TAX LAW ESSAY WINNERS

Each year, the FBA Tax Section sponsors the Donald C. Alexander Tax Law Writing Competition, named in honor of former IRS Commissioner Don Alexander. Mr. Alexander, who passed away in 2009, was an advocate for writing and rhetorical skill in tax law. To carry forward his advocacy, the Tax Section invites JD and LLM students to submit original papers concerning federal taxation. The first and second place winners each earn a cash prizes and a trips to the annual FBA Tax Law Conference in Washington, D.C.

Ethan Beswick, a JD student at Notre Dame Law School, is the recipient of the First Place Award for his paper, titled, "Flying High on Tax Savings: The State of Aircraft Acquisition Tax Law in the Wake of the 2017 Tax Cuts and Jobs Act." Throughout his time at NDLS, he has grown to enjoy the intricacies of tax law, which has inspired him to pursue written work in this field. Upon graduation, Ethan will be joining Varnum LLP as an associate in Grand Rapids, Mich.

Robert Daily, a JD student at University of Georgia School of Law, received the Second Place Award for his paper, titled "A Normative Guide to the Taxation of Education ISAs." During law school, Robert worked at the Department of Treasury in the Office of Tax Policy and in the chambers of the Honorable Judge Amy Totenberg of the Northern District of Georgia. He will be working at Ivins, Phillips & Barker after graduation.

Flying High on Tax Savings: The State of Aircraft Acquisition Tax Law in the Wake of the 2017 Tax Cuts and Jobs Act

by Ethan Beswick

In the wake of the 2017 Tax Cuts and Jobs Act, the atmosphere surrounding the taxation of business jet acquisitions has been significantly altered, the most important of which is a modification to Internal Revenue Code § 168(k), which now allows for a full 100 percent taxable deduction of the purchase price of newly acquired aircraft.[1] This alteration has shifted aircraft ownership from being an unattainable aspiration to an actuality in the lives of many business owners.[2] This excerpted paper seeks to analyze these recent tax changes brought about through the TCJA, while applying these changes to the world of aircraft acquisitions.

Relevant Provisions

In the wake of the TCJA, those business professionals who found themselves seeking to make a first-time purchase or upgrade to their airborne transportation turned to tax planning professionals for guidance on how to navigate the numerous restructurings to the tax laws that govern purchases of this nature. Specifically, the TCJA provided numerous tax incentives for businesses to purchase new or used aircraft or upgrade a pre-existing aircraft. These incentives, their implications, and additional Internal Revenue Code (IRC) sections relevant to an aircraft acquisition are outlined below.

Bonus Depreciation: I.R.C. § 168(k)

First, the TCJA allows for an immediate depreciation deduction of 100 percent of the cost of certain qualified property classified as a business expense—including the purchase of an aircraft—for a limited amount of time.[3] This deduction, referred to as "bonus depreciation" goes above and beyond typical depreciation allowances offered by the IRC.[4] Notably, this bonus depreciation deduction for business expenses is limited in time and scope. Specifically, the newly enacted 100 percent bonus depreciation deduction is allowed to be taken by taxpayers for qualified business property that is placed into service after Sept. 27, 2017, and before Jan. 1, 2023. Subsequently, deductions are reduced to 80 percent of the cost of the qualified property in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026.[5] Absent future legislation, the depreciation schedule then reverts back to the original depreciation schedule under §§ 168(a) through (f).[6]

Importantly, there exist certain qualifications an aircraft must meet in order for the aforementioned bonus depreciation deduction to be taken. Under § 168(k)(2)[7] the aircraft must fit the category of "qualified property." Fortunately, business aircraft generally meet this requirement.[8] Additionally, the aircraft must have been "placed in service" within the allotted timeframe.[9] In order to take advantage of the 100 percent bonus deduction currently available, the aircraft in question must have been placed in service after Sept. 27, 2017, and before Jan. 1, 2023.[10] However, the IRC provides for another year to place the property in service where the property meets the requirements of "longer production period property."[11] Therefore, where property is properly classified as "longer production period property," the 100 percent bonus depreciation allotment extends through 2023.

