermines the equity and efficiency of the tax system. Although a mark-to-market system does not share these weaknesses, it presents problems involving valuation, liquidity, and political acceptability. In addition to ameliorating the inequities and inefficiencies of current law, a disposition standard for realization would mitigate the problems posed by a mark-to-market system.

1. Valuation

Under a mark-to-market system, each taxpayer must report as income the annual increase in the value of that taxpayer's assets.[103] To determine this amount, all assets must be appraised each year. The appraised value of each asset must be compared to that of the prior year and the difference would result in a gain (or a loss) on the tax return.[104] Requiring an annual appraisal of all assets would undoubtedly be burdensome.[105]

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102. If death were treated as a realization event but inter vivos gifts were not treated as such, it is unclear whether the lock-in effect would be diminished. If taxpayers knew that appreciated property could be gratuitously transferred before death without triggering a tax on the appreciation, they might procrastinate with respect to making gifts, believing death is not imminent, with many failing to make gifts before death occurred.

103. *See* Shakow, *supra* note 20, at 1112 ("[T]he accretion ideal . . . [entails] including unrealized changes in the value of property in taxable income.") (quoting Professor William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1115–16 (1974) (omission added)).

104. *Id.* ("Literal achievement of [the accretion ideal] would require that all assets be taken into account at current fair market value at the end of each accounting period.").

105. *See, e.g.*, James R. Repetti, Commentary, *It's All About Valuation*, 53 TAX L. REV. 607 (2000) (discussing the difficult valuation issues posed by a mark-to-market system). Certain proposals would permit less frequent appraisals, except certain assets, and allow for estimates. *See* Shakow, *supra* note 20, at 1120 ("[A] practical system for accrual taxation should not require valuation of every asset owned by every taxpayer.").

In contrast to a mark-to-market system, a system taxing asset appreciation upon disposition would not require an annual valuation of every asset. Rather, each asset owned by any taxpayer would be valued only once, when the asset is transferred. At that time, the transferor would be taxed on the difference between the value of the asset and its basis, regardless of whether a contemporaneous benefit is received.

The novel valuation challenges presented by a disposition standard of realization involve death and inter vivos gifts.[106] Because death would become a realization event under a disposition standard, the property of the decedent must be valued at death to quantify the resulting gains (and losses).[107] Valuing property at death, however, is not a foreign concept—a decedent's assets must often be valued for purposes of federal and state estate taxes and inheritance taxes.[108] In addition to requiring the valuation of assets at death, a disposition standard would require the valuation of assets when lifetime gifts occur. Here too, valuing gifts is not an entirely foreign concept in that federal and state transfer taxes are sometimes imposed on gifts.[109]

In addition to requiring less frequent asset valuations, a system that requires property to be valued when an inter vivos or testamentary gratuitous transfer occurs should be perceived as less artificial than a mark-to-market system. In the case of a mark-to-market system, it is unlikely that a property owner would independently contemplate the value of her assets on the specific day each year that the tax law required assets to be valued. No economic reason would exist for the owner to be focused on the value of the assets on that arbitrary date. The annual valuation of all assets would be driven solely by the tax system and would undoubtedly be burdensome.

In contrast to a mark-to-market system, a disposition standard of realization would trigger valuation at a time when the property owner is likely to be considering the property's actual value. When property is transferred, the transferor will normally confront the question of valuation regardless of whether the tax system mandates valuation at the time of transfer. For example, when a donor decides to make a gift, the donor will normally determine the amount of the gift before making it. In the case of a cash gift, the donor must decide a specific amount to give (unless she simply reaches into her pocket and hands over a wad of cash). In the case of a gift of property, the donor is also likely to go through a mental process of valuing the property before she conveys it. Although a donor would not

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106. Charitable contributions do not present a new valuation challenge because they must be valued to determine the magnitude of the taxpayer's deduction. *See* I.R.C. § 170 (2006).

107. *See supra* note 24 (discussing the limitations on allowing losses even if they are realized under the proposed disposition standard).

108. *See* I.R.C. § 2001; ELIZABETH C. MCNICHOL, CENT. ON BUDGET & POLICY PRIORITIES, MANY STATES ARE DECOUPLING FROM THE FEDERAL ESTATE TAX CUT (Revised Mar. 28, 2006) (referencing the more than twenty states that impose estate or inheritance taxes).

109. *See, e.g.*, I.R.C. §§ 2501, 2502; CONN. GEN. STAT. ANN. §12-640 (West 2005); TENN. CODE ANN. § 67-8-101 (2006). In many cases, gifts of property over a nominal amount tend to be in forms that are not that hard to value like publicly traded securities or real estate (though real estate can sometimes be difficult to value).

normally secure a professional appraisal of the gifted property,[110] the donor undoubtedly will engage in a conscious or unconscious exercise of determining that the property in question is within a range of values that the donor is inclined to bestow on a particular donee. If a donor is inclined to make a gift of roughly $1,000, she might transfer property with a value of $800 or $1,200 to the donee, but it is highly unlikely she will transfer property worth $5,000 to the donee. Thus, a donor who makes a gift of a particular property presumably makes the gift because the value of the property approximates the amount of the gift the donor wishes to make. Because the time of transfer is normally a time when a property owner will confront the valuation question regardless of tax effects, the infrequent valuations required by a disposition standard of realization should be less artificial, and thus less onerous, than the arbitrary annual valuations mandated by a mark-to-market system.

A realization requirement triggered by a disposition standard would entail a one-time valuation of the property, at the time of disposition, rather than the annual valuations required by a mark-to-market system.[111] Moreover, a system tying realization to a disposition would require valuation at a time when the taxpayer would likely be focused on valuation for non-tax reasons. Hence, a realization requirement that defers taxation of appreciated property until a disposition occurs should pose fewer valuation problems than a mark-to-market system.

2. Liquidity

Under a mark-to-market system, tax would be imposed annually on the asset appreciation that accrues each year the taxpayer owns the property. The event triggering the tax (the passage of a year) would not generate cash with which to pay the tax. One criticism of a mark-to-market system, therefore, is that it imposes tax at a time unrelated to a transaction providing the taxpayer with the cash to pay the tax.[112] Thus, a mark-to-market system would create liquidity issues for taxpayers.

Of course, liquidity issues already exist under current law. For example, under current law, value received is normally taxed regardless of its form—one need not be paid in money to have income.[113] If a taxpayer is compensated with property, the taxpayer is taxed on the value of the property received. The fact that the taxpayer received no money to pay the tax is not the concern of the tax system. Many realization events under current law do not involve the receipt of money by the

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110. This statement contemplates a gift to the object of one's bounty rather than to charity. In the case of a gift to charity, an appraisal might be needed to support the corresponding income tax deduction. *See* I.R.C. § 170.

111. *See* Joseph M. Dodge, *A Deemed Realization Approach is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 434 (2001) ("Deeming realization to occur at death (or upon gift) would impose a one-time valuation and liquidity problem, as opposed to annual valuations, and in that respect would be similar to federal transfer taxes.").

112. *See* Schenk, *supra* note 4, at 360–65 (discussing the liquidity concerns surrounding a mark-to-market system).

