

1983

Federal Income Tax Developments: 1982

Merlin G. Briner

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FEDERAL INCOME TAX DEVELOPMENTS: 1982

by

MERLIN G. BRINER*

INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1982 is the tenth in a series of articles published in the *Akron Law Review*. With the inauguration of *The Tax Journal*, I considered it the most appropriate publication for the 1982 Developments. In keeping with the prior format, I have limited the scope of this survey to substantive developments in income taxation.

Due to its tremendous ramifications, a separate section on the Tax Equity and Fiscal Responsibility Act (TEFRA) is included in this year's developments.

To minimize lead time between research and publication, I engaged the most able assistance of second-year law students. Without their substantial contributions and complete dedication this article would not have been possible. In recognition of their efforts, I thank the following students for their efforts in researching, writing and compiling this article:

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I. SUPREME COURT CASES

A. Corporations: Brother-Sister Control Groups

In United States v. Vogel Fertilizer Co.,¹ the United States Supreme Court granted certiorari to settle a conflict among the circuit courts² regarding the Treasury's interpretation of the statutory term "brother-sister controlled group."³

The significant historical details involved two companies: Vogel Fertilizer Co. and Vogel Popcorn Co. Vogel Fertilizer Co. had only common stock which was owned by Arthur Vogel (77.49%) and R. Crain (22.51%). Vogel Popcorn Co. was owned by Arthur Vogel (more than 80%) and the Alex Vogel Family Trust. During the tax years of 1973, 1974 and 1975, Vogel Fertilizer did not claim a full surtax exemption on its tax returns, believing that a full exemption was prohibited by the Treasury Regulations.⁴ Subsequently, in a separate

¹102 S. Ct. 821 (1982).

²*Delta Metalforming Co. v. Commissioner*, 632 F.2d 442 (5th Cir. 1980), *Allen Oil Co. v. Commissioner*, 614 F.2d 336 (2d Cir. 1980), *Fairfax Auto Parts of North Virginia v. Commissioner*, 548 F.2d 501 (4th Cir. 1977), *T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 (8th Cir. 1977).

³I.R.C. § 1563(a)(2). All subsequent code citations are to the Internal Revenue Code of 1954 as amended.

⁴Treas. Reg. § 1.1563-1(a)(3).

case, the Tax Court held the Treasury Regulation invalid⁵ and Vogel Fertilizer filed claims for refunds. The basis of Vogel's refund claims was that Vogel Popcorn and Vogel Fertilizer were not members of a "brother-sister controlled group" and were therefore each entitled to a full surtax exemption for the years in question.

The Court of Claims in *Vogel Fertilizer Co. v. Commissioner*⁶ held for Vogel, determining that the Treasury Regulation⁷ was invalid because it included, for purposes of the 80% requirement, stock owned by a stockholder who had shares in only one corporation of the alleged controlled group.

The U.S. Supreme Court upheld the Court of Claims, rejecting the "singly or in combination" provision of the Treasury Regulation.⁸ The Court found that the statute⁹ required that both the 80% and the 50% requirement be fulfilled by the same indivisible group of five or fewer persons. Therefore, the Court held that "[t]he same '5' or fewer individuals cannot be said to control 80% of both Vogel Fertilizer and Vogel Popcorn because Crain owns no stock in Vogel Popcorn and therefore his 22.51% of Vogel Fertilizer cannot be added to Vogel's 77.49% of that corporation to satisfy 1563(a)(2)(A)."¹⁰

Thus, in order to determine if the relationship between two or more corporations satisfies the test of a "brother-sister controlled group,"¹¹ a person's stock ownership may be taken into account for satisfaction of the 80% requirement, but only if he or she is a shareholder in all of the corporations within the alleged controlled group. The Court's conclusion requires that there be one indivisible group of shareholders who control 80% or more of the corporations involved. Based on the Court's conclusion, the 80% requirement is now the primary basis for determining whether two or more corporations are represented by the same financial interest, and the 50% requirement is used solely to measure common ownership.

The Supreme Court invalidated the Treasury Regulation¹² only to the extent that it called for the counting of the stock of a shareholder, for purposes of the 80% test, who owned stock in only one of the alleged controlled group corporations. The remainder of the Regulation remains valid and must be adhered to in all future transactions.

By resolving the scope of the 80% test, the Court has permitted practi-

⁵Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner, 65 T.C. 789 (1976).

⁶225 Ct. Cl. ____, 634 F.2d 497 (1980).

⁷Treas. Reg. § 1.1563-1(a)(2).

⁸*Id.*

⁹I.R.C. § 1563(a)(2).

¹⁰102 S. Ct. 821, 826 (1982).

¹¹I.R.C. § 1563(a)(2).

¹²Treas. Reg. § 1.1563-1(a)(3).

tioners to focus on the tax planning aspects of the brother-sister corporate structure with renewed confidence in the technical requirements.

B. Gift Tax: Net Gift Doctrine

The United States Supreme Court decision in *Deidrich v. Commissioner*¹³ finally settled the controversy surrounding the "Net Gift" doctrine. The term "Net Gift" refers to a gift conditioned on the donee paying the donor's gift tax. Prior to *Diedrich*, conflict existed among the circuit courts regarding the income tax consequences of net gifts to the donor. In *Diedrich*, the Court, much to the chagrin of the taxpayer, upheld the position advocated by the Internal Revenue Service (IRS): that a "Net Gift" is in reality part gift and part taxable sale, despite the donative intent of the donor.

In several early "Net Gift" cases,¹⁴ the Tax Court consistently rejected the IRS's position upheld in *Deidrich*. The basis for the Tax Court's rejection was that it refused to find that the donor lacked the donative intent simply because the gift was conditioned on the donee paying the gift tax. By focusing on the donor's intent, the Tax Court had little difficulty rejecting the IRS's part-sale/part-gift theory.

With its decision in *Turner v. Commissioner*,¹⁵ the Tax Court unequivocally rejected the IRS's position regarding "Net Gifts." The *Turner* decision held that where a donor gives property conditioned upon the donee paying the gift tax, such a transaction does not constitute a sale by the donor for the amount of the gift tax. *Turner* was upheld by the U.S. Court of Appeals for the Sixth Circuit.¹⁶ The Fourth and Fifth Circuits also rejected the part-sale/part-gift theory.¹⁷

The *Turner* line of cases was weakened by two subsequent decisions. In *Johnson v. Commissioner*¹⁸ the appellate court for the first time accepted the IRS's part-sale/part-gift theory. The U.S. Court of Appeals affirmed the *Johnson*¹⁹ decision but rejected the part-sale/part-gift theory. Instead, the appellate court based its decision on *Crane v. Commissioner*²⁰ and *Old Colony Trust Co. v. Commissioner*,²¹ thereby not actually overruling *Turner* but significantly limiting its application. The second case which served to weaken *Turner* was the Second Circuit case of *Estate of Levine v. Commissioner*.²² In *Levine*, the

¹³102 S. Ct. 2414 (1982).

¹⁴*Lingo v. Commissioner*, 13 T.C. 436 (1954), *Harrison v. Commissioner*, 17 T.C. 1350 (1958).

¹⁵49 T.C. 356 (1968).

¹⁶*Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969).

¹⁷*Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), *Estate of Davis v. Commissioner*, 469 F.2d 694 (5th Cir. 1972).

¹⁸*Johnson v. Commissioner*, 59 T.C. 791 (1973).

¹⁹495 F.2d 1079 (6th Cir. 1974).

²⁰331 U.S. 1 (1947).

²¹279 U.S. 716 (1929).

²²634 F.2d 12 (2d Cir. 1980).

