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Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the “Claim of Right Doctrine” to Found Objects, Including Record-Setting Baseballs

Joseph M. Dodge*

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* Joseph M. Dodge is the William H. Francis, Jr., Professor of Law at the University of Texas School of Law. Professor Dodge has a B.A. from Harvard (1963), an LL.B. from Harvard Law School (1967), and an LL.M. (in Taxation) from New York University School of Law (1973). Professor Dodge is the author of texts, casebooks, monographs, and articles on taxation, and is active in professional organizations and e-mail bulletin boards.

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I. INTRODUCTION¹

This article explores the tax treatment of certain in-kind receipts of property, namely, windfall found objects. The basic and unremarkable thesis is that in-kind property windfalls (commonly referred to as "found objects") are gross income when received. However, there is more than meets the eye here: the finder of a found object often does not obtain clear legal title, so there exists a possibility that the item might have to be returned to its rightful owner. This possibility of having to return the item raises two issues *seriatim*. The first is that the income represented by the found object may not be immediately realized due to the forfeiture condition and attendant valuation problems. This approach is explored but rejected. At this point the solution appears to be including the item in gross income upon receipt and claiming a deduction if and when the item is returned. This approach is commonly referred to as the "claim of right doctrine,"² although, after *James v. United States*,³ its operation no longer is conditioned on the taxpayer's having a "claim of right." In any event, the application of this doctrine to in-kind property (as opposed to cash) is somewhat problematic, but I argue in favor of this approach. The conclusion is that the object should be included upon receipt, but that the idea of "receipt" can here be rendered in a flexible fashion so as to allow for a disclaimer or its functional equivalent.

The endeavor might be vulnerable to the charge of being "much ado about nothing" were it not for a recent piece by Professors Lawrence Zelenak and Martin McMahon arguing that found objects, such as record-setting home run baseballs, are not "residual" gross income⁴ upon acquisition. Zelenak and McMahon justify their thesis by analogy first to imputed income and then to self-created assets, which are not taxed until (and if) they are sold or exchanged. Moreover, Zelenak and McMahon suggest that Regulations section 1.61-14(a), which cites "treasure trove" as being an example of in-kind gross income, is probably invalid or, if it is not, should be withdrawn.⁵

1 . This article was worked up while I was a visiting professor at the Florida State University College of Law. I would like to thank Prof. Steven Bank of that institution for commenting on an earlier draft. Various portions of this piece express ideas found in the Joseph Dodge, J. Clifton Fleming, Jr., and Deborah Geier, *Teacher's Manual to Federal Income Taxation: Doctrine Structure and Policy* 27-66 (2d ed. 1999). I am greatly indebted to my co-authors of said *Teacher's Manual*.

2 . The "claim of right" phrase appeared in *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 424 (1932) (damages award subject to refund if taxpayer were to lose appeal).

3 . 366 U.S. 213 (1961) (embezzled funds are income despite absence of lawful claim and existence of possibility of forfeiture).

4 . The term "residual gross income" means gross income that does not fall into any of the enumerated categories of gross income listed in IRC § 61(a), such as "compensation," "gross income derived from business," "gains derived from dealings in property," "interest," "rents," and so on. These categories do not exhaust "gross income."

5 . Lawrence A. Zelenak and Martin McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 *Tax Notes* 1299, 1308 (Aug. 30, 1999) (hereinafter "Zelenak & McMahon").

According to *Glenshaw Glass*,⁶ residual gross income requires an “accession to wealth,” “realization,” and taxpayer “dominion and control.” I argue narrowly that found objects are not imputed income, that they represent accessions to wealth, and that the so-called treasure-trove regulation is valid without question. So much is relatively easy. The “realization of gross income” issue, as distinct from the “realization of gain” issue, has received little recent scholarly attention. The realization-of-income concept would pose the issue of whether an in-kind receipt of property is includable in gross income at the time received, or at some later time such as: (1) the time of use or obtaining economic benefits from the property, (2) the time all adverse property claims lapse or are settled, or (3) the time of disposition.

In the case of self-created property, income is not realized until the self-created objects are sold. However, found property is not analogous to self-created property. Rather, there is a meaningful distinction between true windfall gains, where something is received for nothing, and nonwindfall gains resulting from the investment of capital and services.⁷ The category of nonwindfall gains includes not only gains from self-created property, but also property that is found or taken from nature in the pursuit of a venture involving the investment of the taxpayer’s labor and/or capital. Nonwindfall gains are, and, under the present realization-based income tax, should be, taxed (if at all) only when realized, i.e., upon sale.⁸ Windfall gains should be taxed upon acquisition, subject to the possibility of meaningful disclaimer.

The realization-of-income area is an obscure and perhaps somewhat messy backwater of income tax doctrine, but it has potential application to windfall found objects due to the fact that the “finder” rarely obtains instant title. I argue that courts should restrict the “realization of income” doctrine to cases where *current enjoyment rights* (as opposed to “legal title”) in property received in-kind are significantly “contingent.” Lack of dominion and control translates into “nonrealization.” Mere nonliquidity, difficulty of valuation, or a possibility of forfeiture should not be a bar to current realization. At worst, a significant possibility of forfeiture would reduce the value of a found object, but that would rarely be the case in the found-object situation. Institutionally, immediate realization should be the judicial norm, barring extreme circumstances, and exceptions should be left to Congress.

It is argued that absence of title does not render a “finding” into an excludible “borrowing.” The claim of right doctrine holds that a forfeitable item should be included in gross income when possession is obtained, and a deduction may be available when the item is returned. I argue that this approach

6 . *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

7 . In general, a “true windfall gain” is distinguishable from other self-obtained property situations because of the taxpayer’s amateur status, a zero or negligible actual cost, a minimal expenditure of labor, and perhaps a negligible opportunity cost.

8 . Whether the gratuitous transfer of an asset or the transfer of an asset incident to a divorce or separation should be a deemed realization event is an issue that transcends the tax treatment of found or self-created assets, and is therefore beyond the scope of this article.

is economically correct and should be extended to property (as well as cash),⁹ and that an appropriate deduction should be available as a matter of right.

Part I advances the propositions that windfall in-kind property receipts are not imputed income but are true accessions to wealth. The category of nonwindfall self-obtained property is distinguished. Part II explores the realization of income concept. Part III sets out the claim of right approach, namely, initial inclusion followed by a later deduction if and when property is returned. Part IV sorts out the various problems in applying that approach to in-kind property receipts in general and found objects in particular. The solution to the problem of record-setting home-run baseballs is, to mix sports metaphors, a "slam dunk."

II. WINDFALL VS. NONWINDFALL IN-KIND RECEIPTS

This part affirms that windfall in-kind property receipts are gross income (as opposed to being untaxed imputed income), and distinguishes self-obtained property resulting from the investment of capital and/or labor.

A. *Is "Income" Equatable with "Cash"?*

Contrary to the "trial balloon" floated by Zelenak and McMahon, gross income is not prima facie equatable with cash.

1. *In-kind receipts under the regulations.*—Initially, Zelenak and McMahon mischaracterize the role of the so-called "treasure trove regulation," Regulations section 1.61-14. That regulation does not establish the principle that in-kind receipts are gross income. That honor belongs to Section 1.61-1(a), which broadly and unambiguously states:

Gross income includes income realized in any form, whether in money, property, or services. Income can be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as cash.

Section 1.61-14, which is captioned "Miscellaneous items of gross income," actually offers a concession with respect to treasure trove:

In addition to the items enumerated in Section 61(a), there are many other kinds of gross income. [The regulation then cites punitive damages, a third-party payment of the taxpayer's income taxes, and illegal income.] Treasure trove, to the extent of its value in United

9 . IRC § 83(a) adopts the reverse approach for forfeitable property received as compensation for services, but I argue, see in the text accompanying notes 148-80 that this deferral approach should not be extended beyond the bounds of section 83.

States currency, constitutes gross income *for the taxable year in which it is reduced to undisputed possession*.¹⁰ [Emphasis added.]

Thus, with regard to “treasure trove” (which is not defined), section 1.61-14(a) states that it is includable in the year that it is reduced to undisputed possession. Since Section 1.61-1(a) refers to “income *realized* in any form” (emphasis added), the clear implication is that treasure trove, as with any in-kind receipt, is gross income, but it is not “realized” until the year it is “reduced to undisputed possession” – which phrase is (also) undefined. Thus, Section 1.61-14(a), insofar as it applies to treasure trove, is not principally an inclusionary rule. In that respect it is redundant to Section 1.61-1(a). Insofar as Section 1.61-14(a) “adds anything,” it is to recognize the possibility of *deferral* of gross income. That is, it indicates that income with respect to treasure trove (and perhaps other found objects) may conceivably be deferred until realized, but the circumstances in which such deferral might be proper are not stated or even hinted at.

In addition, since the purpose of Section 1.61-14(a) is merely to point out the existence of the category of “residual” gross income and to list some examples of it, the concept of “treasure trove” has no special significance, and can be taken to refer to any found object, or collection thereof, having more than *de minimis* market value.

2. “Income” refers to changes in wealth, not cash.—At a higher level of abstraction, Zelenak and McMahon suggest the income tax is “all about” the receipt of cash, with in-kind receipts being taxed only out of expediency, namely, to prevent wholesale erosion of the cash tax base.¹¹ Although it is undoubtedly true that taxing in-kind receipts in many cases does prevent the erosion of the tax base, it does not follow that “income” is equatable with “cash.” Indeed, the notion that “income” is basically “cash” is incoherent.

The “income tax” idea is keyed to changes in wealth (including property).¹² Since Zelenak and McMahon do not suggest that non-consumption cash outlays (savings and investments) are to be deducted when made, it can be assumed that they are not arguing for a cash-flow consumption tax.¹³ But once one posits an “income tax” – a tax in which capital expenditures are nondeductible (with the resulting creation of basis)¹⁴ – one has to concede that

10 . This sentence is almost identical to Rev. Rul. 53-61, 1953-1 C.B. 17. That ruling consists of a single sentence. In both the ruling and the regulation there is no definition of “treasure trove” and no explanation of “reduced to undisputed possession.” Regs. § 1.61-14 was adopted in 1960, T.D. 6500, 25 FR11402 (Nov. 26, 1960).

11 . See Zelenak & McMahon, *supra* note 5, at 1304-05.

12 . See, e.g., United States Treas. Dept., Blueprints for Basic Tax Reform 25-32 (1977) (hereinafter Blueprints) (explaining that the difference between an income tax and a cash-flow consumption tax lies in the fact that an income tax accounts for changes in wealth).

13 . In a cash-flow consumption tax, non-consumption capital expenditures are deducted. See *id.* at 30.

14 . A capital expenditure is a cash outlay that changes the form of wealth, as opposed to being a complete loss of such wealth to the taxpayer during the taxable year. See IRC §§ 263

the dominant paradigm is "changes in wealth." The basis for nondeductibility of capital expenditures is precisely that what matters is wealth, not cash.

In addition, the neutrality (efficiency) norm,¹⁵ as well as the ability-to-pay fairness norm,¹⁶ are justifications for including in-kind receipts (and unrealized appreciation) in the tax base. Arguments for a "cash" view of income would elevate convenience over all other policy norms, but even convenience argues against a "cash" view of income in the case of enterprises that use GAAP accounting.¹⁷

Contrary to the thesis advanced by Zelenak and McMahon, there is not even a coherent or persuasive normative basis for an across-the-board exclusion for unrealized appreciation. Such "convenience" factors as difficulty of valuation and nonliquidity are matters of degree, not inherent quality, and in many cases these factors are not significantly present.¹⁸

3. *Accessions to wealth are not "imputed" income.*—Zelenak and McMahon also argue that the failure to tax imputed income shows that income basically refers to cash receipts. The term "imputed income" as used in the tax literature is not entirely without ambiguity. The principal meanings, which overlap somewhat, appear to be: (1) the flow of satisfactions obtained by a taxpayer (which would include not only the value of satisfactions derived from owning and spending but also the value of leisure, sleep, a happy marriage,

(no deduction for capital expenditures) and 1012 (basis is dollars "in" investment that were previously subject to tax because of being nondeductible capital expenditures).

15 . The neutrality norm stipulates that the tax system should not discriminate among various categories of investments. If found objects are not "after tax" (by reason of being excludible upon receipt), whereas other assets are "after tax" (resulting from nondeductible capital expenditures), then the former would be favored by the tax-system. However, neutrality is not an important norm in this case, since found objects (properly defined) occur by chance. Nevertheless, taxing found objects upon receipt would encourage the highest and best use of such assets: the finder, who has a low subjective preference for the object, would either disclaim it or sell it in the market.

16 . The concept of "ability to pay" is a term of art in the tax literature referring to the tax base, not the medium for paying the tax. As applied to the tax base, it means wealth, as opposed to cash, and is commonly deployed as a justification for an "income tax" (or perhaps a wealth tax) over a "consumption tax." See Blueprints, *supra* note 12, at 31. (The competing norm is "personal consumption" or perhaps "standard of living.")

17 . Taxpayers following "generally accepted accounting principles" (GAAP), as well as other taxpayers subject to the mandate of IRC §§ 447(a) and 448(a), are required to follow the accrual method of accounting, which basically looks, on the income side, to the acquisition of rights to future cash rather than to the receipt of cash itself. See Regs. § 1.451-1(a).

18 . See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 *Corn. L. Rev.* 1627, 1633-37 (1999) (finding the existing line between realization and nonrealization to be incoherent). In my view, it would make more sense from both administrative and policy perspectives to draw the line between liquid and nonliquid assets than between "income" and "appreciation", investors can move more easily between income and appreciation assets than they can between liquid and nonliquid assets.

etc.),¹⁹ and (2) the market-price equivalents of non-market *economic* activity (such as the value of self-grown crops and the rental value of self-owned assets, and possibly the value of self-performed services).²⁰ The flow-of-satisfactions definition is either so all-encompassing as to be worthless,²¹ or else it simply restates the distinction between intangible benefits (utility) and tangible benefits (such as accessions to wealth). The second definition is more useful because it focuses on a particular kind of “economic benefit,” namely, the *hypothetical*, cash income that *would* be obtained if the person, contrary to fact, entered the market and sold or rented her services, self-created goods, or self-owned assets.²²

It might be objected that “income” is something that is objectively determined in terms of market values gleaned from actual market transactions,²³ and that a found object doesn’t fit the usual concept of “market transaction,” at least if that term is conceived narrowly in terms of a bargained-for quid pro quo. However, the market-transaction concept should not be so rigidly conceived, and in any event it is distinct from that of imputed income. The function of the market-transaction idea is (partly) to provide a common denominator for the

19 . See Marsh, *The Taxation of Imputed Income*, 58 Pol.Sci.Q. 514 (1943), excerpted in Paul R. McDaniel, Hugh J. Ault, Martin J. McMahon, Jr. & Daniel L. Simmons, *Federal Income Taxation, Cases and Materials* 83-85 (4th ed. 1998). Robert Haig stated that “income” is “fundamentally” a flow of satisfactions (utility). See Robert M. Haig, *The Concept of Income – Economic and Legal Aspects* (1921), in R. Musgrave and C. Shoup (eds.), *Readings in the Economics of Taxation* 54, 55 (1938). An economics perspective is necessarily concerned with the fact that the inevitable exclusion of *some* satisfactions from the tax base regrettably tends to distort economic behavior and leads to deadweight loss. It does not follow that income in the *legal* sense equates (or should equate) with “flow of satisfactions.” Thus, even the Utilitarian tax tradition generally concedes that (1) consumption is measured by market value (not subjective value), and (2) only satisfactions obtained in market transactions are to be counted. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules under the Federal Income Tax*, 48 Tax L. Rev. 1, 7-10 (1992). The ability-to-pay norm would not include imputed income in the tax base because satisfactions are not “wealth.” See Chancellor Thomas, *Imputed Income and the Ideal Income Tax*, 67 Or. L. Rev. 519 (1988) (arguing that the tax base should not be defined with reference to utility). Of course, one might view ability-to-pay in terms of income-producing capacity rather than in terms of actual wealth outcomes. But this approach, which would (inter alia) tax the acquisition of human capital, is considered too extreme in its imposition of economic norms on human conduct.