113. Treas. Reg. § 1.61-1(a) (2010) ("Gross income includes income realized in any form, whether in money, property, or services.").

transferor. For example, a deferred payment sale, an exchange of one property for another, and an exchange of property for services constitute realization events even if no cash is received when the property is transferred.[114]

Admittedly, a disposition standard for realization not conditioned on the receipt of tangible value would likely create more liquidity issues than current law. A disposition standard would tax inter vivos and testamentary gratuitous transfers with respect to which no consideration is received. Nevertheless, a disposition standard of realization would create less of a liquidity problem than a mark-to-market system because taxes are imposed less frequently. Under a disposition standard, tax is imposed only once on each property owned by the taxpayer, at the time the property is transferred. By contrast, under a mark-to-market system, the appreciation in all assets would be taxed every year for as long as the property is owned. Hence, fewer liquidity issues should be posed by a realization requirement based on a disposition of property standard than by a mark-to-market system. Moreover, the liquidity issues that would be presented by a disposition standard could be relieved by Congress in appropriate cases.[115]

3. Political Feasibility

Significant political resistance to the elimination of the realization requirement is also likely to impede the advent of a mark-to-market system. The view that "paper gains" should not be taxed is firmly embedded in the current culture, and it would be very difficult to mobilize popular support for a system that taxes asset appreciation as it occurs.[116] This reason alone is likely to preclude a comprehensive mark-to-market system from ever being implemented in the United States.

Some degree of resistance is also likely to exist with respect to implementing a disposition standard for realization. Many will likely object to taxing the appreciation in lifetime gifts and testamentary transfers of property. Tying taxation to the physical transfer of property, however, should be less objectionable than a mark-to-market system, at least in the case of lifetime transfers. Under a disposition standard of realization, the taxpayer can still avoid being taxed on paper profits during the taxpayer's lifetime by retaining ownership of the taxpayer's property.

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114. To the extent liquidity issues do exist, various relief mechanisms could be employed to mitigate the adverse effects. *See, e.g.*, I.R.C. § 453 (2006) (granting deferral of income under the installment method); *id.* § 6166 (granting relief from estate tax when estate consists largely of interest in closely held business).

115. *See* Kornhauser, *Constitutional Meaning*, *supra* note 4, at 54 (stating that liquidity problems created by taxing appreciated property transferred gratuitously are not unique and that Congress can grant relief similar to that conferred on sales of closely held businesses and farms). It is true that the magnitude of the single gain and corresponding tax liability under a disposition standard would often be much greater than the annual gains under a mark-to-market system, but relief measures could be molded to address this situation.

116. *See* Schenk, *supra* note 4, at 377–78 (suggesting that people do not view paper profits as income); Schizer, *supra* note 99, at 1606 (stating that an attempt to repeal realization "would create . . . a firestorm of political opposition") (quoting Thomas L. Evans, *The Realization Doctrine After* Cottage Savings, 70 TAXES 897, 898 (1992)) (omission added).

This ability to control the timing of tax, though not ideal from the standpoints of fairness and efficiency, should make the prospect of taxing inter vivos dispositions more tolerable to taxpayers than a mark-to-market system.

Taxing transfers of property at death will likely trigger greater objections because unlike inter vivos transfers, a taxpayer cannot avoid the transfer of all property at death. The income tax consequences of death under current law, however, are inconsistent and difficult to justify—the fact that unrealized gains are not taxed but basis is nevertheless stepped-up to fair market value confers a double benefit that most voters should perceive as irrational.[117] Restoring rationality by taxing gains at death, therefore, should be less politically problematic than implementing a mark-to-market system.[118]

C. Disposition Standard Simplifies the Law

Many ambiguities surround the realization requirement under current law. First, a realization event has never been defined.[119] Instead, ambiguous statutory provisions and a confused common law are the only guideposts for discerning the contours of realization.[120] In addition, the requirement that a contemporaneous benefit must be received for realization to occur further clouds the determination of a realization event and the measurement of gain.[121] These ambiguities create uncertainty that unnecessarily complicates the law.[122]

Refining the realization requirement to treat every disposition as a realization event without regard to the benefit received would dramatically simplify the law. The ambiguity associated with what constitutes a realization event would be replaced by a clear standard; namely, any transfer of property would be a realization event.[123] Moreover, the act of transferring property is a comprehensible

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117. *See* I.R.C. §1014. *But see supra* note 89. Some, however, have argued that the step up in basis at death is "paid for" by the estate tax on the appreciation. Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 364 (1993) (stating, but criticizing, the argument).

118. Rationality could also be restored by denying a step up in basis to the decedent's beneficiaries and perpetuating deferral until the beneficiary disposes of the property. But perpetuating deferral beyond death undermines the revenue goals of the modified tax system. *See* Dodge, *supra* note 111, at 529–30. The dramatic decline in asset values in recent years might further mitigate the resistance to a disposition standard now that so much less untaxed appreciation exists.

119. *See supra* note 4.

120. *See supra* text accompanying notes 25–26 (delineating statutory provisions); *infra* Part III.B (delineating common law of realization).

121. *See supra* Part I.C (suggesting that once the contemporaneous benefit requirement is weakened, there is no longer a conceptual basis from which to determine and measure realization).

122. *See* Kornhauser, *The Story of* Macomber, *supra* note 4, at 123 ("By deferring tax consequences beyond the point in time when the income (or loss) economically occurs, realization significantly increases complexity . . . .").

123. Realization is a mechanical standard under this approach. When realization occurs, Congress can nevertheless defer taxation in appropriate cases by enacting targeted nonrecognition rules. *See infra* text accompanying notes 158–60.

standard. People normally know when they part with ownership of property.[124] In addition, measuring gain by looking to the fair market value of the property transferred eliminates the complexity of attempting to value amorphous benefits under current law's system of tying realization to the receipt of a contemporaneous benefit.[125]

Utilizing a disposition standard for realization would mitigate the inequities and inefficiencies created by the current realization requirement. Moreover, these improvements can be achieved without creating the same degree of valuation, liquidity, and political issues as a mark-to-market system. The disposition standard would also simplify existing law by substituting a clear and administrable set of rules for the current ambiguous and anachronistic system. Part III explains how the proposed disposition standard would be implemented and explores the impact of the new system on current law.

III. IMPLEMENTATION OF A DISPOSITION STANDARD

The implementation of a disposition standard for realization would not be difficult. This Part explains how the disposition standard could be codified. It then compares the treatment of a series of potential realization events under current law to their treatment under the new disposition standard.

A. Statutory Changes

A realization event has never been defined by statute. For more than eighty years, federal tax law has merely quantified the gain that results when a realization event occurs.[126] That gain is measured by the amount of consideration received for the transferred property.[127]

This Article proposes the creation of a new statutory structure to implement the proposed disposition standard of realization. First, a realization event would be defined as follows:

> **Gain or loss is realized when a disposition of property occurs.**[128]

Second, the gain that results when a realization event occurs would be quantified as follows:

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124. *But see* Estate of Starr v. Comm'r, 274 F.2d 294 (9th Cir. 1959) (addressing a situation where it was unclear whether a sale or lease had occurred).

125. *See infra* Part III.B.5–8 (discussing amorphous benefits to transferor in cases such as charitable contributions, inter vivos gifts, testamentary transfers, and foreclosures).

126. *See supra* text accompanying notes 47–48; I.R.C. § 1001(a) (2006) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . .").

127. I.R.C. § 1001(b) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."). The income resulting from a realization event is now described as "[g]ains derived from dealings in property." *Id.* § 61(a)(3).

128. This provision would replace I.R.C. § 1001(a). *See supra* note 126.

> **The amount of gain realized from a disposition of property shall be the excess of the fair market value of the transferred property over its adjusted basis.**[129]

Hence, under the proposed disposition standard, the gain would be measured by the value of the transferred property, rather than the consideration received. This treatment is sensible because the value of the transferred property captures the amount of accrued appreciation that previously had not been taxed.[130]

B. Comparison of Current Law to Disposition Standard

This Section examines a series of transactions involving appreciated property under both current law and the proposed disposition standard. It illustrates how the proposed disposition standard would modify current law. The discussion reveals that the proposed standard would simplify current law and potentially generate additional tax revenue.