For regular "qualified property,"[12] the deadline is then adjusted to Dec. 31 in subsequent years, beginning in 2022, to account for the reduction in the allowable bonus depreciation percentage.[13] Notably, the IRS has issued proposed regulations in which the placed-in-service requirement takes into account situations where a written binding contract exists between the buyer and seller of the aircraft.[14] Therefore, where a written binding contract exists prior to Sept. 27, 2017, and the property is placed in service after this date, the property is only allowed a 50 percent bonus depreciation allowance as governed by the pre-TCJA tax law.[15] The IRS has retained its former definition of a written binding contract, which notes a "contract is binding only if it is enforceable under state law against the taxpayer or a predecessor, and does not limit damages to a specified amount."[16] The applicable Treasury Regulation then continues on to state "a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor…. An option to either acquire or sell property is not a binding contract."[17] Furthermore, the proposed regulations make clear that a letter of intent is not considered to be a binding contract for purposes of the placed in service date of the qualified property.[18]

Additionally, the TCJA has made amendments to § 168(k) regarding the applicability of bonus depreciation to new versus used property. Whereas the former bonus depreciation tax laws only allowed for new aircraft to receive bonus depreciation treatment,[19] under the new § 168(k), used aircraft are granted the same treatment as new aircraft, and as such bonus depreciation can be taken advantage of.[20] There are however limitations to the fact that used property can receive full bonus depreciation; namely, the used aircraft can not be acquired from a related party,[21] and the purchaser can not use the aircraft prior to the purchase of the aircraft.[22] However, the National Business Aviation Association (NBAA) has worked hard to protect businesses that have formerly leased an aircraft and have since decided to purchase the aircraft. Clearly, this purchase scheme would violate the latter of the above noted limitations on used aircraft; however, the IRS' proposed regulations pertaining to § 168(k)[23] make it clear that where an entity formerly leased an aircraft and subsequently exercises its option to buy the aircraft, the entity may still receive a full bonus depreciation deduction. Specifically, "the proposed regulations provide that property is treated as used by the taxpayer (or its predecessor) prior to acquisition only if the taxpayer (or its predecessor) had a depreciable interest in the property at any time before the acquisition."[24] Therefore, under this language, a lessee of an aircraft who then acquires the aircraft at the end of its leasing term will not be treated by the IRS as having used the aircraft prior to its acquisition for purposes of § 168(k)(2)(E)(ii)(I). Finally, should the taxpayer choose to do so, they may elect not to claim bonus depreciation for any class of property that is placed into service during the taxable year.[25] This annual election allows the taxpayer to opt out of bonus depreciation while moving forward with the standard depreciation structure.[26]

So, what does this really mean for businesses seeking to purchase an aircraft while also looking to take hold of tax savings through clever tax planning? Depending on the size, type, and ultimately, cost of the aircraft being sought, significant deductions can lead to significant tax benefits. For example, Marcus Adolfsson, the CEO of online tech publisher Mobile Nations, took advantage of the recent tax changes to purchase a used business jet in December 2017 for approximately $2 million.[27] Because he was able to place the jet in service after Sept. 27, 2017, and because the jet met the requirements to be classified as qualified property, he received a 100 percent bonus depreciation deduction, providing his company with substantial tax savings. Others, like Don Catalano, president of a realty company in New York, are planning to upgrade previous business aircraft platforms to bigger, faster, more capable aircraft.[28] Catalano noted his company would never have pursued the purchase of a new aircraft without the changes to the applicable tax law provided by the TCJA, saying, "Would we have wanted it? Yes. Would we have done it? No."[29] These are two brief examples of companies that have taken advantage of opportunities for tax savings while stepping into (or trading up in) the world of corporate aviation.

Like Kind Exchanges: I.R.C. § 1031

While § 168(k) has allowed for businesses to take significant bonus depreciation deductions—up to the cost of the new or used aircraft itself—the commonly used former method of aircraft acquisition has been repealed by the TCJA. Prior to the TCJA, § 1031 set forth the law of like kind exchanges as applied to aircraft acquisitions; however, this provision can no longer be used as a tool for tax savings when acquiring an aircraft. Formerly, § 1031 allowed a business seeking to upgrade their business aircraft to do so without triggering recognizable gain through trading in their former aircraft to offset the cost of the new aircraft, which allowed for the deferral of taxes resulting from ordinary or capital gains.[30] This was possible because business aircraft generally fell under the category of "like kind" property.[31] As such, instead of selling Aircraft A to fund the purchase of Aircraft B, an entity could simply exchange Aircraft A in part for Aircraft B. This would then allow the entity to avoid the taxable gain from the sale of Aircraft A.[32] However, after 2017, aircraft transactions no longer fall under the umbrella of like kind property, as the amended § 1031 limits like kind exchanges to those involving real property.[33] Therefore, § 1031 is no longer of use to businesses seeking to limit or defer taxable gain throughout the course of an aircraft acquisition.