20 . Henry Simons, in noting the difficulty in ascertaining what might be an “economic” gain, compared self-grown crops, a self-grown flower garden, and self-provided services. See H. Simons, *Personal Income Taxation* 51-52 (1938).

21 . See *id.* at 50-56 (rejecting a “flow of satisfactions” approach to income but acknowledging the problems in defining “income” in terms of “economic” gain).

22 . See Chancellor, *supra* note 19, at 567-69. For example, the so-called “imputed interest” on below-market loans subject to IRC § 7872 is not imputed (hypothetical). Rather, it represents real gain on the investment component of the loan. A below-market loan consists of (1) a “transfer” (or “expense”) component (excess of loan over present value of repayment obligation) and (2) an “investment” (capital expenditure) component (equal to the present value of the repayment obligation). The excess of the repayment amount over the present value thereof is economic gain that is “realized” (as original issue discount) with the passage of time.

23 . See *supra* note 19.

exclusions for intangible (psychic) benefits *and* hypothetical (imputed) income. Although excluded psychic benefits and imputed income can be characterized as "non-market" benefits, it does not logically follow that *all* non-market benefits are per se exempt from tax. The market-transaction concept does not preclude evaluating tax issues on their merits. Obtaining a windfall found object is distinguishable from psychic income and imputed income in being a tangible accession to wealth.²⁴

Income does not cease to be "income" just because the transferor or payor of cash or wealth cannot be identified. Positive law, whether the Code,²⁵ the regulations,²⁶ or the Supreme Court in *Glenshaw Glass*,²⁷ rejects the idea that an idiosyncratic source negates the existence of gross income.

In sum, Zelenak and McMahon have not made a case for equating income with cash. From the policy angle, tax issues are not properly resolved simply by invoking such broad concepts as "imputed income" and "market transaction." That the income tax base has been, and perhaps should be, modified to take into account practical concerns such as difficulty or impossibility of valuation and nonliquidity is commonplace.²⁸ But practical concerns do not automatically trump other norms. Nevertheless, insofar as Zelenak and McMahon are arguing that practical concerns should be taken seriously, I would not only concur but advance the point a step further: accommodation to practical considerations should not be viewed as a "retreat" from "principle," but rather as a "shift" to a *different kind* of principle, namely, a "legal" (as opposed to "economic" or "fairness") principle. Legal issues that are relevant to the present discussion include: (1) whether or not rules that can rarely be enforced, or which are enforced at the whim of officials, are "rules" worth having, and (2) whether various distinctions among tax categories are coherent and intelligible.²⁹ Admitting legal norms into tax policy debates should not be a cause for embarrassment.

24 . See H. Simons, *supra* note 20, at 51 (income is "gain" measured according to objective market standards).

25 . See IRC § 61(a) (defining gross income as "all income from whatever source derived").

26 . Regs. § 1.61-1(a)(1) (repeating Code language).

27 . *Glenshaw Glass*, *supra* note 6, involved a non-bargained-for gain in the form of statutory damages.

28 . See, e.g., Richard Goode, *The Individual Income Tax 26-35* (rev. ed. 1978) (citing compliance and administration); Joseph Sneed, *The Criteria of Federal Income Tax Policy*, 17 *Stan. Law Rev.* 567, 572-74 (1967) (citing "practicality"); William Andrews, *A Consumption-Type or Cash-Flow Personal Income Tax*, 87 *Harv. L. Rev.* 1113, 1141-43, 1148-65 (1974) (citing practical advantages of cash-flow consumption tax relative to an accretion-type or a partial-accretion-type income tax).

29 . In taxes, legal norms obviously relate to compliance and administration. There is a growing literature that evaluates the distinctions made in tax law to economic efficiency concerns. See Weisbach, *supra* note 18; Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 *Stan. L. Rev.* 569 (1994). It is not necessary here, however, to draw the line between economics and law.

B. *Distinguishing In-Kind Windfalls from Unrealized Appreciation*

Tax law generally does not include unrealized gains in income until the sale or other disposition of the property.³⁰ It follows that gain is not realized upon the purchase of property for cash, even where the value of the property significantly exceeds the “cost” thereof. The prime example is the “commercial bargain purchase,” discussed immediately below. A similar situation is presented by self-created property and property (natural resources) obtained as the result of a venture that aims to obtain such property. Examples cited by Zelenak and McMahon include gold found by prospectors and fish and game caught by fishers and hunters, whether amateur or professional.³¹ But these situations do not undermine the case for including windfall found objects in gross income when received, because they all involve unrealized appreciation, that is, the acquisition of property in which value exceeds cost. In contrast, in-kind windfall gains are not purchased. They involve “something for nothing,” and therefore produce an immediate “accession to wealth” that can be treated as current gross income.

1. *Commercial Bargain Purchases.*—In the case of property already owned by the taxpayer, the meaning of realization is usually straightforward: there must be a sale or disposition of the property or, in the case of losses, some event must occur such that the loss can be said to be “sustained,” that is, “fixed” or “final.”³²

The “exclusion” with respect to commercial bargain purchases of property (the proverbial purchase of a Rembrandt oil painting at a flea market for \$100) appears to be viewed as an extension of the unrealized-appreciation concept to its outer limit: appreciation is viewed as any excess of value over cost, even if such excess exists at the moment of purchase.³³ This approach has

30. See IRC § 1001(a) (gain realized only upon “sale or other disposition” of property).

31. I am somewhat confused about the references in Zelenak and McMahon to “big game hunting.” A similar problem arises with game fishing. The people who organize safaris, hunts, and fishing expeditions are basically providing a service to amateurs who enjoy the activity and, if successful, kill game (or catch fish) that can be preserved and displayed as trophies. Occasionally, an individual might organize his or her own hunt (etc.) with an aim, *inter alia*, of obtaining trophies. Hunting and fishing trophies can be viewed either as “self-created” assets or as “self-taken” assets, i.e., as the “products” of business or hobby activities, but in either case they are not included in gross income. (Conventional “awarded” trophies are not discussed in this article, but I hope to discuss them in a future article, where I shall argue that in-kind consumption should sometimes be excluded from gross income and that most awarded trophies should be viewed as in-kind consumption, rather than as accessions to wealth.) Of course, enterprises do exist that collect live fish and game as inventory, and those that collect dead animal and fish parts or by-products, such as elephant tusks, cuttlefish bones, hides, horns, manure, and so on, and sell (or convert) the same as inventory. Enterprises that treat animals and fish (or their parts and by-products) as inventory are not essentially different from farming enterprises.

32. IRC § 1001(a); Regs. § 1.165-1(b).

33. *Pellar v. Commissioner* 25 T.C. 299 (1955)(acq.); 1956-2 C.B. 7, 1956-1 C.B. 5. This rule assumes that the parties are not related in such a way that the transaction can be viewed

practical virtues, since true commercial bargain purchases among unrelated parties are rare, and it would be even rarer for the IRS to find out about them. Moreover, "true" commercial bargain purchases are limited to collectibles and other non-publicly-traded business and investment property. Business and investment property can be taxed upon disposition.³⁴

The commercial-bargain-purchase exclusion also has a principled basis, namely, that the appreciation element in a commercial bargain purchase can be said to occur "after" the purchase, because the true value of a collectible can only be objectively revealed through appraisals or testing the market. Stated more abstractly, for tax purposes the value at the time of purchase is deemed to equal cost, because (objective) value is synonymous with market price.³⁵ Thus, the commercial bargain purchase situation is essentially the same as that of purchasing a speculative investment that turns out to be a bonanza, such as raw land that yields valuable minerals. In both cases the (high) value is "there" upon purchase but is only "revealed" later.

On the other hand, this exclusion (deferral rule) can be criticized on the ground that, if we view the finding of a Rembrandt in an attic to be gross income, it is hard to distinguish the case where the Rembrandt is purchased for a small amount of cash. However, the distinction between an in-kind windfall receipt and unrealized appreciation is clear in principle: in the first, one receives something for nothing, and in the second, one has invested in valuable property. Of course, there may be borderline cases that raise the issue of whether there has been an investment in the valuable property. To count as "investment in the property," the cost should have been purposefully incurred in an activity or venture to obtain valuable property. Thus, the cost of some personal activity, such as a vacation to Belize, that fortuitously results in the finding of gold coins on the beach should not be viewed as "investment in the property."³⁶

as a deliberate attempt by the seller to transfer wealth to the purchaser. Compare IRC § 83(a) (compensation for services). Thus, the commercial-bargain-purchase exclusion posits ignorance by the seller of the property's true value.

34 . Personal-use property (that depreciates in value) would escape tax entirely if not taxed in full upon receipt. Fortunately, depreciating personal-use property will not be the subject of a true bargain purchase. That distinction is pretty much reserved for art works, collectibles, raw land containing natural resources, and perhaps other items whose true quality can escape the scrutiny of merchants. These items fall in the "investment" category for purposes of this discussion because they do not lose value by reason of obsolescence, being displayed, or perhaps even by normal use.

35 . Thus, simply getting a "good deal" in the marketplace (such as a big discount on a car purchase) is not properly viewed as raising a serious gross income issue, since market transactions are reckoned by the income tax on the basis of "cost" rather than value received. For the great mass of arms-length transactions, cost is the best (most objective and easy to ascertain) criterion of value. See Daniel N. Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 *Tax L. Rev.* 215, 222-29 (1990).

36 . Cf. *Cesarini v. United States*, 296 F.Supp. 3 (N.D.Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir.1970) (cash found in a piano is gross income). The result should be the same if diamonds are found in the piano. A harder case would be where a person purchased a

Another argument might be that the commercial-bargain-purchase exclusion confounds the neutrality norm that all investment be after-tax.³⁷ However, here the violation of neutrality is trivial, since transactions of this type are rare, the seller is certainly unaware of the true value of the item, and the buyer may also be unaware of the true value at the time of purchase. Also, the bargain-purchase exclusionary rule avoids valuation disputes between the taxpayer and the IRS.

2. *Sought-after property*.—The point of discussing the “commercial bargain purchase” situation is to show that, doctrinally, the concept of “unrealized appreciation” is, for better or worse, taken seriously. That being the case, it is easy to understand the principle that property that is produced or obtained by a taxpayer’s efforts also does not yield income until the property is sold or disposed of in a realization event.

Thus, contrary to the Zelenak and McMahon thesis, the category of “found objects” does not, as a matter of positive law, encompass each and every asset obtained in-kind by a taxpayer. Rather, found objects (in tax talk) are thought of as acquired at random and without special effort (i.e., by persons in an “amateur” capacity), i.e., as “windfalls.”³⁸ Objects (including those that can be sold in more or less their natural state, such as gold, gems, treasure, oil, fish, and game) that are sought after and obtained as the result of a venture, activity, or enterprise (that requires planning, financing, and implementation) are not usually referred to as “found.” For want of a better term, I will use the word “taken” to refer to in-kind property appropriated as the result of a commercial venture or personal hobby, so as to connote the “active” posture of the taxpayer relative to the “passive” posture of a taxpayer appropriating a windfall found object.

There is no meaningful distinction between “taken” and “self-created” objects. (A “self-created” item is property produced by the taxpayer’s own personal efforts, as opposed to the labor of others or with significant capital investment.) Both taken property and self-created property will be referred to as “self-obtained” property. Both categories of self-obtained property are excluded from income when acquired, but the rationale for exclusion might differ somewhat as between self-obtained business inventory and self-obtained personal-use items.³⁹

locked safe at an auction that contained diamonds: the buyer could well be speculating that the safe would have valuable contents. These were roughly the facts in the non-tax case of *City of Everett v. Estate of Sumstad*, 614 P.2d 1294 (Wash.Ct.App. 1980), at 1505-06, which (dubiously) held that the seller could get the contents of the safe back.

37 . See Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. of Ill. L. Rev. 1019 (1989).

38 . See Comment, *Taxation of Found Property and Other Windfalls*, 20 U. Chi. L. Rev. 748, 748 (1953).

39 . It is hard to conceive of “taken” property as being of an “investment” type or as property to be “used” in a trade or business. The situations cited by Zelenak and McMahon (gold

a. *Self-obtained inventory*.—In the context of a commercial venture, the “taking” of business inventory, such as fish, game, gold nuggets, manganese nodules, native copper, diamonds, truffles, and the raising of sunken treasure from the sea, as well as the “creating” of inventory, such as art or craft works, are similar to the conventional manufacturing of inventory or the raising of crops by a farmer, as far as investment of capital and labor is concerned. Self-obtained property entails *some* investment of capital, whether it be in raw materials, supplies and equipment, the labor of others, or transportation.⁴⁰ Investment does not give rise to income until gain is realized. Even the pure performing of services for wages or fees does not give rise to realized income until the wages are received or accrued. The high labor component of self-created inventory (perhaps) results in a higher accounting profit, but the ratio of profit to accounting cost has nothing to do with when profit is realized. That inventory may be produced in stages (as in manufactured or self-created inventory), purchased intact, or “harvested” intact (as in “taken” inventory) sets out distinctions without a tax difference. Looking at the venture as a whole, the actual obtaining of the inventory, by whatever techniques, is not an “end” but rather a “means” (or opportunity) to earn a profit. The sale of the inventory, not the obtaining of it, is the realization event.

Once again, the correct distinction is not between “found” and “self-created” objects but between windfall property and property obtained in the course of a profit-seeking activity. This distinction is embedded in tax doctrine. Where property (as opposed to cash) is acquired by windfall (without significant effort), it is taxed when realized, which usually means immediately.⁴¹ A windfall, by definition, is the receipt of something for nothing (or virtually nothing). Where property is acquired through investment of labor or capital, it is not really a windfall gain, even if the outcome is extremely profitable relative to the investment.⁴²

Realization of inventory gain is the culmination of the inventory accounting cycle.⁴³ Section 263A (subject to various exceptions) requires capitalization with respect to property that is either “produced” or “acquired for

prospecting, fish and game, salvaging sunken treasure, etc.) all result in the obtaining of property that would (or at least could) be inventory if obtained in the course of a commercial venture. About the only exception I can think of is the capture of wildlife for breeding purposes, but it seems likely that capturing enterprises are carried on by different entrepreneurs than breeders.