1. Sale of Appreciated Property

A sale (i.e., a transfer of property in exchange for cash consideration) is the classic realization event under current law.[131] A sale would remain a realization event under the proposed disposition standard because a sale entails a transfer of property.[132] Under current law, gain is quantified by looking to the amount of cash

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129. This language would replace the first sentence of I.R.C. § 1001(b). The second sentence of I.R.C. § 1001(b) would be modified as follows: "The amount of loss realized from the disposition of property shall be the excess of the adjusted basis of the property over the fair market value." The rules that currently limit the allowance of losses should continue to apply under the new disposition standard. *See supra* note 24.

130. The income resulting from a realization event would be described as "recognized gains from the disposition of property." This description would replace the current law's "[g]ains derived from dealings in property" description. I.R.C. § 61(a)(3). Other corresponding statutory changes should also be made. For example, the "sale or exchange" language in I.R.C. § 1001(c) should be replaced by "disposition" and the basis rule in I.R.C. § 1015 should be changed to the fair market value of the transferred property (but the existing basis rule for gifts of loss property should be retained).

131. *See, e.g.*, Weiss v. Wiener, 279 U.S. 333, 335 (1929) (stating that the income tax laws "do not charge for appreciation of property or allow a loss from a fall in market value *unless realized in money by a sale*") (emphasis added); *In re* Perlman, 188 B.R. 704, 708 (Bankr. S.D. Fla. 1995) ("Gain or loss is not considered for tax purposes until it is 'realized.' Gain is usually 'realized' only upon the happening of a taxable event, for example, when property is *sold* or exchanged.") (emphasis added); IRS, GEN. COUNS. MEM. 38838, IN RE: WHETHER SAVINGS AND LOAN ASSOCIATIONS MAY DEDUCT LOSSES ON THEIR EXCHANGE OF SIMILAR MORTGAGE POOLS 6 (Apr. 19, 1982) ("Since the case involved a sale rather than an exchange, there was obviously a change in the substance of the property of the taxpayer, and the sale was a realization event.").

132. *See supra* text accompanying note 128 (stating a new statutory definition of realization event).

received.[133] By contrast, under the proposed disposition standard, gain would be measured by the value of the transferred property, without regard to the consideration received.[134] In the vast majority of sales, of course, the value of the transferred property will be equivalent to the amount of the cash received in which case the seller's gain would not change under the new standard.[135]

2. Exchange of Appreciated Property for Other Property

An exchange of one property for another constitutes a realization event under current law, and would remain a realization event under the proposed disposition standard.[136] Under current law, the transferor's gain is quantified by the value of the property received.[137] By contrast, under a disposition standard, gain would be quantified by the value of the property transferred.[138] Here again, each party to an exchange would normally be expected to transfer an equivalent amount of consideration in which case the magnitude of the parties' gains would not change under the new standard.[139]

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133. I.R.C. § 1001(b).

134. *See supra* text accompanying note 129 (providing a new statutory rule quantifying realized gain).

135. If disparate amounts were involved, however, the value of the transferred property would still measure the transferor's gain and any excess cash or property would be treated separately from the sale and governed by general income tax principles.

136. For current law, see Treas. Reg. § 1.1002-1(d) (2010) (defining "exchange"). *See* Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 560–62 (1991) (holding that a property exchange gives rise to a realization event as long as the exchanged properties are "materially different"). For the proposed disposition standard, see *supra* text accompanying note 128.

137. I.R.C. § 1001(b).

138. *See supra* text accompanying note 129. Under current law, the basis in the property received in an exchange is determined by the value of the property *received* because the value of the property *received* measures the transferor's gain. *See* Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (Ct. Cl. 1954) (stating that the basis of property received in an exchange is determined by the value of the property received). That basis principle would not apply under the proposed disposition standard. Rather, under the proposed disposition standard, the value of the property *transferred* would establish the basis in the property received by the transferor because the value of the *transferred* property measures the transferor's gain.

139. When one person exchanges property with another, it is unlikely that the value of both properties will be equivalent. But if the parties are unrelated, one would expect the consideration to be "evened up" by having the transferor of the property of lesser value add some cash to make up the difference. If a transferor were to receive consideration of greater or lesser value than the property transferred, the transferor's gain would still be based on the value of the property transferred—a departure from current law. In these circumstances, any excess value flowing one way or the other would be treated separately from the exchange and governed by general income tax principles.

3. Exchange of Appreciated Property for Past or Future Services

Although courts have readily treated an exchange of property for services as a realization event,[140] they rarely address the threshold question of whether services can constitute the requisite benefit for realization to occur. Instead, the courts focus on the difficult issue of quantifying the transferor's gain in these circumstances.[141] This determination is complicated by a statutory definition that limits the amount realized to the "sum of any *money* received plus the fair market value of the *property* (other than money) received."[142] Quite clearly, services are not "money" or "other property." Nevertheless, the courts have willingly treated services as constituting the requisite benefit for realization.[143]

It is not surprising that the courts have treated services as a benefit received by the transferor of property when the property compensates the service performer for *past* services. In these circumstances, a benefit in the form of the services was in fact received by the transferor of the property. It is far more difficult to identify the requisite benefit to the transferor when property is conveyed for the performance of *future* services because no benefit is derived by the transferor of the property until the services are actually performed. Nevertheless, the courts have managed to find the requisite contemporaneous benefit in these circumstances. For example, one court treated the transferor as receiving a benefit equal to the amount of a tax deduction allowed for the value of the transferred property.[144] Another court simply equated future services to past services to establish the requisite benefit.[145]

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140. The clearest statement is found in *International Freighting Corp. v. Commissioner*: "[A]s the delivery of the shares here constituted a disposition *for a valid consideration*, it resulted in a closed transaction with a consequent realized gain." 135 F.2d 310, 313 (2d Cir. 1943) (emphasis added); s*ee also* United States v. Gen. Shoe Corp., 282 F.2d 9, 14 (6th Cir. 1960) (assuming that a realization event occurred when the taxpayer-employer contributed assets to employees' retirement trust); Tasty Baking Co. v. United States, 393 F.2d 992, 995 (Ct. Cl. 1968) (same).

141. *Gen. Shoe Corp.*, 282 F.2d at 12; *Int'l Freighting Corp.*, 135 F.2d at 313; *Tasty Baking Co.*, 393 F.2d at 995.

142. I.R.C. § 1001(b) (emphasis added).

143. *See Gen. Shoe Corp.*, 282 F.2d at 12; *Int'l Freighting Corp.*, 135 F.2d at 313; *Tasty Baking Co*., 393 F.2d at 995. Although the result seems unremarkable, it deviates from the clear statutory language. Services are not "'cash' or 'property.'" Dodge, *supra* note 111, at 436.

144. *Gen. Shoe Corp*., 282 F.2d at 13 ("The 'property' received is an economic gain to the taxpayer of exactly the market or assessed valuation which the taxpayer used as a deduction on its income tax returns."). Compensation paid for services, whether in the form of money or property, is allowed as a deduction to the extent the amount is reasonable. *See* I.R.C. § 162(a)(1).

145. *See Tasty Baking Co.*, 393 F.2d at 994. In *Tasty Baking Co*., the taxpayer claimed a deduction for the value of assets contributed to a pension trust and claimed that its amount realized should be limited to the tax savings created by the deduction, rather than the full fair market value of the property transferred. *Id.* The court stated that *International Freighting Corp.* "is applicable in the business situation such as we have here, if we add: 'services past and future.'" *Id*. at 995 (quoting *Int'l Freighting Corp.*, 135 F.2d at 313).

Although the courts have routinely treated the receipt of services as the requisite benefit to establish realization, the courts have effectively conceded that these services cannot be valued independently of the transferred property.[146] Specifically, the courts have consistently looked to the value of the property to serve as a proxy for establishing the value of the benefit received by the transferor of the property.[147] Hence, when property is exchanged for services, current law looks to the value of the property transferred to quantify the transferor's gain.