Court based its decision on *Johnson* rather than openly contradicting *Turner*, although in fact the *Levine* decision was exactly the opposite of *Turner*.

With *Johnson* and *Levine* as support, the Eighth Circuit in *Diedrich*²³ flatly rejected the *Turner* line of cases. In *Diedrich*, the court upheld the part-sale/part-gift theory advanced by the IRS. Based on the conflict among the circuits, the Supreme Court granted certiorari in the *Diedrich* case in order to put the "Net Gift" dispute to rest.

The Supreme Court upheld the position advocated by the IRS, holding that "the transfer is treated as if the donor sells the property to the donee for less than the fair market value. The 'sale' price is the amount necessary to discharge the gift tax indebtedness; the balance of the value of the transferred property is treated as a gift." Thus, taxable gifts will result to the donor to the extent that the gift tax paid by the donee exceeds the donor's adjusted basis in the gift property.

Based on the part-sale/part-gift theory, the donee will take his or her cost as the basis in the property, the donee's cost being the amount of gift tax paid. The donee's holding period for such property remains unclear. However, if the same reasoning for determining basis is utilized, then the donee probably will not be permitted to tack the donor's holding period.

Finally, although the *Diedrich* decision significantly lessens the advantages of giving away highly appreciated property, the gift tax advantage remains intact. The value of the gift for gift tax purposes is calculated by reducing the fair market value of the gift by the amount of gift tax paid by the donee. In order to perform this calculation properly, the algebraic formula established by the IRS must be employed.²⁴ It should be noted that the donee cannot assume any of the donor's gift tax liability until the donor's unified credit has been exhausted,²⁵ which may pose serious practical problems in a net-gift situation.

II. OIL AND GAS

A. Intangible Drilling Costs (IDC)

Intangible Drilling Costs are those costs incurred by the operator of an oil, gas or geothermal well which may be deducted as a current expense rather than capitalized. This is not to suggest that the operator must expense such costs; the expensing of such costs is at the election of the operator. The operator, of course, may simply elect not to expense the costs and may instead charge them to the capital account and recover the costs through depreciation or depletion. However, once the election to expense the intangible drilling costs is made,

²³643 F.2d 499 (8th Cir. 1981).

²⁴ $\frac{\text{tentative gift tax}}{1 + \text{donor's tax rate}} = \text{actual gift tax}$

²⁵Rev. Rul. 223, 1981-2 C.B. 189.

it is binding upon the operator for all future years. It should be noted that if the operator does elect to expense the intangible drilling costs, recapture of some amounts of such costs may be required upon disposition of the well.²⁶ The authority which permits the taxpayer operator to elect to expense intangible drilling costs is IRC section 263(c); however, this section does not establish what costs constitute intangible drilling costs.

The Treasury Regulations²⁷ and case law²⁸ will determine which costs are intangible drilling costs. The Treasury Regulations provide a number of examples of the types of costs that may be capitalized or expensed at the election of the operator. Such costs include "wage, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Also included are "the costs to operators of any drilling or development work . . . done for them by contractors under any form of contract including turnkey contracts."²⁹ The Tax Court has articulated four criteria which will qualify an expenditure to be expensed rather than capitalized:

(1) the taxpayer must hold an operating or working interest in the property being developed; (2) the costs in question must relate to the development of the property in which the taxpayer has a working or operating interest; (3) the nature of the expenditure must fall within the definitional guidelines provided by § 1.612-4(a), Income Tax Regs.; and (4) the tax payment or incurrence of the costs must occur sufficiently early in the development stages so that the taxpayer is exposed to the unknown risks of development.³⁰

These four criteria in conjunction with the Treasury Regulations form an excellent tool for analyzing an expenditure to determine if it qualifies as an intangible drilling cost.

When a well is owned by more than one individual, the Treasury Regulations are somewhat rigid regarding the deductibility of intangible drilling costs. Treasury Regulation section 1.612-4(a)(3) provides that when there are co-owners of a working interest in an oil or gas well and one of the co-owners pays for a greater portion of the intangible drilling cost than his or her proportionate share of the property, that owner will not be permitted to expense the entire amount of such costs currently. The co-owner who paid the IDC is required to capitalize that portion of the costs which are not attributable to his or her fractional share of the well. In order to circumvent this requirement and insure current expensing of 100 percent of the intangible drilling costs, taxpayers

²⁶I.R.C. § 1.612-4(a)(1).

²⁷Treas. Reg. § 1.612-4(a).

²⁸*Straplings Building Materials v. Commissioner T.C.M. (P-H) ¶ 79.4 (1982).*

²⁹Treas. Reg. § 1.612-4(a).

³⁰T.C.M. (P-H) ¶ 79.4 (1982).

form operating partnerships under state law or other arrangements recognized as partnerships by the IRS.

A brief summary of the facts presented in a recent Technical Advice Memorandum are as follows: (1) *B* and *C* purchased an interest in an oil and gas lease which entitled them to a 75 percent interest in the production. (2) Subsequently the parties entered into a joint venture with *A*, whereby *A* agreed to equip and drill an unstated number of wells. (3) In return for his services and \$15,000, *A* was to receive 70 percent of *B* and *C*'s interest in the production of wells for which *A* provided services. (4) The parties agreed to treat the joint venture as a partnership for federal-income tax purposes. (5) The agreement did not provide for the creation of "capital accounts" reflecting the liquidation rights of the parties. (6) Regarding the deductions for expenses, the agreement provided that these would be allocated to the party paying such expenses. (7) It should be noted at this point that, by the terms of the joint venture agreement, *A* was paying all the intangible drilling costs.

Upon review of the partnership's federal income tax return, the IRS agent proposed (among other proposals) a partial capitalization (30%) of the intangible drilling costs paid by *A*. The IRS Agent felt that the intangible drilling costs, pursuant to Treasury Regulation § 1.612-4(a)(3), should be expensed only to the extent of *A*'s 70 percent interest in the partnership. The basis of the agent's argument was that the 100 percent allocation of the intangible drilling costs to *A* lacked "substantial economic effect."³¹

Upon review the National Office determined that the 100 percent allocation to *A* did have a "substantial economic effect" and was therefore permitted. It should be noted that the Service permitted the full allocation of the intangible drilling costs based upon the provisions of the partnership agreement, despite the fact that the agreement did not provide for formal "capital accounts."

Thus, it remains possible to allocate full current expensing of intangible drilling costs to a co-owner whose proportionate share is significantly less than 100 percent of the property so long as a partnership agreement is the vehicle for such allocation. However, despite the conclusion reached in the Technical Advice Memorandum, creating and maintaining capital accounts for each partner in the partnership is advisable.

A generally accepted principle of tax accounting is that expenses are deductible by a cash basis taxpayer in the year that such payments are made. However, with respect to prepaid intangible drilling costs, this principle is not always controlling. In a recent Tax Court case, *Keller v. Commissioner*,³² the court determined that certain intangible drilling costs are not deductible by cash-basis taxpayers in the year of payment. In *Keller*, a cash basis taxpayer acquired a limited

³¹I.R.C. § 704(b)(2).

³²T.C.M. (P-H) ¶ 79.2 (1982).

partnership interest in an oil and gas drilling program. The partnership, pursuant to I.R.C. section 263(c), elected to expense certain prepaid intangible drilling costs. The prepayments were for footage and daywork drilling contracts. The deduction of the prepaid intangible drilling costs caused a net operating loss for the partnership; therefore, the taxpayer reported a loss on his individual tax return to the extent of his investment in the partnership.