40 . Labor costs in the production or acquisition of inventory are capitalized. IRC § 263A(a); Regs. § 1.263A-1(e)(2)(i)(B) &(e)(3)(ii)(A). From the economic efficiency angle, there is no reason to treat enterprises with paid-for labor differently from those with self-provided labor.

41 . Regs. §§ 1.61-1(a) and 1.61-14.

42 . See Eric Kades, *Windfalls*, 108 Yale L. J. 1489, 1504-20 (1999) (economic analysis and legal doctrine should view commercial ventures *ex ante* and not treat large profits as windfalls simply by looking at *ex post* results).

43 . See IRC § 61(a)(2) (inventory) and (a)(3) (other property); Regs. § 1.61-4(a) and (c) (self-grown crops generate income only when sold, exchanged, etc.); Rev. Rul. 56-496, 1956-2 C.B. 17 (self-grown crops fed to one’s own animals are not a taxable disposition).

resale.”⁴⁴ The term “produced” includes “develop,” “create,” “raise,” or “grow,”⁴⁵ and the term “acquire” is broad enough to encompass “find,” “discover,” “take,” “harvest,” and the like. Similarly, the taxation of natural resources assumes that gross income is realized when the minerals are sold or royalties are received, not when the minerals are acquired or extracted.⁴⁶ The issue of whether or not to capitalize various kinds of acquisition costs assumes that the income or gain with respect to the inventory or other property will be realized upon ultimate sale or disposition.

Treating self-obtained inventory uniquely as gross income at the time of acquisition would be the equivalent of a one-time marking of such property to market, in contrast to wage income or gains from property created or acquired as the result of investment of capital and/or labor. But, if “self-obtaining” should be a realization event, why would not the acquisition of the right to produce or acquire such property (in the form of a license, lease, contract right, mineral claim, salvage permit, etc.) also be a realization event? But neither approach makes sense, unless there is a good reason to single out self-obtained inventory for more burdensome taxation than “conventional” purchased or manufactured inventory.

The distinction between windfall gains and inventory profits is not only imbedded in doctrine but also makes sense from an economics perspective: taxes on business or investment activity influence behavior and create deadweight loss, whereas taxes on true windfalls do not. Thus, economic efficiency dictates that true windfalls be taxed more heavily than economic returns,⁴⁷ and this can be accomplished by taxing windfalls upon acquisition rather than when disposed of.

A possible argument for taxing a particular type of business more heavily than others is that the type of business obtains a “windfall equivalent” in the form of “unearned rents” such as might result from monopoly, unequal bargaining power, government action, or unforeseen events.⁴⁸ However, there is no reason to think that self-obtained inventory reaps a windfall equivalent simply by being taken or self-created. The fact that the value of the taken or self-created items *might* have a value far in excess of any investment of effort or capital does not suggest otherwise.

44 . IRC § 263A(b).

45 . Regs. § 1.263A-2(a)(1)(i).

46 . See IRC §§ 263(c) (expensing of IDCs), 612 (basis for cost depletion), 613(a) & (c)(1) (percentage depletion keyed to net gross income from mining), 616 & 617 (cost recovery), and 636 (status of production payments). IRC § 631(a), allowing a taxpayer to treat the cutting of timber as a sale or exchange, presupposes that the general rule would be that timber gains are realized upon sale.

47 . See, e.g., Richard A. Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* 277-96 (1989); Saul Levmore, *The Case for Retroactive Taxation*, 22 *J. Legal Stud.* 265, 273 (1993).

48 . See Kades, *supra* note 42, at 1505.

Enterprises that offer the hope of a payoff far in excess of investment are generally considered to be "risky investments." For every successful venture, there are numerous failures. In this respect, there is no real difference between a treasure-hunting venture and the development of, say, a patent or copyright (or corpus of artwork) whose commercial success is unknown in advance.⁴⁹ High-risk investments are generally not singled out for discriminatory tax burdens.⁵⁰

It might be argued that the realization principle is wrong, misconceived, or draws lines in the wrong places.⁵¹ True, if all property were marked-to-market, then there would be no reason to exempt self-obtained objects. But if only some property were marked-to-market, self-obtained inventory would not be a prime candidate. The case for marking inventory to market is weaker than, say, marking publicly-traded investments to market: the latter are easier to value and more liquid, and the possibility of tax avoidance by long deferral of realization is much stronger.⁵² At least some categories of self-obtained inventory would be harder to value and be less liquid than conventional purchased or manufactured inventory. In any event, the point here is not to question the realization principle at the policy level, but simply to show that there is an established and principled doctrinal basis for distinguishing self-obtained inventory from windfall gains.

Self-constructed business-use property, such as a building or equipment, is unlike inventory in that it will not be held for immediate sale. Hence, realization of income attributable to such property will be factored into the ultimate sale of inventory and services. This delayed realization of income in a business context raises significant neutrality concerns that are absent in the case of self-created inventory, and will not be discussed here as they have been dealt with elsewhere.⁵³

b. *Self-obtained personal-use property.*—Amateurs, as well as professionals, can discover or harvest wealth in a saleable form, just as both amateurs and professionals can create wealth by their own personal efforts, although their goals differ: a professional (in his or her capacity as such) intends

49 . See Gary Kinder, *Ship of Gold in the Deep Blue Sea* (1998)(describing investment of capital and labor in treasure-seeking venture).

50 . See generally, Michael Livingston, *Risky Business: Economics, Culture, and the Taxation of High-Risk Activities*, 48 *Tax L. Rev.* 163 (1993). Cf. Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 *Tax L. Rev.* 17, 29-43 (1996) (arguing that risky investments are systematically favored under an income tax).

51 . Compare David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 *U. Pa. L. Rev.* 1111 (1986), with David A. Weisbach, *A Partial Mark-To-Market Tax System*, 53 *Tax L. Rev.* 95 (1999).

52 . Inventory is denied capital gains treatment, IRC § 1221(2), precisely because the producer or purchaser of it will sell it (as opposed to hoarding it) without any special tax inducement.

53 . Self-constructed business-use property is discussed in Noel B. Cunningham & Deborah H. Schenk, *How To Tax the House that Jack Built*, 43 *Tax L. Rev.* 447 (1988).

to sell, whereas an amateur (in his or her capacity as such) contemplates use and enjoyment (although eventual sale is conceivable). In short, in the non-business context, a person may find property, create property, or “take” it, all in the course of a hobby activity (such as fishing and hunting).

Self-created property of an individual in an amateur capacity is almost certain to be non-liquid,⁵⁴ and it will likely be held for the creator’s or finder’s personal use.⁵⁵ For this reason, unless such property is included in gross income upon completion, it likely will not be taxed at all.⁵⁶ The argument for inclusion of self-created personal-use property is simple enough: a completed self-created personal-use asset constitutes an accession to wealth or, if you will, enhanced ability to pay.⁵⁷ The argument contra is that, unless and until the item is sold, any economic benefits derived from the item are untaxed “imputed” income. Resolving this issue entails moving beyond labels.

An argument can be made that in-kind consumption should generally not be viewed as gross income (unless there is a good reason to tax it, as in the case of employee fringe benefits).⁵⁸ Although this argument is basically beyond the scope of this article, it can be sketched briefly here. One foundation for the argument is the ability-to-pay “tax justice” norm, which posits that the aggregate tax burden should be apportioned among the population on the basis

54 . It is hard to imagine self-created property with a high degree of liquidity. Alchemy is an illusion, and the creation of currency or bearer bonds is an illegal high-risk activity such that a purchaser would demand a significant discount. Even these examples imply some degree of professionalism. Most self-created property would be in the nature of arts, crafts, utilitarian objects, self-grown crops, and self-raised animals, most of which would initially be intended for personal use. Insofar as they are intended for sale, the taxpayer is operating in a business capacity. An autograph (or autographed item) may be liquid, but since it has no value to the author, it is analogous to business inventory (if sold) or to good-will advertising (if given free of charge).

55 . IRC § 263A(c)(1) exempts self-created personal-use property from the general capitalization rule. Given that such costs are just as much “capital” as in the case of business or investment property, this exception is presumably based on the premise that there is no point in maintaining a basis account for such property, since it cannot be depreciated and probably won’t be sold.

56 . The value will decline to zero in the hands of the acquiring taxpayer or any donee. Property that happens to appreciate in value will escape tax under IRC §§ 102 and 1014.

57 . Doctrinally, a self-created non-inventory asset (not used in the taxpayer’s trade or business) is a “capital asset,” unless excepted under IRC § 1221(3), notwithstanding its derivation from the taxpayer’s personal services. Cf., e.g., *Wodehouse v. Commissioner*, 177 F.2d 881 (2d Cir.1949); *Lewis v. Rothensies*, 61 F.Supp. 862 (E.D.Pa.1944), *aff’d per curiam*, 150 F.2d 959 (3d Cir.1945) (both cases holding that such an asset is “property” for purposes of assignment-of-income doctrine). However, the capital asset issue is conceptually distinguishable from the inclusion-upon-completion issue. The capital asset issue comes into play only when such property is realized upon by sale or exchange. In that context, it is hard to sort out the “appreciation” and “services” components of the gain, and hence an all-or-nothing rule serves a useful purpose.

58 . In the case of employee fringe benefits, the “good reasons” include avoiding significant erosion of the tax base and economic neutrality. Henry Simons appears to take the utility-based position that in-kind consumption should be taxed unless there is good reason *not* to tax it. See H. Simons, *supra* note 20 at 51-55 and 110-24.

of material wealth (as opposed to a flow of satisfactions or utility).⁵⁹ The other foundation acknowledges utility as the basis of taxation but concludes that, for mostly practical reasons, the "consumption" component of the tax base should be figured with reference to amounts spent by a taxpayer on personal consumption, as opposed to benefits received.⁶⁰ Either way, the "consumption" component of an income tax base is reached mainly by disallowing deductions rather than by including in-kind benefits. There are various situations where positive law does not tax in-kind consumption benefits.⁶¹ This exclusionary principle is not rigid. In-kind consumption should be included in gross income where there is good policy reason to do so and such inclusion is not impractical.⁶²

Insofar as in-kind consumption would be deemed excludable, then there would be the issue of distinguishing in-kind "wealth" from in-kind "consumption." Applying this distinction to self-created property would result in the inclusion of non-personal-use assets, but it would arguably result in the exclusion of assets that can be expected to be consumed by the taxpayer.⁶³ Of course, self-created assets that would be expected to hold their value in the long term, such as residences, and possibly arts and crafts, might be viewed as falling on the "wealth" side of the line. But consumable items, such as self-grown crops and utilitarian objects, could reasonably be viewed as in-kind (excludable) consumption, rather than as wealth. (Of course, even under an inclusionary rule the cost of materials, etc., would not be deducted, so that any "investment" component of a self-created personal-use item would be "after tax.")

59 . See 3 Report of Royal Commission on Taxation 3-8 (1966) (Canada) (role of ability-to-pay principle); Alan Gunn, *The Case for an Income Tax*, 46 U.Chi.L.Rev.370, 378-88 (1979) (discussing content of ability-to-pay principle).

60 . See Shaviro, *supra* note 35. Shaviro does not discuss in-kind consumption as such, but would presumably treat it as income when: (1) inclusion is enforceable, and (2) the value of the consumption can be objectively determined.

61 . Examples include imputed income and other benefits received in non-market transactions, in-kind support received by a dependent, in-kind benefits received from the government, working-condition fringe benefits (IRC § 132(a)), other fringe benefits that have been excluded under the "convenience of the employer" doctrine and its statutory successors (the history is described in *Commissioner v. Kowalski*, 434 U.S. 77 (1977)), and "incidental benefits" (such as receiving business entertainment, recruiting trips, and promotions), see *United States v. Gotcher*, 401 F.2d 118 (5th Cir.1968).

62 . Generally, in-kind consumption should be included in gross income where it is judged to be the equivalent of the receipt of cash followed by a free, or lightly constrained, spending choice. Such a situation would likely arise where the parties are quasi-related and in-kind consumption can be transferred in satisfaction of a liability or obligation or in exchange for goods and services.

63 . An example is free samples, which are not included in gross income unless treated as "wealth." See *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975), (free sample included where deduction claimed for donating it to charity); G.C.M. 36,639 (March 22, 1976) (suggesting that unsolicited books are gross income when placed in one's library). Compare G.C.M. 36,865 (Sept. 29, 1976) (books that employee requested from employer and then donated to charity were gross income when received).

It is one thing to argue that self-created personal assets “could” be treated as excludible in-kind consumption, and it is quite another to argue that it “should” be so treated. A conceptual approach to justification would start with the proposition that the value of self-performed services is non-income (a form of excluded “imputed income”). Self-created personal-use property simply is a particular embodiment of the excludible value of self-provided services that happens to produce a flow of satisfactions over a period of time, rather than all at once.

Another theory is that self-provided services (including the creation of personal-use assets) is a substitute for leisure, which is not included.⁶⁴

Yet again, the justification for excluding the value of self-created personal-use assets is that they are not obtained in a “market transaction.”⁶⁵ This approach bases the exclusion on one or more of the following: (1) an inclusionary rule would be unenforceable, (2) an exclusionary rule would tend to impinge upon personal autonomy by directing all human activity to the market,⁶⁶ and (3) a self-created asset would not entail the “withdrawal” of anything from “society.”⁶⁷

Finally, taxing self-provided services (and self-created personal use assets) would tend to be regressive, because these activities are more likely to be engaged in by low-income groups.⁶⁸

Some of these arguments seem somewhat akin to the argument that pain-and-suffering damages should be excluded from gross income because they are a “substitute for” some untaxed good, such as the capacity to enjoy a normal life. Unlike others,⁶⁹ I am skeptical of this kind of argument: converting a non-taxed item to cash is analogous to performing personal services for wages.⁷⁰ Thus, I don’t happen to buy the “substitute for leisure” argument. But

64 . See H. Simons, *supra* note 20, at 110-11.

65 . See *supra* text accompanying note 23.

66 . See Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *Yale L.J.* 1081, 1114-1117 (1980); Gunn, *supra* note 59, at 382 (all arguing against taxing accessions to human capital and in favor of deferring services income until realization).

67 . Henry Simons appears to base the market-transaction principle on all of these theories. See H. Simons, *supra* note 20, at 51 and 110. The last theory may be circular, or redundant with the second theory, since the item is not “in” society because it has not been offered in the market. However, Simons appears to have adopted the market-transaction principle somewhat reluctantly and to have emphasized its value as a principle of measuring income in terms of market prices rather than subjective utility.