Business Entertainment Allowance: I.R.C. § 274

While the TCJA has been widely recognized for its generous bonus depreciation rules under § 168(k), and the repeal of § 1031 for all exchanges other than those dealing in real property, the TCJA made additional, lesser known changes, that affect aircraft acquisitions. First, the rules governing the expensing of business entertainment costs have been amended through the new legislation. Specifically, business entertainment expenditures that were formerly treated as deductible under § 274(a) if they were "directly related to, or in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business …"[34] are no longer offered deductions.[35] Alongside this change, the TCJA eliminated the ability of businesses to deduct the costs associated with business aircraft used for entertainment[36] directly related to business activities.[37] Therefore, businesses must now ask the question, "What is the primary purpose of this trip that requires us to use our company aircraft?" Should the answer be strictly business related, the costs of air travel via the company's aircraft will remain deductible under pre-TCJA tax rules.[38] However, where the answer is tied to purposes of entertainment or personal travel, the trip's expenses will no longer be deductible.[39] Additionally, the regulations provide for rules governing the air travel of employees and other individuals who are not "specified individuals."[40] In sum, the TCJA eliminated the ability of a business to deduct expenditures associated with air travel via company aircraft, unless the primary purpose of the incurred expenses are business related.

Limitation on Depreciation Where Certain Property is Used for Personal Purposes: I.R.C. § 280F

Finally, while the TCJA did not amend the relevant portions of § 280F, taxpayers involved in aircraft acquisitions must be aware that such rules still exist and remain relevant. Specifically, interested buyers of business aircraft must understand that depreciation recapture rules under this provision may create complications should the business wish to take the 100 percent bonus depreciation deduction currently allowed by the bonus depreciation rules previously discussed under § 168(k). Under the depreciation recaptures rules[41] there exists a limitation where the business use of listed property is not greater than 50 percent. Specifically, "if any listed property[42] is not predominantly used in a qualified business use for any taxable year, the deduction allowed under § 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under § 168(g) (relating to alternative depreciation system)."[43] The IRC continues on to explain that where the business use of such property does not exceed 50 percent for the taxable year in which the property is placed in service and such property is not predominantly used for a qualified business purpose in any subsequent taxable year, then any excess depreciation will be included in the taxpayer's gross income.[44]

Therefore, while § 280F does not directly apply to the acquisition of a new or used aircraft, entities seeking to acquire a business aircraft—while taking advantage of the new bonus depreciation rules—must be cognizant of the fact that the aircraft's predominant use must be a "qualified business use."[45] Should the entity not use the aircraft in a manner consistent with the depreciation recapture rules, the original decision to take bonus depreciation will be negated, as the value of the previously taken depreciation deductions will then partially be incorporated into the entity's gross income, requiring the payment of taxes on such sums.

Conclusion

In closing, there remains no doubt the passage of the TCJA of 2017 significantly overhauled the world of aircraft acquisitions. While the implementation of 100 percent bonus depreciation through the amendments to § 168(k) provided the greatest change, the repeal of § 1031 dealing with like kind exchanges in the aircraft context, and the alterations to § 274 granting business entertainment deductions have proven to be anything but trivial. Overall, the TCJA has seemingly resulted in a taxpayer favorable refurbishment of the IRC when it comes to aircraft acquisitions and the tax implications of such transactions. ⊙

Ethan Beswick, J.D., gradutated from Notre Dame Law School in 2019 and received his Bachelor of Arts in political science and economics from Hope College, Holland, Mich., in 2016. *He is grateful to professor Lloyd Mayer for his guidance throughout the research, drafting, and editing process, along with his business tax knowledge that spurred Beswick's interest in completing a tax project of this nature. Beswick is also appreciative of professor Matthew Barrett's willingness to assist in the editing process. He thanks his parents for their constant encouragement as he pursued his dreams in flying, academics, and life. All errors are the author's own.*

Endnotes

1 I.R.C. §§ 168(k)(1)(C) & 168(k)(6)(A)(i) (2018).

2 Rachel Feintzeig, *Tax Change Helps Executives Afford Pricier Planes: Jet Sales Soar as Business Owners Take Advantage of New Tax Write-Off*, Wall Street J. (Sept. 12, 2018), https://www.wsj.com/articles/tax-change-helps-executives-afford-pricier-planes-1536763868.

3 I.R.C. § 168(k)(6)(A)(i) (2018).

4 *See* I.R.C. § 167 and 179 (2018) (setting forth the typical depreciation rules).