The disposition standard proposed by this Article would rationalize and simplify current law when applied to the transfer of property for services. Under the disposition standard, realization would occur whenever property is transferred.[148] Hence, a transfer of property for services would trigger a realization event without regard to the consideration received by the transferor. Moreover, under the proposed standard, the transferor would be taxed on the difference between the value of the transferred property and its basis—no need would exist to contend with the complexity of valuing the services received.[149] In effect, the disposition standard would treat the value of the property transferred as the actual measure of the transferor's income, rather than as a mere proxy for that result. Thus, the proposed standard would simplify the law by eliminating the analytical shortcomings of the current treatment of transfers of property for services.

4. Transfer of Appreciated Property Pursuant to Divorce

The transfer of appreciated property pursuant to divorce has historically been treated as a realization event with little justification for that result.[150] Here again, the courts have looked for a benefit derived at the time of the transfer to determine whether realization occurred and found that "the 'property received' was the release of the wife's inchoate marital rights."[151] Lower courts had concluded that the value of these marital rights was unascertainable, which precluded the transferor from realizing a gain on the exchange.[152] The Supreme Court, in *United*

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146. *See Int'l Freighting Corp.*, 135 F.2d at 313 ("Since the bonuses would be invalid to the extent that what was delivered to the employees exceeded what the services of the employees were worth, it follows that the consideration received by the taxpayer from the employees must be deemed to be equal at least to the value of the shares . . . ."); *accord Gen. Shoe Corp.*, 282 F.2d at 13; *Tasty Baking Co.*, 393 F.2d at 995.

147. *Gen. Shoe Corp.*, 282 F.2d 9; *Int'l Freighting Corp.*, 135 F.2d 310; *Tasty Baking Co.*, 393 F.3d 992.

148. *See supra* text accompanying note 128.

149. *See supra* text accompanying note 129.

150. In *United States v. Davis*, the Supreme Court found the "sale or other disposition" language of section 1001(a) to be "too general to include or exclude conclusively the transaction presently in issue." 370 U.S. 65, 69 (1962). It therefore rested its taxable event holding on the fact that every lower court that had addressed the issue had "assumed that the transaction was otherwise a taxable event." *Id*. at 71.

151. *Id.* at 72.

152. Davis v. United States, 287 F.2d 168, 174 (Ct. Cl. 1961) (holding that the "measure of the value of the wife's right to maintenance and support was dependent upon so many uncertain factors that neither the taxpayer nor a revenue officer could do more than guess at it," and therefore no taxable gain was realized), *aff'd in part, rev'd in part*, 370 U.S. 65

States v. Davis, however, circumvented the difficult issue of valuing marital rights by looking to the value of the property transferred to quantify the reciprocal benefit received.[153] Here again, the value of the property transferred was used as a proxy to measure the transferor's gain when ambiguity existed with regard to the value of the benefit the transferor received.[154]

Under the proposed disposition standard, the transfer of property pursuant to divorce would constitute a realization event just like any other transfer of property.[155] The value of the transferred property would also determine the transferor's realized gain, rather than merely serving as a proxy for that gain.[156] The inchoate marital rights surrendered by the spouse would be entirely irrelevant to the analysis.[157] Hence, the same amount of gain would be realized under the disposition standard as under current law. The proposed standard, however, eliminates the complicated exercise of evaluating the benefit received to determine if a realization event occurred and to quantify the resulting gain.

Subsequent to *Davis*, Congress enacted a statutory nonrecognition rule that defers the taxation of gains realized when property is transferred incident to divorce.[158] The disposition standard for realization proposed by this Article could also accommodate nonrecognition rules in circumstances where Congress makes a policy judgment that the immediate taxation of a realized gain is inappropriate.[159] The proposed disposition standard determines the time of realization, not recognition.[160] Thus, the best of both worlds can be achieved under the proposed disposition standard—it creates a clear standard of realization that mitigates the deferral conferred by current law, while allowing for nonrecognition treatment in situations where Congress deems further deferral to be appropriate.

5. Charitable Contribution of Appreciated Property

Under current law, a gratuitous transfer of appreciated property does not trigger a taxable gain to the donor.[161] Courts have nevertheless treated the contribution as a

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(1962); Halliwell v. Comm'r, 44 B.T.A. 740, 748 (1941) (finding it impossible to evaluate the rights received by the spouse transferring property in a divorce and, therefore, to compute an amount realized), *rev'd* 131 F.2d 642 (2d Cir. 1942); Mesta v. Comm'r, 42 B.T.A. 933, 940 (1940) (finding that the impossibility of valuing the rights received by a spouse transferring property in a divorce precludes realization), *rev'd* 123 F.2d 986 (3d Cir. 1941).

153. *Davis*, 370 U.S. at 72–73.

154. *See supra* text accompanying note 147 (describing the treatment of the value of transferred property as a proxy for the value of services received).

155. *See supra* text accompanying note 128.

156. *See supra* text accompanying note 129.

157. It is unlikely that the rights surrendered by the spouse would significantly deviate from the value of the property transferred in light of the adverse interests of the parties.

158. I.R.C. § 1041 (2006).

159. I.R.C. § 1001(c) would be unaffected by the proposal, other than to conform the "sale or exchange" reference in that provision to the new disposition standard.

160. *See* I.R.C. § 1001(c).

161. *See* Humacid Co. v. Comm'r, 42 T.C. 894, 913 (1964) (involving a charitable contribution).

The law with respect to gifts of appreciated property is well established. A gift realization event because the transfer represents a "disposition" of property.[162] However, the courts have found that the transferor's amount realized under these circumstances is zero. "[T]he amount realized by petitioners under section 1001(b) on the disposition of their stock was zero, *as it would be for any charitable contributor who receives no consideration in return for his contribution*."[163]

The tax treatment of charitable contributions of appreciated property under current law is unsatisfactory for two reasons. First, although this Article advocates the adoption of a disposition standard for realization, no evidence exists that Congress or the early courts ever believed that a mere transfer of property was sufficient for a realization event.[164] Rather, the receipt of a contemporaneous benefit (in the form of money, property, services, or even inchoate marital rights) had been deemed necessary for realization to occur.[165] Thus, the courts' finding that a charitable contribution constitutes a realization event in the absence of a contemporaneous benefit cannot be reconciled with current law.

Second, if a realization event were to occur when appreciated property is contributed to charity, it is far from clear that the donor's amount realized would be zero. A donor may normally deduct the full fair market value of property contributed to charity regardless of the donor's basis in the property.[166] At least one court has treated the deduction resulting from a transfer of property as providing the requisite benefit for a realization event.[167] Although it is questionable whether a donor derives a benefit equal to the nominal amount of the deduction, a donor who transfers appreciated property to charity without being taxed on the gain and

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> of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of a sale.

Id.

162. Withers v. Comm'r, 69 T.C. 900, 904 (1978) ("Section 1001 computes gain or loss whenever there is a 'sale or other disposition of property.' Petitioners' contribution of stock constituted a disposition within the meaning of section 1001."); *see also* Ebben v. Comm'r, 783 F.2d 906, 911 (9th Cir. 1986) (involving a charitable contribution of real estate securing nonrecourse debt, and simply relying on Treas. Reg. § 1.1001-2(a)(4)(iii), for its statement that "the phrase 'other disposition of property' includes a gift of property"); Guest v. Comm'r, 77 T.C. 9, 21 (1981) ("[G]ifts (including charitable contributions) are dispositions within the meaning of section 1001(a)."); BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 28.03 (3d ed. 2002) ("[A] gift is obviously a 'disposition' of property in the layperson's sense . . . ."); Kornhauser, *Constitutional Meaning*, *supra* note 4, at 48 ("A gift is obviously a disposition of property and, but for section 102, should be a taxable event under section 1001 to the donor unless there is some added dimension to realization that a gift does not fit.").