68 . Henry Simons ultimately favored excluding the value of self-provided services while including imputed income from homes but largely on equity (progressivity) grounds. See *id.* at 110-22. Accord, Michael J. McIntyre, “What Should Be Redistributed in a Redistributed Income Tax? Retrospective Comments on the Carter Commission Report,” in W. Neil Brooks (ed.), *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (1988). Simons did not appear to address the issue of self-created personal-use assets.

69 . See *Sol. Op.* 132, I-1 C.B. 92 (1922) (damages for alienation of affection); Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 *Wm. Mitchell L. Rev.* 759 (1988).

70 . See Joseph M. Dodge, *Taxes and Torts*, 77 *Cornell L. Rev.* 143, 152-53 (1992).

the situations are somewhat dissimilar. Pain-and-suffering damages occur in a market transaction (broadly defined) and are payable in cash, and therefore are akin to wages. Self-created personal-use property, on the other hand, has a dual capacity: it is an asset, but the asset provides consumption benefits in kind, and these benefits derive partly from the non-deductible costs of raw materials and equipment and partly from the value of self-provided services.

Even conceding a self-created personal-use asset to be "wealth," there would still be the problem of "realization." Self-created personal-use property entails more than *de minimis* investment,⁷¹ so that any "accession to wealth" resulting from the creative process can be viewed as unrealized appreciation and/or unrealized labor income. In other words, self-created personal-use property, as in the case of self-created inventory, would not give rise to any income until (if ever) such income is realized by a sale or exchange.⁷²

At the level of economic theory, taxing self-created personal-use property upon completion could have three possible effects: (1) forcing taxpayers into market activity (selling their services or products), (2) forcing taxpayers into nontaxed activity (self-provided services or leisure), or (3) having little effect on taxpayer behavior. This is ultimately an empirical question, but the second possibility intuitively seems most likely if one assumes that the tax on self-created items were enforced. In that case, nothing useful would be accomplished by taxing self-created personal-use property. The third possibility (inelasticity) is the most plausible, because an inclusionary rule could not realistically be enforced. Thus, only the first, and least likely scenario, advances the efficiency argument for taxing self-created personal-use assets.

The position that self-created personal-use property is not income (unless and until realized) finds doctrinal support in the authority holding that self-grown crops are not income if consumed by the taxpayer.⁷³

Similar considerations apply to "taken" personal-use property. Here the analogy to imputed income from self-provided services is less compelling, but there is still investment of capital and labor by the taxpayer. That such property is obtained by an investment that is below the property's fair market value is no reason to tax the gain prior to realization.

The borderline between commercial ventures and casual or hobby activities is not always clear, but this distinction should not be relevant to the realization issue. If the self-obtained property has a value in excess of "cost" (broadly conceived), it looks like a gain-seeking venture, discussed above, such that the gain should be taxed only when realized. Indeed, even non-profitable

71 . Even self-grown crops require seeds, fertilizer, water, plows, and so on.

72 . In *Helvering v. Horst*, 311 U.S. 112, 115-17 (1940), there is language that can be construed to equate "realization" with "enjoyment." However, that case was about income attribution, and the ultimate rationale appears to be that income is taxed to the person who controls the enjoyment of the income, rather than the person who actually enjoys the income. Indeed, the realization event in *Horst* was the taxpayer's disposition of an income right. Thus, the word "enjoyment" as used in *Horst* cannot be equated with "utility" derived from ownership.

73 . See *Morris v. Commissioner*, 9 B.T.A. 1273 (1928).

speculative activities (with or without an obvious personal-pleasure flavor), such as small-scale prospecting and salvage operations, would normally be treated as for-profit ventures.⁷⁴

In the typical pleasureable hobby activity involving saleable self-obtained property, it is likely that the costs of pursuing the activity will exceed the value of the product or harvest. Hobbies like hunting, fishing, photography, casual production of arts and crafts, rock hounding, butterfly collecting, etc., entail significant costs that in most cases would exceed the net market value of the harvest. The excess of hobby-activity deductions over *realized* hobby-activity gross income is currently disallowed under Internal Revenue Code section 183(a). Where the self-obtained property is never sold, there would be no need to account for disallowed costs. However, a deemed-realization rule would require taxpayers to account for costs at the time of completion. But, if proper accounting showed a loss (which would usually be the case), the exercise would be pointless. In short, a deemed-realization rule would impose burdensome and unnecessary administrative costs.⁷⁵

It is true that optimal taxation theory suggests that activities undertaken for personal motives (true hobby activities) can be taxed more heavily than gain-seeking activities, since the former are more inelastic than the latter. But, of course, the borderline between hobby and for-profit activities is often difficult to draw.⁷⁶ Speculative ventures may fall on the for-profit side of the line despite repeated failures,⁷⁷ as do activities that actually produce a profit.⁷⁸ Mark-to-market taxation of profitable outcomes from marginal activities would be inferior, because of difficulties in enforcement, to permanently disallowing not only the net losses from such activities, as is currently the case under Section 183(a), but also disallowing the deductions that are currently allowed by Section 183(b)(2).

In conclusion, there are reasonable arguments for the position that, in a realization system, self-created (and taken) objects should not be treated as giving rise to gross income until sale, etc. That is certainly the rule of positive law.

74 . See Regs. § 1.183-2(a) (“small chance of making a large profit” is consistent with objective of making a profit).

75 . Cf. IRC § 263A(h) (waiving capitalization rules for free-lance authors, artists, and photographers). In addition, in some of these situations, such as amateur art and crafts, the value would be very low since there would be no established market for the items.

76 . See Regs. § 1.183-2. The case outcomes under IRC § 183(c) show no consistent pattern. Compare *Nickerson v. Commissioner*, 700 F.2d 402 (7th Cir. 1983) (weekend farmer held to be in for-profit activity); *Golanty v. Commissioner*, 72 T.C. 411 (1979), aff’d 647 F.2d 170 (9th Cir. 1981) (opposite result); *Hawkins v. Commissioner*, 38 T.C. Memo (CCH) 469 (1979), aff’d without opinion, 652 F.2d 62 (9th Cir.1981) (legal secretary writing a book of verse held to be in not-for-profit activity).

77 . See *supra* note 74.

78 . See IRC § 183(d) & (e); Regs. § 1.183-2(b)(6).

3. *True windfalls*

The term "windfall gains" is somewhat redundant: since obtaining a windfall (by definition) entails no significant investment or effort, the result must be an "instant" in-kind gain that suffers no doctrinal impediment to being treated as gross income.⁷⁹ That is, the windfall gain is not (nor analogous to) unrealized appreciation.

Nor are windfall accessions to wealth "imputed income" as that term is usually used, i.e., in the sense of income from self-provided services or self-owned personal-use assets.⁸⁰ Indeed, imputed income, whether meaning a "flow of satisfactions" or as "hypothetical market income" is distinct from material wealth.

There is no categorical doctrinal exclusion for "nonmarket transactions."⁸¹ At the level of theory, the "market transaction" idea does not rule out taxing clear accessions to wealth, regardless of source.⁸² Unlike psychic benefits and imputed income, in-kind windfalls do not pose any unique valuation problem. Moreover, the concept of "market transaction" is ambivalent as it applies to found or discovered property. Many found objects exist in nature; many others were "left there" by another party. It is settled that obtaining cash or property by theft or embezzlement is gross income notwithstanding the lack of a market transaction in the conventional sense.⁸³ There is no apparent distinction between found property that was lost, misplaced, hidden, or abandoned, on the one hand, and stolen property, on the other, as far as the person obtaining the item is concerned. Indeed, the distinction between "finding" and "stealing" is doctrinally meaningless and, in some instances, factually nonexistent (as where a tourist loots a legally-protected archaeological site).

In addition, it would be unseemly to have a rule excluding found objects when the most common category of in-kind windfalls, namely, prizes and awards, is clearly includable.⁸⁴ The only possible distinction between the two cases is that of enforceability. But it would be odd indeed if nonenforceability with respect to windfall found objects were alone sufficient

79 . The term "windfall" is not limited to found objects (and prizes and awards), but may include windfall gains arising out of transactions (such as the commercial bargain purchase or unearned rents). See Kades, *supra* note 42, at 1504. However, since I am not proposing any surtax on windfalls over and above any applicable normal tax, it is not necessary for tax purposes to formulate an economically sophisticated definition of "windfall."

80 . See *supra* note 19. See also *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934) (dictum).

81 . See Regs. §§ 1.61-1 and -14.

82 . See *supra* text accompanying notes 23 and 24.

83 . *James v. United States* 366 U.S. 213 (1961) (cash); *Collins v. Commissioner*, 3 F.3d 625 (2d Cir.1993) (off-track betting tickets).

84 . See IRC § 74(a).

to give rise to a *rule* that windfall found objects are excludable.⁸⁵ Whether a clear inclusionary rule that is difficult to enforce should be publicly abandoned or allowed to lie fallow is dealt with in Part IV.E.

III. REALIZATION OF IN-KIND INCOME

The line between windfall gains, which give rise to current taxation, and gains produced by commercial ventures, taxation of which is deferred until realization, is principled and relatively easy to apply. Arguing that the realization principle is unjustified in theory,⁸⁶ and therefore that it should be construed as narrowly as possible (so as to tax commercial bargain purchases and self-obtained property), is too facile a move, since it obscures the merits of particular issues and of the consequences of redrawing established lines of distinction.⁸⁷ A person might argue the alternative position that the same reasons that underlie the exclusion of unrealized appreciation can be extended to in-kind windfalls. The doctrinal theory for this position would be that not only “gain” but also “gross income” must be “realized.” That gross income must be “realized” is stipulated in the well-known *Glenshaw Glass* case,⁸⁸ as well as in Regulations section 1.61-1(a). Neither authority sheds any light on what “realization” means. This Part raises the issue of whether, or when, the realization principle might actually be deployed so as to defer the recognition of in-kind windfall gains.

A. *Realization of Income through the Eisner v. Macomber Period*

In the very early 1913-1921 period of the modern income tax, many important doctrinal issues were unresolved.⁸⁹ At this time there was a strong

85 . One might avoid the obvious horizontal equity problem by excluding *all* in-kind windfalls, including prizes, awards, and raffle winnings, but that would truly be a case of the tail wagging the dog.

86 . I have advocated in print mark-to-market taxation of publicly traded securities, see Joseph M. Dodge, A Combined Mark-To-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265 (1995), and would probably favor a mark-to-market approach to derivatives. I also favor treating gratuitous transfers of nonliquid property as deemed realization events. See Joseph M. Dodge, Further Thoughts on Realizing Gains and Losses at Death, 47 Vand. L. Rev. 1827 (1994), excerpts reprinted in P.Caron et al., Federal Wealth Transfer Tax Anthology 373 (1997).

87 . For a discussion of the lines drawn by current realization (and recognition) doctrine, see Daniel N. Shaviro, An Efficiency Analysis of Realization and Nonrecognition Rules under the Federal Income Tax, 48 Tax L. Rev. 1 (1992); Weisbach, *supra* note 18. See generally, David M. Schizer, Realization as Subsidy, 73 N.Y.U. L. Rev. 1549 (1998).

88 . *Supra* note 6.

89 . The unresolved issues included virtually everything having to do with basis, whether casual capital gains were income, the amount of the charitable contribution deduction with respect to property, whether exchanges of property were realization events, and the status of recoveries for personal injuries. All of the issues were dealt with by regulation prior to being dealt with by statute. See Revenue Act of 1918, § 202(a), 40 Stat. 1057 (first appearance of rules

constituency for the proposition that "realization" required conversion to cash, but there was also support for the "accretion" ideal. With the passage of time, a "compromise" position evolved with respect to the notion of "realization of gain," so that "cash" was diluted first to "property that is the equivalent of cash," and then to "property having an ascertainable fair market value."⁹⁰ In the case of realization of gain upon the disposition of property, this movement away from a strict cash requirement was limited by eventual acceptance of the open-transaction doctrine, derived from the early case of *Burnet v. Logan*,⁹¹ which applies to sales for contingent-payment consideration.⁹²

In the "realization of income" situation (not involving a disposition of property), the seminal case is, of course, the 1920 case of *Eisner v. Macomber*,⁹³ which held that a pro-rata stock dividend was beyond the power of Congress to tax, because: (1) "income" necessarily implied realization; (2) "realization" required severance of the "fruit" from the "tree" (the underlying investment); and (3) a pro-rata stock dividend wasn't "fruit" (income) in the first place, but rather a reconstituted portion of the tree. The first two of these holdings, and perhaps the third, were overturned by the 1940 case of *Helvering v. Bruun*,⁹⁴ and in any event the third holding is irrelevant to the case of found property, since it cannot be said to be "part" of any underlying investment. The *Macomber* case, significantly, did not hold that "realization" required the receipt of "cash" or "cash equivalent."

Eventually, the stock-dividend issue was settled by the enactment of Internal Revenue Code section 305.

B. Lessee Improvements

The next realization-of-income case of general interest is the 1938 case of *M.E. Blatt Co. v. United States*,⁹⁵ where the government attempted to tax a landlord on building improvements erected by the lessee in the year the

purporting to define basis and amount realized); *Taft v. Bowers*, 278 U.S. 470 (1929) (discussing evolution of basis rules for gratuitous transfers); Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 Sw.L.J. 869 (1985); Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 So. Cal. L. Rev. 397, 400-407 (1987) (realization and recognition).

90 . See Kornhauser, *supra* note 89, 60 So. Cal. L. Rev. at 401-02.

91 . 283 U.S. 404 (1931). See also *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481 (1937) (corporate reorganization). Section 202(e) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227, codified (until the Revenue Act of 1924) the idea that the amount realized was the "readily ascertainable fair market value" of property received.

92 . There is no need here to consider the line of cases dealing with the issue of when an "exchange" might not be a realization event on the theory that the property received is essentially the "same" as the property given up. See *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991) (adopting an expansive concept of realization in exchanges), and cases discussed therein.

93 . 252 U.S. 189 (1920).

94 . 309 U.S. 461 (1940), see *infra* text and note 97.

95 . 305 U.S. 267 (1938).

improvements were completed.⁹⁶ The Court held that the improvements were neither rental income (because not stipulated to be rent) nor “residual” gross income. On the latter issue, the Court made the following holdings: (1) the improvements (painting, certain fixtures, ventilation system, and architect’s fee) would have no value if detached from the building; (2) insofar as the improvements increased the value of the building, the result was unrealized appreciation; (3) insofar as the improvements would have no value at the end of the lease term, they could not be income prior to the end of the lease term; and (4) that insofar as the improvements would possess value as of the termination of the lease, there was no realization of income or gain prior to such time because the lessor could neither use nor dispose of the improvements until the lease terminated.

Two years later, in 1940, the Supreme Court in the *Bruun* case⁹⁷ held, *inter alia*, that the receipt of a building by a lessor upon the expiration of a lease gave rise to residual income equal to the then value of the building,⁹⁸ even though property of this sort is hard (if not impossible) to value, and is quite illiquid insofar as it is “attached” to the land.