5 I.R.C. § 168(k)(6)(A)(i).

6 The former bonus depreciation schedule afforded qualified property a 50 percent bonus depreciation deduction.

7 I.R.C. § 168(k)(2)(b) (2018).

8 *See* I.R.C. § 168(k)(2)(C) (2018) (This provision provides that aircraft generally fall under the definition of "qualified property" as set forth in I.R.C. § 168(k)(2)(A)).

9 *See* I.R.C. § 168(k)(6) (2018).

10 I.R.C. § 168(k)(6)(A)(i) (2018).

11 *See* I.R.C. § 168(k)(2)(B) (2018) (providing the definition of "longer production period property" and I.R.C. § 169(k)(6)(B) for the depreciation schedule for property of this category).

12 As defined by I.R.C. § 168(k)(2)(A) (2018).

13 *Id.* (The placed-in-service deadlines move to Dec. 31, 2022, for the 80 percent bonus depreciation deduction, Dec. 31, 2023, for the 60 percent deduction, Dec. 31, 2024, for the 40 percent reduction, and Dec. 31, 2025, for the 20 percent deduction.).

14 *Tax News Update: IRS and Treasury Issue Section 168(k) Proposed Regulations on 100% Bonus Depreciation,* Ernst & Young (Aug. 10, 2018), https://taxnews.ey.com/news/2018-1619-irs-and-treasury-issue-section-168k-proposed-regulations-on-100-percent-bonus-depreciation.

15 I.R.C. § 168(k)(8)(A) (2018).

16 Treas. Reg. § 168(k)-1(b)(4)(ii).

17 *Id.*

18 *Tax News Update*, *supra* note 14.

19 I.R.C. § 168(k)(2)(A)(ii) (2016) (stating "qualified property" can only be properly so called when "the original use of [the property] commences with the taxpayer…").

20 I.R.C. § 168(k)(2)(A)(ii) (2018) (stating "qualified property" is classified as such when "the original use of [the property] begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E)).

21 *See* I.R.C. § 168(k)(2)(E)(ii)(II) (2018) (stipulating the acquisition of the property can not be from a "related taxpayer" as defined by I.R.C. § 267(b)).

22 *See* I.R.C. § 168(k)(2)(E)(ii)(I) (2018).

[23]Prop. Treas. Reg. § 1.168(k)-2.
[24]*American Bar Association Section of Taxation Capital Recovery and Leasing Committee: Panel: A Discussion on Bonus Depreciation—Unpacking the Guidance* (Oct. 2018).
[25]*See* I.R.C. § 168(k)(10) (2018) (Notably, a taxpayer may choose to opt out of taking a bonus depreciation deduction to avoid the invocation of the new net operating loss (NOL) provisions of the Code.).
[26]*See* I.R.C. § 168(a)-(f) (2018).
[27]Feintzeig, *supra* note 2.
[28]*Id.*
[29]*Id.*
[30]*See* I.R.C. § 1031(a) (2016).
[31]*Id.* (So long as an aircraft used for business was being exchanged for another aircraft to be used in business, the aircraft were formerly treated as "property of like kind" and the gain from such a transaction did not require recognition. This allowed businesses to defer gain on the acquisition of a new business jet.).
[32]If Aircraft A had a fair market value of $3 million, and the entity was seeking to upgrade to a $10 million business aircraft, the entity could simply exchange Aircraft A and $7 million for its acquisition of Aircraft B. This would save then entity approximately $600,000 in taxes assuming Aircraft A were to receive treatment as a capital asset should it be sold to fund the purchase of Aircraft B. Therefore, instead of selling Aircraft A, then purchasing Aircraft B, Aircraft A could be exchanged for Aircraft B, avoiding the tax liability that would have been imposed had Aircraft A been sold in a separate transaction.
[33]I.R.C. § 1031(a) (2018).
[34]I.R.C. § 274 (2016).
[35]I.R.C. § 274(a) (2018).
[36]*See* Treas. Reg. § 1.274-10(b) (Defining "Entertainment air travel" as "any travel aboard a taxpayer provided aircraft for entertainment purposes. "Business entertainment air travel" is then defined as "any entertainment air travel aboard a taxpayer provided aircraft that is directly related to the active conduct of the taxpayer's trade or business or related to an expenditure directly preceding or following a substantial and bona fide business discussion and associated with the active conduct of the taxpayer's trade or business." Notably, "[a]ir travel is not business entertainment air travel merely because a taxpayer-provided aircraft is used for the travel as a result of a bona fide security concern under § 1.132-5(m).").
[37]*See* Treas. Reg. § 1.274-10.
[38]I.R.C. § 162(a) (2018) (granting deductions for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…").
[39]Treas. Reg. § 1.274-10 (Notably, under 274(l), deductions are denied for transportation and commuting expenses.).
[40]*See* Treas. Reg. § 1.274-10(a)(2)(ii). "Specified individuals" are defined as individuals who are subject to § 16(a) of the Securities Act of 1934 in relation to the taxpayer. "[F]or example, a specified individual is an officer, director, or more than 10 percent owner" of the entity in question. *See* Treas. Reg. 1.274-9(b)(1).
[41]I.R.C. § 280F(b)(1) (2018).
[42]*See* I.R.C. § 280F(d)(4)(A)(ii) (2018) (Defining "listed property" as "any other property used as a means of transportation…." Understandably, a company's private business jet would properly be classified as "listed property" for purposes of application of these depreciation recapture rules.).
[43]I.R.C. § 280F(b)(1) (2018).
[44]*See* I.R.C. § 280F(b)(2)(A) (2018).
[45]*See* I.R.C. § 280F(d)(6)(B) (2018) (Defining "qualified business use" as "any use in a trade or business of the taxpayer.").