The IRS filed a deficiency notice against the taxpayer based on the disallowance of more than half the intangible drilling cost deduction claimed by the partnership. The basis of the Service's disallowance was threefold:

- (1) the prepayments of the intangible drilling costs were nondeductible, refundable deposits; (2) the prepayments lacked a business purpose; and (3) the deduction of the prepayments in the year of payment would result in a material distortion of income.

This three-part test for current deductibility of prepaid expenses was basically the same test utilized by the Service in a prior Review Ruling.³³

The Tax Court accepted the Service's argument in principle but did not concur with the test applied. Instead, the Court fashioned its own two-part test for determining if a cash-basis taxpayer may properly deduct prepaid intangible drilling costs in the year of payment. The Court's test provided substantially the same as the prior test, except it did not require a business purpose for the prepayment to be deductible.³⁴

The effect of the test on the partnership is that only the IDC on the turn-key contracts are fully deductible. The reason is that only on these contracts can the partnership's liability not be relieved; thus no distortion results to the partnership's income if the deduction is taken in full.

Thus, while taxpayers have been given the election to deduct intangible drilling costs currently,³⁵ there apparently will be some restrictions when the election involves prepaid intangible drilling costs. The most important restriction is the application of the distortion of income test³⁶ at the partnership level. This is significant in that it will give the Service broad discretion in determining what prepaid expenses distort income at the partnership level.

Following the *Keller* decision, the IRS issued an interesting private letter ruling.³⁷ In the letter ruling the Service continued to follow its prior Revenue

³³Rev. Rul. 75-152, 1975-1 C.B. 144. The Ruling pertained to prepayment of cattle feed and provided in pertinent part: "First, the expenditure must be a payment . . . rather than a mere deposit; second, the prepayment must be made for a business purpose and not merely for tax avoidance; and third, the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income." *Id.*

³⁴Under the Tax Court's test, for a prepayment to be deductible (1) it must be a payment rather than a deposit and; (2) the deduction of such prepayment must not result in a material distortion of income.

³⁵I.R.C. § 263(c).

³⁶I.R.C. § 446(b).

³⁷Ltr. Rul. 8226135.

Ruling,³⁸ where it permitted a cash basis taxpayer to deduct prepaid intangible drilling costs in the year paid when such costs were paid based upon a binding contract arrived at in an arm's length transaction. This is apparently distinguishable from *Keller* in that under the facts of that case the partnership had the power to alter the contract to such an extent that it could compel a refund of large portions of the prepaid intangible drilling costs.

Another important development in the area of intangible drilling costs involved offshore exploratory wells. The nature of offshore oil and gas exploration is that wells are drilled from a mobile platform in order to determine the existence of oil or gas deposits. If a profitable deposit is discovered, a permanent platform replaces the mobile platform and producing wells are drilled. The IRS's position has been that the cost of exploratory wells is not subject to the intangible drilling cost election and therefore must be capitalized. The Service will permit the intangible drilling cost deduction only after a discovery of a profitable deposit has been made. The Service has not met with much success in the Tax Court for the court has consistently rejected the position that IDC's are only deductible when a permanent platform is installed.³⁹ This year for the first time a circuit court has accepted the view of the Tax Court in holding that a taxpayer may elect to deduct as intangible drilling costs those amounts expended in drilling offshore exploratory wells currently.⁴⁰ The Third Circuit, in rejecting the Service's position, stated, "[o]bviously, such a construction would have the effect of turning the Congressional objective of rewarding risk-taking on its head."

B. Fee Paid For Oil and Gas Lottery Program

In the recent Tax Court decision, *Nicolazzi v. Commissioner*,⁴¹ the Court held that the fee paid for the purpose of securing non-competitor leases on federal lands was not currently deductible. Because the services provided for the fee did not involve the management or disposition of an existing property interest held by the taxpayer, the fee was not deductible as an expense for the production of income under I.R.C. section 212. The Court found such fee to be more closely related to a commission than investment advice and therefore the fee constituted a capital expenditure which must be amortized over the life of the lease(s) acquired rather than expensed.

C. Advance Royalties

The Seventh Circuit Court of Appeals, in the case of *Engle v. Commissioner*,⁴² became the first appellate court to decide on the issue of when

³⁸Rev. Rul. 71-252, 1971-1 C.B. 146.

³⁹Standard Oil Co. v. Commissioner, 129 F.2d 363 (7th Cir. 1942), *Gates Rubber v. Commissioner*, 74 T.C. 1456 (1980), *Sun Company, Inc. v. Commissioner*, 74 T.C. 1481 (1980).

⁴⁰*Sun Company, Inc. v. Commissioner*, 677 F.2d 294 (3d Cir. 1982).

⁴¹T.C.M. (P-H) ¶ 79.7 (1982).

⁴²677 F.2d 594 (7th Cir. 1982).

royalty owners are entitled to percentage depletion on advance royalties paid with respect to properties from which no oil or gas was produced in the year of payments. It has been the IRS's position that royalties do not qualify for percentage depletion unless there is production from the wells on which such depletion is claimed. This view was also held by the Tax Court, which looked to "The express language of section 613A(c) limiting the percentage depletion deduction to stated quantities of production is so clear that it permits no other reasonable interpretation."⁴³ The following year the Seventh Circuit reversed the Tax Court, finding the statutory language ambiguous.⁴⁴ The Court went on to find that based on the legislative history and the law prior to the enactment of I.R.C. section 613A, no authority existed to impose such a requirement. Thus, it seems that, at least in the Seventh Circuit, production is not a prerequisite for a taxpayer who wishes to take percentage depletion on the advance royalties he or she has received.

An important point is that the IRS has issued proposed regulations⁴⁵ which could have a significant impact upon the payment of advance royalties. The proposed regulations would permit percentage depletion on advance royalties only to the extent that such royalties are covered by actual production in the year of payment. Furthermore, whenever the royalties exceed current production, the applicable percentage depletion on such excess is lost forever; the regulations do not allow for a carryover of advance royalties. This is clearly illustrated by the following example: In 1975, *D* received his annual payment of a recoupable advanced royalty of \$100x in connection with oil property. Later in 1975, \$60x (of the \$100x advanced royalty) was recovered from production from the property. In 1976, *D* received another advanced royalty payment of \$100x. Later in 1976, \$140x (\$40x of the \$100x advanced royalty received in 1975 and the \$100x advanced royalty received in 1976) was recouped from production from the property. Neither advanced royalty payment was attributable to production in excess of *D*'s depletable oil quantity. *D* is entitled to percentage depletion for 1975 only with respect to \$60x of the advanced royalty received:

$$100x \text{ dollars} \times \frac{\$ 60x}{\$100x}$$

D is entitled to percentage depletion for 1976 with respect to the \$100x received in 1976. With respect to the \$40x received in 1975 not attributable to production in 1975, *D* is not entitled to percentage depletion for any year. Of course, *D* is entitled in 1975 to determine the allowable cost depletion with respect to the entire \$100x received in 1975.⁴⁶

⁴³Engle v. Commissioner, 76 T.C. 915 (1981).

⁴⁴Engle v. Commissioner, 677 F.2d 594 (7th Cir. 1982).

⁴⁵Prop. Reg. § 1.613A-3(a)(4).

⁴⁶Prop. Reg. § 1.613A-3(a)(4) example (4).

It is, of course, unknown at this point what impact, if any, the *Engle* decision will have on the Service's position regarding advanced royalties. However, the Service is unlikely to reverse its position. Therefore, care should be taken to equate percentage depletion on advanced royalties with actual production whenever possible. When this is not possible, be prepared to have the depletion challenged by the Service.