On the merits, nonliquidity should not be a basis for a court deciding that an in-kind accession to wealth is not income. The concept of “nonliquidity” is indeterminate: the concept of illiquid property ranges from property that is marketable but where valuation is imprecise (such as real estate, the sale of which also entails significant transaction costs) to property that has no market but conceivably might be sold as the result of direct solicitation (such as a closely held business interest). Moreover, the causes of nonliquidity are varied, and include imperfect market information, lack of a market mechanism, and legal inhibitions on alienation. Any attempt by courts to draw lines according to “degree” of nonliquidity (or difficulty of valuation) would only create uncertainty. *Bruun* clearly overrules two of the holdings of the *Blatt* case. After *Bruun*, it is clear that there is income when another party *directly* adds to the taxpayer’s physical capital.⁹⁹ Also, it is irrelevant whether the addition can be detached or severed from the taxpayer’s original investment. And, as mentioned above, difficulty of valuation and relative illiquidity were no bar to inclusion in

96 . The government’s theory of the case was faulty: the amount includable, according to the government, was the lessee’s cost reduced by the accounting depreciation that would have accumulated as of the end of the lease term. Such includable amount was to be pro-rated in gross income over the remaining lease term. The correct valuation approach would have been the present discounted value, as of the completion of the improvements, of the estimated fair market value of the improvements at the end of the lease term.

97 . *Helvering v. Bruun*, 309 U.S. 461 (1940).

98 . In a somewhat confusing passage, the Court seemed to hold that the stipulated gain was income if it represented *either* the value of the building (whether or not such building was readily removable from the land) *or* the enhancement in value of the property attributable to the building, in each case as of the date the lease was cancelled. See 309 U.S. at 467-68.

99 . If another person *indirectly* adds value to the taxpayer’s investment (such as where the state builds a freeway interchange near the taxpayer’s land), the resulting enhancement in value to the taxpayer’s investment is treated as unrealized appreciation.

Bruun. What remains are two factors. The first is that in *Blatt* the lessee, not the lessor, had current possession and use of the item. Possession by another party would seem to indicate "lack of dominion and control," but perhaps lack of current dominion and control is one form of "nonrealization." The second relevant factor is that the improvements may or may not have been expected to survive the lease term. In other words, there was a condition precedent to future dominion and control.

Since *Blatt* involved a future interest following a possessory interest in another that was contingent both as to coming into possession and value, it is not clear if any of: (1) futurity, (2) contingency as to possession, or (3) uncertain future value are alone sufficient to defeat current realization, or whether all must be present.¹⁰⁰

An analogous line of authority to *Blatt* holds that a debtor does not realize income when a third party guarantees a debt, but only when the third party makes good on the guarantee.¹⁰¹ This situation involves a contingent future right, but there is no third-party possession as such. However, a bare contract right might be viewed as a weaker case for current realization than a contingent interest in property.¹⁰²

In any event, the specific outcome of *Bruun* was reversed by the enactment of Internal Revenue Code sections 109 and 1019.

C. Employee Compensation

The issues of valuation, liquidity, and contingency were also played out in cases in the area of employee compensation prior to the enactment of Section 83 in 1969. There are basically two lines of cases, one involving stock options, and the other involving restricted property.

1. *Employee stock options*.—In the stock option situation, the two leading Supreme Court cases upheld the government's attempt to tax the

100 . See also *United States v. Frazell*, 335 F.2d 487 (5th Cir.1964), cert. denied, 380 U.S. 961 (1965) (compensatory right to acquire interest in speculative oil properties upon the occurrence of a future contingency stipulated to be includable when interest became possessory).

101 . *Maher v. Commissioner*, 469 F.2d 225 (8th Cir.1972), acq. Rev. Rul. 77-360, 1977-2 C.B. 86.

102 . An aberration in the realization doctrine occurs in the case of cash received in put and call options: the cash is not included in gross income when received despite the fact that there is no repayment contingency; rather, the transaction is held "open" until it is closed either by the lapse of the option or the transfer of the underlying property. See Rev. Rul. 71-521, 1971-2 C.B. 313. Critical commentary on this approach is given in Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property*, 48 *Tax L. Rev.* 233 (1993); Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 *Tax L. Rev.* 725 (1992); Calvin H. Johnson, *Taxing the Income from Writing Options*, 73 *Tax Notes* 203 (1996). This aberration derives from being unable to determine the character of the income until the transaction is closed. In any event, it has more to do with "realization of gain" than with "realization of [in-kind] income."

“spread” between the option price and the fair market value of the stock at the exercise date. In the 1945 *Smith* case,¹⁰³ there was no spread on the date the options were issued, and hence there could have been no compensation income at that time. Nevertheless, the Court held that the spread on the exercise date was “compensation” because the employer, upon issuing the options, contemplated the possibility of a future spread. Also, the Treasury had issued regulations holding that a bargain purchase of employer property by an employee was income if it was in the nature of compensation.¹⁰⁴

In the 1956 *LoBue* case,¹⁰⁵ the Court rejected the taxpayer’s attempt to invoke the commercial-bargain-purchase exclusion on the ground that the compensation situation is not an arms-length purchase in commerce. The taxpayer’s principal contention in *LoBue* was that the compensation, if any, occurred when the options were issued, not when they were exercised. The Court said that this was a theoretical possibility, but not for this taxpayer, since the options in question were nontransferable, lacked a “readily ascertainable” fair market value, and were subject to conditions precedent and subsequent. The Court endorsed the Treasury’s practice since 1923 of deferring taxation until the exercise date unless the options possessed a readily ascertainable fair market value when granted.

This line of cases might be construed to support the view, contrary to *Bruun*, that the receipt of in-kind property does not give rise to realized income if the property is not transferable *or* if it is hard to value. However, this deferral of realization rule was promoted by the Treasury, not taxpayers, and for strategic reasons: such factors as nontransferability and the existence of contingencies would drastically reduce the value of an option, and the absence of a current spread might eliminate value entirely,¹⁰⁶ resulting in a zero or small inclusion of compensation income, with all subsequent appreciation being capital gain.¹⁰⁷ The “readily ascertainable fair market value” test has now been codified,¹⁰⁸ and the regulations, emphasizing “readily ascertainable,” construe

103 . Commissioner v. Smith, 324 U.S. 177, reh’g denied, 324 U.S. 695 (1945).

104 . Regs. § 101, Art. 22(a)(1).

105 . Commissioner v. LoBue, 352 U.S. 859 (1956).

106 . The “old” view was that an option could have no (or negligible) current value if there was no current “spread” between the option price and the current fair market value of the underlying property. This view is now obsolete. See Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. Pol. Econ. 637 (1973), and *The Valuation of Option Contracts and a Test of Market Efficiency*, 27 J. Fin. 399 (1972).

107 . The assumption has always been that there can only be one “compensation” event, subsequent to which the employee has converted to “investor” status. The logic of this position escapes me. It would seem that any transfer of value from an employer to an employee can be treated as compensation. Nevertheless, the only-one-compensation-event approach was codified in IRC § 83(e)(3) and (4).

108 . IRC § 3(e)(3).

the test so narrowly as to render deferral of compensation the usual result except where the option is actively traded on an established market.¹⁰⁹

In short, the stock option cases may stand for the proposition that difficulty of valuation is alone sufficient to defer realization. On the other hand, these cases may be *sui generis*, being based on acquiescence in the Treasury's willingness to concede deferral except in cases of maximum liquidity. Moreover, the deferral of realization is only until the option is exercised (or allowed to lapse), as opposed to when the stock obtained by such exercise is sold.

2. *Vested vs. nonvested in-kind compensation.*—In the case of property other than stock options, doctrinal development more closely conforms to an early-realization model. In the 1947 *Ward* case,¹¹⁰ it was held that an employee receiving a future interest (an annuity contract) had current income, since the annuity contract was both vested and assignable. "Dominion and control" was not an issue: the taxpayer acquired a property right, and no third party had a current possessory interest. The 1950 *Drescher* case¹¹¹ took matters a long step further in holding that a vested future interest (again an annuity contract) was current income even though it was not assignable.

The *Drescher* result accords with the "economic benefit" doctrine sanctioned in the 1951 *Spruill* case.¹¹² The economic-benefit doctrine covers the situation where: (1) cash is placed in a trust or escrow for future distribution to the taxpayer, (2) the taxpayer's rights in the trust or escrow are fully vested, and (3) (debatably) the cash is to be invested.¹¹³ There is no requirement that the taxpayer's interest be alienable.

These cases establish - seemingly in contrast to the stock option cases - that even total illiquidity, along with attendant difficulties of valuation, is not, standing alone, a bar to current realization of in-kind gross income.¹¹⁴ It might be argued that these authorities are confined to the "compensation" situation, since the latter is an enumerated category of gross income that is to be broadly

109 . See Regs. § 1.83-7. An option (not actively traded on an established market) might not have a readily ascertainable fair market value even if the option is transferable, not subject to contingencies, and is exercisable immediately, because an option can possess value over and above the date of grant spread due to the "option privilege." See supra note 106. Under Regs. § 1.83-7(b)(3), the option cannot possess a readily ascertainable fair market value unless the value of this option privilege "can be measured with reasonable accuracy."

110 . *Ward v. Commissioner*, 159 F.2d 502 (2d Cir.1947).

111 . *United States v. Drescher*, 179 F.2d 863 (2d Cir.1950).

112 . *Spruill v. Commissioner*, 16 T.C. 244 (1951).

113 . See *Reed v. Commissioner*, 723 F.2d 138 (1st Cir.1983). Imposition of an investment requirement seems incorrect, since the absence of a duty to invest the cash simply reduces the current value of the taxpayer's interest, just as the lack of transferability reduced the value of the taxpayer's annuity in *Drescher*.

114 . In *Drescher*, the annuity had to be reduced to present value and then was to be further discounted on account of nonliquidity.

construed.¹¹⁵ It is true that “compensation” is broadly construed, but it must be noted that the “economic benefit” doctrine exists outside of the employee compensation area.¹¹⁶ Therefore, the *Drescher* holding should likewise extend beyond the compensation area.

It might be argued that the economic-benefit doctrine is distinguishable because that doctrine “belongs” in the realm of cash-method accounting, rather than in that of “realization.” But the cash method can be viewed as a statutory resolution of the “realization” issue limited to cases where rights to future cash are acquired.¹¹⁷ The cash method has never been viewed as allowing deferral with respect to in-kind property income.¹¹⁸ The economic-benefit doctrine can be viewed as a determination that a *funded* right to future cash is “property” rather than the sort of right to future cash that yields deferred realization under the cash method.¹¹⁹ Only unfunded rights to future cash entail deferred taxation under the cash-method doctrine.¹²⁰ It is hard to imagine one “finding” an unfunded right to future cash. A bearer bond, or gold bullion, would be viewed as in-kind property.

To continue the discussion of compensation received in the form of property, the 1952 *Kuchman* case held that an employee did not have gross income on the receipt of property that was subject to a substantial risk of forfeiture, on the theory that such property would have *no* fair market value.¹²¹ Presumably, no rational person would purchase such property where the forfeiture condition “follows the property” and where the occurrence of the forfeiture condition is under the control of one or more third parties. Any value assigned to such an interest would be pure guesswork, and any such investment would be a gamble.

115 . See Regs. § 1.61-2(d).

116 . See *Kuehner v. Commissioner*, 214 F.2d 437 (1954) (stock sale proceeds); *Reed*, supra note 113 (real estate escrow); *Pulsifer v. Commissioner*, 64 T.C. 245 (1975) (lottery winnings). The economic benefit doctrine has been codified in the deferred compensation area. IRC § 402(b)(1).

117 . The cash method is authorized by IRC § 446(c)(1).

118 . See Regs. § 1.446-1(c)(1)(i).

119 . Application of the economic benefit doctrine would not necessarily require inclusion of a (nongratisuitous receipt of a) remainder interest in trust. A vested remainder in trust implies a current possessory interest in another party, a factor which is not present in the compensation situation. The fact of a possessory interest in another party might preclude realization on the theory that the taxpayer lacks “dominion and control.” However, if the remainder is vested, the remainder interest should be sufficiently noncontingent and capable of valuation to satisfy the test of “realization.” Compare Rev.Proc. 92-64, 1992-2 C.B. 422 (economic benefit doctrine defeated where, in deferred compensation “rabbi trust,” the employer’s creditors, and vicariously the employer, have a contingent interest in the trust, the exercise of which would defeat the employee’s rights).

120 . See Regs. § 1.83-3(e) (employee compensation).

121 . *Kuchman v. Commissioner*, 18 T.C. 154 (1952) (reviewed) (acq.).

Other cases have reached a similar result where the compensation took the form of a contingent right (unrelated to forfeiture conditions), such as a pure profits interest in speculative property.¹²²

This deferred-realization approach for contingent property has been codified in the compensation area by Internal Revenue Code section 83(a).¹²³

The Section 83 approach can be critiqued, or at least viewed as being idiosyncratic. The restricted property situation is properly characterized as "current ownership and possession subject to a condition of divestiture," whereas the *Blatt* (lease) situation involved a non-possessory interest subject to a condition precedent.¹²⁴ The problem of valuation *could* be finessed by including the value of the restricted property without regard to forfeiture conditions, and then allowing a deduction for the basis thereof if and when the property is subsequently returned. This approach is followed in the case of the receipt of forfeitable cash outside of the compensation area, as is explained in Part III, as well as where an employee makes an election under Section 83(b) to currently include the forfeitable property in gross income.¹²⁵ The question of whether that approach *should* be extended to (noncompensatory) in-kind property receipts in general and to found objects in particular is dealt with in Part IV.

IV. A "BORROWING" MODEL FOR RECEIPTS INVOLVING DOUBTFUL TITLE

Insofar as generalizations can be made across transactional categories, it is reasonable to claim that "nonrealization" is limited to cases where the taxpayer lacks current enjoyment, dominion, and/or control over the property and/or where ultimate enjoyment of in-kind property is significantly contingent on future events. On the other hand, neither mere difficulty of valuation nor a

122 . See *Vestal v. United States*, 498 F.2d 487 (8th Cir.1974).

123 . IRC § 83(a) also makes clear that the lapse of such forfeiture conditions is a realization event. Compare *Lehman v. Commissioner*, 17 T.C. 652 (1951) (reviewed) (contrary result under prior law). In *Lehman*, the Tax Court held that the lapse of a forfeiture condition could not give rise to income that could be called "compensation" because the then value of the stock might bear no relation to the value of the services rendered; otherwise, the increase in value to the date of lapse was simply unrealized appreciation. *Lehman* seems contrary to the spirit, if not the letter, of *Smith* and the later *LoBue* case. Cf. also *Boston Consol. Gas Co. v. Commissioner*, 128 F.2d 473 (1st Cir.1942) (unclaimed deposits became gross income when statute of limitations for their refund expired). In addition, if the reason for deferral of income is impossibility of valuation, and if the lapse of a forfeiture condition removes such difficulty, then such lapse should mark the realization of income. The Treasury subsequently issued Regulations to reverse the *Lehman* result. Regs. § 1.421-6, T.D. 6416, 1952-2 C.B. 126. These regulations were confirmed (and superseded) by the enactment of IRC § 83(a) in 1969.