A Normative Guide to the Taxation of Education ISAs

by Robert Daily

There is a revolution in how students pay for higher education. Colleges like the University of Purdue[1] and coding academies like Lambda Inc.[2] have offered students the ability to sign an income-sharing agreement (ISA), an arrangement whereby a student receives immediate funding from a third party (usually the college or education provider) "in exchange for agreeing to pay a percentage of his or her future income for a period of time."[3] The third party receives a claim dependent on "the personal financial success of the" student, without a "guaranteed return of principal."[4] Many scholars have addressed the thorny ethical and practical concerns that the ISA arrangement bring, but fewer scholars have addressed the tax implications of these arrangements.[5] And as many have noted, the lack of a clear tax characterization has likely inhibited the growth of these innovative agreements.[6]

Most parties, like Purdue, claim these ISAs are a form of derivative contract governed by the open transaction doctrine.[7] Parties also claim that students who do not pay back enough of the ISA need to recognize cancellation of debt (COD) income. But as this paper explains, both of these positions are normatively incorrect. Before explaining why these positions are wrong from a tax policy perspective, this paper provides some background.

Current Law

To explain the tax consequences of the ISA, take an example. Assume a college enters into an ISA with a student under these terms: the college will pay the cost of tuition and fees, $10,000, on behalf of the student; the student must pay back 5 percent of her salary for 10 years; the student need not repay any additional amounts under the ISA once she pays back 2.5 times of the funding amount ($25,000); and the student need not pay anything if she makes less than $25,000.[8]

At its core, ISAs represent a new transaction, one that does easily fit into one of the Tax Code's set of binary characterizations. The ISA could be *debt* because a payback ratio looks like interest; could be *equity* because the student seems to sell a piece of her earnings; or could be a *partnership* because the college and student are unified in trying to find a high-paying job for the student. But these characterizations fail: the ISA is not debt because the amount is not definite enough; not equity because the lender does not have enough control over the student; and not a partnership because the parties do not have enough intent to join one.

Instead, most ISA lenders treat these ISAs as financial contracts governed by the open transaction doctrine. This characterization is partially right. The contract does seem like a financial contract, and, more specifically, like a variable prepaid forward contract. No commentator or ISA provider has suggested this characterization, but the variable prepaid forward characterization seems most apt under current law given that the characterization acts as a backstop. When tax practitioners believe that a particular financial instrument does fit into a traditional debt, equity, or partnership characterization, they often call the instrument a variable prepaid forward.[9] The government may challenge this characterization and argue that the instrument is debt because the tax consequences of debt are much less favorable to private parties. But the government will likely be unsuccessful: neither the amount nor the interest rate is fixed; the amount is unsecured by any asset; and the lender may receive nothing if the student fails to ever obtain a job.

But this characterization is subject to tremendous uncertainty. We need more clarity regarding the tax consequences of ISAs. Yet we also need to consider whether these tax consequences are normatively good or bad. We should ask, how ought we tax these agreements?

Unified Approach?