III. TAX SHELTERS

A. *Administrative Matters*

An estimated 300,000 tax returns are currently under investigation for utilizing abusive tax shelters. In the past, the IRS has consistently held to a "no settlement" stance in its review of such litigating vehicles.⁴⁷ But as a result of the backlog of pre-1981 cases under investigation, new policies have been implemented by the IRS in an effort to dispose of the case backlog quickly and efficiently.

The new approach includes new settlement procedures and a new appeals conference. Under the new policy, District Offices are permitted to dispose administratively of pre-1981 cases by allowing tax shelter participants, against whom deficiencies have been assessed, to execute closing arguments,⁴⁸ allowing a deduction only for "out-of-pocket" expenses incurred in the first year. The remaining credits and deductions originally claimed by the taxpayer will be disallowed under the "out-of-pocket expense" basis for settlement. According to the IRS Manual,⁴⁹ when the taxpayer does not accept the administrative offer during the settlement proceedings, any subsequent deficiency asserted in a deficiency notice will be based only on meritorious adjustments and will not reflect the administrative offer.

The new settlement procedures are permanent features of the appeals process. The IRS anticipates that the settlement of cases at the lowest possible level will allow the more efficient use of resources in pursuing more flagrant pre-1981 cases.

The litigating vehicle cases pending before the Tax Court are also currently subjected to review for settlement purposes. In order for a case to be considered for settlement and therefore removed from the Tax Court docket, the case must either: (1) have some litigating hazard; (2) not set precedent; or (3) be serious enough to cause problems if left unlitigated. This new procedure will attempt to resolve the Tax Court's current dilemma of coping with a high volume of pending tax-shelter cases.

⁴⁷Cases where the tax benefits have no basis in economic reality or where legal precedent should be established.

⁴⁸A closing agreement is a final determination of tax liability that is binding on both the Internal Revenue Service and the taxpayer.

⁴⁹Internal Revenue Manual Trans. 1218-132 September 14, 1982.

New "weapons" have been devised in ERTA and TEFRA to combat the post-1981 cases involving abusive tax shelters. Section 6700, a TEFRA addition to the Internal Revenue Code, exclusively details the new penalties and sanctions to be imposed to reduce the attractiveness of abusive tax shelters.

The new statutory tools enacted under ERTA and TEFRA include:

- (1) Civil sanctions against promoters: the imposition of a civil penalty equal to the lesser of \$1,000 or 10% of the gross income derived by the promoter of an abusive tax shelter;
- (2) Injunction: a civil action to enjoin a promoter of an abusive tax shelter from further engaging in such shelter activity; and
- (3) Penalties: a) an increase in interest rate for underpayment to 20%; b) a penalty of 10% to 30% on tax benefits resulting from "gross valuation overstatement";⁵⁰ and c) the 5% negligence penalty plus a new penalty tax equal to the interest charge.

The new sanctions and penalties will be imposed according to the procedural rules detailed in I.R.C. Section 6703.

The IRS has not limited its attack on abusive tax shelters to the audit and settlement procedures. The attractiveness of many tax shelters has also been reduced by the imposition of less liberal allowances for deductions and credits for particular and more abusive tax shelters.

B. Partnerships

One of the most recent abusive tax shelter devices to plague the Tax Courts involves the taxpayer's participation in a limited partnership. The primary "business" of the limited partnership is to secure an investment in over-valued, income producing assets. The most common investment targets for these limited partnerships have been real estate and motion pictures.

The most attractive characteristic of the limited partnership "tax shelter" is the potential loss deduction which may result from the partnership's operations. The potential of a large depreciation deduction and excessive investment tax credit offer an attractive means of devising a tax-shelter plan.

1. Real Estate Partnership

In the case of *Beck v. Commissioner*,⁵¹ the taxpayers were limited partners in two partnerships. Both partnerships were originally formed for the purpose of purchasing commercial real estate. Each partnership entered into pur-

⁵⁰I.R.C. § 6700(b)(1) defines "gross valuation overstatement" as ". . . any statement as to the value of any property or services if

(a) the value so stated exceeds 200 percent of the amount determined to be the correct valuation and
 (b) the value of such property or services is directly related to the amount of any deduction or credit allowable under Chapter 1 to any participant."

⁵¹678 F.2d 818 (9th Cir. 1982).

chase agreements with separate entities to purchase unimproved lots of land. Each agreement included similar terms: (1) a minimal down payment; (2) a non-recourse promissory note, secured by an all inclusive deed; and (3) a sum constituting prepaid interest. The non-recourse loan was the principal source of financing in each purchase agreement.

The Ninth Circuit Court of Appeals upheld the Tax Court's decision to deny the taxpayers a deduction for the interest expense claimed by the taxpayers under section 163 (a) of the Internal Revenue Code. The appellate court, in adopting the Commissioner's position, held that the partnership's tax loss was not substantiated because: (1) the purchase price of the property far exceeded the property's fair market value; and (2) the taxpayer was not subject to personal liability on the underlying non-recourse notes. Therefore, both the interest deduction and resulting share of the partnership's loss were viewed as disallowed deductions.

The taxpayers contended that the value of the land, as determined during the trial proceedings by an expert appraiser, was in error. The court disagreed with the taxpayers' contention and held that the purchase price of the unimproved lots was grossly inflated under both agreements.

The appeals court concluded that any interest deduction for the prepaid interest was not allowable. The Ninth Circuit held that the non-recourse loans did not qualify as "genuine indebtedness" under section 163 (a) of the Internal Revenue Code since the face amount of the note was in gross excess of the fair market value of the property. The gross over-valuations were \$738,000 and \$84,000, respectively. The court stated that the transactions lacked economic substance. Therefore, no genuine indebtedness existed.

2. Movie Pictures Partnership

The limited partnerships which made their investments in motion pictures produced a different array of abusive tax shelter problems for the courts to address. In recent tax shelter cases, the courts have been confronted with issues such as: (1) excessive asset basis; (2) improper depreciation methods; and (3) the eligibility for investment tax credit on the tax shelter assets. In the case of *Max E. Wildman*,⁵² the Tax Court reviewed the method of computation used in determining the depreciation deduction on the tax return of a movie distributor partnership. The Tax Court held that the depreciable basis for a movie investment is limited to the fair market value of the movie at the time of purchase, rather than the actual purchase price of the asset. As a result, the large depreciation deduction on the movie investment was drastically reduced.

In *Wildman*, the taxpayer was a limited partner in a partnership formed for the purpose of acquiring and distributing the motion picture "Sea Wolf."

⁵²78 T.C. 67 (1982).

In 1975, the partnership purchased "Sea Wolf" for \$4,000,000. The terms of the purchase agreement included a down payment of \$460,000 cash and a \$3,540,000 non-recourse note.

In 1975, the partnership claimed a depreciation deduction of \$1,001,739, as computed by the income forecast method. The Tax Court held that the partnership used the proper depreciation method in calculating the depreciation deduction. However, the court concluded that the film's income receipts and the depreciable basis of the motion picture, used by the partnership in the depreciation formula, were inaccurate.

Since the useful life of a motion picture is difficult to measure, the Tax Court views the income forecast method as an accurate method of reflecting net income on a movie venture. The income forecast method matches the current depreciation deduction with the current income derived from the motion picture.

The actual computation of the income forecast method of depreciation is as follows:

$$\frac{\text{Current year's income}}{\text{Estimated total income}} \times \text{cost of film} = \text{allowable depreciation for current taxable year.}$$

In *Wildman*, the Tax Court first addressed the issue of the accuracy of the net income amount derived from the motion picture in the current year. The taxpayer argued that the "anticipated" net receipts should be included in the computation of "net income" of the motion picture. In *Wildman*, the partnership had not actually received any income from the movie in 1975. Therefore, the Tax Court denied a depreciation deduction to the partnership and to the taxpayer.