124 . An analogous situation to *Blatt* would be a promise to make a future transfer property to the taxpayer if certain conditions precedent were satisfied. In that case, deferral of income would arguably be proper.

125 . IRC § 83(a)(1) (amount includable computed with regard to fair market value unreduced by forfeiture conditions).

prohibition on alienation preclude realization upon initial receipt. All of this is consistent with doctrine in the “realized gain” area.¹²⁶

The crucial issue here is whether, outside of Section 83, the forfeitability of property is the kind of contingency that would preclude current realization when the taxpayer first obtains the property. The leading non-compensation case involving the forfeitability of cash is *North American Oil Consolidated v. Burnet*,¹²⁷ decided in 1932, which held that the receipt of a cash damages award was current income notwithstanding the possibility that the cash might have to be refunded if the taxpayer lost on appeal. The “claim-of-right” idea was so literally followed by the Supreme Court in the 1946 *Wilcox* case as to produce an exclusion for embezzled cash.¹²⁸ The 1952 *Rutkin* case limited *Wilcox* to “void title” cases.¹²⁹ In *Rutkin*, an extortionist was held to have obtained gross income notwithstanding having “voidable” title. The *Wilcox-Rutkin* distinction was swept aside by the 1961 *James* case,¹³⁰ which held that, legal subtleties notwithstanding, a person has gross income when receiving cash unless there is a consensual obligation to repay.

The *James* approach is normally treated as delimiting the “borrowing exclusion,” as opposed to dealing with “realization.”¹³¹ But there really is no essential distinction between the two doctrines. Thus, one can describe a conventional borrowing as a “nonrealization of income” event on account of the absolute obligation to repay; “realization of income” occurs if, when, and to the extent that the repayment obligation is subsequently cancelled.¹³²

Regulations section 1.61-14, which was promulgated in 1957, prior to the Supreme Court decision in *James*, states that treasure trove is gross income in the year that it is “reduced to undisputed possession.” This approach seems to echo *Wilcox*, which was undermined by *Rutkin* and overruled by *James*. The IRS did not withdraw its acquiescence in *Wilcox* until 1962.¹³³

The approach set out in *James* seems to be suitable for found cash as well as stolen cash, since the two situations present near-identical scenarios. Applying *James* to in-kind cash windfalls results in a finder’s having income

126 . See *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir.1975) (cash-method taxpayer must treat in-kind property as “amount realized” at its fair market value even if property is not “cash equivalent”); Regs. § 15A.453-1(d)(2)(ii)(A) (open-transaction reporting allowed only for contingent payment obligations whose value cannot be readily ascertained). A special case is the “pool of capital” (nonrecognition) doctrine in the oil and gas area. See Walter Schwidetzky, *The Pool of Capital Doctrine: A Peace Proposal*, 61 Tul. L. Rev. 519 (1987).

127 . 286 U.S. 417 (1932).

128 . *Commissioner v. Wilcox*, 327 U.S. 404 (1946).

129 . *Rutkin v. United States*, 343 U.S. 130 (1952).

130 . See *James v. United States*, 366 U.S. 213 (1961) (embezzled party had right to recoup funds embezzled by taxpayer).

131 . The possibility of having to refund the item to its true owner does not really raise a “lack of dominion and control” issue, despite gratuitous statements apparently to the contrary made in *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

132 . See IRC § 61(a)(12).

133 . Rev. Rul. 61-185, 1961-2 C.B. 9, revoking G.C.M. 24945, 1946-2 C.B. 27.

upon taking possession of the cash, notwithstanding a possibility that the cash might have to be turned over to another, unless the finder immediately agreed to turn over the cash to a claimant (or possibly into an escrow pending ultimate disposition of the claim).¹³⁴

V. CAN *JAMES* BE APPLIED TO WINDFALL FOUND OBJECTS?

Despite *James*, the "reduced to undisputed possession" language in Section 1.61-14 would appear to control in the case of found cash and property, or at least of "treasure trove."¹³⁵ To discern a proper construction of "reduced to undisputed possession," it is desirable to look first at the relevant law of personal property, before trying to settle the issue of tax doctrine.

A. *Property-Law Status of Found Items*

Herein is a brief description of personal property law as it applies to found items. The law turns out to be quite complex and unclear in application. Generally speaking, "finder's keepers" is *not* the prevailing rule.

"Finder's keepers" is the prevailing rule only for *abandoned* items, as well as for fish and game. However, the finder's title may be superseded by that of the private landowner or of the state, due to trespass or a violation of law or regulations.¹³⁶ Abandoned property¹³⁷ would not be a significant income tax category in any event, since abandoned property is likely to have little intrinsic or net salvage value (or else it would have been sold by the original owner).

As to "lost" (as opposed to abandoned) items, a finder who takes possession has good title against all persons except the owner. But a finder's right to possession is inferior to the landowner's if the finder is a trespasser, as may also be the case if the finder is an invitee or licensee.¹³⁸

134 . My research has failed to uncover any dispute in which a taxpayer attempted to exclude, or defer realization of, income with respect to a windfall found object pursuant to the "reduced to undisputed possession" language of Regs. § 1.61-14.

135 . See *Commissioner v. Estate of Hubert*, 117 S.Ct. 1124 (1997) (tax treatment of certain estate administration expenses governed by Treasury regulation, as construed by the Supreme Court, in absence of clear resolution under the Code).

136 . See R. Brown, *The Law of Personal Property* (3d ed. W. Rauschenbush) (1975) §§ 1.6, 2.1, 2.2, and 2.4 (hereinafter referred to as Brown).

137 . To be "abandoned," there must be an intent to abandon, which might be shown by facts indicating that the owner made no attempt to recover an item. There is probably no such thing as "abandoned" cash.

138 . See *id.* at §§ 3.1 and 3.3.

Next, as to “misplaced” items,¹³⁹ the finder’s title is inferior not only to that of the owner but also to that of the owner of the premises where the item was misplaced.¹⁴⁰

A fourth category is “treasure trove,” meaning “gold or silver in coin, plate, or bullion [that] is found concealed in a house or in the earth or other private place, the owner thereof being unknown.”¹⁴¹ Note that “treasure trove” refers only to cash and cash-like property. In England treasure trove escheats to the state, but in the United States it is usually treated as abandoned, lost, or misplaced, as the case may be.¹⁴² It is worth noting the treasure-trove category is quite narrow. It does not include treasure recovered from the sea, the shore, or other public place.

Finally, the ownership of found (or stolen) items may be the subject of statute¹⁴³ and, especially in the case of cultural property, international agreement.¹⁴⁴

In sum, except for abandoned objects and objects that have no owner, the finder’s “title” is subordinate to that of the true owner (or possibly the state), and his or her right to *possession* may be inferior to the owner of the property where the item was found. Thus, in general, the finder has the duties of a gratuitous bailee, and can be forced to return the item to the true owner in good condition.¹⁴⁵ If the finder sells the item to a third party, the purchaser may (or may not) acquire valid title as a bona fide purchaser without notice,¹⁴⁶ but the finder-seller would be liable (civilly and criminally) for conversion. Despite the foregoing, the finder may obtain title against the owner after the running of the

139 . A “misplaced” item is an item set aside by the owner, who then forgets to pick it up. Thus, a diamond ring left on a dressing table in a hotel would be misplaced, whereas a diamond ring that washed down the shower drain would (presumably) be lost.

140 . See Brown, *supra* note 136, at § 3.4.

141 . See Brown, at § 3.3.

142 . See *id.*

143 . These statutes, often of pre-Civil War vintage, exist in about one-third of the states. Typically, they provide that the finder of any object over a de minimis value post local notice of the finding; after the running of a period of time, and assuming that the owner does not appear, the finder can keep a portion of the value and the rest escheats to the state. Apparently, these statutes are so rarely used as to be virtually a dead letter. See David Riesman, Jr., *Possession and the Law of Finders*, 52 Harv. L. Rev. 1105, 1123-24 (1939). (The author, then a professor at what is now S.U.N.Y. Buffalo Law School, is the same David Riesman of *The Lonely Crowd* fame.)

144 . See UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects, June 24, 1995, art. 3(1), 34 I.L.M. 1322, 1331 [hereinafter UNIDROIT Convention] discussed in Lyndel V. Pratt, *Commentary on the UNIDROIT Convention* (1997). See generally, Lyndel V. Pratt & P.J. O’Keefe, *Law and the Cultural Heritage* (3 volumes, 1989) (describing state, national, and international law as it pertains to the excavation, theft, sale, etc., of art objects and other objects classed as “cultural heritage”).

145 . A bailee has a duty of care over the property, as well as the duty to return the property to the bailor. See Brown, *supra* note 136, at §§ 11.1 and 11.7.

146 . Under the UNIDROIT Convention, *supra* note 144, art. 3(1), the bona fide purchaser rule is abrogated, so that persons who possess objects covered by the Convention have an unqualified obligation to return the item.

statute of limitations (usually six years) if the finder's possession is adverse to the owner. Of course, the concept of "adverse" possession is highly fact-driven.¹⁴⁷

B. *Applying Regulations Section 1.61-14 to Windfall Found Objects*

Stated narrowly, the issue to be faced at this point is how to "construe" the language of Regulations section 1.61-14 as to found items. My conclusions are: (1) courts should view the regulation as being ambiguous, (2) the regulation should be construed in light of *James*, and, (3) the *James* principle can and should be applied to property (as well as to cash).

The meaning of the phrase "reduced to undisputed possession" is inherently ambiguous: in virtually all cases, possession (a physical fact) is held by one party. It is "title" (a legal fact) that would normally be "disputed." In the context of the law of personal property, a "right to possession" is inferior to ownership but superior to possessory claims of other claimants. Thus, a finder and the owner of the premises on which the property is found (or the state) might dispute possession, but whichever party prevails has inferior title to the owner. For that very reason, it is likely that disputes over possession would rarely be litigated in the courts.

Whether all of this learning is intended to have been encompassed by the phrase "reduced to undisputed possession" is somewhat speculative, since that phrase is not elaborated upon in either Section 1.61-14 or the rulings that preceded it. Indeed, it is doubtful that the regulation was drafted on the basis of a sophisticated understanding of personal property law, since the regulation refers to a category ("treasure trove") that is not generally recognized by American law. Also, as previously mentioned, the regulation was issued in the confused environment of *Wilcox* and *Rutkin*, prior to the clarification imported by *James*. Thus, "undisputed possession" may have been a way of stating the now obsolete claim of right idea.

Whether one views the language in Section 1.61-14 as being borne out of confusion as to both tax and personal-property-law doctrine, it should be construed, in light of *James*, in a literal fashion, i.e., to mean "possession (as opposed to title), except where possession (or title) is actually being disputed" (as opposed to being merely "disputable" in the abstract).

C. *Forfeitable Property Outside of Internal Revenue Code Section 83*

Given the ambiguity of the regulation, it is pertinent to ask whether or not the *James* principle *should* apply to receipts of found (or stolen) property

147 . See Brown, *supra* note 136, at §§ 4.1 and 4.2. For items covered by the UNIDROIT Convention, art. 3(3), the statute of limitations runs at the earlier to occur of (1) 50 years from the theft (etc.) or (2) three years from the owner's discovery of the item's location.

(as well as of cash), or whether such property should be treated as non-realized income until such time as the forfeiture conditions imposed by law lapse.¹⁴⁸

An advocate of deferred realization might argue on the basis of precedent, namely, the *Kuchman* case, discussed earlier,¹⁴⁹ involving forfeitable property received as compensation. One reply is that *Kuchman* was superseded first by regulation and then by the enactment of Internal Revenue Code section 83(a). More generally, there is a good reason to confine *Kuchman* to the domain of employee compensation. In the employment area, it can be said that risks of forfeiture tied to employment render the income from the property as being “compensation” (income from human capital) until the forfeiture conditions lapse; thereafter, the employee converts from “employee” status to “investor” status with respect to the property.¹⁵⁰ This particular status-shifting idea has no application to in-kind windfall receipts.

Another reason to distinguish (returnable) found objects from restricted property subject to deferred realization under Section 83 is that, in the Section 83 situation, the value of the restricted property would be unascertainable because potential assignees would be “on notice” of the forfeiture conditions.¹⁵¹ The same could not be assumed to be the norm in the case of found (or stolen) property. Even in the case of found or stolen objects to which the bona-fide-purchaser rule would not apply,¹⁵² the possibility of forfeiture could be expected to be an element of risk that would reduce value rather than destroy it completely.¹⁵³

Thus, in-kind property income must be included, when realized, at its then fair market value. Difficulty of valuation (that does not wholly destroy value) is not sufficient to cause deferred realization. The amount currently includable should be the “normal” market value of the property, as reduced by the possibility of forfeiture (which would be factored into market value). In the case of forfeitable property received as compensation, the conditions of forfeiture may be of a nature and significance as to render the property

148 . See Comment, *supra* note 38, at 756 (posing issue of whether found object is included when found, when claimed (as of “right”), or when the statute of limitations has run against the loser.)

149 . See *supra* note 121 and accompanying text.

150 . See Mark P. Gergen, Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital, 44 Tax L. Rev. 519, 544-50 (1989) (also arguing that difficulties of valuation are overrated and should not generally be a bar to realization of income or gain).

151 . See IRC § 83(c)(2) (property is transferable only if transferee is free of forfeiture conditions).

152 . See *supra* note 146. Illegal drugs are subject to seizure and forfeiture. See Priv.Ltr.Rul. 92-07-004 (Oct. 21, 1991) (illegal drugs included in gross estate at full value, despite possibility of forfeiture).

153 . Cf. *Erickson v. Commissioner*, T.C. Memo (P-H) ¶ 89, 552, *aff'd*, 937 F.2d 1548 (10th Cir. 1991) (value of seized drugs lays basis for inference that taxpayer had unreported income with which to purchase same). Presumably, the cost incurred by a drug dealer in obtaining illegal drugs contains a possibility-of-forfeiture discount.

incapable of valuation in the employee's hands,¹⁵⁴ so that even the government might be better off under a deferred-realization rule.

What scant authority exists correctly holds that the *James* principle extends to (stolen) property as well as to cash.¹⁵⁵

The same analysis applies to the case of windfall found objects. If the finder fails to "disclaim" the item, or is not approached by the owner, within a reasonable (short) period of time, the finder should be treated as having "undisputed possession." At this point, it seems unlikely that forfeiture will occur as a practical matter.¹⁵⁶ The true owner is not likely to learn about the finding and the identity of the finder, and the finder is not (at that point) likely to seek out the owner. In short, the finder has possession and command over the found object.¹⁵⁷ Moreover, the circumstances may be such to indicate that the owner is long dead or far away. Indeed, in a great many cases it can be presumed that the (negative) value of the forfeiture condition is unascertainable, and, therefore, zero. Alternatively (as in the case of art works without provenance), the market would simply factor the defect in title into the market value.¹⁵⁸ In sum, the possibility of forfeiture would, at most, rise to the level of a valuation consideration, and would not be so overwhelming as to justify deferral.