A gating question is whether we should adopt a unified approach to how we tax education ISAs. Should Congress or the U.S. Treasury write rules that treat all ISAs the same? And should there be bright-line rules to encourage clarity and promote investment in ISAs or broad standards that might prevent abuse? Many scholars have weighed in on the standards versus rules debate. The takeaway for this paper is that rules are better when we want to promote clarity[10] and standards are better when concerned about abuse and horizontal equity.[11]

Professors Oei and Ring argue that developing "a unified regulatory scheme" for ISAs "may create as many problems as it solves."[12] They argue that ISAs are "contested and complicated transactions" and "heterogeneous," so each ISA raises different policy concerns.[13] Because each ISA is different, Oei and Ring suggest "a case-by-case" approach to regulating these agreements.[14] They argue that "comparison, analogy, and classification" to more traditional transactions "can help clarify potential arguments and concerns" and "pinpoint … whether and when a particular transaction raises [policy] concerns."[15] And comparing the ISAs to traditional forms of financing will be more equitable and efficient.[16] But is the tax uncertainty surrounding these transactions vital to effectuate goals of equitability and efficiency?

This paper takes the opposite view and argues that we need more certainty and that without the tax certainty, the market for ISAs will continue to fizzle. Although there are many valid criticisms of these transactions, the ISA represents a "financial innovation" that has the potential "to broaden access to and improve the financing of higher education…."[17] We ought to design a tax system that encourages such innovation.[18] Oei and Ring are correct to suggest that we need to consider tax equity and efficiency, but we can only make those considerations once the ISA market becomes established. The government needs to provide more tax clarity to establish the ISA market. Once that market has been established, then it can consider tax equity and efficiency claims.[19] A safe harbor rule that applies to certain types of education ISAs will provide more comfort and encourage more investment in the ISA market. As with any safe harbor rule, this will likely be a rough-justice cure that may not be appropriate in every ISA situation. But given the enormous benefits that ISAs offer, the government should provide tax clarity.

The biggest problem with trying to figure out the proper characterization is not the characterization but that the tax world operates in a fictional binary state of the world. Even though the Tax Code necessitates calling something either debt or equity, education ISAs and other human equity claims do not fit nicely into either particular characterization. But any characterization does not decide *how*, and most important *when*, the education ISA will be taxed.[20] More relevant is whether students should recognize COD income and whether the enormous tax timing benefit that investors get from using the open transaction doctrine is appropriate.

COD Income

Start with the student's perspective. The biggest questions are whether the student needs to recognize income when she enters into the ISA and if the student does not pay back the full "funding amount," whether she needs to recognize COD income. If the variable prepaid characterization is appropriate, the answer to question one is easy: the student should not need to pay any income tax at the time of funding. The student's tax liability is in flux until determination of the amount the student makes payments under the ISA.

The second question should also be an easy one given the variable prepaid characterization: students only need to recognize COD income when they do not pay back their debts. Because the variable prepaid forward is a derivative contract and not debt, they need not recognize COD income.[21] But most lenders—including the most prominent issuer of ISAs, Purdue—require that students recognize COD income when the student fails to pay back the funding amount of the ISA.[22] In the example from earlier in the paper, the student would recognize COD income if the student did not make total payments of at least $10,000.

An analogy is that an ISA is like a typical sports contract with incentives and uncertain payment terms.[23] A player may receive the highest amount only under the contract if the player meets certain performance objectives. Failing to meet those objectives does not create COD income to any party; rather, the implicit assumption is that the contract had uncertain payment terms. The ISA and a typical sports contract are not debt, they are contracts with a contingent payment unknown at the time of funding.

But if derivative contracts do not trigger COD income, why do so many lenders insist that it does trigger income? One reason is that the lenders believe the debt characterization may actually be more appropriate. Maybe lenders and the debt-like structure of the ISA makes the debt characterization seem likely in the eyes of the IRS. But such an argument is unavailing because the parties do many things to avoid the debt characterization for tax and nontax reasons. Another more nefarious reason is that the lender may want to take a "loss" on the ISA if the student fails to pay back the full lending amount. With the student recognizing COD income, there is at least a plausible (although probably spurious) argument that the lender should receive basis in the ISA to take a loss.

It is inappropriate for students to need to pay back COD income when they pay back an amount under the ISA that is less than the funding amount. Paying any amount of COD income is contrary to the plain meaning of the Tax Code.