163. *Withers*, 69 T.C. at 904–05 (emphasis added); *see also Guest*, 77 T.C. at 21 ("[I]n the usual case a taxpayer receives nothing in exchange for making a gift, and thus his section 1001(a) 'amount realized' is zero.") (citing *Withers*, 69 T.C. at 904).

164. *See supra* Part I.D.

165. *See supra* Part I.B.

166. I.R.C. § 170 (2006). The fair market value must normally be reduced by the amount of gain that would not be long-term capital gain if the property had been sold by the donor for its fair market value (determined at the time of the deduction). I.R.C. § 170(e)(1)(A).

167. United States v. Gen. Shoe Corp., 282 F.2d 9, 13 (6th Cir. 1960) ("The 'property' received is an economic gain to the taxpayer of exactly the market or assessed valuation which the taxpayer used as a deduction on its income tax returns.").

deducts the full market value of the property undeniably derives a net economic benefit from the transfer.[168] In addition to the benefit of the tax deduction, a donor undoubtedly reaps psychological rewards that are arguably as real as the amorphous "inchoate marital rights" surrendered by an ex-spouse pursuant to a divorce.[169] Thus, the common law stance that a donor of appreciated property derives no benefit from the contribution is questionable.

In contrast to current law, under the proposed disposition standard for realization, a realization event would occur when appreciated property is contributed to charity because the contribution entails a transfer of the property.[170] The donor would be taxed on the difference between the market value of the contributed property and its basis.[171] Thus, the deferral of tax on the appreciation that accrued prior to the contribution would be terminated when the contribution occurs. The nature and extent of the benefit derived by the donor when the contribution occurs would be irrelevant to, and thereby simplify, the analysis. In addition to being logical and simple, the proposed disposition standard would yield a new source of tax revenue when applied to charitable contributions of appreciated property. To fully evaluate the revenue effect, however, behavioral adjustments must be considered. For example, fewer charitable contributions of appreciated property might occur after the disposition standard is adopted because the tax on the unrealized gain might deter potential donors.[172]

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168. It would seem more logical to treat the benefit as limited to the tax savings derived from the deduction. *See* Tasty Baking Co. v. United States, 393 F.2d 992, 994 (Ct. Cl. 1968) (involving a taxpayer who claimed a deduction for the value of assets contributed to pension trust and then claimed that the trust's amount realized should be limited to the tax savings created by the deduction, rather than the full fair market value of the property transferred).

169. *See supra* Part III.B.4 (explaining how courts dealing with transfers of appreciated property pursuant to divorce have historically treated "inchoate marital rights" as property). Psychic benefits are not generally captured by the definition of gross income. As a purely administrative matter, these benefits are normally difficult to quantify (e.g., the joy I get from looking out the window on a sunny day) and precedent exists for excluding them from the tax base even in the absence of an explicit statutory exclusion. *See* CHIRELSTEIN, *supra* note 64, at 27–28 ("Life is full of benefit producing activities—shaving oneself, mowing one's own lawn, jogging around the block for exercise—which might at a stretch be converted to market purchases for cash. But presumably no one would seriously argue that § 61 should be broadened to include such imputations . . . .").

170. *See supra* text accompanying note 128.

171. *See supra* text accompanying note 129. The donor would still be allowed a deduction for the fair market value of the property. *See* I.R.C. § 170 (2006). It would be sensible to still allow the donor to deduct the entire market value of the property because the donor is taxed on the accrued gain at the time of the contribution. Unlike current law, the donor would now be treated in the same manner as if she sold the property and contributed the proceeds to charity.

172. Note that the taxpayer contributing appreciated property to charity would continue to enjoy a characterization benefit under the proposed disposition standard; namely, a capital gain with respect to the realization event and an ordinary deduction with respect to the charitable contribution. Whether this type of characterization benefit should be curtailed is beyond the scope of this Article.

6. Inter Vivos Gift of Appreciated Property

The tax treatment of gifts of appreciated property has a convoluted history that effectively precluded the courts from confronting the threshold question of whether a gift is a realization event. At the origin of the tax law, three benefits were bestowed on gifts of appreciated property. First, the donor was not taxed on the appreciation in the gifted property when the gift was made.[173] Second, the donee was permitted to exclude the value of the property from income.[174] Finally, the donee was allowed to step-up the basis in the property to market value.[175] In 1921, Congress eliminated the third benefit by limiting the donee's basis to that of the donor.[176] This amendment, however, was not intended to bless the donor's ability to transfer the appreciated property without triggering the gain.

> Closing this avenue of avoidance by requiring the donee to take the same basis as the donor did not mean that Congress meant to exclude the appreciation from the donor's income if it was constitutionally taxable. Congress simply did not give the matter any thought . . . .[177]

As a general matter, the courts have refrained from treating a gift as a realization event,[178] notwithstanding that a gift is undoubtedly a "disposition."[179] Thus, the

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173. *See* Taft v. Bowers, 278 U.S. 470 (1929) (involving a donee who was taxed on the appreciation that had accrued while property was in the hands of the donor without any discussion of why the donor was not taxed on the appreciation in the gifted property).

174. *See* Kornhauser, *Constitutional Meaning*, *supra* note 4, at 13, 38 (explaining that all tax legislation following the passage of the Sixteenth Amendment excluded gifts and bequests from gross income without any explanation for the exclusion).

175. *Id*. at 49–50 (explaining that a donee was accorded a fair market value basis in gifted property from 1913 until 1921).

176. Revenue Act of 1921, ch. 136, § 202(a)(2), 42 Stat. 227, 229.

177. Edward T. Roehner & Shelia M. Roehner, *Realization: Administration Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173, 191 (1953).

178. In *Evangelista v. Commissioner*, which involved a gift of encumbered cars to a trust for the benefit of the taxpayer's children where the trust assumed the taxpayer's *recourse* liability, the court concluded that gifts are not realization events because "if Congress intended a transfer that is properly characterized as a gift to be a taxable disposition it would have shown this intent more explicitly." 629 F.2d 1218, 1222 (7th Cir. 1980). But the *Evangelista* court concluded that insufficient facts existed to support a finding that a gift was made and therefore the transaction was a taxable disposition. *Id.* at 1224–25; *see also* Diedrich v. Comm'r, 457 U.S. 191, 198–200 (1982) (determining that a donor realized gain when she made a gift of appreciated property conditioned on the donee's agreement to pay the gift tax; Justice Rehnquist, in dissent, remarked, "[t]he Court in this case . . . begs the question of whether a taxable transaction has taken place at all"). *But see* Levine v. Comm'r, 72 T.C. 780, 789 (1979) (involving a gift of real estate to a trust for the taxpayer's grandchildren where the court stated: "That there was a disposition of the property by decedent seems clear. . . . The question, however, is not whether a disposition occurred within the meaning of section 1001(b), but whether a gain was realized from such disposition."), *aff'd,* 634 F.2d 12 (2d Cir. 1980).

179. *See* Treas. Reg. § 1.1001-2(a)(4)(iii) (2009) (providing that "[a] disposition of

jurisprudence in the gift area comports with the historic view that a transfer of property, though necessary for a realization event, is not sufficient because a contemporaneous benefit also must be received by the transferor.[180] The courts have never explored the question of whether the donor of appreciated property derives a benefit. A donor undoubtedly enjoys psychological benefits from making a gift, but benefits of that type are probably too amorphous to satisfy current law's contemporaneous benefit requirement for realization.[181] Moreover, no tax benefit is derived by a donor because gifts (unlike charitable contributions) are not deductible.[182]

Although a gift has not historically been treated as a realization event, there is nothing inherently unique about a gratuitous transfer that would preclude Congress from treating a gift as a realization event.[183] No constitutional impediment exists to taxing the accrued appreciation existing in property transferred as a gift.[184] Moreover, other commentators have advocated this result.[185] Congress, therefore, could tax the unrealized appreciation in property transferred gratuitously simply by adopting the "disposition" standard advanced in this Article.