At the level of financial theory, a compelling argument can be made that, once a taxpayer appropriates possession of a found (or stolen) object, it is *never* appropriate to treat it as having been "borrowed,"¹⁵⁹ since even an *acknowledged* "restoration" obligation has no "interest" (rent) component. The best rationale for the borrowing "exclusion" derives from financial analysis:¹⁶⁰

154 . The chances that an employee may be fired are significant. Moreover, an employee may decide that it is in her best interests to seek another position, despite triggering the forfeiture condition.

155 . See *Collins v. Commissioner*, 3 F.3d 625 (applying *James* to stolen pari-mutual tickets); *Vasta v. Commissioner*, T.C. Memo (P-H) ¶ 89, 531 (applying *James* to seized cocaine); Rev. Rul. 71-528, 1971-2 C.B. 219 (securities received as advance commissions). Cf. *Delaney v. Commissioner*, T.C. Memo (P-H) ¶ 82, 666 (taxpayer received gold coins from Swiss source; held: value of coins is includable, since taxpayer could not prove that they were purchased); *Melsa v. Commissioner*, T.C. Memo (P-H) ¶ 77, 415 (value of groceries taken from wholly-owned corporation).

156 . See *Riesman*, supra note 143.

157 . See *Corliss v. Bowers*, 281 U.S. 376 (1930) (stating, in context of revocable transfer, that income taxation is keyed to beneficial enjoyment and command, rather than technical ownership).

158 . An art object or cultural artifact subject to the UNIDROIT Convention is subject to a serious risk of forfeiture if discovered. However, the UNIDROIT Convention has not been ratified by the United States. Moreover, it (arts. 1, 2, and 3(1) & (2)) is limited to transnational instances resulting from the theft, illegal export, or illegal excavation, of certain categories of valuable objects, and would be more of a concern to individuals and institutions who have purchased such items.

159 . See *Stahl v. United States*, 441 F.2d 999 (D.C.Cir.1970) (bailment not a loan, resulting in inability of bailor to take bad debt deduction).

160 . The financial justification is contrasted with the "traditional" reliance on business accounting doctrine, which justifies the exclusion on the basis of a "liability" to repay principal

in an arms-length borrowing, the amount borrowed is equal to the present value of the obligation to pay both principal and interest.¹⁶¹ If there is no obligation to pay interest or rent, as is the case with a bailee, the borrower has an accession to wealth on account of not having to pay interest or rent,¹⁶² and the only issue is “when” (and how much) such accession to wealth occurs (and how it is to be measured). If the borrowing is for a term, the borrower’s accession to wealth can be reduced to present value. If the borrowing is “on the lender’s demand,” the borrower has gain for each taxable period that interest (or rent) is not paid.¹⁶³ Since the date, if any, when a found object might have to be returned cannot be known in advance, the found-object scenario is closer to a demand borrowing than to a term borrowing.

A close proxy for including imputed interest (or rent) in income is to include the value of the cash (or property) in income when received (unreduced by the “value” of the restoration obligation) and then to give the taxpayer a deduction (or tax credit) if and when the cash is repaid (or the property is returned). For example, assume cash or property worth \$100,000 is received with an annual discount rate or rental value of 6%. One year later, the item is returned. If the imputed interest or rent were included in gross income, the taxpayer would incur an annual tax liability of \$2,400 (assuming a 40% tax rate). Alternatively, assume that the taxpayer includes \$100,000 in year one, resulting in a \$40,000 year one tax, and deducts \$100,000 in year two, resulting in a tax savings of \$40,000. This pair of events is the equivalent of a one-year interest-free loan of \$40,000 to the government, which (at a discount rate of 6%) is worth \$2,400 to the government.¹⁶⁴

that “offsets” the incremental “asset” (the borrowed cash or property). This accounting treatment ignores the obligation, if any, to pay interest or rent. The absence of such an obligation means that the *value* of the repayment obligation is less than the borrowed amount. The excess of the borrowed amount over the value of the repayment obligation indicates that the borrower’s wealth is increased because of the borrowing-repayment series of events. The accounting treatment of borrowing ignores this increase in wealth; the financial treatment does not.

161 . This analysis assumes a “market” interest rate.

162 . See Brown, *supra* note 136, at § 11.9 (right of gratuitous bailee to use property is implicit compensation for bailee’s services).

163 . See IRC § 7872 (imputing interest on certain below-market-interest loans, and distinguishing between term loans and demand loans).

164 . This analysis raises the issue of whether or not the precisely correct result is to confer a credit equal to the increase in tax attributable to the year one exclusion, as opposed to a deduction. The credit approach has initial theoretical appeal, but it produces the wrong result where the property was held by the finder for personal use and decreased in value during the period between the find and the return. See *infra* notes 168-173 and accompanying text *infra*. In any event, IRC § 1341 allows a choice between a credit and a deduction in certain circumstances, but it is not clear if that section would apply in the windfall found object situation, because IRC § 1341(a)(1) requires that “it appeared that the taxpayer had an unrestricted right to such item.” Although this language prevents thieves and embezzlers from using IRC § 1341, it is not clear how one would apply “unrestricted right” to a finder lacking clear title (and perhaps even a right to possession), and how one construes “appeared” in the context of the niceties of personal property law. (There appears to be no case dealing with this issue.) One might prefer either a deduction approach or a credit approach in principle, but there is no justification for giving the

This result can be obtained under the *James* doctrine without statutory enactment. However, contrary (perhaps) to prevailing case law,¹⁶⁵ the deduction should be granted as a matter of right.¹⁶⁶ A doctrinal basis for granting the deduction would be that the property, even if of the personal use variety, did involve a "transaction entered into for profit" under Internal Revenue Code section 165(c)(2) insofar as the taxpayer acquired the property for nothing, rather than having purchased it.¹⁶⁷ This approach also supports the proposition that the deduction should be the lesser of the taxpayer's basis (earlier amount included) or its value at the time of restoration.¹⁶⁸

Reinforcing the conclusion that a *James*-type analysis should apply is the observation that, like *James*, bailment-type obligations are imposed by state law, rather than by the consent of the parties. As a practical matter it is quite unlikely that finders would report found objects as gross income when the possibility of forfeiture lapses, since: (1) finders are unlikely to know when this occurs (unless there is an actual settlement or proceeding to determine title); (2) taxpayers generally do not think of having gross income when a forfeiture condition (such as the running of a state law statute of limitations) lapses; and (3) there is no reporting obligation on the part of any third party, or any public event, that would put the IRS on notice of the lapse of forfeiture conditions.

taxpayer a choice. Also, IRC § 1341 has generated substantial litigation costs that probably outweigh any dubious gain in "equity." Therefore, IRC § 1341 should be repealed.

165 . Although the repayment deduction (or, where available, the IRC § 1341 credit) is often allowed, see Rev. Rul. 76-374, 1976-2 C.B. 19 (repayment by embezzler is deductible as a "loss" under IRC § 165), it is not allowed as a matter of right, and, even where allowed, it might be an "itemized deduction" or even a "miscellaneous itemized deduction" under § 67. Some cases take the position that the repayment must either satisfy the requirements of IRC § 1341 or be independently deductible as an expense under IRC § 162 or § 212. See Pahl v. Commissioner, 67 T.C. 286 (1976). However, the better view is that § 1341 can apply only if a deduction would be allowed by some other Code section. See IRC § 1341(a)(2); *United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969); *Wood v. United States*, 863 F.2d 417 (5th Cir.1989). Conversely, failure to satisfy the requirements of IRC § 1341(a) should not bar a deduction under other Code provisions. (In the case of property, the deduction should be allowed under IRC § 165(c)(2).) Nevertheless, the deduction has been disallowed in various situations. See *Murphree v. United States*, 867 F.2d 883 (5th Cir.1989) (repayment of embezzled amount deductible as loss only if "involuntary"); *Wood*, supra (drug dealer's loss deduction resulting from forfeiture to government disallowed on public policy grounds). The public policy doctrine would not apply to the restoration of a found object, and neither should voluntariness be a bar to deductibility so long as the original owner has a colorable claim to title. See *Barrett v. Commissioner*, 96 T.C. 713 (1991) (nonacq.). See also *Pike v. Commissioner*, 44 T.C. 787 (1965) (acq.) (voluntariness only a bar to using IRC § 1341, but not a bar to deductibility).

166 . Accord, Harold Dubroff, *The Claim of Right Doctrine*, 40 *Tax L. Rev.* 729, 748-49 (1985). My research has not uncovered any case involving personal-use property that has considered this issue.

167 . Cf. Rev. Rul. 82-74, 1982-1 C.B. 110 (restitution of insurance proceeds obtained as a result of committing arson to one's own property; deduction allowed, but only to the extent of the gain earlier recognized by reason of having received the insurance proceeds).

168 . That portion of the property represented by the decline in value attributable to personal use was not acquired for profit.

As in *James*, there is a rather obvious doctrinal “hook” for distinguishing current-realization from deferred-realization cases involving found objects. In *James*, the hook was the taxpayer-centered test of “consensual obligation to repay.” In the found-object situation, the doctrinal equivalent would be “meaningful efforts to find the true owner.” A person who is seriously trying to return the object to the true owner is not exercising “dominion and control” over the object, and therefore is not currently “realizing” the income, at least until such efforts cease or become moot. This approach fits within the phrase “reduced to undisputed possession” in Regulations section 1.61-14, which would be viewed from the finder’s position, not that of the owner.

Finally, applying *James* would also serve the aims of the underlying property law, which is to provide incentives for finders to return objects to their true owners.¹⁶⁹

Interesting and perplexing issues would seem to be posed on account of the likelihood that the value of the object at the date returned will be greater (or less) than the value when acquired. What is the amount of the finder’s deduction, and does the return of the object constitute a realization event to the finder and/or the original owner? If these issues cannot be resolved, then the case for applying *James* to windfall property receipts would be weakened. I believe that these issues can be coherently resolved on the basis of the principle that, if the item is eventually returned, any appreciation or depreciation during the finder’s period of possession should be allocated to the original owner, who ultimately reaps the benefit of any appreciation or the burden of any depreciation (that does not represent personal consumption of the finder).¹⁷⁰

Thus, the finder, according to *James*, would include the property in gross income, and acquire a basis in the property in an amount equal to its value upon the acquisition of possession. Upon returning the item, the finder should not be viewed as realizing gain or loss on the difference between such basis and the value at the date returned, because the return of the property to the original owner does not “pay for” any benefit received either from the property or the original owner,¹⁷¹ other than the initial accession (which has already been taxed to the finder). The return of the item to the original owner would entail a deductible loss to the finder, since the finder became the “tax owner” by reason of the earlier inclusion in gross income.¹⁷² If the item had not been held for personal use, the deduction would be the finder’s adjusted basis. If the property

169 . See Kades, *supra* note 42, at 1522; Riesman, *supra* note 143, at 1124.

170 . This approach is consistent with the authorities cited in *infra* note 176, which would apply to the owner’s side of the transaction.

171 . Compare *Diedrich v. Commissioner*, 457 U.S. 191 (1982) (discharge of gift tax liability); *United States v. Davis*, 370 U.S. 65 (1962), *reh’g denied*, 371 U.S. 854 (settlement of support obligation running to ex-wife); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir.1943) (payment of compensation); *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir.1940) (loan repayment).

172 . The finder would acquire basis only by actually reporting the item as gross income. See *infra* note 185.

had been held by the finder for personal use, the loss deduction should be the lesser of the finder's adjusted basis or the value of the item at the time the item is returned.¹⁷³

The original owner's tax treatment should hinge on whether such owner took a deduction upon the loss of the item. If such a deduction had been taken, the recovery of the item would trigger the tax benefit rule: an amount equal to the original deduction would be included in gross income to the extent that it reduced taxable income.¹⁷⁴ The original owner's original basis would then be restored.¹⁷⁵ Alternatively, if no deduction had earlier been taken, the original owner's basis would still be available. Because the original owner retained an interest in the property (the right of recovery), the re-acquisition should not be treated as a realization event.¹⁷⁶ In this fashion, the original owner's tax treatment will be the same as if the item had never been lost.

The foregoing analysis answers any possible objection to the effect that the *James* approach should be limited to receipts of cash (given that U.S. cash can have no value apart from its face amount).

In conclusion, the "reduced to undisputed possession" language in Section 1.61-14 should be strictly construed against deferred realization. The key is the use of the word "undisputed," as opposed to "undisputable." It is reasonable to confine deferred realization to situations where an actual dispute is joined at (or shortly after) the finder's appropriation of the item, as opposed to the indeterminate realm of situations where a dispute (sooner or later) is conceivable. Possession should be viewed as being disputed only if the finder: (1) turns the item over to a third party or the state,¹⁷⁷ or (2) segregates the item

173 . Thus, if the item is worth \$100x when found, is held by the finder for personal use, and is worth \$85x when returned, the finder would deduct \$85x as an ordinary loss upon return, but the loss of \$15x would not be allowed on the ground that it represented personal consumption obtained by the finder. Cf. Regs. § 1.165-7(b)(1). If the item is held for investment, there would be an ordinary loss of \$100x. If the item appreciated to \$127 when returned, there would be also be an ordinary loss deduction of \$100x.

174 . See IRC § 111.

175 . The basis would presumably be fully restored even if all or a part of the original deduction had been disallowed, for example, by IRC § 165(h). See *Dobson v. Commissioner*, 320 U.S. 489 (1943), reh'g denied, 321 U.S. 231 (1944) (basis in property is not lost where loss deduction failed to produce a tax benefit).

176 . Cases applying the tax benefit rule to recoveries of property that were deducted under IRC § 170 support this approach. In that context, the taxpayer includes the lesser of the property's fair market value when returned or the amount, if any, of the prior deduction, with no recognition of gain (or loss). See *Rosen v. Commissioner*, 611 F.2d 942 (1st Cir.1980); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct.Cl.1967); *885 Investment Corp. v. Commissioner*, 95 T.C. 156 (1990).

177 . Cf. *United States v. Merrill*, 211 F.2d 297 (9th Cir.1954) (after discovering mistake, taxpayer agreed to repay funds and thereby avoided inclusion in gross income). But cf. *Quinn v. Commissioner*, 524 F.2d 617 (7th Cir. 1975) (rejecting *Merrill*). *Merrill* is limited to "mistake" cases, and does not apply to embezzlement and other misappropriation cases. See, e.g., *Buff v. Commissioner*, 496 F.2d 847 (2d Cir.1974).

(as in a lost-and-found department).¹⁷⁸ Short-term or half-hearted action, such as posting notices on electric poles or advertising in the newspaper, should not be sufficient to negate or defer “undisputed possession,”¹⁷⁹ unless such action results in the prompt return of the item to the original owner.

