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Response

Determining Value in Barter Transactions: A Response to Robert Keller's *The Taxation of Barter Transactions*

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In *The Taxation of Barter Transactions*,[1] Professor Robert Keller asserts that consistently following five basic tax principles would result in the correct taxation of all barter transactions. These five principles are:

(I) "All economic benefits, regardless of form, are includable in income; the amount of the income is the fair market value of the benefit received;"[2] (II) "If the value of the benefit received cannot be determined with reasonable accuracy but the value of the benefit given up can be, the value of the former is presumed to equal the value of the latter;"[3] (III) "The 'cost' basis of property received in a taxable barter exchange is the property's fair market value at the time of receipt;"[4] (IV) "The term 'paid or accrued' or 'paid or incurred' includes the fair market value of an in-kind benefit received in a taxable transaction by the taxpayer;"[5] and (V) "Even if the reporting of an item of gross income under Principle I would permit the taxpayer to claim an equal tax deduction under Principle IV, both the income and the deduction items must be reported on the taxpayer's income tax return."[6]

The fair market value of the benefit received in a barter transaction figures prominently in Professor Keller's analysis. Fair market value fixes the amount of taxable income (Principle I), the basis of the property received (Principle III), and the

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1. Keller, *The Taxation of Barter Transactions*, 67 MINN. L. REV. 441 (1982).
2. *Id.* at 445.
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*

amount of any possible deduction (Principle IV). Professor Keller recognizes that fair market value for these purposes would not always be retail value,[7] and suggests:

> The proper rule of valuation in barter exchanges would be that goods and services received in a barter exchange from a seller should be valued at the cash price the recipient would have been required to pay had he or she purchased the same quantity of goods and services from this seller for cash.[8]

This response criticizes Professor Keller's use of "hypothetical cash purchase price" to determine fair market value. It argues that participants enter into barter transactions precisely because they are unable to sell their goods and services for cash. Consequently, use of hypothetical cash purchase price inflates the actual value of goods and services.

Virtually no seller would prefer in-kind assets to cash payments.[9] Cash is infinitely more transferable, and therefore, it is infinitely more flexible. When an in-kind asset is received in trade, it must be traded again for something else, unless it represents the recipient's optimum purchase at that moment. Because the second trade involves both transaction costs and risks of downward fluctuations in the traded item's value, it is highly unlikely that sellers would be indifferent between cash receipts and in-kind receipts.[10]

The information available on who enters into direct barter transactions and why they barter supports this hypothesis. Some barter to evade taxes[11] and others do so to enrich themselves through fraudulent transactions,[12] but most barter because it provides the opportunity to sell goods that could not otherwise be sold. Professor Keller acknowledges that: "As-

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7. *Id.* at 450-51.

8. *Id.* at 451.

9. For a discussion of the economic theory underlying this proposition, see W. BAUMOL & A. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 364-67 (1979).

10. *See generally* Newman, *Transferability, Utility, and Taxation*, 30 U. KAN. L. REV. 27 (1981) (discussing tax authority demonstrating that nontransferable assets are worth less than transferable assets).

11. Congress evidenced its concern with the tax evasion possibilities of bartering by the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. The Act requires barter exchanges to comply with the tax reporting and recordkeeping requirements of other brokers. *See id.* § 311(a)(1), 96 Stat. at 600 (codified at 26 U.S.C. § 6045(c)(1) (1982)); *id.* § 311(b), 96 Stat. at 601 (codified at 26 U.S.C. § 7609(a)(3) (1982)).

Professor Keller's analysis necessarily assumes that any attempt at tax evasion in a barter transaction will fail. Otherwise, there would be no tax consequences. I too will ignore tax evasion.

12. *See* Federman, *Barterer Beware,* BARRON'S, Dec. 14, 1981, at 4 (allegations of an annual billion dollar business in bartering real estate for grossly overvalued jewelry).

suming all tax liability stemming from the bartering will be reported properly, the major advantage to a taxpayer in joining a barter exchange is simply that of obtaining new business."[13] Barter is most appealing for those who possess "an excess of merchandise."[14] An executive of a nationwide barter exchange characterized most bartered goods as "dead inventory" which cannot be moved by other means.[15] Although Professor Keller contends that "doctors or lawyers with all the cash business they can handle would gain little from joining [barter exchanges],"[16] the president of the Pfseister Barter Exchange has observed that the exchange has so many chiropractor and podiatrist members that it is turning away new members from these fields.[17] Clearly, most bartered goods and services are items that could not have been sold for cash, or certainly not for a cash price the seller would have accepted.