The Tax Court also focused on the issue of the proper cost basis of the motion picture to be used in the computation of the depreciation deduction. The Tax Court did not allow the taxpayer to include the face amount of the non-recourse note (\$3,540,000) in the depreciable basis of the motion picture. The court held that where the principal amount of the non-recourse note unreasonably exceeds the fair market value of the property securing the note, the non-recourse note will not be includible in the depreciable basis of the asset.

Taxpayers who invest in limited partnerships similar to the partnership in *Wildman* should be aware of the Tax Court's strict scrutiny of the large depreciation deductions taken for such tax shelters. Without the large depreciation deduction, many tax shelters lose their "tax appeal."

The Tax Court has not allowed the investment tax credit for purchasers of movie distribution rights. In the case of *Charles H. Seigel*,⁵³ the Tax Court

⁵³78 T.C. 46 (1982).

strictly adhered to the literal language of section 48(k). The Tax Court held that the investment tax credit will be applied only to new motion picture property, as was the intent of Congress. As a result of this Tax Court decision, another favorable characteristic of a tax shelter scheme is lost.

In *Seigel*, the taxpayer purchased an interest in a limited partnership that had purchased the movie "Dead of Night" for \$900,000. The terms of the purchase agreement consisted of \$55,000 cash; a \$92,500 recourse note; and a 6% non-recourse note of \$752,000.

The taxpayer argued that although the film was used property when acquired by the partnership, the motion picture was eligible for investment tax credit. The Commissioner and the Tax Court disagreed with the taxpayer's interpretation of section 48(k). The court stated that section 48(k)(1)(A) provides for investment tax credit only for new film or tape and only if the taxpayer actually has an ownership interest in such property.

Since the taxpayer in *Seigel* conceded that the partnership had purchased the interest in the motion picture as "used" property, the Tax Court held that no investment tax credit was allowed for the purchase of such used property, per section 48(k).

Taxpayers who invest in tax-shelter assets should be aware of the Tax Court and the Commissioner's unfavorable view of such plans. The Commissioner has not been generous in allowing large depreciation deductions or investment tax credit on tax shelter assets.

IV. DEDUCTIONS

A. *Maintaining Home Near Workplace*

The Tax Court held in the case of *Clarence Bailey*⁵⁴ that the cost of maintaining a mobile home near a hospital was not a deductible expense by the hospital lab chief.

The taxpayer was required, as a condition of his employment, to be on emergency call-back duty every third week of 1976 and 1977. Because he lived so far from the hospital, Bailey maintained a mobile home near the hospital so that he would be readily available in case of an emergency. On his 1976 and 1977 tax returns, Bailey claimed deductions for the cost of maintaining the mobile home during those years. The IRS disallowed the deductions on the grounds that they were not ordinary and necessary business expenses.

The Tax Court gave judgement for the IRS, holding that lodging expenses are deductible only when incurred as a moving or travel expense.⁵⁵ In order for travel expenses to be deductible, they must be incurred away from home.

⁵⁴*Clarence Bailey*, T.C. Memo 1983-452.

⁵⁵I.R.C. §§ 62(8), 162(a).

In analyzing the situation at hand, the court found that Clarence's tax home was the hospital; therefore, a mobile home parked near the hospital was not "away from home." Further, the court stated that the choice of maintaining a residence in an area removed from one's tax home is a personal one and any expense arising from maintaining a second residence is similarly a personal expense.

B. *Medical Expense*

Certain capital improvements to a taxpayer's home which have been necessitated for medical reasons may be deductible as a medical expense.⁵⁶ However, such improvement qualifies as a medical expense only to the extent that the total expense exceeds the amount by which the permanent improvement increases the value of the property.⁵⁷

The Tax Court's decision in *Paul Lerew*⁵⁸ stands for the proposition that there must be an actual expense which exceeds the increase in value to the property. In *Lerew*, the taxpayer's wife suffered from a degenerative joint disease. Her physician prescribed daily swimming exercises as therapy, but as her physical condition was rapidly deteriorating there was not enough time to build a swimming pool at the Lerew home. The Lerews therefore purchase a new home, complete with a swimming pool, for a total price of \$250,000.

The Lerews claimed a medical expense deduction of \$15,000. This figure was arrived at by subtracting the amount by which the pool increased the value of the house, \$5,000 as determined by a real estate broker, from the estimated cost to build a pool of the same specifications or \$20,000.

Agreeing with the IRS, the Tax Court held that no deduction is allowable. The court reasoned that the Lerews could not show that they had incurred any expenses in excess of the increase in value of the property since any amount they might have paid to acquire the pool would represent the increase in value of the property caused by the presence of the pool.

The court stated that the actual price paid for the pool is the crucial figure, not the hypothetical cost of construction, since the actual price should be equal to its fair market value.

C. *Educational Expenses*

◦ Expenditures made by a taxpayer to maintain or improve skills required in his or her business or employment or to meet the express requirements of his or her employer or the requirements of law or regulations, imposed as a condition to retaining his or her salary, status, or employment, are deductible

⁵⁶I.R.C. § 213.

⁵⁷Treas. Reg. § 1.213-1(e)(1)(iii).

⁵⁸*Paul Lerew v. Commissioner*, 41 T.C.M. (CCH) 918 (1982).

as educational expenses.⁵⁹ Such expenses are not deductible, however, if incurred in undertaking a course of study which will lead to qualification of the taxpayer for a new trade or business.

This distinction was cited by the Tax Court in two recent cases where a deduction for educational expense was denied. In the case of *Charles A. Robinson*,⁶⁰ Elaine Robinson worked part-time as a licensed practical nurse (LPN) while enrolled in a four-year degree program which qualified graduates to take the State Registered Nurse Examination. The taxpayer contended that the courses did not qualify her for a new trade or business but served merely to maintain and improve her nursing skills.

The Tax Court held against the taxpayer. It based its decision on the Minnesota statutes pertaining to nursing and the job descriptions used at the hospital where Elaine worked. In both cases registered nursing was viewed as being significantly different as an occupation from practical nursing. Registered Nurse's (RN) have a greater level of authority than LPN's; in all cases the LPN is subject to supervision by an RN.

The Tax Court applied what it called a "common-sense" approach in determining that an Air Force pilot's training for civilian flight engineer qualification did indeed lead to qualification of the taxpayer for a new trade or business, and thus the expenses incurred in such training were not deductible.

In the case of *Larry J. Brandt*,⁶¹ Brandt was a pilot in the Air Force who took a course to prepare for the Federal Aviation Administration's written exam for flight engineers. Brandt argued that a greater knowledge of the work of the flight engineer was helpful to him in his work as a pilot. But the court found that the flight engineer's responsibility is to keep the plane's engines in operational condition, whereas the pilot is responsible for flying the plane.

D. Home Office Expense

In *John W. Green*,⁶² the taxpayer was allowed a deduction for office-at-home expenses where the office was used only to receive telephone calls after office hours. Deductions for office-at-home expenses are generally barred by the Code⁶³ with certain exceptions. The taxpayer in *Green* tried to get around the general rule by contending that his at-home office was used on a regular basis as (1) the taxpayer's principal place of business, or (2) a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business.⁶⁴ The Tax Court rejected the

⁵⁹Treas. Reg. § 1.162-5.

⁶⁰*Charles A. Robinson*, 78 T.C. 37 (1982).

⁶¹*Larry J. Brandt*, T.C. Memo 1982-180.

⁶²78 T.C. 30 (1982).

⁶³I.R.C. § 280A.

⁶⁴I.R.C. § 280A(c)(1).

deduction based on the first exception, but allowed the deduction under the second.