If the proposed disposition standard for realization were adopted, a gift of appreciated property, like any other transfer of property, would constitute a realization event.[186] The donor's gain would be measured by the difference between

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property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject").

180. *See supra* Part I.B (discussing how the courts have historically interpreted the realization requirement as mandating the transfer of property in exchange for contemporaneous consideration).

181. *See supra* note 169; BITTKER ET AL., *supra* note 162, at ¶ 28.03 ("[T]axpayers making gifts . . . *could* be viewed as receiving non-economic satisfactions equal to the value of the transferred property.").

182. I.R.C. § 262 (2006) (noting that "personal, living, or family expenses" (such as gifts) are not tax deductible).

183. BITTKER ET AL., *supra* note 162, at ¶ 28.03 n.13 ("[T]he making of a gift or bequest could be viewed as an appropriate time to tax the transferor on appreciation not yet taxed . . . .").

184. *See, e.g.*, *President's 1963 Tax Message*, *supra* note 16, at 596–602 (delineating an opinion of the General Counsel of the Department of the Treasury as to the constitutionality of taxing the accrued appreciation in a gratuitous transfer of appreciated property); Surrey, *supra* note 64, at 791 ("[T]he gift of any property which has appreciated in value should be a realization of the economic gain represented by such appreciation. Income taxation of donors at the time of their gift is thus permissible. . . . Whether donor or donee . . . should bear the tax is a question now of policy alone, unconfused by supposed constitutional restrictions."). *But see* Ordower, *supra* note 64, at 58 ("While deferral of taxation on gratuitous transfer may lack the constitutional foundation of the general realization principle, it nevertheless may be as firmly entrenched in the tax law as that principle and remain . . . far more than a simple matter of administrative convenience.").

185. *See, e.g.*, Kornhauser, *Constitutional Meaning*, *supra* note 4, at 54 ("A new provision should be enacted stating that a gift . . . is a realization event to the donor . . . and thus taxable to him . . . ."); SIMONS, *supra* note 2, at 166 ("Every transfer of property by gift should be treated as a realization, at the fair market value as of the date of the transfer, by the donor.").

186. *See supra* text accompanying note 128.

the value of the property transferred and the donor's basis.[187] The benefit, if any, received by the donor would be irrelevant to the analysis. The transfer would merely terminate the deferral previously conferred on the appreciation of the donor's property.[188] Treating a gift of appreciated property as a realization event should also help to generate additional tax revenue.[189]

7. Transfer of Appreciated Property at Death

The income tax law of the United States has never treated death as a realization event.[190] Nevertheless, the basis of a decedent's appreciated property is stepped up to market value when death occurs.[191] Hence, under current law, untaxed appreciation that accrues during a taxpayer's lifetime is entirely exempt from income tax if the property is held until death. As Professor Zelenak explains, this exemption does not manifest a policy decision:

> This tax forgiveness *did not originate as a conscious policy decision*. Rather, it *occurred almost accidentally* from the combination of two ideas that were accepted instinctively during the early years of the income tax: that the mere transfer of property at death did not constitute a realization of gain or loss on the property, and that fair market value basis for heirs was appropriate to prevent taxation of capital . . . .[192]

It is understandable that death would not be treated as a realization event in a system that historically conditioned realization on the receipt of a contemporaneous benefit when property is transferred. No apparent benefit is enjoyed by a decedent when death occurs.[193] Consequently, as long as realization is deemed to require the receipt of a contemporaneous benefit, death cannot be a realization event.

Although death has not historically been treated as a realization event, Congress could establish that result by enacting the disposition standard proposed by this

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187. *See supra* text accompanying note 129.

188. If gifts of appreciated property are treated as realization events, Congress should permit the donee to step-up the basis in the gifted property to market value because all the previously untaxed appreciation would be taxed to the donor when the gift occurs.

189. The revenue effect would result from acceleration of income by triggering it to the donor rather than preserving it for the donee. *See* I.R.C. § 1015 (2006). Here again, behavioral effects must be considered when evaluating revenue effects. For example, the disposition standard might cause certain gifts that otherwise would have been made to be deferred due to the income tax imposed on gifts of appreciated property. It is assumed that the current federal gift tax would be retained when the disposition standard is adopted for income tax purposes.

190. *See supra* note 16. Other countries, such as Canada, treat death as a realization event. Dodge, *supra* note 111, at 431.

191. I.R.C. § 1014 (2006). *But see supra* note 89.

192. Zelenak, *supra* note 117, at 363–64 (emphasis added).

193. The step-up in basis conferred on the decedent's successor constitutes a benefit from death, but this basis adjustment does not benefit the decedent. *See* I.R.C. § 1014. *But see supra* note 89.

Article. The Constitution does not impede the treatment of death as a realization event.[194] Moreover, other commentators have advocated this result.[195]

At death, the decedent's assets are necessarily transferred pursuant to the decedent's instructions or by operation of law. Under a disposition standard for realization, therefore, death would represent an event that terminates the deferral of tax on gains that accrued during the decedent's lifetime.[196] The gains realized at death would be based on the market value of the decedent's property.[197] The issue of whether the decedent derives any benefit from death would be irrelevant as to both whether realization occurred and the magnitude of the decedent's gains. Although the proposed disposition standard still allows gains to be deferred until death, the new standard would no longer permit deferral to be extended beyond one's lifetime.[198] As a result, treating death as a realization event should reduce the existing incentive to defer lifetime transfers and thereby generate additional tax revenue.[199]

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194. *See, e.g.*, *President's 1963 Tax Message*, *supra* note 16, at 596–602 (delineating an opinion of the General Counsel of the Department of the Treasury as to the constitutionality of taxing the accrued appreciation in a testamentary transfer of appreciated property); Surrey, *supra* note 64, at 791 ("[T]axation of decedents on any hitherto unrealized appreciation in value of the property constituting their estate is entirely proper under the income tax, because of the 'realization' `` that occurs at death. Whether . . . decedent or legatee, should bear the tax is a question now of policy alone, unconfused by supposed constitutional restrictions.").

195. *See, e.g.*, Laura E. Cunningham & Noël B. Cunningham, *Commentary: Realization of Gains Under the Comprehensive Inheritance Tax*, 63 TAX L. REV. 271, 276–80 (2009) (arguing that realization at death rule is preferable to carryover basis at death rule on grounds of simplicity, efficiency, equity, and revenue-raising potential); Dodge, *supra* note 111, at 439 ("[T]he central point is that attributing unrealized gains (and losses) to the gratuitous transferor is correct in principle under an income tax . . . . Nor can one object that Congress cannot enact a deemed realization rule . . . ."); Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms and a Rebuttal*, 70 COLUM. L. REV. 1365, 1381–89 (advocating taxing asset appreciation at death); Shaviro, *supra* note 4, at 6 (recommending a change in the law to "[t]reat transfers by reason of death as taxable sales for fair market value"); Victor Thuronyi, *Capital Gains and Tax Reform*, 123 TAX NOTES 1244, 1245 (2009) ("All gains should be taxed at death or earlier.").

196. *See supra* text accompanying note 128.

197. *See supra* text accompanying note 129. By virtue of taxing previously unrealized appreciation at death, the step-up in basis to market value conferred by current law on the decedent's successors should still apply. *But see* note 89.