Open Transaction

The party who enters into the ISA with the student likely cares most about the timing of the transaction. Under the variable prepaid characterization, the lender does not recognize income at the time of funding and would either recognize income each year it receives payment (installment sale) or would recognize income after it recovers all of its basis (open transaction doctrine). Although no ISA contract has given the variable prepaid forward label to the instrument, each contract states that the parties agree to recognize income via the open transaction doctrine, which posits that a party recognizes no gain attributable to a sale until the party recovers the entire amount of their basis.[24] This doctrine is an enormous tax benefit that effectively acts as a zero-interest loan to lenders.

Applying the open transaction doctrine to these variable prepaid forward contracts seems inappropriate under current law. Specifically, as many commentators have argued, the open transaction treatment is not justified unless Congress creates an exception.[25] Instead, it is more likely that the ISA would be treated as an installment sale under § 453.[26]

Congress can recognize another open transaction exception to ISA lenders, but should it? There are two reasons why such an exception may be appropriate. First, the exception will encourage more private taxable investors, like Lambda School, to create ISAs. Those who create ISAs will benefit from paying tax in a later tax year. Investors will flock to these ISA programs, as long as the open transaction benefit is commonly understood in the market. This benefit does not accrue to nonprofits like Purdue University who enter into ISAs with their own students, but nonprofits would benefit if those universities securitize these ISAs.

Second, the open transaction treatment is more administrable than using the installment sale rules.[27] Under the installment sale rules, ISA lenders would need to estimate the profit from the ISA each year to comply with their tax obligations. Lenders would prefer not to pay expensive accountants and lawyers to figure out this amount. It is likely this added administrative cost would disincentive those from investing in the ISA market. With the open transaction treatment, lenders can easily comply with their tax obligations and would be more likely to create more ISAs.

But the actual cost of applying the open transaction treatment is unknown. Applying open transaction treatment to education ISAs would essentially create another education subsidy, a program that will bring in less tax revenue and that will encourage and subsidize the cost of higher education.[28] Although four sessions of Congress have proposed bills regarding the tax treatment of ISAs, no member of the Treasury or the Joint Committee on Taxation has even calculated the potential revenue loss.[29]

The open transaction treatment is normatively correct only if we consider the cost of extending such treatment. For example, assume that traditional loans were replaced with ISAs—in this scenario, the cost of Open Transaction treatment would be significant. Before we consider whether using this treatment is appropriate, we need to know the true cost. It is at least possible that the open transaction subsidy may cost more than many other education incentives. We need to consider the open transaction subsidy with these incentives so Congress can decide how much taxpayer money we should use to subsidize higher education.[30]

Summary

Even with the over trillion dollars of student debt facing borrowers,[31] some commentators have suggested that we need to increase investment in higher education.[32] ISAs offer an effective subsidy that could spur even more investment in higher education. To help guide this discussion, this paper has offered thoughts on two normative aspects of taxing education ISAs: whether students should recognize COD income and whether lenders should obtain the open transaction treatment. ⊙

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Endnotes

[1]*See ISA Sample Contract,* Purdue U., https://www.purdue.edu/backaboiler /disclosure/contract.html (last visited Jan. 1, 2019).

[2]*See* Lambda School, https://lambdaschool.com (last visited Jan. 1, 2019).

[3]Diane Ring, *A New Wave of Income Share Agreements*, Surly Subgroup (Apr. 26, 2016), https://surlysubgroup.com/2016/04/26/a-new-wave-of-income-share-agreements; *see also* Shu-Yi Oei & Diane Ring, *Human Equity? Regulating the New Income Share Agreements*, 68 Vand. L. Rev. 681, 684 (2016); Jeff Schwartz, *The Corporatization of Personhood*, 2015 U. Ill. L. Rev. 1119, 1120-21 (2015); Benjamin M. Leff & Heather Hughes, *Student Loan Derivatives: Improving On Income-Based Approaches to Financing Law School*, 61 Vill. L. Rev. 99, 99 (2016).

[4]Ring, *supra* note 3.

[5]*See* Oei & Ring, *supra* note 3; Leff & Hughes, *supra* note 3.

[6]Miguel Palacios et al., *Investing in Value, Sharing Risk: Financing Higher Education Through Income Share Agreements*, http://www.starvingthebeast.net/wp-content/uploads/2016/04/investing-in-value-sharing-in-risk-financing-higher-

education-through-inome-share-agreements_083548906610.pdf (noting that the tax and "legal uncertainty" of these contracts "has made it difficult to attract investors and has prevented the market from developing on a larger scale").

[7] *Supra* note 1.