John Green's employer provided him with an office where he spent 20% of his workday. The remainder of his eight-hour workday was spent outside of this office at various job sites and in meetings with contractors and business associates. As an account executive for a condominium development firm, the taxpayer was required (as a condition of his employment) to receive telephone calls from clients at his home after his regular business hours. These calls came from individuals, many of whom were unable to contact Green during office hours. The calls averaged 2¼ hours per night, five nights a week. The taxpayer also used his office-at-home to return calls in response to messages received by his secretary during the day.

The court rejected the taxpayer's argument that since he spent equal amounts of time in his company and home offices, both should qualify as his principal place of business. Stating that the number of hours of use was not the determinative factor, the court responded that there can be only one principal place of business for a particular business. The court examined the facts of the case and in determining which office was the principal place of business applied the test of which office is the "focal" point of the taxpayer's business. The court held that the company's office was the principal place of business.

The Tax Court did, however, accept the taxpayer's second contention that his home office was used to meet clients. The Court took into consideration the following factors in determining whether a telephone call constitutes a "meeting or dealing" by a client or customer: (1) the taxpayer was required (as a condition of his employment) to take calls from clients in the evenings; (2) the calls were received on a regular basis; (3) Green used one room of his house exclusively for taking the calls and keeping files and information used in his business; (4) the calls were client-initiated; and (5) taking the calls at home was essential to his employer's condominium-management business, as well as to the taxpayer's performance of his duties.

It should be noted that there were three dissenting opinions in this case, with seven judges who felt that the deduction should be disallowed. The majority emphasized that telephone contacts will not satisfy the statutory requirements in all cases. The court went further in stating that in most situations the opposite conclusion will probably be reached and the physical presence of the patient, client, or customer will probably be required.

E. Retirement Community Entrance Fee

In the case of *Helen W. Smith*,⁶⁵ the Tax Court held that only that portion of a one-time entrance fee to a retirement community which is applicable

⁶⁵79 T.C. 19 (1982).

to the right to care at an adjacent convalescent center is deductible as a medical expense.

In *Smith*, the taxpayer paid a \$20,000 entrance fee to a retirement community for her parents who were her dependents for tax purposes. The retirement community provided no direct medical services to the residents. Residents were required to be ambulatory and able to care for themselves. An exception occurred where two persons resided in the same apartment. In that case, one of the persons was required to be self-sufficient and capable of caring for the other. However, the residents were entitled to a certain number of free days at the convalescent center within a few hundred yards of the retirement community.

The taxpayer deducted the \$20,000 entrance fee on her 1976 return as a medical expense. The IRS disallowed all of the deduction except for that portion of the fee which was allocable to the medical insurance provided by the retirement community.

The Tax Court agreed with the Service: an entrance fee paid to a retirement community which does not provide medical or nursing care is not a deductible medical expense. But the Court went further to hold that the portion of the fee which provided for free days of care at the adjacent convalescent center was deductible as medical expense in the year paid.

The Court held that the intent of section 213⁶⁶ is to allow a deduction for expenses incurred and paid in a taxable year.⁶⁷ Since the obligation to pay the fee was incurred when the residency agreement was entered into, the legal obligation to pay existed at that time also, and not in future years when such services would be received.⁶⁸

The *Smith* case seems to indicate that the expenses for costs of maintenance at an institution other than a hospital where no direct medical services are provided to the residents will not be deductible as a medical expense.

F. *Illegal Insurance Premium Discounts*

Under section 162(c)(2),⁶⁹ a trade or business expense deduction for payments is disallowed if such payment is illegal under State law. However, the section is qualified by the words, "but only if such state law is generally enforced." The Internal Revenue Service bears the burden of proof in showing that the payments are illegal.

Section 162(c)(2) qualifies the general rule of section 162(a), which allows the taxpayer to deduct "all the ordinary and necessary expenses paid or incur-

⁶⁶I.R.C. § 213.

⁶⁷*Bassett v. Commissioner*, 26 T.C. 619 (1956).

⁶⁸79 T.C. at 168.

⁶⁹79 T.C. 19 (1982).

red during the taxable year in carrying on any trade or business.”

In the case of *John W. Custis and Eleanor H. Custis*⁷⁰ the taxpayers were licensed insurance agents in the State of Ohio. The Custises sold life insurance to individuals under an arrangement whereby the first-year premiums were paid by the Custises themselves. These payments were treated as “returns and allowances” against gross receipts on the taxpayers’ returns. At that time, it was generally unlawful for insurance agents in Ohio to pay or rebate insurance premiums on the life of an insured as an inducement to purchase insurance.⁷¹

The IRS determined deficiencies in the taxpayers’ federal income taxes for the taxable years of 1973, 1974 and 1975, contending that the deductions for “returns and allowances” against gross receipts were not deductible business expenses, and in actuality were illegal payments made in violation of a “generally enforced” state statute. The Commissioner also questioned business travel and entertainment expenses claimed by the taxpayers.

The decision in the *Custis* case, as well as in several prior cases dealing with the same issue seem to turn on the definition of the term “generally enforced” as it is used in section 162(c)(2).

The court in *Custis* stated that there clearly seemed to be a violation of the Ohio law but went on to hold that the Service had failed to show by clear and convincing evidence that the Ohio statute was generally enforced during the years in question. In its opinion the court cited *Boucher v. Commissioner*⁷² as the only case which expressly dealt with the question of whether a state statute was generally enforced within the meaning of section 162(c)(2).

The facts of *Boucher* are similar to those presented in *Custis*. *Boucher* dealt with a Washington state insurance statute which was quite similar to the Ohio statute. The Tax Court in *Boucher* held that the Washington statute was generally enforced even though there were no attempts made to discover violations of the statute and no actions were taken over a twenty year period as to actual violations.

The facts of *Custis* reveal that the IRS contacted the Ohio Department of Insurance regarding Custis’ premium rebating activities. In response to the IRS inquiry, a representative of the Department of Insurance prepared an affidavit in which he stated that the Department would investigate and take whatever administrative action necessary.

At the time of the Tax Court trial, the Department of Insurance had taken no official action against Custis. The Tax Court held that the rebate statute was not generally enforced and thus the premium rebates were deductible. The

⁷⁰I.R.C. § 213.

⁷¹*Bassett v. Commissioner*, 26 T.C. 619 (1956).

⁷²79 T.C. at 168.

court pointed out that there had been no formal action taken as a result of the statute since 1970. The court went further to state that the IRS had failed to sustain the burden of proof in that the evidence offered by the Service in support of its position was the testimony of the Department of Insurance representative expressing an interest in copies of certain documents. In fact, the Department of Insurance representative revealed in his testimony that up until the trial he was unaware of the name of the insurance company which Custis represented.

The distinction between *Custis* and *Boucher* lies in the evidence offered by the IRS in support of its position. In *Boucher*, the IRS showed that the Washington Insurance Commission issued advisory letters on a routine basis as to whether certain practices were in violation of the anti-rebate statute. Evidence was also offered that the lack of prosecution was a result of there being few, if any, violations of the law. In *Custis* neither of the above factors was present.

G Casualty Loss Deduction

In the case of *Hills vs. Commissioner*,⁷³ the Eleventh Circuit District Court of Appeals reviewed the issue of whether a voluntary election not to file an insurance claim for a theft loss precludes a casualty loss deduction under I.R.C. section 165. The Eleventh Circuit diverged from prior judicial treatment and upheld the Tax Court's findings which permit a taxpayer to claim the deduction for a casualty loss even though the taxpayer had not sought insurance reimbursement for the loss.