198. Additional benefits of taxing gains at death include that "it enforces the principle that income should be taxed to the person who earned it; it imposes tax at an ideal time in terms of ability to pay . . . ; and, unlike carryover basis, it solves the problem of lock-in." Zelenak, *supra* note 117, at 367.

199. In contrast to the behavioral changes that might result from taxing inter vivos gratuitous transfers of property, for example, *see supra* notes 172, 189 (suggesting that behavioral changes might result in fewer gifts and charitable contributions), it is unlikely that behavioral changes will result from taxing appreciated property at death (other than perhaps that owners of appreciated property might take better care of themselves). It is assumed that the current federal estate tax would be retained when the disposition standard is adopted for income tax purposes. Others have proposed to substitute an income tax on unrealized

8. Transfer of Distressed Property to Lender—Deed-in-Lieu of Foreclosure, Abandonment, Foreclosure

When borrowers are unable or unwilling to service debt that exceeds the value of the property securing the debt, the distressed property can find its way back to the lender through a variety of different means.[200] A borrower inclined to cooperate with the lender might voluntarily convey the property to the lender, rather than waiting for the lender to initiate foreclosure proceedings. By contrast, an uncooperative borrower might simply abandon the property in advance of foreclosure or, instead, hold the property until the lender forecloses. Under current law, the tax consequences to the transferor of distressed property differ depending on whether the property secures recourse debt or nonrecourse debt.[201]

When distressed property is transferred to the lender in satisfaction of recourse debt, the tax consequences are consistent with the disposition standard proposed by this Article, regardless of whether the transfer is voluntary or involuntary. Specifically, a realization event occurs and the transferor's gain is measured by the value of the transferred property.[202] The portion of the debt that exceeds the value of the transferred property is also taxed to the transferor but independently of the property transfer.[203] This excess debt is taxed as discharge of indebtedness income and can often be excluded by a financially distressed borrower.[204]

Unfortunately, matters are not as simple when property securing nonrecourse debt is transferred. The courts have historically had little difficulty finding a realization event when a borrower transfers property with a value *at least equal to* the nonrecourse debt it secures.[205] Under these circumstances, the shedding of the nonrecourse debt establishes the requisite contemporaneous benefit to trigger a

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appreciation at death for the federal estate tax. *See, e.g.*, Dodge, *supra* note 111, at 431–32, 529.

200. For purposes of this section, "distressed property" refers to property securing indebtedness in excess of the value of the property where the property is not generating sufficient income to service the debt. Unrealized appreciation will exist in distressed property when the value of the property exceeds its tax basis.

201. In the case of a recourse liability, the debtor's exposure extends to all assets the debtor owns and is not limited to the property securing the debt. By contrast, in the case of a nonrecourse liability, the debtor's exposure is limited to the property securing the debt and does not extend to the property owner's other assets. *See* BLACK'S LAW DICTIONARY 1020–21 (9th ed. 2009) (defining recourse and nonrecourse debt).

202. Treas. Reg. § 1.1001-2(a)(2), (c) ex. 8 (2010) (demonstrating that the amount realized on a sale or other disposition of property securing a *recourse* liability is limited to the value of the property).

203. *Id.*

204. *See* I.R.C. §§ 61(a)(12), 108(a)(1)(A), (B), (E) (2006) (allowing the exclusion of discharge of indebtedness income if the discharge occurs in a Title 11 case, when the taxpayer is insolvent, or if the indebtedness is qualified principal residence indebtedness discharged before 2013).

205. Crane v. Comm'r, 331 U.S. 1, 13 (1947).

realization event.[206] In addition, the benefit derived from shedding the debt causes the transferred debt to be treated as a receipt included in the transferor's gain.[207]

When a borrower transfers property securing nonrecourse debt *in excess of* the value of the property, however, the contemporaneous benefit that current law relies on to establish a realization event and to measure the transferor's gain does not exist.[208] Nevertheless, current law treats the transaction as a realization event and includes the entire unpaid debt in the seller's amount realized when distressed property securing nonrecourse debt is sold.[209] Even in the absence of a sale, the courts have not been deterred from treating the voluntary return or abandonment of distressed property as a realization event in these circumstances.[210] These results

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206. *See id.* at 14 (when property securing nonrecourse debt is sold, a benefit equal to the unpaid amount of the nonrecourse debt is contemporaneously derived).

207. *See id.*; Parker v. Delaney, 186 F.2d 455, 458 (1st Cir. 1950) (relying on *Crane*'s holding that "the taxpayer received a benefit in the amount of the mortgage as well as the boot. . . . so long as the value of the properties was not less than the liens" in the case of a taxpayer's voluntary conveyance of real estate securing nonrecourse debt to the lender); Freeland v. Comm'r, 74 T.C. 970, 974 (1980) ("That a disposition, causing gain or loss to be recognized under section 1001, occurs upon a reconveyance of property in satisfaction of a mortgage obligation is well settled."). The same result is reached when the debtor abandons the property or holds the property until foreclosure. *See* Helvering v. Hammel, 311 U.S. 504, 510–11 (1941) (finding that the involuntary nature of foreclosure does not preclude sale treatment); *Parker*, 186 F.2d at 459 (holding that abandonment was also a disposition); Middleton v. Comm'r, 77 T.C. 310, 319–20 (1981) (a loss case involving an abandonment of land securing nonrecourse debt where the court followed *Freeland* and found that there was no difference between a voluntary reconveyance and an abandonment), *aff'd* 693 F.2d 124 (11th Cir. 1982).

208. Comm'r v. Tufts, 461 U.S. 300, 307–09 (1983).

209. *Id.* at 309; *see* I.R.C. § 7701(g) (2006) (stating that for purposes of determining gain or loss, the market value of property shall be treated as being not less than the amount of nonrecourse indebtedness the property secures); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 75, 98 Stat. 494, 594–95 (1984) (codified at I.R.C. § 7701(g) (2006)), *reprinted in* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 239–40 (1984).

210. *See* Yarbro v. Comm'r, 737 F.2d 479, 481–84 (5th Cir. 1984); Lockwood v. Comm'r, 94 T.C. 252, 255–59 (1990). *Yarbro* involved the abandonment of land securing nonrecourse debt where the debt exceeded the fair market value of the property. *Yarbro*, 737 F.2d at 481–84. The main issue was characterization of the resulting loss, and the court relied on the *Crane* Court's finding that "the taxpayer does receive a benefit from the disposition of the property: he is relieved of his obligation to pay the debt and taxes and assessments against the property" effectively ignoring the *Tufts* Court's holding that no benefit is derived at the time of transfer when property securing debt in excess of its value is transferred. *Id.* at 484. *Lockwood* involved the abandonment of personalty securing nonrecourse debt that appears to have exceeded the value of the property where a dispute existed about the amount of the resulting loss. *Lockwood*, 94 T.C. at 255–59. The court invoked a pre-*Tufts* case, *Middleton v. Comm'r*, 77 T.C. 310, 321 (1981), *aff'd* 693 F.2d 124 (11th Cir. 1982), for the principle that "[b]eing relieved of that debt is a benefit realized by petitioner on the abandonment," thus effectively ignoring the *Tufts* Court's holding that no benefit is derived at the time of transfer when property securing debt in excess of its value is transferred. *Id.* at 259.

cannot be reconciled with existing jurisprudence which requires a *contemporaneous* benefit for realization to occur.[211]