At a more abstract level, the foregoing analysis suggests that “lack of dominion and control,” as when an object is disclaimed or returned, can directly indicate non-income, or it can indicate lack of current “realization,” i.e., where the circumstances denoting lack of dominion and control may be only “temporary.”

Since the realization-of-income principle potentially applies to all (in-kind) gross income items,¹⁸⁰ and since the realization-of-income principle is (inartistically) acknowledged in the “reduced to undisputed possession” language of Section 1.61-14, there is every reason to view Section 1.61-14 as illustrative only. Indeed, Section 1.61-14 by its terms only purports to be illustrative. Therefore, no particular weight should be placed upon the term “treasure trove.”

D. *Home-Run Baseballs*

To apply the foregoing analysis to record-setting baseballs chased down by fans results in the conclusion that the baseballs would be current gross income, as it appears that no person or entity (other than the finder) has a legal claim to the balls that would preclude current realization under the Section 1.61-14 or general tax principles. The item should be deemed realized unless it is disclaimed within a reasonably short period of time. The concept of disclaimer can be applied flexibly in this context to allow the ball to be “returned” to the home team, the league, an organization affiliated with the league (such as the Baseball Hall of Fame), and (more debatably) the player hitting the ball.¹⁸¹

An argument for “nonrealization” unique to the home-run-baseball situation might be that the value of any record-setting object cannot be

178 . Cf. *Miele v. Commissioner*, 72 T.C. 284 (1979) (segregation of prepaid fees into restricted account).

179 . Generally, the case law takes a very hard line against attempts by embezzlers and thieves to avoid *James*-type income (by, for example, agreements to return the item or actually returning the item during the same taxable year). E.g., *Buff v. United States*, 496 F.2d 847 (2nd Cir.1974) (confession of judgment); *Estate of Sympson v. Commissioner*, 1994 RIA T.C. Memo ¶ 94,002 (renouncing claim to item), aff’d 95-1 T.C. ¶ 50,276 (unpublished opinion, 10th Cir.1995); *Taylor v. Commissioner*, 1997 RIA T.C. Memo ¶ 97, 513. Compare *Gilbert v. Commissioner*, 552 F.2d 478 (2d Cir.1977) (contemporaneous intent to repay avoids *James*); *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954) (good faith mistake); *Gaddy v. Commissioner*, 38 T.C. 943 (1962) (immediate agreement to restore excessive rent).

180 . See Regs. § 1.61(a)(1); *Commissioner v. Glenshaw Glass*, supra note 6.

181 . The IRS took precisely this position in IR - News Release 98-56, 16 Stand. Fed. Tax Rep. (CCH) ¶ 46,532. See Comment, *The Tax Implications of Catching Mark McGwire’s 62nd Home Run Ball*, 52 Tax Law. 871 (1999) (arguing that the taxpayer, by directing the ball to McGwire, rather than to Major League Baseball, exercised dominion and control rather than making a true disclaimer).

determined at the moment it is acquired, because such value can be diminished by subsequent record-setting items. But, insofar as the object *could* lose value due to future events, the current market value would be significantly discounted. From such discounted amount the value might well increase, since the possibility of subsequent record-setting items may disappear (due to the end of a season or of a slugger's career). The contingencies that affect future value are closer in kind to those that produce unrealized appreciation and depreciation than those that can be called conditions of forfeiture: a record-setting item does not lose all significant value just because the record might be (and eventually is) surpassed. Thus, the argument that value uncertainty precludes realization is not persuasive.

Another possible argument is that obtaining a record-setting baseball is closer to a commercial venture, or to a commercial bargain purchase, than to a found object, because the taxpayer "invested" in a ticket to attend the game. However, the price of the ticket is exhausted by the entertainment value of the game. The cost of the ticket is a personal consumption expense. There is no separate basis in the remote opportunity to obtain the record-setting baseball.¹⁸²

E. Should the Regulations Be Changed as to Windfall Found Objects?

In light of the foregoing, there is no basis for concluding that found objects, including record-setting baseballs, are not gross income when obtained (assuming the item is "accepted"). There is also no basis for the notion that Section 1.61-14, which only makes concessions to taxpayers, is invalid as to treasure trove or to any other category of found object.

At this point, Zelenak and McMahon appear to argue that, since the IRS does not enforce the inclusion of found objects in gross income, the Treasury should withdraw the sentence in Section 1.61-14 referring to treasure trove. As a preliminary matter, the evidence cited by Zelenak and McMahon (absence of cases and private letter rulings) does not establish that the IRS ignores the principle that in-kind windfall receipts are gross income. The absence of cases and rulings involving found objects suggests that taxpayers and their advisors have no doubt that found property is gross income when received, except perhaps pending an actual and bona fide dispute over ownership. (As previously mentioned, the fact that the IRS does not advance the treasure trove regulation in the case of commercial ventures involving fishing, big game, and treasure hunting is justified and natural: these situations involve produced inventory, not found objects.)

The other possibility is that taxpayers systematically cheat on this issue, notwithstanding potential liability for fault and no-fault penalties for not

182 . A similar situation was presented in *Cesarini*, where the taxpayer purchased a piano that happened to contain concealed cash. The entire purchase price was allocated to the piano. The cash was held to be wholly taxable.

reporting significant items of gross income.¹⁸³ Such cheating would hardly be the fault of the IRS, however, which has no independent access to knowledge of in-kind windfalls except from what might appear in newspapers. But it is hard to imagine revenue agents scouring newspapers just to learn about in-kind windfalls of significant value, which are rare in any event.

That the IRS cannot reasonably be expected to enforce a rule that found objects are generally gross income might be a cause for concern to one who thinks that all law should be enforced to the letter. The principal problem with a law that is rarely enforced is that of arbitrary exercise of discretion by government officials, and possibly that of undue intrusions into privacy. These concerns would not seem to be especially present in the case of in-kind windfall gains, since the IRS would simply maintain its posture of ignorance unless tipped off by publicity or possibly an informer. Since found objects of significant value are fairly rare, the IRS would not find it worthwhile to launch invasive “fishing expeditions.” There is no reason to think that the IRS would abuse “prosecutorial discretion” in this area, nor is there anything inherently “private” or “personal” about in-kind windfall gains.

Another possible concern with a rule that is mostly unenforceable is that it will breed disrespect for the law. However, in the case of in-kind windfall gains, unenforceability does not imply that the rule itself is misconceived.¹⁸⁴ A parallel situation is posed by state laws imposing fines on littering. In both cases the rule embodied in the law establishes, and to some degree publicizes, a norm governing conduct, but in both cases widespread enforcement is impossible. This is especially the case with a tax rule that cannot be enforced by imposing a reporting obligation on the transferor, given that tax is basically a self-enforcement regime. Windfall found objects are (generally) small fish indeed relative to market transactions. The aggregate amount of found currency and other objects is probably very small compared to the aggregate amount of unreported wages, for example. The IRS is not required to devote its very scarce resources to trivia.

Despite an assumed low level of enforcement effort, the regulations bearing on windfall receipts of cash or property serve a purpose in the very rare case where large amounts of cash or high-value assets are found. These events are subject to publicity, so that enforcement is a possibility. Also, as mentioned earlier, an inclusionary tax rule provides taxpayers with an incentive to take meaningful steps to return the property to the true owner. If non-cash liquid items are not treated as gross income when received, the government faces the possibility that the taxpayer will claim: (1) a basis equal to fair market value upon receipt notwithstanding the fact that the income was not reported, or (2) capital gains treatment equal to the full amount realized on sale. Although the

183 . See IRC § 6662.

184 . For example, the fact that criminal laws relating to sodomy and drug use are largely unenforceable calls attention to the fact that zealous enforcement would cause governmental intrusions into privacy.

taxpayer will probably be stuck with a zero basis,¹⁸⁵ he or she may well obtain capital gains treatment,¹⁸⁶ although that seems wrong as a matter of principle.¹⁸⁷

It is worth repeating the fact that the inclusionary rule is not found in the treasure trove regulation, Regulations section 1.61-14, but rather in Section

185 . Basis should be zero for in-kind income that is not in fact included in gross income, since the function of basis is to prevent double taxation of previously-taxed dollars (or tax-exempt dollars). However, at one time it appeared that failure to report an in-kind income item did not preclude acquiring a basis. See *Bennet v. Helvering*, 137 F.2d 537 (2d Cir.1943) (taxpayer not estopped, by erroneous exclusion, from claiming basis equal to value when property acquired). Cf. *Helvering v. Salvage*, 297 U.S. 106 (1936) (assumed that government's only remedy in this type of case was doctrine of estoppel, which was not available on the facts presented). Fortunately, the weight of authority now appears to favor a zero-basis rule, without regard to estoppel. See *Charley v. Commissioner*, 91 F.3d 72 (9th Cir.1996) (conversion of employer-paid frequent-flyer credits to cash; the credits were not included as earned); *Continental Oil Co. v. Jones*, 177 F.2d 508 (10th Cir.1949) (no basis from erroneous exclusion, even though elements of estoppel not present); *Timken v. Commissioner*, 141 F.2d 625 (6th Cir.1944) (no basis for unreported in-kind dividend). Cf. *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943) (no basis for property purchased with excluded non-shareholder contributions to capital); *Helvering v. Gowran*, 302 U.S. 238 (1937) (zero basis for non-taxed stock dividend); *Robbins v. United States*, 21 F.Supp. 403 (Ct.Cl.1937) (taxpayer, who erroneously excluded prior item, estopped from claiming refund on theory that basis was value upon receipt). An erroneous exclusion might also give the IRS a remedy under IRC §§ 1311(a) and 1312(7) (consisting of inclusion in the earlier year, despite the statute of limitations, plus interest), but only if: (1) the taxpayer maintained "inconsistent positions," see IRC § 1311(b)(1)(B), (2) there is a current determination that basis equals fair market value on receipt, and (3) there was a prior (erroneous) "determination" (Tax Court decision or closing agreement) in the taxpayer's favor, see IRC § 1313(a). IRC §§ 1311-1314 should not be viewed as the exclusive remedy for the IRS in erroneous-exclusion situations, since it is based on assumptions about underlying "tax common law" that are no longer valid.

186 . It is not clear whether a zero basis (or lack of investment) precludes capital asset treatment. Cases allowing capital asset characterization include *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960) (surrender of lease), and *Ofria v. Commissioner*, 77 T.C. 524 (1981) (sale of self-developed know-how). In these cases, the taxpayer can be said to have made an investment that did not happen to be capitalized. Other cases have denied capital asset treatment: *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960) (no separate basis in "temporal slice" of an asset owned by the taxpayer); *Hort v. Commissioner*, 313 U.S. 28 (1941) (same); *Norton v. United States*, 551 F.2d 821 (Ct.Cl.1977), cert. denied, 434 U.S. 831 (franchise right in which taxpayer had no investment); *Vestal v. United States*, 498 F.2d 487 (8th Cir.1974) (contingent right not previously included in income); *Foote v. Commissioner*, 81 T.C. 930 (1983) (surrender of tenure).

187 . The weight of commentary is that significant investment by a taxpayer should be a prerequisite for capital asset treatment. See Jay A. Soled, *The Sale of Donors' Eggs: A Case Study of Why Congress Must Modify the Capital Asset Definition*, 32 U.C. Davis L. Rev. 919, 960-62(1999); William Popkin, *The Deep Structure of Capital Gains*, 33 Case W. Res. L. Rev. 153, 197-198 (1983); Calvin Johnson, *Seventeen Culls from Capital Gains*, 48 Tax Notes 1285, 1288 (Sept. 3, 1990). Assuming a zero basis that results either from not reporting the in-kind receipt as income or from a deferred-realization-of-gross-income rule, the gain (at least to the extent of market value when received) does not reflect unrealized appreciation and therefore should not obtain capital gains treatment. Cf., *United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969) (refund of partially excluded income is deductible only to extent of earlier inclusion); *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975) (free samples donated to charity were included in gross income at their acquisition-date value).

1.61-1(a), which states that in-kind receipts are income when realized. The Treasury is hardly going to withdraw that regulation. Nor should it. The Treasury has to maintain the position that a rule is a rule, and that taxpayers cheat at their own risk.¹⁸⁸

F. *Let Congress Do It*

In the end, the issue of the taxation of record-setting home run balls is the perfect setting for Congressional intervention. Congress could fulfill its role of “waving the flag” over symbolic issues (the American Pastime) and, in the process, finessing valuation difficulties, in an extremely narrow area without doing any serious damage to the tax system.¹⁸⁹ Indeed, the legislation might perform a service by expressly denying both basis and capital gain treatment to windfall property not included in gross income upon receipt. Perhaps the legislation could give the taxpayer an election to include the item at market value, so that subsequent appreciation would be capital gain.

In all seriousness, a principal lesson to be derived from the history of realization doctrine is that virtually every contested realization issue has been settled by ad hoc legislation or government concession.¹⁹⁰ Courts are best equipped to elaborate rules based on clear and coherent categories, but “difficulty of valuation” and “nonliquidity” are matters of degree, and courts are ill-equipped to sort out cases of this type. In contrast, in-kind property subject to contingencies that render such property inalienable, incapable of current enjoyment, or without any readily ascertainable fair market value can be said to fall into a separate and distinct category of nonrealized income. Home-run baseballs are not contingent property, but Congress, not the courts, can legitimately create a separate deferral rule for home-run balls apart from the current-inclusion rule for (noncontingent) in-kind windfalls generally.

VI. CONCLUSION

So what’s new? It may be somewhat of a surprise to find that the so-called treasure-trove regulation, in the course of citing a certain kind of windfall found object as being an example of “residual” gross income, actually hints at the possibility of deferred realization. Moreover, deferred realization is not wholly implausible, since the finder usually does not acquire clear title, so that there is at least a theoretical possibility of having to return the item to a superior claimant. Moreover, there is a body of “realization of gross income” doctrine that potentially opens the door to income deferral.

188 . Nothing written in the pages of this journal will convince a person who thinks that winning a lottery (or obtaining a windfall) entails avoiding tax as well.

189 . Accord, Comment, *supra* note 181, at 879.

190 . See IRC §§ 83 (restricted property and compensatory stock options), 109 (lessee improvements), 305 (stock dividends); Regs. § 1.61-14 (treasure trove whose title is disputed).

However, upon further inquiry it is concluded that deferred realization is limited to rare and unusual circumstances. Although exactly what combination of circumstances (including perhaps lack of possession, or "dominion and control") might justify deferral may be hard to state with exactitude, it is clear enough that windfall found objects should not be held to be within any such deferred-realization rule. A better approach is to treat the item as gross income when acquired, taking into account any discount due to uncertainty over title, and then to allow, as a matter of right, a deduction in the appropriate amount if and when the item is returned.¹⁹¹ The return would not be a realization event to the original owner, but any prior loss deduction would have to be reversed according to the tax benefit rule.

There are also lessons here about the appropriate roles of Congress, the Treasury, the courts, and the IRS on the income tax stage.

191 . See *supra* text accompanying notes 171-73.