The taxpayers in the *Hills* case were victims of a theft loss of \$760.00. The taxpayers were insured for the loss under their insurance policy. However, they elected not to claim the loss under the insurance policy, but rather to claim a casualty loss deduction on their federal income tax return in the year of the loss.

The Commissioner contended that a two-prong test must be applied in section 165 cases: (1) whether there had been a loss; and (2) if a loss was determined, whether the loss had been compensated by insurance or otherwise.

It was the Commissioner's argument in the *Hills* case that since all reasonable possibilities of recompense were not pursued by the taxpayers, no deductible loss was realized. The Commissioner further contended that since the taxpayers did not seek insurance reimbursement the loss was caused by the taxpayers' election not to file an insurance claim. Therefore, the IRS held the position that the loss did not qualify as a section 165 deductible loss.

The Eleventh Circuit did not agree with the Commissioner's position. The court relied on the plain language of section 165(a) and applied the two-prong test as provided in this section of the Internal Revenue Code.

⁷³691 F.2d 997 (11th Cir. 1982).

Section 165(a) states that a deduction is allowed for any "loss . . . not compensated for by insurance or otherwise." The two-tier test encompassed in this statute is (1) whether there was a loss and (2) whether the loss was compensated for by insurance or otherwise. The Eleventh Circuit Court interpreted this two-tier test literally and concluded that the mere fact that a loss is covered under an insurance policy does not automatically disallow a loss deduction under section 165 if the taxpayer/insured elects not to seek insurance reimbursement for the loss suffered.

The *Hills* situation is directly addressed by section 165(c)(3) of the Internal Revenue Code. This section pertains to personal losses of property, including losses resulting from theft. As a result of the decision of the Eleventh Circuit in the *Hills* case, a deduction is allowed on a taxpayer's income tax return even though no insurance reimbursement was sought by the taxpayer to cover the theft loss.

This issue of whether failure to claim insurance reimbursement bars a deduction has surfaced in areas other than casualty losses. A Private Letter Ruling⁷⁴ addressed the issue of the deductibility of medical expenses where the taxpayer had not filed a claim for insurance reimbursement. The IRS's position, as detailed in the 1981 Letter Ruling, states that no deduction is permitted under this factual situation.⁷⁵

Taxpayers should be keenly aware of whether other courts follow the Eleventh Circuit decision. If a trend develops, the taxpayer may be relieved of the obligation to seek insurance reimbursement for losses prior to claiming a deduction on the federal tax return.

V. CORPORATIONS

A. Preferred Stock — Section 306

When a shareholder sells or redeems section 306 stock, ordinarily income will result from such transactions.⁷⁶ As defined by the Code, section 306 stock is certain stock issued as a stock dividend or stock issued in a reorganization, or stock issued in a section 351 incorporation transfer.⁷⁷ Stock is classified as section 306 stock in order to prevent "preferred stock bail-outs" of corporate earnings at capital gains rates.

In the case of a tax-free reorganization, stock received is section 306 stock if (1) it is stock other than common stock and (2) the effect of the transaction is substantially the same as a stock dividend.⁷⁸ The IRS has held that voting

⁷⁴Ltr. Rul. 8102010.

⁷⁵*Id.*

⁷⁶I.R.C. § 306.

⁷⁷I.R.C. § 351.

⁷⁸I.R.C. § 306(c)(B).

preferred shares are "stock other than common" if they are limited to a maximum amount as to dividends or liquidation proceeds.⁷⁹ In a new ruling, the Service holds that where a shareholder, in the course of a recapitalization, exchanges all of his or her shares of common for voting-preferred stock, and shortly thereafter buys non-voting common shares in the same corporation, the voting preferred shares are section 306 stock.⁸⁰

The new ruling was issued in response to the following situation. A corporation undergoing a recapitalization which qualified as a tax-free reorganization, had 100 shares of common stock outstanding twenty shares of which were owned by shareholder *W*. Under the reorganization, all the shareholders surrendered their old common shares in exchange for new voting-preferred shares. The new preferred shares were limited and preferred as to dividends and also had a fixed liquidation preference. Shareholder *W* received fifteen shares of the preferred while other shareholders received a total of eighty shares. A short time later, shareholder *W* bought ten new shares of non-voting common stock from the corporation. These shares made up the entire common stock of the corporation and were purchased for half of their value.

All of the preferred stock received by shareholder *W* was deemed section 306 stock by the IRS. The Service concluded that the common-for-preferred exchange, taken together with the later purchase of the ten shares of common, enabled the shareholder to bail out earnings by selling preferred stock while still maintaining an equity position.

In determining the tax consequences of the exchange, the IRS said that it would treat the transactions as if shareholder *W* had exchanged fifteen shares of old common stock for the new preferred stock and had exchanged the remaining five shares of old common plus cash for the ten shares of new common. Further, the Service concluded that the new common would be treated as the old common in determining the section 306 status of the preferred shares. As such, the fifteen shares of new preferred were deemed section 306 stock.

B. Corporate Recapitalization

In 1982, the IRS announced that it will not issue advance rulings as to whether a transaction is a Type E reorganization under I.R.C. section 368(a)(1)(E) or a transaction that also qualifies under I.R.C. section 1036.⁸¹ Section 1036 permits the exchange, without the recognition of gain or loss of common stock for common stock, or of preferred stock for preferred stock, in the same corporation.⁸²

⁷⁹Rev. Rul. 79-163, 1979 - 131 C.B.

⁸⁰Rev. Rul. 82-191, 1982 - 46 I.R.B. 11.

⁸¹Rev. Proc. 82-30, 1982-19 I.R.B. The new Revenue Procedure is effective for all ruling requests made after April 30, 1982.

⁸²Treas. Reg. § 1.1036-1.

Gerald G. Portney, Associated Chief Counsel (Technical) for the IRS, stated that advance ruling requests were made for "insurance" reasons; i.e., to know that certain intended tax consequences will in fact be achieved. Although the IRS has not barred other types of advance "insurance" rulings, it has apparently singled out the recapitalization rulings for two reasons: first, because there has been an extremely large number of requests for advance rulings in this area; and, second, because the Service seems to consider the law to be settled in this area. Portney noted that there are Treasury Regulations, as well as some twenty-five published Revenue Rulings on the subject of recapitalizations. Any future developments in the area of recapitalizations will be addressed in published Revenue Rulings, according to Portney.

There will be one exception to the new bar on advance rulings for corporate recapitalizations. Advance rulings will continue to be issued if the recapitalization is an integral part of a larger transaction and it is impossible to determine the tax consequences of the larger transaction without a making determination with regard to the recapitalization.

VII. INTEREST FREE LOANS

In *Baker v. Commissioner of Internal Revenue*,⁸³ the Second Circuit affirmed an earlier decision of the Tax Court which held that the taxpayer did not realize taxable income from interest free loans received from a corporation of which he was president and shareholder. The Second Circuit, adhering to the principle of stare decisis followed the *Dean* line of decisions.⁸⁴ The IRS has been attempting to overrule *Dean* since 1973 but has not succeeded either before the Tax Court or before any reviewing court of appeals.⁸⁵ However, the IRS found a friendly ear in the Court of Claims in *Hardee v. U.S.*⁸⁶

W. L. Hardee and his wife were the principal shareholders, with Hardee as president, of approximately 95% of Sea Garden Sales Company, Inc., a closely-held corporation engaged in several business activities including marine, industrial and municipal supplies, farming and ranching, and the operation of a fleet of deep-sea shrimp trawlers.

Hardee's practice of borrowing began in the 1950's. He maintained a running loan amount with Sea Garden, borrowing money as needed and putting money back when able to do so. The borrowings were evidenced by promissory notes with no obligation to pay any interest. By the end of 1972, Hardee's in-

⁸³677 F.2d 11 (2d Cir. 1982).