Far more rational results could be achieved if the disposition standard proposed by this Article applied to the transfer of distressed property securing nonrecourse debt. Under the proposed standard, a realization event would occur when property securing nonrecourse debt is voluntarily conveyed to the lender, abandoned, or held until foreclosure, just as a realization event would occur whenever property is transferred.[212] In addition, the transferor's gain would be based on the value of the transferred property, rather than the amount of the nonrecourse debt, thereby causing the transferor to be taxed on any previously deferred gain.[213] The portion of the debt that exceeds the value of the property would not be included in the amount realized because the objective of the disposition standard is to tax only the appreciation in the transferred property. In this regard, the debt has nothing to do with the deferral of tax conferred by the realization requirement on previously accrued appreciation. Therefore, the portion of the nonrecourse debt exceeding the value of the property would be isolated from the property transfer and taxed as discharge of indebtedness income,[214] the same result that occurs under current law when distressed property securing recourse debt is transferred.[215] The proposed disposition standard would consequently rationalize and simplify the law by

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211. *See Tufts*, 461 U.S. at 309. The *Tufts* Court rationalized the inclusion of the nonrecourse debt in the amount realized as the quid pro quo for a benefit the borrower derived *when the property was acquired*. At the time of acquisition, the borrower was permitted to include the nonrecourse debt in the basis of the acquired property and enjoy tax benefits (e.g., depreciation deductions) resulting from that basis. If the owner did not repay the debt before transferring the property, the owner was required to "pay" for the basis conferred when the property was acquired by including the unpaid debt in the amount realized. Although *no contemporaneous benefit was derived* from shedding the debt when the property was transferred, the time of transfer was the last chance to make the owner "pay" for the tax benefits enjoyed while the taxpayer owned the property. Otherwise, the owner would enjoy the tax benefits from the basis in the property without paying for them.

212. *See supra* text accompanying note 128.

213. *See supra* text accompanying note 129. The fact that the property secures debt in excess of its value does not preclude gain because the value of the property could still exceed its basis. If, however, the basis of the property exceeded its value, a loss would be realized when the property is transferred.

214. I.R.C. § 61(a)(12) (2006). Discharge of indebtedness income can often be excluded by a financially distressed borrower. *See supra* note 204. Others have advocated this bifurcated treatment of nonrecourse debt. *See Tufts*, 461 U.S. at 318 (O'Connor, J., concurring) ("The logical way to treat . . . this case . . . is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan."); Motion for Leave to File Brief Amicus Curiae and Brief for Wayne G. Barnett as Amicus Curiae, *Tufts*, 461 U.S. 300 (1983) (No. 81-2536) (advocating that the property element of the transaction be treated discretely from the debt element of the transaction). The *Tufts* Court felt it was too late in the game to isolate the excess debt from the sale in light of *Crane* and its progeny. *Tufts*, 461 U.S. at 310 (majority opinion).

215. *See supra* text accompanying notes 201–04.

reconciling the tax treatment of property transfers involving nonrecourse debt with property transfers involving recourse debt.

9. Destruction or Theft of Appreciated Property

Under current law, no realization event occurs when uninsured property is stolen or destroyed. Realization does not occur in these situations because no contemporaneous benefit is derived by the taxpayer.[216] Under a disposition standard, however, realization occurs when property is transferred, regardless of whether the transfer is voluntary or involuntary.[217] The destruction of property effectuates a transfer and, therefore, should constitute a realization event under a disposition standard.[218] Stolen property, on the other hand, is not transferred because ownership continues to reside in the victim of the theft.[219] If, however, it ultimately becomes apparent that the stolen property will never be recovered, realization would occur under the proposed disposition standard. Tying realization to a determination that stolen property will not be recovered introduces an element of uncertainty to the system that could undermine the simplicity achieved by the disposition standard.

Strong political resistance would likely exist to treating the destruction and theft of appreciated property as events that trigger taxable gains.[220] If the proposed disposition standard is adopted, it would be prudent for Congress to refrain from taxing the accrued appreciation when appreciated property is destroyed or stolen. Congress can achieve this result by enacting a targeted nonrecognition rule that applies to destroyed and stolen property.[221] Such a rule would deter the tax treatment of this relatively small subset of property transfers from serving as a lightning rod for opposition to the proposed disposition standard.

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216. If insurance proceeds are received for the property, the events would be treated as a sale for tax purposes. *See* I.R.C. § 1033 (2006) (allowing for elective nonrecognition of gain on involuntarily converted property under certain circumstances).

217. *See supra* text accompanying note 128.

218. The fact that the transferor no longer owns the property establishes that a disposition occurred; the absence of a transferee is irrelevant to the analysis.

219. *See* Autocephalous Greek-Orthodox Church v. Goldberg & Feldman Fine Arts, Inc., 717 F. Supp. 1374, 1398 (S.D. Ind. 1989) ("[A] thief never obtains title to stolen items, and . . . one can pass no greater title than one has. Therefore, one who obtains stolen items from a thief never obtains title to or right to possession of the item.") (citing Torian v. McClure, 83 Ind. 310 (1882); Breckenridge v. McAfee, 54 Ind. 141 (1876)); 63C AM. JUR. 2D *Property* § 34 (2008) ("[T]he theft of goods or chattels does not divest one who owns, or has title to, such property from his or her ownership of the property, since one cannot make good title to that which he or she does not own. The owner may follow and reclaim the stolen goods wherever he or she may find them . . . .").

220. It should, however, be noted that in many cases, the victim of the casualty or theft would be allowed a deduction for the market value of the property if the gain were triggered. By contrast, under current law, the deduction is limited to the basis of the property. *See* I.R.C. § 165(b), (c)(3).

221. Some precedent exists for exceptions of this sort. *See* I.R.C. § 1033 (allowing for elective nonrecognition of gain on involuntarily converted property under certain circumstances).

10. Non-Dispositions: Mortgage, Pledge, Option, Partition

A variety of transactions that do not constitute realization events under current law would still not be realization events under a disposition standard. For example, the mortgaging of property, even when the mortgage proceeds exceed the taxpayer's basis in the property, would not be a realization event because no transfer of property has occurred.[222] Similarly, the acts of pledging, optioning, and partitioning property would not constitute realization events because no transfer of ownership occurs in these situations. Although it is arguable that some of these transactions should terminate the deferral of tax on accrued appreciation,[223] the proposed disposition standard should be enacted and its impact assessed before considering any further relaxation of the realization requirement.

CONCLUSION

The realization requirement has always been a fundamental element of the United States income tax. Yet, the requirement remains an enigma as antiquated notions that a contemporaneous benefit is required to terminate the deferral of the tax on accrued gains continue to thrive. The realization requirement is inequitable, inefficient, and complicates the tax system. For these reasons, and because of the ever increasing revenue needs of the United States, a new standard should be adopted that curtails the deferral of tax on accrued gains.

This Article proposes the adoption of a disposition standard of realization that would treat every transfer of property as a realization event. Under this standard, when appreciated property is transferred, the accrued appreciation would be taxed without regard to the consideration received by the transferor. As such, the mere transfer of property would normally terminate the deferral of tax on all previously accrued gains. Unlike current law, the new standard would terminate tax deferral now conferred on gratuitous inter vivos and testamentary transfers of appreciated property.

A disposition standard of realization would curtail the inequity and inefficiency of the current realization requirement. In addition, a disposition standard of realization would simplify the law by substituting a clear and administrable set of rules for an ambiguous and anachronistic system. Although a disposition standard does not eliminate all the problems associated with a realization based tax system, it would dramatically improve the system and help to generate much needed tax revenue.

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222. *See* Woodsam Assoc. v. Comm'r, 198 F.2d 357, 359 (2d Cir. 1952) (finding that a borrowing against property is not a realization event).

223. *See, e.g.*, Anthony P. Polito, *Borrowing, Return of Capital Conventions, and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467, 481–505 (1998) (demonstrating the absence of any compelling principle that justifies treating a borrowing transaction as a non-taxable event).