[8] These terms are taken from the Purdue Back a Boiler program sample ISA. *See id.*

[9] *See* Michael S. Farber, *Equity, Debt, Not-the Tax Treatment of Non-Debt Open Transactions*, 60 Tax Law. 635, 636 (2007).

[10] *See, e.g.,* David A. Weisbach, *Line Drawing Doctrine and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627, 1679 (1999).

[11] *See, e.g.,* Sarah B. Lawsky, *Modeling Uncertainty in Tax Law,* 65 Stan. L. Rev. 241, 272-73 (2013).

[12] Oei & Ring, *supra* note 3, at 686.

[13] *Id.* at 709. Professors Oei and Ring mention some of the possible policy concerns. On one hand, the ISAs may "offer a more realistic means for financing higher education than traditional loans" because the agreement "taps into new sources of credit," protects "against earnings shocks," and may make it easier for the student to obtain funding. *Id.* at 707-08. On the other hand, the ISAs "raise important questions regarding personal autonomy, free choice, and self-determination," may exacerbate "likely inequalities in who gets funded (e.g., based on race, gender, or profession)," and may have "potential design laws (moral hazard and adverse selection)." *Id.* at 708.

[14] *Id.*

[15] *Id.*

[16] *Id.* at 710-11.

[17] Schwartz, *supra* note 3, at 1175; AEI Report, *supra* note 6 ("[ISAs] are not about control, but instead grant students freedom from the constraints, anxiety, and financial risk that accompany traditional loans. Through their income-based payment structure, ISAs transfer the financial risk of investing in higher education from students to ISA providers who, by investing in large groups of students, can diversify it.").

[18] James Surowiecki, *The New Futurism*, New Yorker (Nov. 4, 2013), https://www.newyorker.com/magazine/2013/11/04/the-new-futurism ("The old way of borrowing was predicated on a world in which the job market was stable and everyone had a steady income. That world of work is changing. The way we finance it needs to change, too.").

[19] The government should also be vigilant to ensure that ISAs actually improve higher education financing and do not perpetuate existing norms, but those concerns can be corrected through regulation. *See, e.g.,* Schwartz, *supra* note 3, at 1174.

[20] Farber, *supra* note 9, at 637 ("Once one has figured out how to determine whether an instrument is a [nondebt instrument] … the next task is to determine how the instrument is taxed.").

[21] *See* I.R.C. § 108(a) noting that a taxpayer "indebtedness" before she recognizes COD income.

[22] *See ISA Sample Contract*, *supra* note 9.

[23] *See, e.g.* Reuben Fischer-Baum, *Ricky Williams's Awful NFL Contract Never Gave Him A Chance*, FiveThirtyEight (Sept. 30, 2016, 12:57 PM), https://fivethirtyeight.com/features/ricky-williams-awful-nfl-contract-never-gave-him-a-chance (describing Ricky Williams' initial NFL contract that was loaded with incentives that were never achieved).

[24] *See Burnet v. Logan*, 283 U.S. 404 (1931).

[25] *See* Jeffrey L. Kwall, *Out with the Open-Transaction Doctrine: A New Theory for Taxing Contingent Payment Sales*, 81 N.C. L. Rev. 977, 979 (2003); Kevin J. Liss, *Rationalizing the Taxation of Options in the Age of Derivatives*, 61 Tax Law. 855, 869-70 (2008).

[26] *See* Treas. Reg. § 15a. 453-1(d)(2)(iii).

[27] *Cf.* David M. Schizer, *Realization As Subsidy*, 73 N.Y.U.L. Rev. 1549, 1609 (1998) (noting the administrability benefits of the realization rule). *But see id.* (arguing that the realization requirement also has costs because it increases "transactional complexity").

[28] *Cf. id.* at 1553.

[29] *See* ISA Act of 2017, Investing in Student Success Act of 2015; Investing in Student Success Act of 2014, H.R. 4436, 113th Congress; Pay it Forward College Affordability Act of 2013.

[30] *See* Camilla E. Watson, *Reforming the Tax Incentives for Higher Education*, 36 Va. Tax. Rev. 83, 88 (2017).

[31] *See* Abigail Hess, *US Student Debt Levels Set a New Record in 2018—Here's How Much the Typical Borrower Owes*, CNBC (Dec. 28, 2018, 9:30 AM), https://www.cnbc.com/2018/12/27/student-debt-levels-set-a-new-record-in-2018-heres-how-much-the-typical-borrower-owes.html.

[32] *See generally* Michael Simkovic, *The Knowledge Tax*, 82 U. Chi. L. Rev. 1981 (2015).