⁸⁴*Dean v. Commissioner*, 35 T.C. 1083 (1961).

⁸⁵The First, Fourth, Fifth, and Ninth Circuits have affirmed the Tax Court's adherence to *Dean*: *Greenspun v. Commissioner*, 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); *Beaton v. Commissioner*, 40 T.C.M. (CCH) 1324 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981); *Suttle v. Commissioner*, 7 T.C.M. (P-H) 1638 (1978), *aff'd*, 625 F.2d 1127 (4th Cir. 1980); *Martin v. Commissioner*, 39 T.C.M. (CCH) 531 (1979), *aff'd*, 649 F.2d 1133 (5th Cir. 1981).

⁸⁶82-2 U.S. Tax Cases ¶ 9459 (Ct. Cl. 1982).

debtedness to Sea Garden was approximately \$503,000; at the end of 1974 he owed \$474,000.⁸⁷

The Commissioner asserted that as a result of these loans Hardee received an economic benefit measured by the interest he would have been required to pay had he obtained the loans in an arm's length transaction. The IRS computed the daily balance of Hardee's indebtedness to Sea Garden and applied a 7 percent interest factor to derive an interest-not-charged figure. The Commissioner assessed a deficiency of \$24,926 for 1973 and \$24,675 for 1974.⁸⁸ During these same years, Hardee held \$500,000 worth of tax-exempt municipal bonds, but the questions arising from these investments was held moot by the decision.

The Tax Court's and circuit court's rationale in the *Dean* case is that if taxpayers were to have additional income on the imputed interest of an interest-free loan, there would not be any taxable income because of a corresponding deduction of the imputed interest under I.R.C. section 163(a).⁸⁹

The Court of Claims in *Hardee* turned to the express language of section 163(a). It held that the deduction is conditioned on the actual payment or accrual of interest within the taxable year. Since the loans were interest-free there was no payment of interest and therefore no deduction.

The Court of Claims looked at *Commissioner v. National Alfalfa Dehydrating*⁹⁰ where the Supreme Court said that the "propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence. Rather, it depends upon legislative grace; and only where there is clear provision in the Code can any particular deduction be allowed."⁹¹ The Court of Claims adhered to the principle in *National Alfalfa* that tax consequences be determined according to the facts as they stand and not according to facts that could have been.⁹² The court said that "had Mr. Hardee's loans been structured differently by giving him first the interest in cash and the loans thereafter that he then might have been allowed a deduction."⁹³ Since Congress had not provided for this in the Code there should be no deduction since there was no actual interest paid."⁹⁴

This decision has yet to be reviewed by the full Court of Claims. If the full Court determines that *Hardee* was decided properly, taxpayers will be well

⁸⁷*Id.*

⁸⁸*Id.*

⁸⁹I.R.C. § 163(a) provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness."

⁹⁰417 U.S. 134 (1974).

⁹¹417 U.S. 134, 148-49 (1974).

⁹²82-2 U.S. Tax Cases ¶ 9459 (Ct. Cl. 1982).

⁹³*Id.*

⁹⁴*Id.*

advised to pursue the issue in the Tax Court. A conflict between circuit courts often leads to a Supreme Court review, however, the Court may wait for Congressional resolution of the conflict.

The Eleventh Circuit recently held in *Dickman v. Commissioner*⁹⁵ that taxable gifts result when lenders make interest-free loans to a relative and a closely-held corporation. This decision is contradictory to the Seventh Circuit's position in *Crown v. Commissioner*.⁹⁶ *Crown* held that interest-free loans were not gifts.

Paul B. Dickman, deceased, his wife Esther, their son Lyle and his family owned Artesian Farm, Inc., a Florida corporation. In the years 1971 to 1976 Paul and Esther loaned money interest-free to Lyle and Artesian. The Commissioner determined that the loans resulted in taxable gifts and assessed deficiencies against Esther and Paul. The Tax Court ruled that all loans were on a demand basis and followed the *Crown* decision. The Eleventh Circuit rejected *Crown* outright and reversed, making no distinction between "term" and "demand loans."

Crown was justified on the difference between "term" and "demand notes." Non-interest-bearing term notes used to secure a loan have been held to be bargained-for exchanges requiring gift taxation.⁹⁷ *Crown* and the earlier case *Johnson*⁹⁸ held that an owner is free to use or not to use his or her property, and there are no tax implications from the failure of an owner to make the highest and best use of such property. The taxpayer has no right to interest, and since the loans are on a demand basis the taxpayer does not give up complete control over the property; therefore, there are no gift tax consequences. The Eleventh Circuit said these courts missed the point; that if an owner does transfer property for less than full consideration, that does constitute a taxable gift.⁹⁹

The Eleventh Circuit argued that the reach of the gift tax provisions should be broadly interpreted.¹⁰⁰ The court cites several occasions where the Supreme Court has indicated this broad reading.¹⁰¹ The court also said this was evidenced by the Congressional Committee Reports and by the Treasury Regulations.¹⁰²

⁹⁵*Dickman v. Commissioner of Internal Revenue*, 690 F.2d 812 (11th Cir. 1982).

⁹⁶*Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978).

⁹⁷*Blackburn v. Commissioner*, 20 T.C. 204 (1953); *Estate of Berkman v. Commissioner* 387 T.C.M. (CCH) 183 (1979).

⁹⁸*Johnson v. United States*, 254 F. Supp. 73 (N.D. Tax 1966).

⁹⁹690 F.2d 817.

¹⁰⁰I.R.C. § 2501(a)(1); I.R.C. § 2511(a); I.R.C. § 2512(b).

¹⁰¹*Commissioner v. Wemyess*, 324 U.S. 303 (1954); *Smith v. Shaughmessa*, 318 U.S. 176 (1943); *Bobinette v. Helvering*, 318 U.S. 184 (1943).

¹⁰²H. REP. NO. 72-708, 72d Cong. 1st Sess. 27-28 (1932); Treas. Reg. § 25.2511-1(c).

The Eleventh Circuit determined that the right to use money is property for tax purposes.¹⁰³ The court cited several decisions what have held that the right to use property for a predetermined, definite period of time constitutes property for tax purposes.¹⁰⁴

The Commissioner argued that the right to use thousands of interest-free dollars transferred without consideration to Lyle and Artesian is encompassed within the gift tax statute. He pointed out that Lyle and Artesian received the beneficial enjoyment of the transferred property which under the Treasury Regulations constituted a taxable gift to the extent of that right.¹⁰⁵

The Treasury Regulations provide that in the case of a transfer of property which is an incomplete gift because the donor retains dominion and control, the receipt of "income or other enjoyment of the transferred property by the transferee" during the period before the gift is complete "constitutes a gift of such income or of such other enjoyment taxable as of the calendar quarter . . . of its receipt."¹⁰⁶

The Eleventh Circuit determined that the right to use money is property for tax purposes.¹⁰³ The court cited several decisions which have held that the tory to the Seventh Circuits' *Crown* position and will probably warrant a Supreme Court review of the interest-free loan, gift tax consequences area.

¹⁰³690 F.2d 815.

¹⁰⁴*Threlfall v. U.S.*, 302 F. Supp. 1114 (W.D.Wis. 1969); *Allen v. Commissioner* 57 T.C. 12 (1971); *Thriftmart, Inc. v. Commissioner*, 59 T.C. 598 (1973); *Sullivan v. Commissioner*, 16 T.C. 228 (1951).

¹⁰⁵690 F.2d 812 at 815.

¹⁰⁶Treas. Reg. § 25.2511-2(f).

¹⁰⁷690 F.2d 812 at 819.