Professor Keller's treatment of the tax consequences of bartering on exchanges that use trade units as the medium of exchange supports the conclusion that hypothetical cash purchase price should be discounted. Professor Keller notes that the economic value of "one dollar's worth" of trade units is usually less than one dollar.[18] This discount makes sense given the low marketability of bartered assets and the relative inflexibility of trade units on the larger trade exchanges when compared to cash. The commission charged by most exchanges also makes trade units worth less than cash. These commissions are analogous to the costs associated with retrading bartered items in direct transactions. It is inconsistent for Professor Keller to recognize the appropriateness of this discount with respect to the trade exchanges while ignoring it with respect to direct barter transactions. Therefore, hypothetical cash purchase price, which determines fair market value for purposes of Principles I, III, and IV, overstates the value that the seller would have been able to obtain for the goods or sevices in a cash transaction.

13. Keller, *supra* note 1, at 486 (footnote omitted).

14. Tarshis, *Cashless Commerce,* HARPER'S BAZAAR, Oct. 1982, at 196, 217.

15. Telephone conversation with Bill Boyce (Apr. 20, 1983).

16. Keller, *supra* note 1, at 486.

17. Rohmann, *Cashing in on Cashless Swaps,* FORBES, Mar. 29, 1982, at 120.

18. Keller, *supra* note 1, at 496. For possible IRS authority on using trade units to determine value, see 269 IRS LETTER RULINGS REP. 8216010 (CCH) (Dec. 31, 1981) ("The next issue to be addressed is whether trade units are capable of being valued. The general rule is that it is only in rare and extraordinary cases that the value of the property exchanged cannot be ascertained with reasonable accuracy.").

Determining that hypothetical cash purchase price overstates market value also calls into question Principle II, which determines the benefit received in the barter to be the value of the goods or services given up. Professor Keller notes:

> Where evidence of the value of the property given up is no more reliable than that of the value of the property received, using the former to value the latter would be a circular bootstrap operation, inevitably involving the use of the value of each . . . to determine the value of the other.[19]

I submit that direct barter transactions will usually be between two individuals who would have preferred cash to barter but were unable to sell their goods or services for cash. In such instances, Professor Keller's hypothetical cash purchase price is not a reliable indicator of the value of either item. Therefore, the presumed equivalence in Principle II will usually not apply.

Formulation of a precise method to measure such a noncash discount is problematic. One might conclude that barter transactions must be deemed nontaxable events because accurate valuation is impossible. Such a conclusion, however, would be disastrous. Large numbers of taxpayers, who otherwise would have engaged in cash transactions, would engage in barter to take advantage of the new tax loophole. The influx of these participants would change the nature of barter. Hypothetical cash purchase price would soon equal market value, and, as a result, the reasons for discounting the value of bartered goods and services below their cash purchase price would be eliminated.

Thus, although accurate taxation of direct barter transactions is impossible, exemption of those transactions from taxation would be disastrous. I submit that creating an arbitrary percentage discount, to account for the economic disadvantages of barter, provides a second best solution for determining value. Professor Keller notes that the larger trade exchanges could determine the "purchasing power ratio" between trade units and dollars, and convert the ratio to a discount.[20] I predict that this discount will prove to be within the same percentage range for most barter transactions in most years. If my guess is correct, it would not take too many years of statistical data to derive an average discount figure that would be generally accurate. This figure could be used to discount the hypothetical cash purchase price in direct barter transactions. The use of this across-the-board discount admittedly would create a

19. Keller, *supra* note 1, at 455 (footnote omitted).
20. *Id.* at 497.

small loophole, encouraging those who otherwise would not do so to engage in barter. That loophole, however, would be an acceptable price to pay for increased fairness and accuracy in the taxation of those already engaged in barter.